BBVA Research Flash

Canada

Bank of Canada Weighing Global Risks

- **Overnight rate remains at 1%**
- **Bank of Canada (BoC) statement suggests European contagion, slower North American growth risks have declined**
- **BoC appears more hawkish on inflation due to "marginally" improved growth and commodity price increases from geopolitical risk-premium**

The Bank of Canada (BoC) announced today that it will maintain its overnight target rate of 1%. The Bank's rhetoric in today's statement implies that the central bank views some growing upside risks to inflation. For example, the run-up in oil prices, which reflect the geopolitical risk premium stemming from the Iranian nuclear negotiations, and the continued strength in domestic spending represent an upside risk scenario to inflation in the near-term. However, the BoC stated "total inflation is expected, along with core inflation, to be around 2 per cent over the forecast horizon, reflecting the combination of modest growth of labour compensation, an economy operating around its potential over time, and well-anchored inflation expectation." Thus while growth prospects have improved and upside risks to inflation firmed, long-run expectations remain rooted.

On external and internal growth dynamics, the bank appears to have improved its outlook with regard to external headwinds, owing to decreased stress in the EU and better than anticipated US growth. Furthermore, the bank's emphasis on European financial contagion overhang has reversed since its January release, believing now that the expected loss from such an event has decreased and overhang on expectations abated. Thus, the growth outlook is "marginally" improved since January. However, on domestic conditions, the bank remains concerned about overleveraged households given statements such as "spending is expected to remain high…as households add to their debt burden, which remains the biggest domestic risk." Moreover, the Bank still expects net exports to contribute little to future growth given weakened foreign demand and ongoing exchange rate "competitiveness challenges," even though US activity has trended stronger. Thus, on balance, when factoring in possibilities of slowing emerging market demand, oil price shocks and continuation of global deleveraging, we maintain our expectation for a September 2013 rate increase, with both upside and downside risks now more balanced.

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