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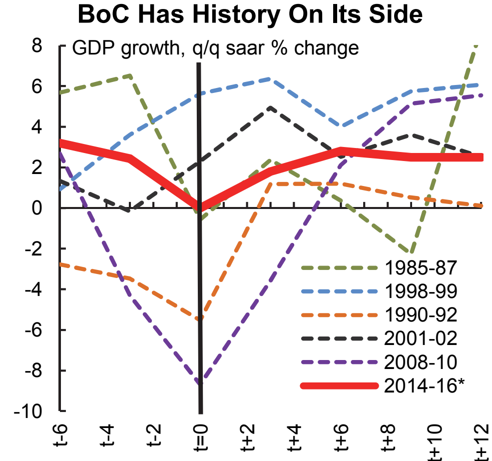
The BoC Has History On Its Side, But The Future Is Uncertain

- **The BoC's forecast recovery following a weak Q1 is not out of line with what happened during past oil shocks, but it's not clear whether history will prove to be a useful guide.**

Governor Poloz has recently been fond of saying that the oil shock is a front-loaded one-time phenomenon, and that the worst effects will start to dissipate in Q2 and be gone by the second half of this year. Is the Bank of Canada too optimistic on the recovery that it expects to unfold following the first quarter that probably posted very little if any economic growth? Our house view is still biased toward answering yes to this question and we continue to caution that the BoC's growth forecasts are at the top end of the private sector consensus. What must nevertheless be acknowledged is that history may be on the BoC's side, even if today's risks are potentially putting the Canadian economy into uncharted waters.

Witness the accompanying chart. While it may look like a Picasso, it shows what happened to broad economic growth during past oil price corrections that have been comparable in magnitude and length of time to what has been experienced this time around since last summer. Quarterly economic growth during past oil shocks is shown as dashed lines that convey what was happening to growth six months before oil prices hit a low point, at the low point (time t=0), and 12 months afterward. The BoC's current forecast for quarterly growth from time t=0 (ie: 2015Q1 in this case) onward is shown as the solid red line in the chart and is spliced onto actual growth over 2014H2. The BoC's forecast does not stand out terribly from past experiences on average. The BoC is forecasting a stronger rebound than during some past oil price shocks like the 2008 crisis and the early 1990s, but it is forecasting a slower rebound than what was experienced during other oil price corrections. At least on the surface of things one cannot reject outright the BoC's top-of-consensus growth forecast.

Chart 1



Source: Scotiabank Economics, Statistics Canada.
*April 2015 Monetary Policy Report Forecast.
t = 0: lowest WTI price during specified timeframe.

That said, drawing inferences from history in a forward-looking sense can be fraught with difficulties. For instance, the experiences shown as the periods from 2008-2010 and 1990-1992 in the chart probably don't help us much here even though they showed sharper downturns and somewhat slower recoveries. The first one speaks to the global financial crisis and had an awful lot going wrong in the world economy beyond just collapsing oil prices. The second one was a period of great turmoil in the Canadian economy as the global and US backdrops were soft, Canada was coming off the housing and consumption boom of the 1980s that unfolded into a major drop in Toronto house prices, the Bank of Canada was in the early days of embracing inflation targeting and was driving short-term interest rates to very high levels, Canadian governments were beginning to retrench, the country was adapting to the Canada-US and then NAFTA trade pacts, and political instability reached a crescendo with the 1995 Quebec referendum.

Today, however, there are some tailwinds like currency depreciation that has improved upon but not offset a long-term deterioration in the country's cost competitiveness, and several headwinds against the outlook that were less prevalent in the past. One headwind is a household sector that is currently at record high levels of activity and indebtedness by multiple yardsticks including the home ownership rate, real per capita consumer spending, renovation spending, debt-to-income, and an assortment of house price measures. Two is record

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vulnerability to the energy sector that now accounts for about one-in-four export dollars, one-in-five cap-ex dollars, and about 14% of GDP through direct and indirect influences such that the country's overall exposure to the plunge in oil prices has never been so great. These two developments carried many intertwined effects on the Canadian economy and their mutual advancement as two of the most powerful drivers of the Canadian economy occurred over a long period of time. That may imply that the risk is that coming off all-time peaks in resource investment and being at all-time records across the household sector could carry adjustment effects for an extended time period depending upon the uncertain outlook for the speed of the US recovery and the effects of CAD depreciation among other factors.

While history is on the BoC's side in forecasting a fairly rapid rebound into the second half of this year and beyond, there are enough differences between today and those past shocks that may justify a more conservative posture toward the risks facing the outlook. That balance of risks continues to lean toward a base case for further rate cuts as the BoC's policy bias changed markedly after January, but I do think that the BoC will be on a long pause. At a minimum, we need to get into data later this year that will help to test the central bank's assertion that the shock will be short-lived and the rebound timely. An extended pause possibly spanning not just this year but also next could also be realized as the BoC evaluates the decline of the resources sector and then transitions toward evaluating what could well be negative spillover effects of tightening by the Federal Reserve.