

Bank of Canada Monetary Policy Report

Some recalibration of the monetary tone.

A fairly robust post meetings statement on Tuesday largely spelled out the Bank's disposition as it pertains to monetary policy - its a kid glove process. Yet if Tuesday's post meeting statement was noteworthy for its dovish elements (trimmed forecasts and output gaps) today's MPR and post meeting Q&A are noteworthy for some firmer statements that move the compass closer to a more balanced tone. A tone that supports higher rates over the forecast period.

Although the Governor is quick to point out that nothing is preordained, in both the MPR and comments in the Q&A there is the recognition that rates are going higher.

For those tasked with pricing the future cost of money in the here and now, the questions of when and where are no friends.

Re-calibrating the tone.

In the post meeting statement on Tuesday we got "the policy response to the European sovereign debt crisis has reduced the risk of an adverse outcome and increased the prospect of sustainable long term growth (although), it is expected to slow the global recovery over the projection horizon." A bit of a good news that gets tipped over on its side. In today's monetary policy report we get to have a better look at the potential upside to the story. "Globally, on the upside, the boost in confidence as advanced countries restore fiscal sustainability could generate greater-than-expected offsets to the fiscal consolidation." A rather broader take on the potential impact of the fiscal story that was absent from yesterday's post meeting statement.

The challenge

From the standpoint of the BoC's economic forecasts, story continues to emphasize the need for a roll over in demand away from a reliance upon the consumer and government spending on over to business investment and external demand. And of course it is here where the greatest challenges lie. We would all like to see the economic baton handed off with the precision of an Olympic relay team but outside of the realm of economist' fantasy this is unlikely to be the case. Indeed, just as most recognize the need for external demand to pick up the slack that is expected to be left behind by the consumer and government, the BoC revised its growth forecasts for the US down in both 2010 and 2011 (2.9% and 3.0% respectively). And although global growth is pushed higher to 4.6% up from 4.2% for 2010, Canada's main economic attachment point remains the US economy from the standpoint of external demand. An uncertain and uneven demand picture in the US presents and uncertain and uneven external demand picture for Canada.

And of course the trajectory of business demand remains a potential event risk. To date it has yet to flower. But then we have really on just embarked upon economic recovery and it is unlikely that businesses following the wrenching process of right sizing in face of financial crisis and economic recession, it is unlikely that in face of the uncertainty spawned by European sovereign credit risk and concerns for an ebb in emerging market growth, that businesses are going to be keen to reinvest in the absence of a more certain economic picture. It is early days yet for business investment and we would suggest that this is more of a 2011 story.

Stick to the facts and the forecasts.

Net, net, despite the downward revisions to growth and the pushing back on expectations for when the output gap is expected to close, we have to ask ourselves, with the economy forecast to be operating at full capacity slightly less than 18 months from now, what interest rate target makes sense.

If we stick with the core forecasts provided by the BoC (growth rates in 2010 and 2011 at 3.5% and 2.9% respectively - an economy forecast to be operating at full capacity by the end of 2011), they continue to point to an overnight rate that needs to move higher. To be certain, the current rate of 0.75% would be wholly out of place come the end of 2011 with the economy operating at full capacity. On that there is little debate. Rather, an economy operating at capacity would suggest the need for policy more in keeping with rate neutrality. To avoid these types of debates the BoC reiterated in the Q&A that it has no target for a neutral interest rate. But just for fun, lets add a little more context.

The Fed's Yellen has suggested that a real rate of 1-3% could be considered rate neutrality for the US economy. Borrowing from that and applying it to Canada, tends to suggest that with an inflation target of 2% rate neutrality is found in the 3 - 5% range. At 0.75%, the current BoC overnight rate target tends to suggest that there is still some potentially long legs left in the current rate cycle.

And in a candid moment in amongst a less than candid unfolding of the current monetary cycle, the BoC acknowledges this in its inflation forecasts. "This projection (inflation projection) includes a gradual reduction in monetary stimulus consistent with achieving the inflation target." Further to this point, in the Q&A, Governor Carney was picked up on Reuters as saying that "Canadians should manage household debt to prepare for more normal interest rates".

Canada is indeed in the midst of a rate cycle. The direction of rates seems clear. The unknown remains the relative steepness of the BoC's rate escalation ladder. We continue to forecast 25bp rate hikes at each of the remaining fixed rate meeting dates for 2010 with a year end target at 1.50%. A still rather stimulative rate profile for an economy that would be 12 months away from hitting full capacity if the current forecasts hold as correct. For year end 2011 we are forecasting a overnight rate of 2.50%, still back of what we would considered in side the range of rate neutrality, but acknowledging that rate policy and consumer behavior are bound tighter now than in the past by high levels of variable rate debt held by the Canadian consumer. So too does it acknowledge the less than robust recovery that can be expected following a balance sheet inflicted developed world recession.

Disclosure appendix

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