Special Report

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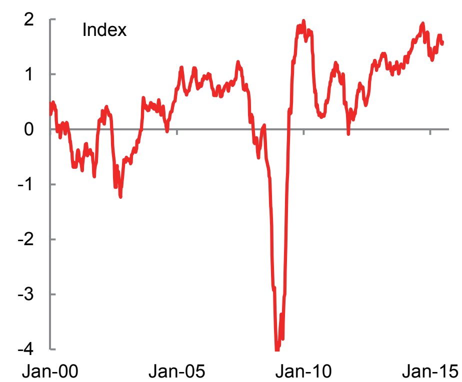
A High Bar For Further BoC Rate Cuts

We would not make a BoC rate cut in July a base case as of yet. In fact, I believe there is a high bar for cutting further any time soon and go one step further in that I believe another rate cut at this juncture would do more damage than good over time. **Our forecast remains no change in the BoC's overnight policy rate over the duration of this year and all of next.** That's consistent with what we've been saying for a while in that markets are attaching too high of a probability to further BoC cuts and we would position against it. What follows is a ten pointer on key arguments.

1. **Financial conditions are not tight**. In fact, by the BoC's own financial conditions index, conditions are more relaxed than they've been in a year and largely due to global forces. Their index is signalling about 26% easier overall financial conditions than at the end of January when the central bank cut and not far from the easiest conditions on record (chart 1). This combined policy and market easing has not been given enough time to influence the economy as of yet. Recall that this measure is a broad composite of much more than just short-term rates (go here) and includes a mixture of positive and negative contributions from house prices, business lending conditions, credit spreads, the overnight rate, 10 year GoC yields, CAD in trade-weighted nominal exchange rate terms, and the TSX.

Chart 1 **BoC's Financial Conditions Index**
Still Accomodative



Source: Scotiabank Economics, Bank of Canada

2. **Canada's problem is an exogenously determined terms-of-trade shock and cutting rates will do little to reverse this.** The country is a price taker in most of what it does and so its ability to influence the global market tone that drives the price of what it sells relative to what it buys in world markets is very limited.

3. **The problem is not in the rate sensitive sectors**. At least not yet. Housing markets are ripping. Retail sales are looking like they are reversing the Q1 decline albeit with limited Q2 tracking. Cap-ex is weak but this is a function of depressed cash flow in the resource sectors that drove the prior run-up in investment spending. Will cutting rates really boost the sectors that did much of the damage to April's GDP report like resources (can't influence commodities), utilities (can't influence weather, with utilities output just coming off a large surge in Jan/Feb) and manufacturing (bigger challenges than CAD)? Not likely.

4. **Keep your powder dry**. A -0.1% dip in April GDP provides little new information to get in a flap over and so I've been somewhat amazed to see some of the urgent sounding cries that have hit the tapes from others. Consensus expected a +0.1% rise, and we were flat, so the surprise to what had been understood by most forecasters was small which makes for an over-reaction. There is nothing the BoC can do now or in future to reverse what has been happening in 2015H1. Monetary policy acts with a long and variable lag. I'd rather see the BoC hold something in reserve should it really have to adjust to potential future risks in the domestic economy. At 0.75% on the overnight rate there is little left in the tank without embracing riskier monetary policy options like at the Riksbank but without having to unwind the Riksbank's premature 175bps of policy tightening over 2010-11, much softer core inflation readings, and greater Swedish exposure to European weakness.

5. On those domestic risks, **housing imbalances** are at the top of the list. I haven't changed my views in warning about housing risks. When every variable in the housing and consumer sectors is at a record high,

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prudence dictates that you caution markets. Timing asset market developments is not a strength of economics on the upside or downside, but it would be foolhardy to ignore the difficulty in sustaining growth off of all-time record highs in the home ownership rate, real per capita consumer spending, house prices by every measure, household leverage, and renovation spending. The country's financial system and mortgage markets are totally different than markets like the US and parts of Europe and this is an important stabilizer against true hard landing worries that we don't believe in. So is an improving US economy. But these points do not negate the fact that the hottest markets of Toronto and Vancouver have had large and prolonged price corrections that have restrained the economy in the past despite this point and for varying reasons over time that could all well repeat (cycle maturity, immigration shifts, rate risk, etc). Shock bond markets and with it put upward pressure on the key five year mortgage rate and then further front-end policy flexibility could well be required. Unless the BoC thinks it can forecast a housing downturn better than anyone else amidst a market that has reached new highs on unanticipated persistence to falling fixed borrowing costs that has played an important part in bailing out the housing optimists, then it should retain policy flexibility. Otherwise, we are approaching the limit at which lower variable and fixed rates can add ongoing upsides to housing markets.

