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ECONOMICS: CANADA PERSPECTIVES

UNEASY BALANCE BETWEEN ECONOMIC OUTLOOK AND FINANCIAL STABILITY AFTER BOC RATE CUT

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The Bank of Canada (BoC) announced that it reduced its overnight rate by 25 basis points to 0.50% on July 15. The decision to cut official rates at its monetary policy meeting was a surprise to many and was entirely due to a reassessment of the economic outlook.

BoC Reassesses as Growth Outlook Reduced

Following the rate cut, the BoC now expects second-quarter real GDP to decline 0.5% and full-year growth to be only 1%—or roughly half the growth that was forecasted back in April. The substantial reduction in the growth outlook stems from three factors. First, incremental weakness in oil prices in the short and longer term has triggered a further reduction in planned investment spending in the energy and mining sectors. Second, the ongoing restructuring of China's economy and the negative feedback to global commodity demand has hurt many Canadian companies. And third, the failure of non-energy exports to rebound—even though the currency has been weak for an extended period of time—raises issues on competitiveness and future growth prospects (*Display 1*).

It is hard to argue with the BoC reassessment, especially the weak export sector. Indeed, our below-consensus-growth view on the Canadian economy was primarily centered on the lack of a competitive manufacturing sector. And, the transition from a housing- and consumption-led economy to one that is driven more by exports and investment would be very difficult to achieve without a significant weakening of the exchange rate.

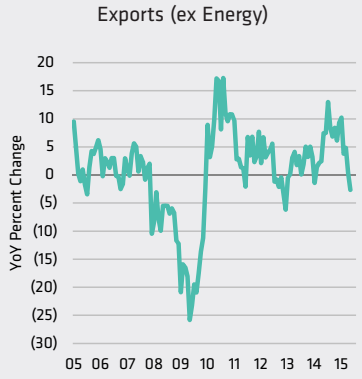
The BoC basically admitted as much in its July statement, but they also linked the decision to cut official rates to a delay in a return to full capacity and weaker inflation outlook as well: "The Bank anticipates that the economy will return to full capacity and inflation to 2 per cent on a sustained basis in the first half of 2017." This is slightly later than what was stated in the April report.

Inflation and Growth Concerns Cited

In a way, we were surprised by the decision to cut rates in July because of the risk on financial stability, which the BoC admitted remained very high given the record level of indebtedness of the household sector (*Display 2*) and the fact that housing prices are still rising at a relatively fast pace. Plus, the non-oil region more than offsets the weakness in house prices in the mining-related regions.

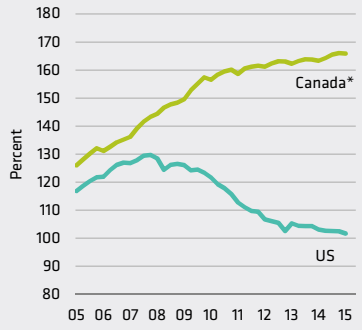
BoC Governor Stephen Poloz admitted that the decision to cut rates could increase financial vulnerabilities, but still felt the

Display 1
No Rebound in Export Growth



Through May 31, 2015
Source: Haver Analytics and Statistics Canada

Display 2
No Signs of Deleveraging in Canada



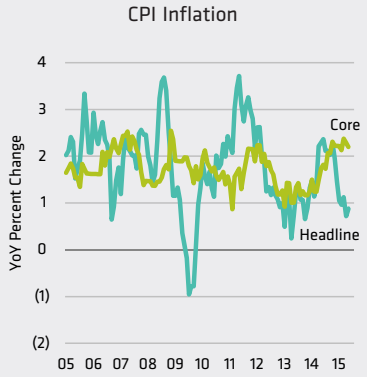
*Canada debt to 4Q moving sum of disposable income
Through March 31, 2015
Source: Haver Analytics, Statistics Canada, US Federal Reserve Board and AB

downside risks to economic growth and inflation outweighed the financial stability risks (*Display 3*).

Publicly, Poloz appears to be campaigning for even more currency weakness to help the economic growth and inflation transition in Canada (*Display 4*). In his opening statement, he actually stated that the prospect of an interest-rate increase in the US would be welcome, and although he linked it to the fact that it would mean US growth was faster, he also mentioned that monetary policy operates through different transmission channels, with long bond yields and the exchange rate being the most important. Poloz seems to be counting on further weakness in the Canadian dollar to help the country's economy turn around. And, he stated that if growth does not rebound as planned, the BoC has additional tools at its disposal.

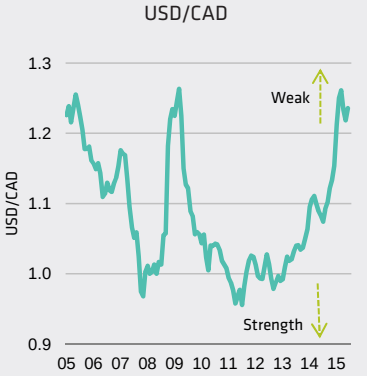
For now, we think our forecast of 1%–1.5% growth in 2015 still looks to be on track and expect the currency to trade in the 1.30 to 1.35 USD/CAD range in the second half of the year. ■

Display 3
Core Inflation Remains Sticky



Through May 31, 2015
Source: Haver Analytics and Statistics Canada

Display 4
BoC Banking on Currency Weakness to Help Turnaround



Through June 30, 2015
Source: Bank of Canada and Haver Analytics