Economics
Canada

Canada Economics

Revising our forecast for monetary policy

- **The BoC's post meeting statement and monetary policy report reflect little inclination to raise rates soon**
- **The BoC sees poor productivity growth and a strong Canadian dollar as eroding Canada's competitive edge…**
- **…thus limiting Canada's ability to leverage the pickup in US and global economic growth**

Change in view: Next Bank of Canada rate hike now postponed until July

The Bank of Canada (BoC) left rates unchanged at 1.00% during its policy meeting this week, an outcome that matched Street forecasts and our own. The decision was followed by a post-meeting statement that suggested there was little interest at the BoC to change its rate posture in the very near term. Today's release of the Bank of Canada's monetary policy report, which updates its economic base case, did little to change this sentiment, frustrating our original call for a March hike of 25bp. We are now forecasting rate hikes to begin at the 1 July meeting with our year-end rate forecast remaining unchanged at 2.00%.

Although the BoC raised its growth forecasts for 2011 and 2012 to 2.4% (net +0.1ppt) and 2.8% (net +0.2ppt), respectively, the revisions were not enough to cause a corresponding tightening in the output gap, which, according to the BoC, should close at the end of 2012.

Regarding the timing of potential policy changes at the BoC, we believe the primary driver will be the evolution in the net trade story, which has the potential to significantly affect excess supply in the economy. In our view, Europe will continue to inject uncertainty into the BoC outlook; however, in terms of policy impact, it is worth recalling that the rising sovereign debt crisis in the summer of 2010 did little to deter the BoC from hiking rates in June, July, and September of that year. And, concerns at the BoC in 2010 over the unevenness of the US economic recovery have since been replaced by upward revisions to its US economic growth forecasts.

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Summary of forecast changes

	Q1 2010	Q2 2010	Q3 2010f	Q4 2010f	Q1 2011f	Q2 2011f	Q3 2011f	Q4 2011f	Q1 2012f	Q2 2012f
Previous overnight rate forecast	0.25	0.50	1.00	1.00	1.25	1.75	2.00	2.00	2.25	2.75
Current overnight rate forecast	0.25	0.50	1.00	1.00	1.00	1.00	1.50	2.00	2.50	2.50

