IMF urges Canada to continue stimulus

By David Parkinson
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The International Monetary Fund said Canada's economy is "coping well" with the fallout from the oil shock, but cautioned that both fiscal and monetary policy should keep their foot on the gas as the fallout from oil's collapse and, now, the devastating Alberta wildfires continue to cloud the country's economic fortunes.

"The Canadian economy and financial system overall are coping well," considering the depth of the impact of the oil slump on business investment, said the IMF's mission chief to Canada, Cheng Hoon Lim. The IMF estimated that oil-sector spending will decline about 30 per cent this year, on top of a 40-per-cent plunge in 2015 – about in line with the latest estimates from the Bank of Canada.

Ms. Lim made her remarks in a conference call with media, in conjunction with the international financial institution's release of its report on its annual consultation with Canada. The report included new forecasts that the Canadian economy will grow by 1.75 per cent in 2016 and 2.25 per cent in 2017 – similar to the Bank of Canada's most recent projections, issued last month, of 1.7 and 2.3 per cent, respectively.

The growth projections were produced before the Alberta wildfires that have forced mass evacuations and ground large portions of the province's huge oil sands region to a halt. Some economists have offered quick estimates of how deep the impact will be on Canada's economic growth; Royal Bank of Canada cut its second-quarter gross domestic product growth estimate to 1.5 per cent annualized, from 2 per cent, citing the fire impact on May's economic activity alone.

But, Ms. Lim said, "I think it's still a little early to have a definitive assessment" of the impact of the fires on Alberta's and Canada's economies. She added that any growth lost now could be offset by increased activity later in the year as the fire-affected region around Fort McMurray rebuilds from the disaster.

She also argued that added that if it turns out that the Alberta fires pose a deep and lasting hit to the economic outlook, "clearly there is room" in both Bank of Canada interest rates and in the federal government's budget to provide additional economic stimulus.

Indeed, the IMF's new report stresses that monetary policy "should stay accommodative" and fiscal policy "should be pro-growth" – advocating continued stimulation of the economy from both the central bank and the federal government. In both cases, the IMF indicated, Canadian policy makers have room for further stimulation "if downside risks materialize and the economy falters."

However, it cautioned that the central bank's interest rates "should not … solely bear the burden of supporting the economy, given potential financial stability risks associated with a low interest rate environment." The statement indicates that the agency is comfortable with Ottawa running budget deficits to help re-energize the economy, along with continued low interest rates from the central bank.

"The federal government's pro-growth 2016 budget is appropriate," the report said.

The IMF's forecast includes its estimate that the stimulus measures in Ottawa's recent deficit budget will boost real GDP growth by 0.5 percentage point in each of 2016 and 2017, "based on a conservative fiscal multiplier." That's about in line with estimates from both the Bank of Canada and the federal government

– which some economists have criticized as overly optimistic.

“If the economy takes a turn for the worse, additional fiscal easing should be considered, for which there is room,” the report argued. “The additional fiscal easing should be temporary, and could be achieved by bringing forward planned infrastructure spending or by temporarily cutting personal and corporate income taxes.”

“A more active role for fiscal policy will strengthen the overall policy mix, by reducing the need for further monetary easing and thus limit the scope for excessive risk taking in a low interest rate environment,” the report said.

To that end, the IMF said it remains concerned about the risks posed by Canada’s high debt levels tied to the housing market – especially if the Canadian economy were to take a sharp turn for the worse.

“A severe recession that triggers a sharp rise in the unemployment rate could destabilize housing markets, setting off adverse feedback loops in the economy and leading to greater financial stability risks. Given extensive government-backed mortgage insurance, the impact of a severe housing downturn on the federal fiscal position could be considerable and potentially limit the room for fiscal stimulus down the road,” it said.

The agency said that the macroprudential measures Canada has taken to cool housing-related debt have “been broadly effective in alleviating financial stability risks and reducing taxpayer exposure to mortgage finance.” But it did caution that “financial vulnerabilities have become more apparent” because of the oil shock, and warned that the country’s banks will have to increase their provisions for bad loans related to the energy sector.

The IMF also said that it believes that the Canadian dollar, which has been recovering in recent months after a deep decline, is now “modestly overvalued, relative to medium-term fundamentals and desirable policy settings.” But in the conference call, Ms. Lim clarified that the agency estimates this overvaluation to be quite small, “from zero to 5 per cent,” suggesting that she considered it a non-issue.

“I wouldn’t emphasize that,” she said.