Global Economic Research

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CAPITAL MARKETS RESEARCH

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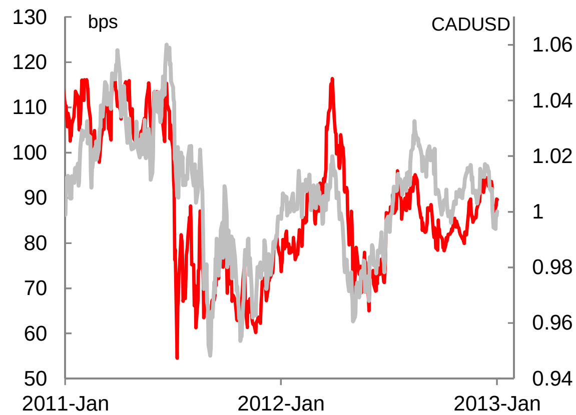
Special Report: Bank Of Canada On Hold Throughout 2013-14

- **We explain a half dozen reasons for our forecast change.**

We have changed our house forecast for the Bank of Canada to show no rate change throughout 2013-14. As such, the overnight rate is forecast to end 2014 at an unchanged 1%. Our prior print forecast was that the BoC would remain on hold until 2014Q1 and so we are therefore now pushing that out by about a full year. While I have long spoken about how the fat tail risks to our print forecast are skewed toward later rather than sooner, this is a pretty sizeable forecast change that merits delving into some of the key reasons.

1. The Fed & CAD

Chart 1 **The Fed Constraint**



Canada 2s - US 2s (LHS) CADUSD (RHS)

Source: Bloomberg, Scotiabank Economics

We are forecasting the Fed to begin raising its fed funds target rate by mid-2015 and have greater confidence on the Fed call. It is difficult to expect Fed funds target rate hikes before early 2015 and so timing a BoC hike to occur around the same time seems reasonable. What informs our Fed view? We assume that the Fed will continue its MBS buying through to the end of 2013 and continue Treasury purchases into early 2014. After that point, we assume that Chairman Bernanke's order of operations marked by ceasing asset purchases, continuing with coupon reinvestment but then halting this and shifting toward tightening through a variety of tools including possible increases in the fed funds target will take us well into at least 2014 before the US faces materially higher short-term interest rates. We do not believe that the BoC will be able to significantly widen Canada-US spreads at the front end of the yield curve without imposing a more deleterious overshooting of the currency's rate of exchange against the USD which remains the key cross from the standpoint of the country's trade balance. As evidenced by chart 1, the period in which the BoC has swung from dovish in late summer 2011 to hawkish late last winter and through the summer and now back to dovish has motivated substantial swings in the 2-year Canada-US spread within a roughly 60bps band. This, in turn, has been responsible for driving much of the CADUSD volatility (versus the USDCAD convention to more easily show the correlation on a chart). To widen the Canada-US 2s spread by, say, another 100bps from here could well prompt sharp currency appreciation which we do not believe the economy could handle without encountering further downside risks to both growth and inflation via imported pass-through effects of a stronger Canadian dollar. In short, there are limits to the independence of a central bank in a modestly sized economy that is heavily dependent upon its bilateral trading and capital markets relationship with the United States. Adding to these constraints are a host of domestic economic concerns.

2. The Effects Of Macroprudential Rule Tightening

We now feel that we have more evidence that cumulative regulatory tightening of lending conditions since 2008 and up to this past June's further tightening of mortgage rules is sharply cooling credit growth and housing markets. We don't wish to turn this into a housing paper that we have treated with near exhaustion in our slide decks and notes, and instead focus upon the end policy focus of evidence on household sector imbalances and their linkages with household finances. The cumulative, lagged impact of this rule tightening lessens the BoC's

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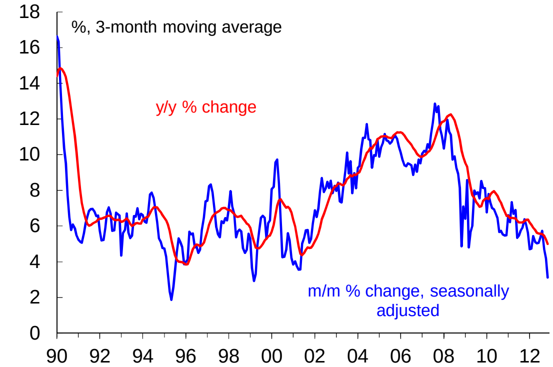
focus upon perhaps having to reinforce its effects by raising interest rates. As evidenced by chart 2, Canadian household credit growth is running at its slowest pace since the moribund 1990s. As the lagged effects of rules-based and less transparent forms of regulatory tightening continue to unfold, there may well be additional downsides to credit growth as we have consistently argued.