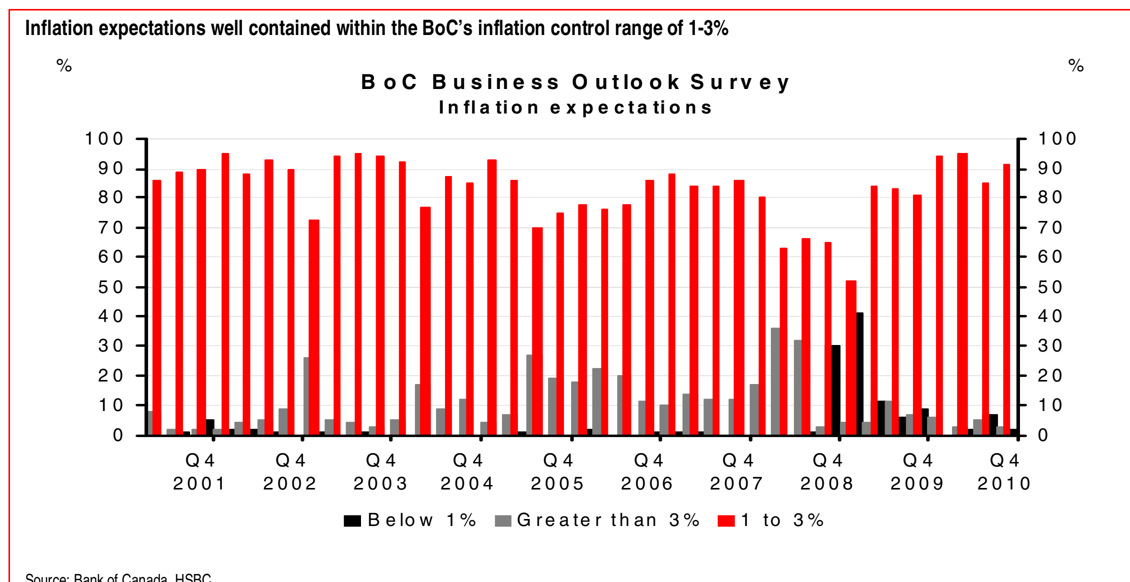
Source: HSBC Canada

The outlook for net trade moves to the fore

We are choosing to focus on the BoC's concern about the outlook on net trade as the chief determinant of policy. This outlook is colored by the dampening effects associated with poor rates of productivity growth in Canada, which are nipping at the heels of Canadian competitiveness in a weak USD/CAD environment. Together, the impact of weak productivity and a strong Canadian dollar are curbing the Bank's view on Canada's ability to leverage an improved outlook for the US and tap into the global economic recovery. And, although BoC growth expectations for the US economy have been bumped up, courtesy of US tax cuts, the Bank's view is that Canada's ability to generate returns on the back of these stimulative measures will be limited by the focus of those tax cuts on consumption. Canadian exports remain concentrated on capital goods and non-energy commodities rather than consumables. Still, we would suggest that anecdotal data out of the auto sector are painting a firmer picture, which, we believe, will contribute to the recovery of some considerable lost ground for Canadian auto exports as we head deeper into 2011.

In terms of inflation, the BoC maintains considerable elbow room on policy, afforded by its belief that inflation expectations remain anchored around its inflation target of 2%, and well within its inflation control range of 1-3%.

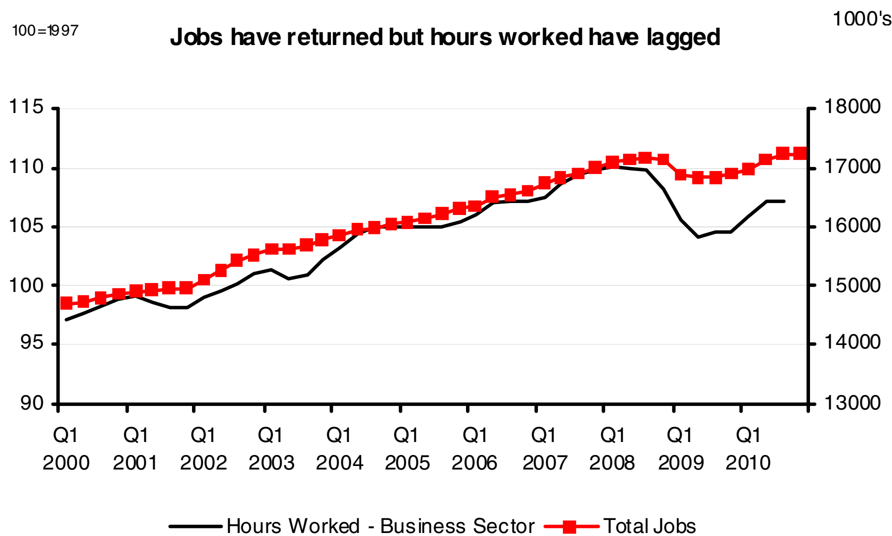
Inflation expectations well contained within the BoC's inflation control range of 1-3%



Source: Bank of Canada, HSBC

Rapid employment growth in net jobs during the first half of 2010 appeared to challenge the view that there remained plenty of slack in the Canadian economy. However, the lack of follow-through in hours worked suggests otherwise. Whereas the total number of employed has returned to pre-recession levels, hours worked have lagged, supporting the contention that there is still considerable slack in the economy, and supporting a generally benign outlook on inflation.

