# Bank of Canada cuts growth forecast as uncertainty mounts

By Bill Curry
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The Bank of Canada is lowering its forecast for economic growth this year amid disappointing export figures, weaker business investment both at home and in the United States and global uncertainty in the wake of Brexit.

The bank announced as expected Wednesday that it is keeping its overnight interest rate at 0.5 per cent.

The July Monetary Policy Report forecasts real gross domestic product growth of 1.3 per cent in 2016, which is down from the 1.7 per cent projected in April. Growth for 2017 is now projected to average 2.2 per cent, down from the 2.3 per cent forecast in April.

Bank of Canada Governor Stephen Poloz had previously said the Canadian economy would return to its potential at some point in the second half of 2017, but the bank now expects this closing of what it calls the output gap will occur "somewhat later" and "toward the end of 2017." It also cautioned that the timing of this is highly uncertain because of the challenges in forecasting the effects of Brexit – as well as the structural adjustments taking place in the Canadian economy – as growth shifts away from the energy sector in favour of non-commodity exports.

But despite the weaker growth outlook and rising risks, economists said the central bank's tone largely remained upbeat, with little change to the bank's bigger-picture view on how Canada's economic recovery is unfolding.

"With an eye on a fire-breathing housing market and core CPI consistently above 2 per cent, as well as awaiting the coming fiscal stimulus and still-friendly financial conditions, the Bank basically stayed on course today," said Douglas Porter, chief economist at Bank of Montreal, in a research note.

At a news conference in Ottawa, senior Bank of Canada officials explained why they remain optimistic about stronger growth on the horizon in spite of short term challenges.

"Our bottom line is that the underlying forces that underpin stronger growth in Canada are intact and the adjustment of the economy to lower oil prices is well under way," said senior deputy governor Carolyn Wilkins, who appeared with Mr. Poloz.

"Most importantly for Canada, there is good underlying momentum in the U.S. economy, even if the composition of US growth is somewhat less favourable for Canada than it was in April... All of this suggests that the weak start to 2016 was largely temporary."

The July report marks the bank's first comprehensive assessment of how the economic shocks of last month's United Kingdom referendum vote in favour of leaving the European Union and the Alberta wildfires will affect growth.

The fallout from the Brexit vote has highlighted the resiliency of the global financial system, according to the bank, but the negative effects will be seen in the form of trade and investment flows as well as a weakening of overall business confidence.

The impact on Canada is expected to be modest, with the bank estimating a 0.1-per-cent reduction in the level of Canadian GDP. Canada's direct trading relationship with the United Kingdom is relatively small, accounting for just 3.5 per cent of Canadian exports.

As for the wildfires in the Fort McMurray area that led to mass evacuations and temporary production shutdowns in the oil patch, the bank estimates real GDP growth was reduced by

about 1.1 percentage points in the second quarter as a result. However the return of oil production and rebuilding activity in the region is expected to more than offset that decline in the third quarter.

While oil prices have increased nearly $10 (U.S.) per barrel since April, the bank said prices are still below what is required for many oil producers to break even and are not high enough to create profitable new investments in oil sands projects.

“The Canadian economy continues to adjust to low commodity prices. The reallocation of investment and employment from the resource sector to the non-resource sector is progressing,” the bank stated in its report. “The expansion of activity in the non-resource sector will assert itself as the dominant trend in the second half of 2016 as the drag from declining investment in the energy sector wanes.”

“While Canada has faced its share of unanticipated bumps this year, most are expected to prove temporary and, thus, have not taken the Bank of Canada meaningfully off course,” said Toronto-Dominion Bank economist Brian DePratto in a research note. “That said, these bumps reinforce the expectation that the Bank of Canada’s foot will remain firmly on the accelerator, with the benchmark overnight rate likely to be held at 0.5 per cent for some time to come.”

On housing, Wednesday’s report said the sharp price increases in the greater Vancouver and Toronto areas could be driven by self-reinforcing expectations, making those markets more sensitive to an adverse housing shock.

The bank sets interest rates with the goal of keeping inflation between one and three per cent and aims for a two per cent midpoint target. The bank noted on Wednesday that total consumer price index inflation remains in the lower half of its targeted range. The bank’s forecasts for inflation have been revised slightly higher for the first three quarters of 2016 in comparison to the April projection.

CIBC economist Nick Exarhos pointed out that the bank is now using stronger language when it comes to concern over the Toronto and Vancouver housing markets, which would suggest the bank will be reluctant to cut interest rates further.

“The statement cites that financial vulnerabilities are ‘elevated and rising,’ with Vancouver and Toronto singled out. That’s a significant escalation in language from the last statement, which had mentioned risks ‘moving higher,’” said Mr. Exarhos in a research note. “Although still anemic growth rules out hikes any time soon, the stance on the housing market clearly sets a high bar to further easing from here.”