Chart 2 Household Credit Growth



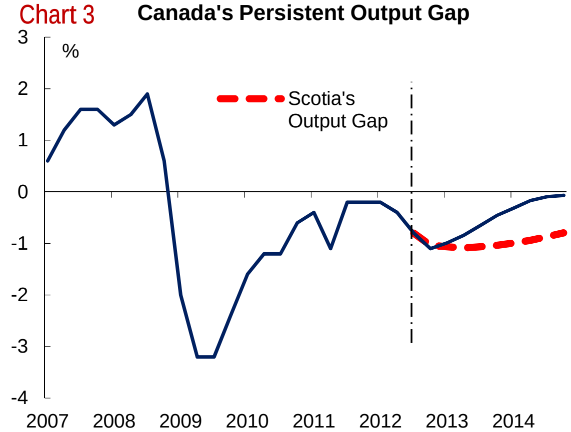
Source: Bank of Canada, Scotiabank Economics.

More recent support for this bias is that the BoC recently shifted its own stance toward forecasting that the household debt-to-income ratio will be flat around current levels over 2013-14. That is a strong signal to markets that the central bank's concerns regarding household imbalances are waning. The BoC now believes that there are "the beginnings of a more constructive evolution of imbalances in the household sector" which in plain English means that debt growth and housing markets are coming off the boil.

3. Spare Capacity To Persist

Chart 3 flags that we are still materially different from the BoC's revised assumptions on spare capacity, and that is one reason why we think the BoC remains a tad on the optimistic side. We have argued since a note last August that the BoC was being too aggressive with respect to the pace at which spare capacity would be closed. The chart shows that the BoC now sees spare capacity closing off toward the end of 2014 and therefore just pushed out its prior view that this would occur by the end of this year. Using the BoC's potential GDP growth assumptions (i.e., the economy's "speed limit") but replacing their actual GDP growth forecast with Scotiabank's forecast, results in the red dashed line for our view on what happens to the output gap.

Chart 3 Canada's Persistent Output Gap



Source: Bank of Canada, Statistics Canada, Scotiabank Economics

Recall that being above the horizontal line signals excess aggregate demand that may be inflationary and below it signals excess aggregate supply in the economy that may be disinflationary — importantly with all else equal on limitations to this framework of thinking. We see spare capacity persisting into 2015 at a minimum and therefore do not anticipate that the BoC's malleable 1-3% inflation target band within a flexible framework will be significantly challenged.

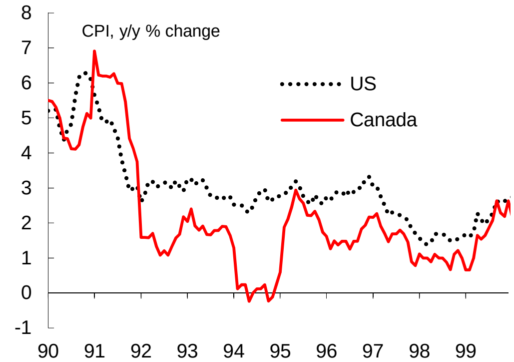
Even if the output gap were to close by the end of 2014 as the BoC forecasts, that does not mean that an outbreak of inflation risk lies around the corner in such a manner that would require policy tightening beforehand. One reason for this is that we don't know what the BoC is assuming on 2015 growth relative to the economy's non-inflationary speed limit since it has yet to publish 2015 forecasts. The BoC is simply too smart to go out that far. Nor do we have tremendous confidence in timing the potential inflation response should the economy happen to trip into spare excess demand and not be pre-empted by monetary tightening.

