December 6, 2017

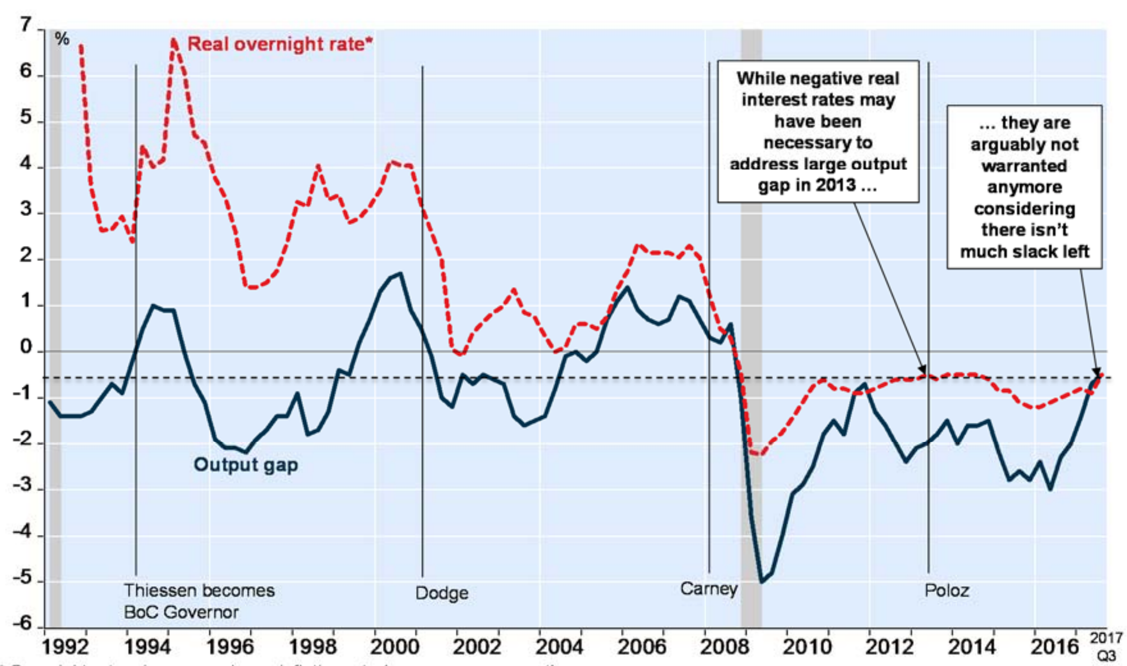
BoC keeps rate at1% but sees diminishing slack in labour market

To no surprise, the Bank of Canada left the overnight rate unchanged at 1.00%. The central bank acknowledged growth remain above potential in the second half of 2017 and recognized that the recent uptrend in core inflation reflects "the continued absorption of economic slack". While the central bank recognised strong employment growth and rising wages, it still sees some slack in the labour market "albeit diminishing".

Bottom line:

The Bank of Canada acknowledged the improvement in the labour market but still sees continuing slack "albeit diminishing" and maintained a more dovish tone than expected. While this statement did not set the table for a January move, one can't rule out such outcome if, as we think, the labour market remains firm, wage inflation continues to percolate, core inflation moves up gradually, and Q4 shows continuing momentum. It's possible that January's MPR shows growth upgrades to reflect recently announced fiscal stimulus at the provincial level. We continue to think that monetary policy is too loose. Indeed, as the chart below shows, one would be hard-pressed to find prior instances outside of a recession with a similar combination of a near-zero output gap and a negative real overnight rate. The Bank of Canada is facing an uneasy arbitrage in the coming months. How to adjust monetary policy when the unemployment rate has fallen to a 40-year low, and NAFTA remains a bag of uncertainties?

Canada: Are negative real interest rates still necessary?
Output gap (integrated framework) versus Real overnight rate*



* Overnight rate minus annual core inflation rate (common component)
NBF Economics and Strategy (data via Statistics Canada, Bank of Canada)

Stéfane Marion/Paul-André Pinsonnault

Here is the press release (sections highlighted by us):

December 2, 2017

The Bank of Canada today maintained its target for the overnight rate at 1 per cent. The Bank Rate is correspondingly 1 1/4 per cent and the deposit rate is 3/4 per cent.

The global economy is evolving largely as expected in the Bank's October Monetary Policy Report (MPR). In the United States, growth in the third quarter was stronger than forecast but is still expected to moderate in the months ahead. Growth has firmed in other advanced economies. Meanwhile, oil prices have moved higher and financial conditions have eased. The global outlook remains subject to considerable uncertainty, notably about geopolitical developments and trade policies.

Recent Canadian data are in line with October's outlook, which was for growth to moderate while remaining above potential in the second half of 2017. Employment growth has been very strong and wages have shown some improvement, supporting robust consumer spending in the third quarter. Business investment continued to contribute to growth after a strong first half, and public infrastructure spending is becoming more evident in the data. Following exceptionally strong growth earlier in 2017, exports declined by more than was expected in the third quarter. However, the latest trade data support the MPR projection that export growth will resume as foreign demand strengthens. Housing has continued to moderate, as expected.

Inflation has been slightly higher than anticipated and will continue to be boosted in the short term by temporary factors, particularly gasoline prices. Measures of core inflation have edged up in recent months, reflecting the continued absorption of economic slack. Revisions to past quarterly national accounts have resulted in a higher level of GDP. However, this is unlikely to have significant implications for the output gap because the revisions also imply a higher level of potential output. Meanwhile, despite rising employment and participation rates, other indicators point to ongoing – albeit diminishing – slack in the labour market.

Based on the outlook for inflation and the evolution of the risks and uncertainties identified in October's MPR, Governing Council judges that the current stance of monetary policy remains appropriate. While higher interest rates will likely be required over time, Governing Council will continue to be cautious, guided by incoming data in assessing the economy's sensitivity to interest rates, the evolution of economic capacity, and the dynamics of both wage growth and inflation.

Information note

The next scheduled date for announcing the overnight rate target is January 17, 2018. The next full update of the Bank's outlook for the economy and inflation, including risks to the projection, will be published in the MPR at the same time.

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BoC Policy Monitor

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