PERSPECTIVE

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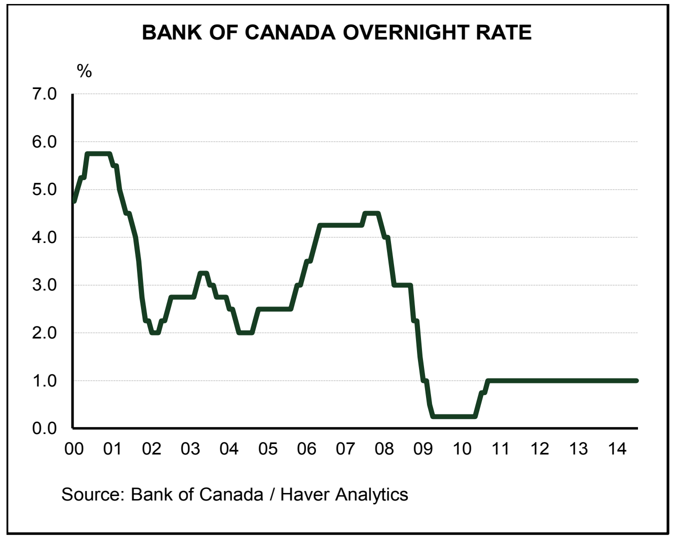
DOVISH TALK FROM BANK OF CANADA WON'T LEAD TO LOWER RATES

The Bank of Canada has been on hold for an unprecedented 45 months, and TD Economics expects the overnight rate to remain unchanged for at least another year. Futures markets are in agreement, as they anticipate the next move in rates will be a hike, but not until the fourth quarter of 2015. This consensus view is predicated on the belief that the economy will deliver only moderate growth, gradually eating up the available economic slack and closing the output gap in early 2016. The economic backdrop augurs that inflation will remain close to the Bank's 2% target, implying no rush to reduce the degree of monetary stimulus, but also no need to lower rates. However, I was recently asked whether the Bank of Canada's neutral bias on rates and its dovish talk could lead to a surprise interest rate cut. I think this is highly unlikely, but the question is not ridiculous given some of the recent economic developments.

The Bank of Canada's last communique did indicate a neutral bias, which implies that rates could move either up or down in the future. The monetary authority had been counting on stronger economic growth arising from increased exports that, in turn, was hoped to lift business investment. But, with the U.S. economy contracting in the first quarter and the global economy struggling to accelerate, these expectations have been subject to, in Governor Poloz's own words, "serial disappointment". Canadian economic growth in the first quarter was only 1.2% annualized, implying that the slack in the economy increased to an estimated 0.5% to 1.5% of GDP. Meanwhile, job growth has effectively stalled, with virtually no year-over-year employment growth in June. The result has been an unemployment rate hovering at close to 7% since the start of this year. Another key development since March has been an appreciation of the Canadian dollar, from 89 U.S. cents to around 93 U.S. cents, which reduces Canadian export competitiveness (perhaps limiting the future export acceleration) and which could temper Canadian inflation by constraining import prices. Inflation expectations are also well anchored at close to the Bank's 2% target. So, one could justify an easing in monetary policy to boost economic growth, either through lower borrowing costs or a weaker Canadian dollar, without running the risk of creating an inflation problem.

There is, however, a strong multifaceted case against the Bank cutting rates. First, while economic growth fell below trend in the first quarter, the tracking for the second quarter is in the range of 2.0% to 2.5% annualized. There is evidence that the U.S. economy has strengthened and the robust pace of U.S. payroll growth has raised questions about whether the first quarter real GDP presented an accurate picture of the state of the U.S. economy. Moreover, the Bank of Canada's published forecast anticipates 3% or better growth in the U.S. for remainder of the year. In other words, there is still hope that the export/investment-drive pick-up in Canadian growth is in the cards.

Second, and very importantly, Canadian inflation has accelerated. In late 2013, Canadian headline inflation dropped below 1% and caused the Bank to flag concerns about downside risks to inflation in their subsequent communiques. However, over the last quarter, inflation has rebounded, with headline inflation in June reaching 2.4% and core inflation edging up to 1.8%. While the Bank stressed in its recent Monetary Policy Report that some of the acceleration in inflation was deemed to be temporary factors, the monetary authority had to drop the reference to downside risks to inflation. Since there is a single policy goal of achieving 2% inflation over the medium term, the change in the language creates a significant complication for the Bank if it now wishes to cut rates. It doesn't make it impossible to cut, but it would open the central bank up to criticism that it should have acted before now. If anything, the Bank's communications are signaling reduced odds of a cut.



Third, the Bank of Canada still has to be mindful of domestic imbalances coming from excessively priced real estate and overleveraged household balance sheets. It is true that personal debt growth has slowed to a mid-single digit pace, but it is broadly rising in line with income. In other words, the personal debt-to-income ratio may have stabilized, but it has done so at a dramatically high level. In the Bank's own words "near record-high house prices and debt levels relative to income leave households vulnerable to adverse shocks". The first rule of the Hippocratic Oath is 'do no harm'. Well, the Bank has to balance any boost to economic growth with the risks of the boost to personal leverage.

Finally, there is a fundamental question of how much of a lift the Canadian economy will receive even if the Bank cuts rates. With the overnight rate currently well below the rate of inflation, monetary policy is already providing considerable stimulus to the economy. Any easing of monetary policy has to be minimal, given the starting point is from an overnight rate of 1.00%. The main reason for Canada's recent poor economic performance is largely due to weakness in the external environment that the Bank does not control. The only thing a cut in rates would likely really do is lower the value of the Canadian dollar, which admittedly could have a stimulative effect. However, monetary policy is not supposed to be targeting the level of the exchange rate and the value of the loonie is only back to where it started the year, well below parity. If the U.S. economy gains more momentum in the coming quarters, there is a good chance that the greenback will strengthen vis-à-vis other currencies, including the Canadian dollar.

The bottom line is that the Bank currently feels that the 1.00% overnight rate is appropriate in balancing the risks to inflation, and while it may say that it is neutral with respect to the timing and the direction of the next move in rates, the balance of risks are that the next move is up – but not for a long time. The latest communique makes it clear that the evolution of monetary policy is data dependent. In truth, it is really dependent upon what happens to global demand for Canadian exports. If the global economy falters, rates could come down in Canada. However, the more likely case is that demand will strengthen, improving Canada's fortunes, but with economic growth averaging a bit above 2% and not posing a material inflation risk. The evolution of developments in the United States suggest that quantitative easing will be ended in October 2014, and then six-to-twelve months later, the Federal Reserve will begin to raise rates in response to a stronger U.S. economy. One can debate whether the Bank of Canada will tighten monetary policy before, in tandem, or after the Fed. But, one cannot debate that higher rates in the U.S. will also mean higher rates in Canada. A more important question is how high rates will go? And, there is good reason to believe that the normal level of interest rates is far lower than it was in the past.

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