Still considerable slack in the employment picture suggests that inflation can remain subdued

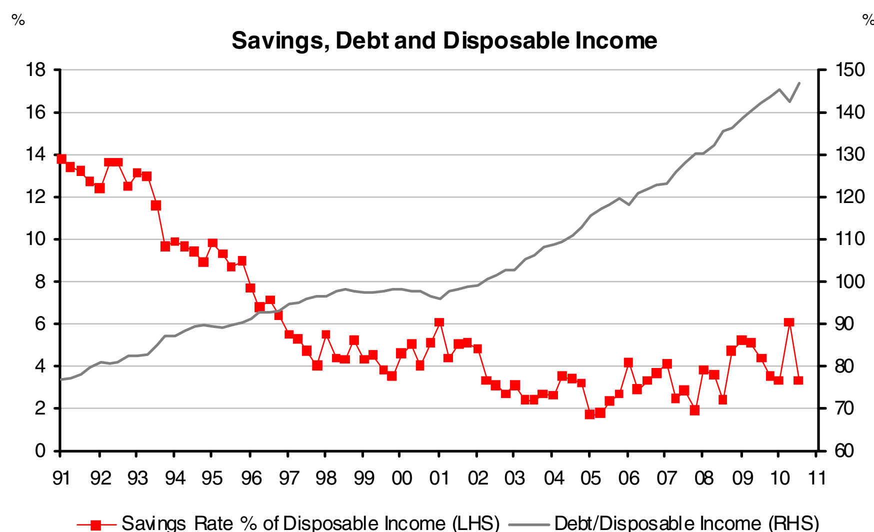


Source: Datastream, HSBC

If only life were so simple

Just as net trade has confounded our expectations for a renewed cycle of tightening to begin in March, we believe that continued growth in consumer leverage has the potential for frustrating the BoC's interest in remaining on the sidelines. In front of this week's rate announcement, the Canadian finance ministry released changes to the funding formulas for mortgages that included reduced amortization periods (from 35 to 30 years), as well as reducing the rate of financing to 85% from 90% of the value of a property as a means to curb the growth in household debt. Federal authorities also announced that they would no longer provide insurance on personal lines of credit secured by the value of a home.

Spoiling the party: The accumulation of debt at the household level has been worrying



Source: Datastream, HSBC

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For now, it appears as if the BoC is content to leave responsibility for curbing the growing consumer debt problem to the fiscal authorities, viewing changes in the rates structure as the last line of defense against consumer indebtedness, to be employed only after administrative efforts have failed.

To be certain, the administrative changes to the funding formulas for mortgage debt have raised the barriers to entry into the housing market. However, in the absence of a complementary policy out of the BoC that seeks to alter the pricing signals for money, they may fail to change the underlying debt dynamic in Canada. We would suggest that the root cause of the debt problem in Canada is its cost (cheap) combined with its availability in an economy with a fully functioning banking system. Altering the calculus of a mortgage does not remove the pricing incentives that are encouraging the borrow-and-spend mentality, while, at the same time, removing any incentive to save.

Bottom line

We believe that a combination of factors will pull the BoC off of the sidelines early on into the third quarter of 2011. At the top of the list, we fear that administrative efforts to curb the consumption of credit among consumers will be fraught with frustration, failing to address the underlying pricing dynamic that is driving the accumulation of debt. The very essence of monetary policy is aimed at encouraging or discouraging certain behaviors through changes in the costing of money. “Money is cheap” is an oft-heard refrain these days.

A less severe view on net trade will develop over the proceeding months, we believe. From our perspective, the BoC is underestimating global growth – its forecast is for 4.0% growth in 2011 versus our forecast of 4.3%. There is also a decent body of evidence suggesting that while challenging, the stronger Canadian dollar is being actively managed by corporate Canada. The most recent BoC survey on FX hedging stated: “The recent level of the Canadian dollar was viewed as having a negative impact on Canadian exporters; however, anecdotal reports indicated that exporters have become better placed to deal with the current strength in the Canadian dollar than in the past.” Also, there is a competitive benefit that is expected to accrue from the strong pickup in business investment witnessed in 2010.

Finally, the BoC forecasts a closing of the output gap by the end of 2012, which presupposes a rate structure moving towards some semblance of rate neutrality, in line with the view of an economy operating at full capacity by the end of 2012. This view necessitates a move to a higher rate profile beginning well in advance of reaching full capacity. In keeping with that view, the BoC’s projections for inflation “include a gradual reduction in monetary stimulus over the projection horizon…”

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Disclosure appendix

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