Bank of Canada Preview — Downside Risks Persist

Next Wednesday's Bank of Canada announcements will include the statement that hits the wires at 10amET and a full forecast update contained within the April edition of the Monetary Policy Report followed by a press conference at about 11:15amET.

Neither we nor markets expect a rate change at this meeting. **The risk leans toward a clearer dovish bias relative to the one-in-four market odds of a rate hike by year-end that is likely highly premature.** Governor Poloz will come armed with plenty of fresh reasoning for a dovish bias and I wouldn't be surprised to hear him repeat that cut risk remains on the table to counter downside risks.

There is fresh evidence of what he has termed the "serial disappointment" surrounding the role of net exports in driving domestic growth (chart 1). Export volumes were up by about 2½% q/q in Q4 of last year and they are tracking a full reversal of that gain in Q1. Net trade is tracking a multi-percentage point drag on GDP growth in Q1, particularly thanks to the full reversal of an import distortion to growth in Q4. The BoC has long desired less reliance upon households to drive growth and that still isn't happening.

A key argument why the BoC can diverge from the Federal Reserve on rate actions (and they've done so before under difference circumstances) is that Canada's household cycle is far more mature than in the US and hence so is about two-thirds of the economy given the weight on consumption and housing in GDP. The home ownership rate is far higher in Canada and at cycle highs, the debt service burden is much more strained, the debt-to-income ratio is at a record high and so are house prices. Hiking at a mature point in the household sector risks rolling it over with little else to drive growth.

Complementing this fuller cycle view is the still-accommodative nature of the BoC's operational framework for assessing the monetary policy framework. Using our latest forecasts for actual GDP growth and the BoC's forecasts for potential GDP growth, we still forecast the traditional output gap measure closing around mid-2018 as the BoC guided in the January MPR, while the newer measure of slack likely won't close until decade's end (chart 2). Persistent slack makes it challenging to reverse the declining trend in the BoC's three new(er) core inflation measures (chart 3). The BoC does not forecast these new core CPI measures, but it is likely to stand by its earlier forecast for headline inflation to hover around 2% next year and match the inflation target. The BoC is unlikely to foresee the economy slipping into material excess aggregate demand that would put upward pressure on its inflation target at any point during its forecast horizon.

It seems almost trivial in this fuller cycle sense to emphasize the latest data wiggles—even as said data has been highly mixed. For instance, job growth has been strong, but wage growth is barely over 1% y/y and therefore real wages are falling while hours worked have been weak. Consumption growth is solid but likely temporarily boosted by factors like a large jump in child benefit payments, but investment imploded over 2016H2 and the weakness in exports has already been noted. The latest Business Outlook Survey hinted at little evidence of capacity pressures, stable inflation expectations and strong investment intentions. Translating intentions into actual investment will take time and involves uncertainty, and while an investment recovery is a missing ingredient to more balanced growth, it would nevertheless potentially expand productivity capacity in disinflationary fashion. On both a fair and balanced reading of recent data and a longer cyclical perspective, the BoC can afford to be dovish next week.

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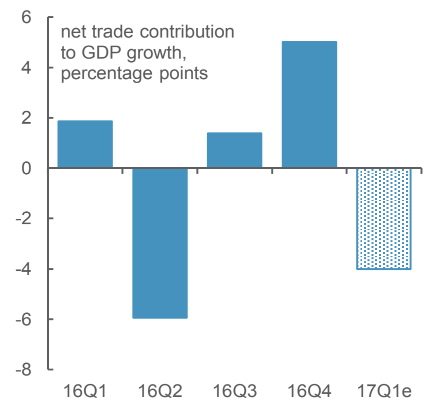
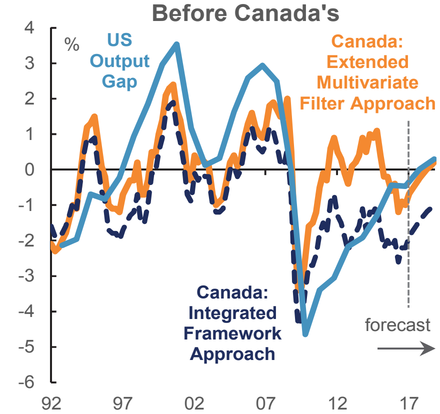
Chart 1 **Serial Frustration Continues**



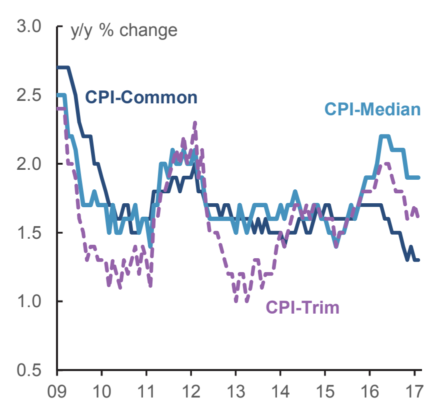
Sources: Scotiabank Economics, Statistics Canada.

Chart 2 **US Spare Capacity Gone Before Canada's**



Sources: Scotiabank Economics, Bank of Canada, IMF.

Chart 3 **Falling Canadian Core Inflation**



Sources: Scotiabank Economics, Statistics Canada.