The reason for this difference of opinion on when spare capacity closes relates to different growth assumptions. The BoC is repeating its established tendency to push out bullish optimism after downgrading near-term growth. The Fed has generally taken a similar approach over the years. The BoC may turn out to be right going forward, but our forecast differences are material when compounded over the quarters. In 2013Q3 and Q4, the BoC thinks the Canadian economy can return to nearly 3% GDP growth versus our view that is in the low 2% range and which is comparable to the economy's speed limit such that we don't build more spare capacity but we don't close it either. Material forecast differences persist into 2014, and it may be prudent to play it safer yet on housing risks and what we have flagged in the past on risks to Canadian exports.

4. Inflation Could Easily Keep On Undershooting

Canada is seriously undershooting the BoC's inflation target with headline CPI currently tracking 0.8% y/y. In the process, the BoC's inflation targeting apparatus is suggestive of an asymmetric approach to returning headline inflation back to its trend line; the BoC might be expected to adopt an easing bias when falling so short of its inflation target. The household imbalances perspective is one reason why the BoC has not embraced an easing bias; indeed, this is supported by BoC references to maintaining tighter monetary policy than would otherwise be warranted through a strict, mechanistic focus upon its inflation target precisely because it has been so focused upon engineering a hopefully soft landing in the household sector. As we have previously noted, however, the BoC is shifting away from this line of reasoning.

Chart 4 Back To The 1990s?



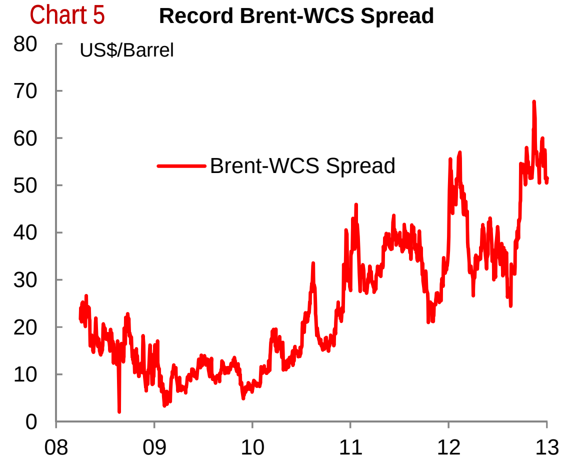
Source: Statistics Canada, BLS, Scotiabank Economics.

Regardless, we are left with the reality of having to forecast inflation in Canada relative to the US. Key here is that we think there are parallels between today's conditions and the 1990s. Canadian and US GDP growth are strongly correlated over long periods of time, but there have been instructive periods of relevance to monetary policy when the economies are off-cycle to one another and particularly in the household sector. During the 1990s, the move away from the structural highs that existed at the end of the 1980s and early 1990s across multiple household sector measures meant less pricing power for Canadian businesses serving the business-to-consumer segments. Canadian inflation consistently under-shot US inflation as chart 4 depicts. A repeat of that is entirely possible, and so I'm not sure we buy the BoC's base case projection for headline inflation to neatly shoot back to its 2% target by 2014H2. A stronger argument would posit that the two countries' household sectors have never been as off-cycle relative to one another as is the case today.

5. Canada's Oil Price Discount

Another reason to think that Canada's output gap might persist for longer than previously anticipated is the unwelcome weakness in the crude oil producing sector with an emphasis on heavy oil. The most recent Bank of Canada statement flagged a "record discount on Canadian heavy crude" which it attributed in part to "temporary disruptions" and in part to "persistent transportation bottlenecks." While the former will pass, the latter are likely to exacerbate the issue as output of Canadian and U.S. crude — which both travel on North America's integrated pipeline network — is set to increase significantly in 2013 by most estimates. The result is a material risk that bottlenecks might keep the spread between Canadian heavy crude and world prices above their normal level (see chart). Should the price gap persevere, will it begin to deter capital spending and other investment in the sector over the next two years? It's hard to say with any certainty; however, the Bank of Canada is hinting here at another downside risk to its projections, and one which has the potential to weigh on capital investment moving forward.

Chart 5 Record Brent-WCS Spread



Source: Bloomberg, Scotiabank Economics

6. Uncertainty During A Leadership Transition

Throughout this framework is the added uncertainty imposed by the pending leadership transition at the Bank of Canada in the wake of Governor Mark Carney's announced departure. We assume policy continuity, but a risk is slanted toward a transition that could afford the opportunity for a new Governor to guide markets with his or her own bias in consultation with the Governing Council.