CAPITAL MARKETS RESEARCH

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Special Report: With The Output Gap Closing, What Will The BoC Do?

The biggest risk to tomorrow's Bank of Canada policy statement is that the Bank signals that the economy is much closer to balance than previously anticipated and that indeed spare capacity in the Canadian economy could be entirely shut by the end of this year or early next year. That would be at least three quarters earlier than the BoC had last signalled in its January Monetary Policy Report (MPR) and the January rate statement. That could also pose the risk of pulling forward the BoC's forecast that headline and core inflation do not sustainably converge upon the 2% target until the end of 2013 assuming tightened policy along the way or, as Governor Carney states, "within the next seven quarters." Given that the BoC explains its policy rationale within the malleable context of output gap and inflation dynamics much more so than many other global central banks, such a sharp shift in output gap dynamics is important to understand in greater detail. Indeed, such a move could be interpreted by markets as a relatively hawkish signal to the benefit of CAD and once and for all killing off that segment of the market that still longs for rate cuts despite the very high bar associated with taking a step back in the direction of the complications associated with operating at the lower zero bound.

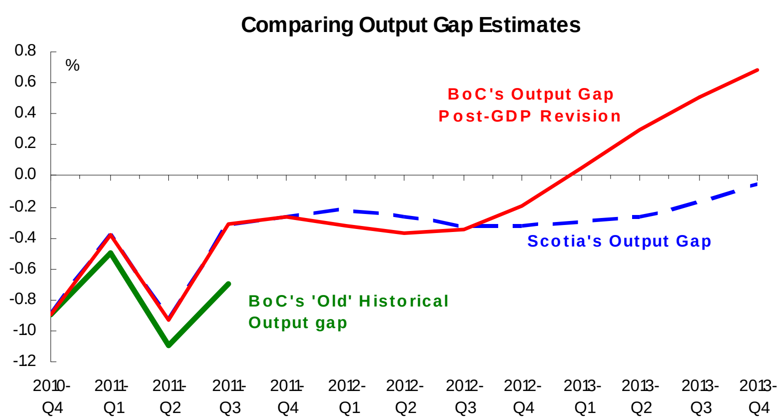
We position this as a risk because the BoC could well buy some time and treat tomorrow's text as a maintenance statement. One reason is that the BoC is scheduled to update the output gap calculations on its web site likely only by next week. It could thus issue the statement and update the figure with little fanfare and hold off on commenting about the future evolution of the gap. Another reason is that the BoC could wait until the April statement when the BoC also releases its next full MPR which would enable it to more fully explain its output gap math including any potential shifts in the components. In our opinion, however, it would be difficult for the BoC to ignore such a material change in its communications over the nearly six weeks before the next MPR. We would think it to be appropriate for the BoC to comment on the matter in tomorrow's statement.

Overall, our forecast remains for the BoC to commence hiking in 2013Q3 but the two tail risks to this view have been altered by the changed output gap dynamics as we now set out to explain.

Why The Output Gap Has Changed

The BoC is now faced with a materially smaller output gap thanks to the sizeable upward revision to 2011Q3 GDP and sustained, albeit much slower, momentum into 2011Q4. 2011Q3 growth was revised higher from 3.5% to 4.2% and Q4 growth came in only two-tenths lower than the BoC anticipated in the January MPR. The net effect was that the level of output in the economy ended 2011 about a half percentage point higher than what the BoC had previously anticipated. Leaving the BoC's assumption for potential GDP growth unchanged for 2011 means that the output gap therefore narrowed materially. The

Chart 1



Source: Bank of Canada, Statistics Canada, Scotia Economics.

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BoC has yet to publish a Q4 output gap, but its estimate for Q3 was -0.7%, signalling a moderate amount of slack in the economy. We figure that because of the new information, the output gap as at Q3 was actually closer to -0.3% — or nearly a half percentage point lower and that much closer to balance in the Canadian economy. The output gap likely then ended 2011 at the same -0.3% since actual GDP growth of 1.8% in Q4 was very close to the BoC's assumption for potential GDP to have grown by 1.6% in 2011. Given the enormous uncertainty with respect to modelling output gaps and their components, to be speaking toward net slack of only -0.3% in the Canadian economy would be a material change in our judgement — implying the economy is nearer to full capacity, at which point inflation may be a risk.