6. In the meantime, **cutting rates will only risk inflaming housing imbalances** while doing little for the external sector of the economy that primarily depends upon what the world hands Canada via commodity prices and US growth. Cutting rates now or soon will transfer future housing and consumption demand to the present and limit policy flexibility down the road.

7. **There is no readily apparent disinflation or deflation problem at this point.** Core inflation is above target and the BoC's forecasts have been consistently chasing it higher through upward revisions all the while talking through 'temporary' factors. So have ours. So have yours. That says to me we don't fully understand the drivers, shouldn't dismiss every sector-specific influence, rely too heavily upon output gaps that I think are highly over rated in the domestic context, models that forecast core 6-24 months in advance are weak, and we should therefore err on the side of caution toward the inflation mandate. The BoC cannot do anything about commodities that are depressing headline inflation — other than to wait until headline base effects drop out into late year and early next and drive headline CPI inflation higher to close the gap with core.

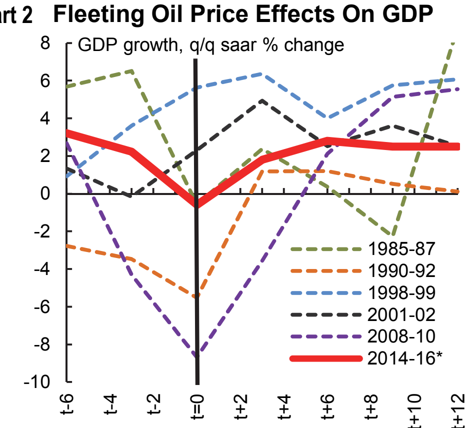
8. **Let the Fed do the work on the currency**. Eventually we'll arrive at lift-off and the USD may strengthen versus CAD. That will force Canadians to pay more for imported goods to an uncertain extent and by corollary reduce household purchasing power in an economy that is significantly dependent upon imported consumer goods. Cutting rates would only aggravate a not-so-transitory import price shock that lasted for years to the downside when CAD was appreciating and I see no reason to dismiss it as transitory to the upside when CAD is depreciating unless we stretch the definition of transitory to be measured in several years.

9. Deliberately trying to weaken a currency that is not obviously overvalued by any large amount in purchasing power parity terms is a **weak foundation for a nation's industrial strategy**. It is also unlikely to be a sustainable strategy over the economic lives of major investments. Deeper cost and productivity problems have made Canada far less competitive in manufacturing unit labour cost terms to the US and Mexico over the past couple of decades and it would take entertaining a much weaker currency to negate this cost differential while inflating associated risks. Simply put, there is no easy cure for competitiveness challenges.

10. While it is difficult to time, **most negative oil price shocks have fleeting effects on growth** (second chart). The chart is one we've repeatedly used and shows that six quarters ahead and 12 quarters after comparable oil price shocks to what has been experienced in the past typically portrays the worst effects as being fairly short lived before, as Governor Poloz notes, the benefits of lower oil prices and an improving global economy eventually take over. Patience is required. Fleeting doesn't mean something that can be measured with the precision of the exact month, like why we didn't see a rebound in April. The second half of the year is likely to get better than the first half. Trying to time this story with great precision poses significant future policy risks.

11. Bonus! Volatility in the conduct of monetary policy may put participation in nearer-dated debt auctions at risk. This is consistent with views we have heard in discussions with clients abroad. It lessens the strength of real or implicit forward guidance and communications in general.

Chart 2 Fleeting Oil Price Effects On GDP



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