TD Economics

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Release: BoC leaves overnight rate at 1.00% and preserves cautious tone

- As expected, the Bank of Canada (BoC) left its target for the overnight interest rate unchanged at 1.00% for a fourth consecutive meeting since September 2010.

- Today's statement was more dovish than markets expected, but broadly in line with our views. The BoC mentions that "the global economic recovery is proceeding broadly [as expected], although risks remain elevated". Recent geopolitical events were given a mention in their likely temporary support of higher commodity prices.

- In Canada, the BoC acknowledged that "the [recovery] is proceeding slightly faster than expected". By the same token, despite recent strong export growth, "the export sector continues to face considerable challenges from the cumulative effects of the persistent strength in the Canadian dollar and Canada's poor relative productivity performance". Inflation is said to be "consistent with the Bank's expectations" and "reflecting considerable slack in the economy".

- The boilerplate statement that the current level of the overnight rate "leaves considerable monetary stimulus in place, consistent with achieving the 2 per cent inflation target in an environment of significant excess supply in Canada" was maintained, as was the open-ended statement that "any further reduction in monetary policy stimulus would need to be carefully considered".

Key Implications

- In light of today's BoC statement, we still identify 19 July 2011 as the likeliest date at which it will next raise its policy rate. Those looking for a change to a more hawkish tone, particularly in the forward-looking guidance part of the statement were disappointed.

- Yesterday's release of GDP figures to close out 2010 show the economic recovery is proceeding more rapidly than anticipated by the BoC in its January forecast. By itself, this would argue in favour of raising the overnight rate sooner (April or May) rather than July or later.

- Moreover, real (inflation-adjusted) short-term interest rates near zero remain extremely accommodative. Nominal short-term rates would need to rise to at least 2% to get within reach of a more "neutral" level, which even conservative estimates place in a 3-4% range. On the face of it, with the output gap now on track to close as early as year-end 2011, the BoC would appear to be behind the curve. However, a number of other factors suggest that, in fact, the BoC is not behind the proverbial curve.

- First and foremost, inflationary pressures are subdued. Weak stateside demand and prices, a strong Canadian dollar, an unemployment rate still well above its pre-recession level, and well anchored inflation expectations are all lending a hand in keeping core inflation grounded. Core inflation was well below the 2% target at 1.4% in January. It will likely be even weaker in February and slightly below the BoC's forecast of 1.4% for Q1 as a whole.

- The BoC may also have low-balled potential growth, which would explain why stronger economic and job growth has not pushed inflation higher. Don't be surprised if revisions eventually show a larger output gap in 2010-2011, back on track to close by the end of 2012, as forecast by the BoC in January.

- Some downside global economic risks may have receded from the headlines in recent months, such as those associated with European sovereign debt or U.S. housing. Yet they linger in the background and can resurface at any time. Moreover, another source of risk – this time geopolitical – has come to the fore. Political turmoil in

North Africa and the Middle East has caused crude oil prices to surge. So far, this is based on fear more than actual disruptions in oil supply, and may not last unless the turmoil continues to spread. For many countries, a sustained bout of higher crude oil prices creates strong inflationary pressures. Not as much for Canada, however. The currency and terms of trade help contain this type of price pressure. Oil prices would need to head materially higher for a sustained period of time to threaten the global economic recovery. What's more, when such oil price spikes are not driven by demand, they rarely translate into lasting price pressures because they tend to choke off growth in oil-importing nations through demand destruction.

- In the wake of today's statement, markets will pare back bets that a rate hike is in the pipeline in April or May, thereby modestly selling off the short end of the yield curve and leading the CAD down a bit after it sat above USD 1.03 prior to the decision. All said, with the added consideration that the U.S. Federal Reserve is expected to bring QE2 to term by June, a bit longer pause for the BoC until a next hike in July still appears the fairest bet.

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