Canada Flash

Bank of Canada (BoC) maintains that "some withdrawal" of monetary stimulus may be necessary, but reaffirms downside risks

In today's interest rate decision, the BoC reaffirmed their position that "some modest withdrawal of the present considerable monetary policy stimulus" may be needed. Unlike the last release, which suggested a decreased probability of external risks, this release highlighted the deterioration of external conditions including weakening emerging market demand and increased risks from Europe. Nevertheless, the BoC continued to stress robust — although possibly overheating — domestic consumption, particularly in the housing market. In short, this communication supports our expectation for a rate increase in 1Q13.

- **Global outlook bleaker**

  The optimistic growth forecasts of the BoC in 1Q12 were attached to the qualifier that Europe would continue to improve, emerging market demand would remain unchanged, and the US would continue to grow at a more robust pace. However, in June, fears of an EU dissolution increased, US growth was revised slightly downward, and emerging market demand slumped. Now that 1Q12 growth came in below BoC expectations and external conditions are deteriorating, the previous growth optimism appears unfounded. We expect the output gap will not close as fast as anticipated and given that inflation is also expected to dip below 2%, there is no reason to bias rate adjustments to the near-term.

- **Countervailing trends prompt wait-and-see approach for BoC**

  The wait-and-see communication from the BoC is likely a reflection of the disparate growth conditions. On one hand, domestic consumer demand remains robust; although, it has been less "balanced" than desired because housing activity was stronger than expected. Conversely, global conditions were weaker than expected, with a negative outlook in medium-term. Thus, the risks to overheating or stalling growth appear balanced with a slight dovish bias. However, the BoC is aware that their "considerable monetary policy stimulus" acts as an incentive for consumers to "add to their debt burden"; thus, their language implies that the bank is hesitant to ease policy further in the short to medium-run. Any adjustment to target funding rates is unlikely in 2012, barring a tail-risk event in Europe.

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