Where Will The Gap Go In Future?

Where we go with the output gap in 2012 and into 2013 then critically depends upon whether one relies upon the BoC's relatively optimistic growth assumptions for 2013, or Scotia's more conservative forecast which has served us well compared to the consensus bias throughout the crisis period.

Scotia and the BoC have similar growth forecasts for 2012, but they then part company in 2013. In 2013, the BoC expects quarterly growth rates of 3.1%, 3.1%, 3% and 2.8% as published in the January MPR, whereas Scotia expects growth of 2.2%, 2.2%, 2.5% and 2.6%. The impact this has upon output gap dynamics into 2013 is shown graphically in chart 1 and the effects are significant. Using the BoC's forecast for actual GDP growth, the output gap closes into early next year in contrast to the BoC's January MPR assumption that this would not occur until 2013Q3 (which itself has been a moving target that has floated around the back half of 2013). Indeed, by the end of 2013, the BoC's output gap has shifted into excess demand at 0.7% of GDP which in turn is the largest net excess demand position since 2008Q3 — prior to when Lehman's collapse intensified the global crisis.

Using Scotia's forecast for actual GDP, however, results in the economy not closing off excess supply until the end of 2013 which is in line with the BoC's January MPR view. Thus, whether or not Canada has spare capacity into late 2013 or shuts it much sooner depends upon where one sits on the continuum of forecast opinions for growth in that year. The BoC's response could therefore well be to repeat a move it has made before during the crisis phase by again reducing its 2013 growth assumptions.

Does It Matter?

This naturally begs the question: does it matter? Yes and no. In the short-term, markets could take a signal in tomorrow's statement like "The Bank now judges the economy to be closer to balance than previously understood and that the economy will be back to balance within a year" to be somewhat hawkish in nature — that is, if such a statement is left unmitigated by offsetting caution. So in the very short term, yes, such a signal could well matter to markets.

But would it matter in the longer-run debate over when the BoC will ultimately return to tightening monetary policy? Probably not, in our view, and for over a half dozen reasons.

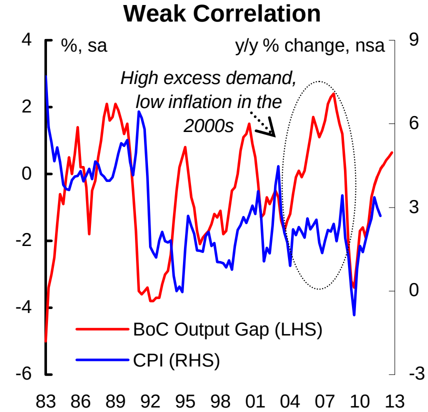
First, Governor Carney has already made it abundantly clear that the BoC will likely lag behind the closure of the output gap in pushing toward a lower neutral rate for this cycle. Carney has noted that the BoC has utilized flexibility in achieving its operational inflation target through monetary cycles in the past. This gives him considerable leeway by which to judge the tenuous connection between output gaps and inflation.

Second, the BoC could well simply tweak its assumptions on a number of variables over 2012-13 and stick to its house view published in the January MPR that the output gap doesn't close until the end of 2013. The BoC could achieve this by either backing away from 2013 growth assumptions, or by raising potential GDP assumptions. What it would be held to task for, however, is if it did not acknowledge that there is now materially less current excess supply in the Canadian economy than was previously understood.

Third, the output gap is not exactly the best predictive tool in forecasting inflation in any event. Thus, even if the output gap closes earlier than anticipated, it does not mean that Carney would automatically interpret that as cause to hike in order to

Chart 2

Output Gap & Inflation: Weak Correlation



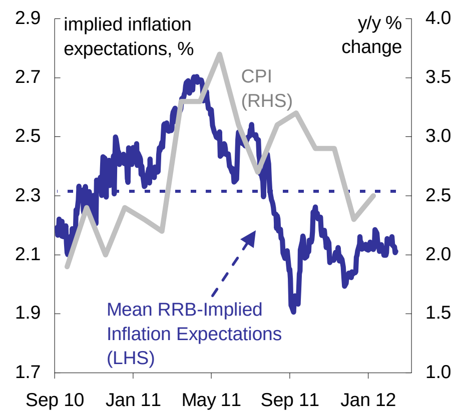
Source: Bank of Canada, Scotia Economics.

