GDP report raises questions about the Bank of Canada's next move

By David Parkinson
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Until now, Bank of Canada Governor Stephen Poloz has stood defiantly in the face of Canada's slowing economy, insisting that he still plans further rate hikes as soon as the smoke clears. Friday's dismal economic growth figures may compel him to change his stance. With the economy in a stall, it's time to start considering whether the next rate move could be down rather than up.

Statistics Canada reported that real gross domestic product grew a puny 0.4 per cent annualized in the fourth quarter, the weakest quarter in 2½ years – and well below the Bank of Canada's most recent estimate of 1.3 per cent. That lowered growth for all of 2018 to just 1.8 per cent – again, short of the central bank's estimate of 2 per cent, and down sharply from the previous year's 3 per cent. December marked the third time in four months that the economy actually contracted.

The sobering news arrives as Mr. Poloz and his colleagues are in the midst of deliberations for next week's interest-rate decision. After three rate increases last year, the bank already put further hikes on hold in December; but Mr. Poloz has continued to insist – as recently as in a speech last week – that rates still needed to move higher "over time." The bank is universally expected to keep its key rate at 1.75 per cent again on Wednesday. But if the bank's brass aren't talking about taking that pause another step – removing that pure bias for eventual hikes and opening the door, at least a crack, for a rate cut – they should be.

The notion was probably on the minds of currency traders Friday morning, as they sliced nearly a full U.S. cent off the value of the Canadian dollar in the wake of the report. (The hectic sell-off was exacerbated by a pretty serious gaffe at Statscan, as the GDP report was posted on the agency's website nearly a half-hour before its scheduled release time of 8:30 a.m. ET. The agency blamed the premature release on a "technical issue," but hadn't provided any further explanation at the time of this writing.)

It's notable that the Bank of Canada's counterpart in the United States, the Federal Reserve, left open the possibility for rate cuts in the statement accompanying its most recent rate announcement at the end of January, by dropping its reference to the need for "further gradual increases" in rates. And it did so with an economy that grew a much stronger 2.6 per cent annualized in the fourth quarter, and is expected to grow 1.5 per cent in the first quarter – roughly double expectations for Canada.

The Bank of Canada's reluctance stems from its belief that Canada's slowdown largely reflects last fall's slump in Canadian oil prices and ensuing production cuts, the impact of which look to be only temporary. That may prove to be the case. Nevertheless, Friday's report suggests that the fourth-quarter GDP slump extends well beyond oil. It showed weakness in household spending, in business investment, in exports, in manufacturing and construction. Evidently, oil is not the only problem.

The Bank of Canada had already expected the first quarter of 2019 to be even weaker than the last quarter of 2018. That's because the biggest shoe to drop in the oil sector's slump – Alberta's deep government-imposed cuts to the province's oil output – didn't take effect until Jan. 1. Taken together with the surprising weakness in the fourth quarter, we could well

be looking at a two-quarter period with essentially no growth. It wouldn't take much to tip it over to a contraction.

Faced with that reality, the central bank may need to at least reconsider its commitment to marching rates higher. Perhaps the bank was premature in assuming that it could withdraw stimulus, and that the economy was ready to stand on its own feet. Or perhaps global economic conditions have eroded to the point where that is no longer the case. Perhaps the so-called neutral rate of interest – Mr. Poloz's stated goal for rates, at which they are neither stimulating nor constraining the economy – is lower than the central bank has been assuming, and we're already very close to neutral. Regardless, it will have to acknowledge that with growth even further below capacity than it had thought, the economy will have more slack in it than expected – a compelling reason in itself for the bank to step back from talk of rate hikes.

If the Bank of Canada were to follow the Fed's lead, and remove from its rate-decision statement the explicit reference to the need for further rate increases, it wouldn't necessarily signal that a rate cut is on the table – but it would at least take the bias toward a rate increase off the table. It would give the bank more flexibility to move straight to a rate cut should some unforeseen shock hit an economy already teetering on the edge of contraction, to provide a bit of timely stimulation.

In the no-growth economy where we now find ourselves, that may be ammunition that the bank will want to have at the ready. Even if it never has to use it.