BBVA Research Flash

Canada

Monetary Policy Report October 2011

- **Inflation to slow considerably in 2012H1**
- **Growth forecasts for 2011 revised to lower edge of last consensus estimates**
- **Report indicates a longer hold for monetary policy than previously anticipated**

The Bank of Canada's (BoC) release today of its Monetary Policy Report reveals a strong shift from its July projections, with slower projected Canadian growth in 2011 and 2012, but higher growth in 2013. We previously regarded BoC's assumptions for 2012 US growth as too high and in today's report they are substantially revised (cut almost in half compared to July's forecast). The forecasts also incorporate a moderate US fiscal drag, similar to our expectations. However, BoC remains optimistic for US growth in 2013 and we regard this as likely to be a downside surprise for the central bank in the future. The Bank's expectations for world growth slow measurably in 2012, but include a soft landing for major emerging markets like China. The forecasts presented by the Governing Council indicate a certain amount of volatility in the near future for Canada in terms of both growth and inflation.

In particular, BoC revised its 2011Q4 growth number to 0.8% QoQ annualized from 2.9%. As a result, the average QoQ annualized growth rate projected by BoC for 2011 is 1.5%, close to our own last projection of 1.7%. However, our forecast was the second-lowest in last month's consensus survey and the closest to BoC's new forecast (although we expected Q3 to be rocky, whereas BoC expects Q4). There will therefore be considerable umbrage since BoC's new forecast departs so significantly from market expectations. The changes translate to lower 2012 YoY rates, but the QoQ annualized rate for 2012 is largely the same as in the July forecast. The main sticking point we foresee is that BoC expects Canada to shift into 3.0% QoQ annualized growth starting in 2012Q3 and lasting to the end of the forecast period. We expect average QoQ annualized growth to be lower than BoC's 2.6% and therefore for the output gap to be reduced slower than they currently expect. One part of BoC's revisions was the realization that the output gap is larger than they previously forecasted due to less GDP growth.

Turning to inflation, two of the main drivers affecting BoC's forecast are seasonalities and oil. The effects of harmonized sales tax and clothing increases are expected to wash out in the data over the next two quarters and headline CPI will fall from 3.0% YoY in 2011Q3 to 1.0% YoY in 2012. As such, core inflation will flirt with 2.0% and then remain below this level until 2013. This is also linked to BoC's oil forecast, which remains around 87dpb for several quarters. Within the report, the Bank discusses some of the issues with energy providers using different Brent and WTI mixes, which complicates the benchmark oil price used to figure energy-related inflationary pressures. These inflation forecasts are a significant development in BoC's outlook and are strongly related to their expectations for oil, seasonalities, and also their revised output gap estimation.

Today's Monetary Policy Report reveals a very cautious BoC that is prepared for negative external events. According to the Governing Council, slower external export demand, damaged domestic equity markets and lower commodity prices will impart a dampening effect on Canadian growth. With a larger output gap and continued external uncertainties, it is clear that monetary policy will be on hold for longer than we previously expected, with a next rate increase in 2013.

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