January 9, 2019

Oil price collapse gives BoC pause

The Bank of Canada left the overnight rate unchanged at 1.75% today. Explaining its decision to remain cautious, the BoC pointed to both international (US-China trade conflict) and domestic factors. It said that the oil price decline has “a material impact on the Canadian outlook”. The central bank expects a “temporary slowing in the fourth quarter of 2018 and the first quarter of 2019” that will open up the output gap.

In the Monetary Policy Report (MPR), the BoC lowered its 2019 Canadian GDP growth forecast by four ticks from 2.1% to 1.7%, but raised 2020 to 2.1% (from 1.9%). Last year’s (2018) growth estimate was lowered by one tick to 2.0% as the central bank cut a full percentage point from its Q4 estimate which now reads just 1.3% annualized. Growth in the first quarter of 2019 is estimated at just 0.8% annualized. Downgrades to 2019 were due to consumption, housing, government’s spending and business investment, which more than offset upgrades to trade. Forecasts of inflation were also lowered, not surprising in light of slower growth projections and lower oil prices, although the central bank says inflation will return to 2% “by late 2019”. Real gross domestic income is expected to rise only 0.9% this year compared to the 2% increase estimated in last October’s MPR.

The Bank of Canada says the output gap in 2018Q4 was between -1% and 0%. Potential GDP growth estimates were left unchanged. The neutral nominal policy rate (R-star) has also been left unchanged at 2.5-3.5%. Forecasts for world GDP growth were left unchanged at 3.4% for both this year and next. The BoC still expects the U.S. economy to grow 2.4% this year and 1.6% in 2020.

Press conference:

Governor Poloz was asked to clarify what the Bank means when it says that the policy rate will need to rise over time into a neutral range. He said the objective is to inject “ambiguity” about the timing of rate increases and to be intentionally vague so as not to suggest any pre-set course. The decision of when to resume policy normalization will be taken in light of upcoming data. According to the Bank, the Canadian economy’s deviation from full capacity will be temporary and not sufficient to materially affect the inflation outlook over the medium term. So while GDP growth is projected to be weak in 2018Q4 and 2019Q1, the Bank expects some acceleration afterwards. Governor Poloz suggested that underlying domestic demand indicators are probably going to look quite good over the coming months. Still, it may take 4 to 5 months before the Bank will have a better view and get confirmation from the data that policy is ready to move further towards neutral.

Bottom line:

The Bank of Canada’s no-change decision was widely expected. The central bank had to be sensitive to the 2018Q4 commodity price collapse and opted to not tighten monetary policy further. The 2019 GDP growth downgrade was not surprising either in light of a lower-than-expected savings rate and declining terms of trade (both of which will limit consumption this year) and oil production cuts in Alberta (which will temporarily weigh on 2018Q4 and 2019Q1 GDP growth). The BoC still says that the overnight rate will “need to rise over time into a neutral range”. But at this point, considering uncertainties with regards to the global economy and hence oil prices, as well as Governor Poloz’s comment in the press conference that it may take 4 to 5 months before the BoC gets a better picture of the underlying trend in the economy, we expect the central bank to remain in pause mode until the second half of the year.

Krishen Rangasamy/Paul-André Pinsonnault

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

January 9, 2019

The Bank of Canada today maintained its target for the overnight rate at 1 ¾ per cent. The Bank Rate is correspondingly 2 per cent and the deposit rate is 1 ½ per cent.

The global economic expansion continues to moderate, with growth forecast to slow to 3.4 per cent in 2019 from 3.7 per cent in 2018. In particular, growth in the United States remains solid but is expected to slow to a more sustainable pace through 2019. However, there are increasing signs that the US-China trade conflict is weighing on global demand and commodity prices.

Global benchmark prices for oil have been about 25 per cent lower than assumed in the October Monetary Policy Report (MPR). The lower prices primarily reflect sustained increases in US oil supply and, more recently, increased worries about global demand. These worries among market participants have also been reflected in bond and equity markets.

The drop in global oil prices has a material impact on the Canadian outlook, resulting in lower terms of trade and national income. As well, transportation constraints and rising production have combined to push up oil inventories in the west and exert even more downward pressure on Canadian benchmark prices. While price differentials have narrowed in recent weeks following announced mandatory production cuts in Alberta, investment in Canada's oil sector is projected to weaken further.

These developments are occurring in the context of a Canadian economy that has been performing well overall. Growth has been running close to potential, employment growth has been strong and unemployment is at a 40-year low. Looking ahead, exports and non-energy investment are projected to grow solidly, supported by foreign demand, the CUSMA, the lower Canadian dollar, and federal tax measures targeted at investment.

Meanwhile, consumption spending and housing investment have been weaker than expected as housing markets adjust to municipal and provincial measures, changes to mortgage guidelines, and higher interest rates. Household spending will be dampened further by slow growth in oil-producing provinces. The Bank will continue to monitor these adjustments.

The Bank projects real GDP will grow by 1.7 per cent in 2019, 0.4 percentage points slower than the October outlook. This revised forecast reflects a temporary slowing in the fourth quarter of 2018 and the first quarter of 2019. This will open up a modest amount of excess capacity, primarily in oil-producing regions. Nevertheless, indicators of demand should start to show renewed momentum in early 2019, leading to above-potential growth of 2.1 per cent in 2020.

Core inflation measures remain clustered close to 2 per cent. As expected, CPI inflation eased to 1.7% in November, due to lower gasoline prices. CPI inflation is projected to edge further down and be below 2 per cent through much of 2019, owing mainly to lower gasoline prices. On the other hand, the lower level of the Canadian dollar will exert some upward pressure on inflation. As these transitory effects unwind and excess capacity is absorbed, inflation will return to around the 2 per cent target by late 2019.

Weighing all of these factors, Governing Council continues to judge that the policy interest rate will need to rise over time into a neutral range to achieve the inflation target. The appropriate pace of rate increases will depend on how the outlook evolves, with a particular focus on developments in oil markets, the Canadian housing market, and global trade policy.

Information note

The next scheduled date for announcing the overnight rate target is March 6, 2019. 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 on April 24, 2019.

BoC Policy Monitor

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