enforce the BoC's inflation target in some rigid formulaic sense. The connection between the output gap and inflation was at its strongest prior to the early 1990s and then became more erratic thereafter (chart 2). Witness, for example, the push toward large net aggregate excess demand in the years before the crisis while inflation remained subdued. That may be because of secular downward influences upon global inflation including but not limited to factors such as China's rise and the impact this had upon bringing cheaper consumer goods to world markets. To be charitable to the BoC, it may also be because domestic monetary policy shifted toward being more pre-emptive in an explicit inflation targeting framework from the early 1990s onward such that inflation expectations built into many contracts became more stable and less connected to output gaps. That may be true, but it bears pointing out that output gaps became weaker predictive tools for inflation globally over the past two decades, and not just in Canada, as global forces exerted influences upon inflation rates the world over.

Fourth, while Governor Carney may signal a tad more encouragement toward European developments (albeit on the same day when we find out if Greece got its 75% take-up rate), he may express slightly greater concern about China's economy. Thus, geopolitical concerns could remain as a theme that at least partly over-rides the role played by the domestic output gap debate. China arguably matters more to Canada and its financial markets given the commodities trade. In fact, European turmoil has carried some benefits to the Canadian economy via lower fixed term borrowing costs owing to bond safe-haven seeking, and a still lower CAD against the US than its peak last year — all within the context of modest direct trade and banking ties to Europe (although the indirect ties through the US are greater). If China is successful at implementing a lower growth target, then this could well come at the expense of the commodities complex that supports much of the Canadian economy. Further, while Carney may signal some greater encouragement toward the US economy, we're skeptics in that debate. Real US consumer spending has been flat for three months now, and capital goods orders have retreated as we warned following the year-end surge to get in ahead of expiring depreciation incentives. Progress in US job markets has been welcome but remains inadequate to materially relieve unemployment levels. Indeed, job growth has levelled off over recent months. Also consider that growing tensions in the Middle East that have Iran sparking an upward bias in oil and gasoline prices will have to be acknowledged as part of the geopolitical backdrop.

Chart 3

Canada: RRB-Implied Average Inflation to 2041 & CPI



Source: Statistics Canada , Bloomberg, Scotia Economics.

Fifth, the domestic economy isn't exactly sparkling. Job market momentum has been lost on a trend basis, and the country's housing and consumer sectors sit at heavily leveraged structural peaks that could well challenge future growth.

Sixth, why tighten monetary policy on output gap reasoning when the Canadian economy is already facing material tightening in other respects? This includes a shift toward fiscal drag at the combined federal, provincial and municipal levels of government. It also includes the impact of a currency that is still operating near parity against the USD; while it is still weaker than the 94 cent peak last July, it has appreciated since last Fall's 1.055 trough against the USD. Further, consider that real wages are going nowhere in Canada as inflation is offsetting nominal wage gains. As gasoline prices surge again, this effect is being further reinforced to the effect of killing off disposable income growth. Finally, the country is soon likely to engage in another round of tightened housing finance policy in pro-cyclical fashion. This would be despite household credit growth having already slowed markedly and despite the fact that the country sits at heavily leveraged all-time peaks for most forms of activity in the household sector that will make future sustained growth in housing demand difficult.

Seventh, as shown in the accompanying third chart, long-run inflation expectations are reasonably well behaved around the BoC's 2% target. Canada's breakevens are not as reliable in the near-term as they are in the US market, but thirty year implied expectations derived from the real return bond market suggest market confidence in the BoC's inflation targeting apparatus that should comfort the BoC.

As a final consideration for now, we also continue not to rule out QE3 being pursued by the US Federal Reserve as we've written about throughout this year, though whether further bond purchases will be sterilized or not is open to debate. If not sterilized, then the potential currency implications could make it difficult for the BoC to front run the Fed through materially early policy tightening. The QE3 story we told in our January 20th piece "Fed's Published Rate Forecasts Could Be A Warm-Up To QE3" has gathered some momentum in our view due to the disappointing readings on US consumer spending and business investment — an issue that we flagged above and that we had argued would occur in that paper.