January 14, 2016

Special Report

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Bank of Canada Should — And Probably Will — Stay On Hold

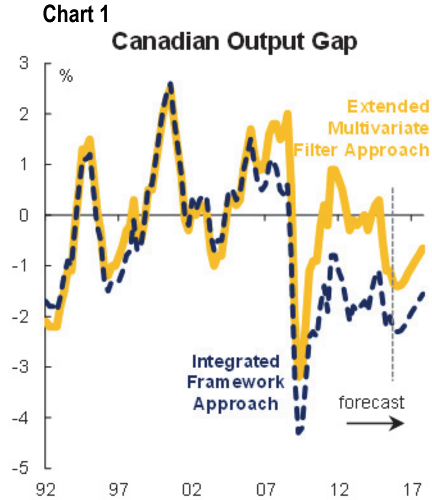
We take the opportunity to reinforce our view that the Bank of Canada will pass on the opportunity to cut its overnight rate again next week. **We summarize the cases for and against easing and they net out to our unchanged base case that further rate cuts are plausible in future but not likely just yet.** The complex issues at hand are not just about the next meeting; they are about conducting a prudent overall policy mixture for the longer-term health of the Canadian economy.

The Weaker Case For A Cut

- The Canadian economy is again disappointing BoC expectations and will be challenged to secure any growth whatsoever when final Q4 GDP figures land. A complex array of temporary and deeper underlying forces are responsible. The BoC is likely to revise downward its near-term growth estimates from the forecasts published in its October Monetary Policy Report (MPR).

- We do not forecast either definition of the output gap to close over our published forecast horizon that stretches to the end of 2017. Chart 1 shows our forecasts for the two measures of the gap that the BoC follows. A material amount of disinflationary slack will persist throughout the next two years. Indeed, it is not a stretch that excess capacity will persist to decade's end and perhaps later as part of what Governor Poloz describes as complex forces that will take years to play out.

Chart 1



Source: Scotiabank Economics, Bank of Canada.

- Lower oil prices yield less pressure on headline CPI than previously expected. This would give the BoC reason to push out its forecast for headline CPI to reach 2% until later than 2017Q1 which was the expectation in the October MPR.

- The oil price that matters more to Canada is Western Canada Select and more so in CAD not USD terms. In USD terms it has recently been around US$16 and in C$ terms around C$24. That is pushing down to the range often described as the variable cost break-even point. It would be premature to shut production down at C$24 oil and based upon the first two weeks of trading in the new year (it was $33 coming into the new year). Prices above this variable cost break-even point but below the much higher all-in break-even point mean that continued production recovers variable costs and chips away at some fixed costs. Prices at this level or lower mean that only variable costs are being recouped if at all and thus the profit incentive to continue producing deteriorates. That poses a downside risk to overall output, export volumes and thus the contribution of trade to broad GDP growth. Individual company circumstances differ, but in aggregate we do not believe that oil production in Canada is on the verge of shutting down; further, prices would likely respond positively to less supply pressure globally in this scenario and help restore equilibrium. It is unclear that monetary policy should attempt to manage this process.

- Global market instability is posing downside risks to our existing growth forecasts for the Canadian economy.

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- The BoC believes it has considerable policy flexibility in terms of its lower effective bound for policy rates as well as other unconventional tools, and so giving away another bullet does not compromise its future easing options.

- The Business Outlook Survey contained weak components. In particular, companies reported higher excess capacity. Such anecdotes are bearish for corporate Canada's outlook.

- The inventory cycle is a downside risk to industrial production as the inventory-to-sales ratio has not been this high since the depths of the global crisis.

- Similar combinations of downgrades to the domestic outlook and declines in commodity prices have spurred the BoC to cut rates in the past.

The Stronger Case Against A Cut — For Now

- It wouldn't matter. Canada is going through needed adjustments following a terms of trade lift to domestic incomes that was then leveraged to record heights in the household sector. Coming off such influences involves simply working through such imbalances. Cutting rates risks further inflaming sectors already in a state of imbalance, notably housing, while doing little for the rest of the economy. The prospect of a multi-year adjustment is not something a rate cut next week can lean against. Adapting to a new reality within the limits of policy — fiscal, monetary and regulatory — may be the order of the day.

- Modest fiscal stimulus is in the works. That could give the BoC some confidence that it can pass the baton to the Federal government. The BoC may wish to wait at least until a Federal Budget has been brought down which punts the easing risk into Spring or later. The market was probably more correct in its BoC pricing in this regard than it has become into the new year.

- The BoC may view the full lagged effects of easing to date as not having worked their way through the economy. That would counsel patience.

- One view is that a depreciated CAD to date is to be relied upon more heavily than further rate cuts to stimulate export growth. Another view posits that CAD works differently this time and so attempts to depreciate it through the role of monetary policy above and beyond drivers like oil, copper and other commodity prices are less likely to be successful on net. Canada remains a high-cost producer and the currency has not depreciated enough to offset the long-term deterioration in productivity adjusted labour costs. Lower cost jurisdictions like Mexico have experienced comparable currency depreciation versus the USD and are more likely to leverage off of a US recovery than Canada.

- An arguably greater vulnerability is likely that which faces consumers in the form of a potentially massive import price shock in the context of limited wage growth and relatively high leverage. Cutting further in such fashion as to add downside risks to the currency increasingly risks a stagflation scenario for Canada. Little growth and import price pressures could be mutually reinforcing. My personal view is that sharp currency depreciation will carry lagged upward effects on import price inflation for years to come as an offset to slack arguments and this should be reinforced only with the greatest of care at elevated peaks across everything in the household sector.

- Governor Poloz has changed his mind in the past, but he was more forcefully guiding a positive message last week than at any other point I recall over the past year. He dismissed China concerns as more about markets than fundamentals, he sounded upbeat about global growth, and he emphasized benefits of lower oil and CAD depreciation starting to appear by way of nonresource sectors. Had the Governor been more uncertain about near-term policy in a desire to keep options open on game day, we would have expected him to convey a less buoyant spirit. If anything, our read on Governor Poloz's bias was that he was cheerleading the economy (see our recap of his speech here).

- Rate cuts don't help the resource sector which is only about 15% of the economy (energy) and 20% (total).

- I maintain my personal view that imbalances in housing markets are being aggravated by BoC easing. This risks courting a larger problem down the road. One that would be further driven by additional rate cuts and the effect on rates at least in some segments of the market accompanied by the depreciating effects on the currency that would make Canadian real estate even cheaper for foreign buyers relative to domestic drivers.

- How much of a potential rate cut passes through administered lending rates is uncertain but full pass-through has been resisted to date and remains an offsetting risk.

- There is merit to keeping some powder dry in the face of potentially greater macroeconomic and financial market risks down the road. It is already questionable whether the BoC's estimate of 100 points worth of potential additional conventional easing toward what it estimates as the -0.5% lower effective bound would get fully passed through administered rates or offset a turn for the worse in housing as households could be wary of attempting to catch a falling knife. It becomes even more questionable if easing inflates the peaks higher in the near-term and exhausts limited policy flexibility. Policies like negative rates are seeking evidence that they are working in Europe, while QE would have limited effect on rates with the 5 year Government of Canada bond yield already at only a half percentage point and mixed effects through the currency as a drag on consumers but a possible mild lift for trade. Our more detailed thoughts on applying QE and negative rates in Canada can be found here and here.

- Cutting in response to developments over the first two weeks of the new year in both oil markets and China may be premature.