Canada Flash

April 2012 Monetary Policy Report

Following yesterday's interest rate announcement, which contained a shift in language towards "modest" adjustments to monetary accommodation, the Bank of Canada released today a detailed account of the Canadian economy in their quarterly Monetary Policy Report (MPR). In total, the message is clear; regardless of external risks, domestic demand is sufficiently buoying Canadian growth and thus strong accommodation may not be appropriate. This assertion comes with a new outlook for external demand that includes a smaller than previously forecasted contraction in Europe with a rebound in 2H12, decreased divergence of the Brent-WTI spread (supply shock due to geopolitical risk and glut in Cushing, OK), stable US growth, and slower but still robust emerging market demand. On internal dynamics, the Bank believes credit conditions for both households and firms are more favorable than in January and thus the risks of choking-off the recovery have declined. Moreover, with claims of firming inflation and a declining output gap it appears the bank is suggesting risks could be shifting more towards the upside. Given that Canada still relies heavily on external demand, any interest rate increase will necessarily depend on the global dynamics. However, it is clear that export performance, as seen by the BoC, is currently overshadowed by domestic demand conditions.

- **Easing credit conditions boosting financials and households**

  In terms of internal credit, the BoC believes that supply and price of credit to business and households is "very simulative." Both the Senior Loan Officers survey and Business Outlook survey improved from a perceived tightening in 4Q11 to easing in 1Q12. Furthermore, the effective rate of business and households are at what the bank perceives as sufficient levels. The boost in liquidity has also buoyed consumption, improved the equity performance of financial firms, and improved demand conditions in both government and corporate credit markets. Regardless of the positive contribution of enhanced liquidity, the bank remains cautious of over-stimulation as consumption is currently being partially driven by consumer debt. Thus, BoC continues towards a more cautious tone with regard to credit.

- **Oil price divergence a risk to interest rate policies**

  The BoC, in yesterday's interest rate announcement, alluded to inefficiencies in crude oil markets, in particular the price divergence between WTI and Brent. While minimally impactful thus far, it appears currently available distribution networks, supply distortions (geopolitical risks) and increased US production could attenuate the price distortions and ultimately threaten growth. Specifically, the price divergence is between Brent crude prices, which is what a majority of petroleum imports are priced at, and the WTI, which is the received price on a large portion of exports. The result is twofold. First, the rising input prices (Brent) adds to internal inflationary pressures, and, second, the price increases negatively impact external aggregate demand. As such, a scenario involving further price divergence would likely push the rate hike further into the future (assuming the commodity price effect on inflation is transitory).

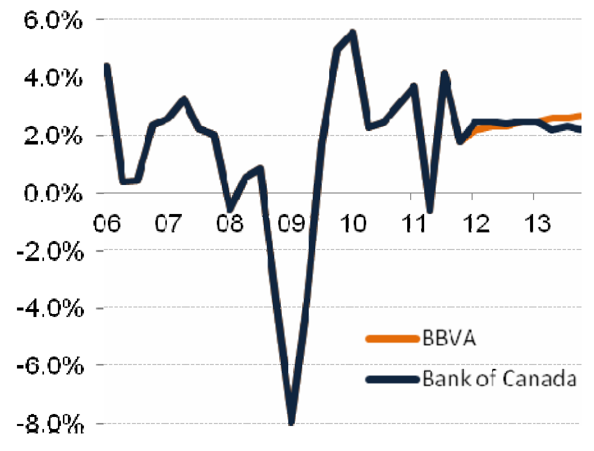
- **Domestic consumption to drive growth, inflation risks attenuated**

  According to the BoC, consumption will contribute 1.3pp to GDP over the next three years. Conversely, net exports are projected to only contribute 0.2pp and 0.1 pp in 2012 and 2013, respectively. Nevertheless, the growth in domestic consumption appears to be a sufficiently offsetting the decline in net exports over the forecasted period given the BoC is also anticipating the output gap to close to 0.4pp in 1Q12. The declining resource slack, however, has been a large contributor to recent inflation trends, according to the BoC. Conversely, the price effects of 2011 which include higher commodity prices and regional tax increases, are abating and suggest one-off factors are increasingly less at play. In total, the declining output gap and diminished external risk suggest the BoC will shift its focus to internal dynamics.

- **Currently external risks are balanced**

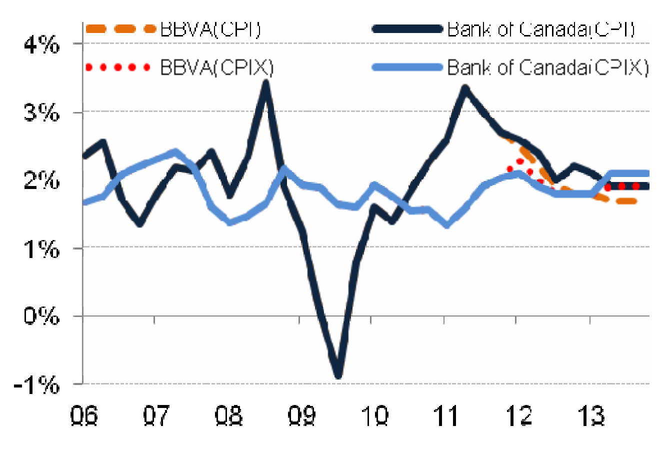
  The most dramatic shift in the BoC's tone came in regard to external headwinds. In the previous release much of the domestic story remained the same: consumption was robust, although fueled by increasing debt, most markets were sufficiently liquid and inflation was higher but within a comfort zone. This release, however, changed the tone considerably with regard to external demand and risks. For example, now expectations are for emerging markets to experience "stronger foreign demand, somewhat easier financial conditions and higher commodity prices"; for the US labor market improvements and accommodative monetary policy to promote stronger than anticipated growth; and for a less severe contraction in Europe. This shift in expectations from January suggests more evenly balanced external risks. Thus, if external risks remain balanced, internal dynamics will likely be the major influence on near-term interest rate policies.

Chart 1
GDP



Source: BBVA Research, Haver, BoC,

Chart 2
Inflation



Source: BBVA Research, Haver, BoC

Table 1
Bank of Canada and BBVA Forecasts (light blue= BBVA forecasts)

	2011	2012				2013			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	1.8	2.5	2.5	2.4	2.5	2.5	2.2	2.3	2.2
		2.2	2.3	2.3	2.5	2.5	2.6	2.6	2.7
Core Inflation	2.1	2.1	1.9	1.8	1.8	1.8	2.1	2.1	2.1
		2.3	2.0	1.8	1.8	1.8	1.9	1.9	1.9
Total CPI	2.7	2.6	2.4	2.0	2.2	2.1	1.9	1.9	1.9
		2.5	2.2	1.9	1.8	1.7	1.7	1.7	1.8
Brent	109	118	122	121	119	117	115	113	112
		114	126	124	120	110	105	105	106
BoC Rate	1.0	-	-	-	-	-	-	-	-
		1.0	1.0	1.0	1.0	1.0	1.25	1.25	1.25

Source: Haver & BBVA Research
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