Looming economic risks may temper Bank of Canada's optimistic outlook

By David Parkinson
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The Bank of Canada has spent much of this year showing an unshakable confidence that the Canadian economy was on track for better times ahead. Now might be as good a time as any to start to sound just a little shaken.

This Wednesday, the central bank delivers its latest interest rate decision as well as the quarterly update of its economic forecasts. While no one expects the bank to change its key rate, which has held at 0.5 per cent for the past year, observers will be paying keen attention to changes in the bank's view of how the economy is unfolding, as well as how the bank views the considerable risks that are now looming around its outlook.

Early in the year, as the country's battered energy sector suffered a renewed slump in prices, the central bank resisted growing calls for another interest rate cut to go along with its two cuts in 2015, instead expressing more optimism in an economic recovery than many observers considered warranted. It was betting on the federal government's increased spending plans to help offset the weakness in private sector spending. It was also keenly cognizant of the risks of exacerbating Canada's record household debt levels, and frenzied Vancouver and Toronto housing markets, by cutting rates and making borrowing even more attractive.

By the time the central bank issued its April forecasts, its optimism looked prescient. The economy had roared out of the gates in January, exports had surged to record levels, and gross domestic product growth was well ahead of expectations. The bank raised its economic forecasts, and projected that the output gap – the difference between the economy's actual output and its full capacity, a critical factor in deciding when interest rates need to rise or fall – would close by the second half of 2017, a bit sooner than it had previously forecast.

Since then, the stars have not exactly aligned in the economy's favour.

The Alberta wildfires slammed the brakes on what was already shaping up as a slow second quarter, pretty much assuring that the country's GDP shrank in the quarter. (We won't know for sure until the quarterly GDP statistics are released in late August, but the Bank of Canada essentially conceded this in its late-May rate decision statement.) The impact from the fires will be temporary, and the resumption of oil production and other economic activity in the region should fuel something of a GDP rebound in the third quarter, but the slowdown nevertheless has put the economy behind the schedule the central bank has laid out for the return to full capacity.

A critical component of the bank's outlook for improved growth this year, the export sector, has slipped into a funk. Last week's merchandise trade report for May showed that non-energy exports, by value, have fallen for four successive months. It may just be a temporary pause in an otherwise strong trend – after all, these declines came after non-energy exports hit an all-time high in January. But it certainly raises some questions about whether the non-energy export story, dependent on expectations of robust growth in the critical U.S. market, is as compelling as the Bank of Canada has maintained up to now.

And then there's Brexit. The British referendum result, calling for the country to exit the European Union, has thrown a bucket of ice-cold risk in the face of the global economic outlook. It's near impossible to quantify the impact of the climate of uncertainty generated by the vote. But the anticipated drag it will have on business investment and growth, not just in Britain and Europe but rippling throughout the global value chain, will at very least have a delaying effect on interest rate increases at central banks the world over – including those in the United States and Canada.

The question is how significant this effect might be. But caution alone would justify postponing rate hikes by a quarter or two.

Before the Brexit vote, the bond market was pricing in a 40-per-cent chance that the U.S. Federal Reserve would raise its key rate before the end of this year; after the vote, that fell to 15 per cent, and the market now isn't offering decent odds for a hike until at least the middle of next year. Royal Bank of Canada's economists, who before the vote had been predicting a Canadian rate hike by mid-2017, now don't expect any increase before 2018.

Indeed, if Brexit contributes to a delay in the Fed raising rates, that alone could provide a compelling argument for the Bank of Canada to lean toward a slower path for its own rates. Exports have benefited considerably from last year's deep declines in the Canadian dollar, and should continue to benefit from the currency's current competitive levels. But the loonie might face upward pressure if traders start to get the idea that there might be less of a gap between the timing of a U.S. rate hike and a Canadian one.

The Bank of Canada consistently professes that exchange rates are not a focus of its policy decisions, but the fact nevertheless remains that its goals for the Canadian economy are more achievable if it can keep Canadian currency expectations muted. (And it certainly wouldn't be the first time that Bank of Canada Governor Stephen Poloz was accused of talking down the dollar.)

With that in mind, the Bank of Canada would be more than justified on Wednesday to either ease off its economic growth forecasts and its projection for the closing of the output gap, or to at very least stress the decidedly downside risks to its forecasts. It might even want to drop a hint or two that a rate cut is not out of the question later this year if conditions take a turn for the worse.