Bank of Canada sees longer, deeper economic slump, casts doubts on future rate hikes

By Barrie McKenna
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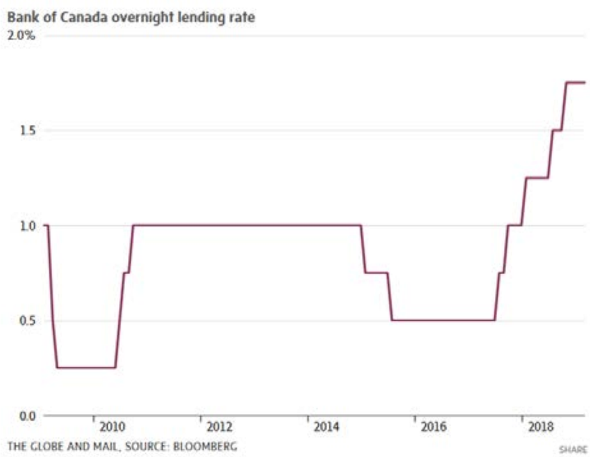
A suddenly gloomier Bank of Canada is warning of a longer and deeper economic slump, raising serious doubts about its repeated promise to keep raising interest rates.

The central bank kept its benchmark rate unchanged Wednesday at 1.75 per cent and said that Canada's economy will be significantly weaker in the first half of 2019 than it forecast just two months ago.



The shift in tone moves Bank of Canada Governor Stephen Poloz a step closer to shelving entirely a plan to raise rates in the months ahead.

Mr. Poloz had "little choice but to water down" his rate-hike warnings in the face of slowing global and Canadian growth, said Avery Shenfeld, chief economist at Canadian Imperial Bank of Commerce.

Barring a sudden economic rebound, "further rate hikes in 2019 are all but off the table," Brian DePratto, an economist at Toronto-Dominion Bank, said in a research note.

Mr. Poloz may not be ready to say so explicitly, but financial markets are already anticipating his next move could be rate relief. According to Bloomberg, the probability of a cut in the coming months has jumped to nearly 10 per cent from zero before Wednesday's central-bank statement.

Slower growth also means federal Finance Minister Bill Morneau may be tempted to spend a little more cash to stimulate the economy in his March 19 pre-election budget – even though the government will have less tax revenue to do work with.

The Bank of Canada's view of where the economy is headed keeps shifting. As recently as late January, the central bank was insisting the slowdown was temporary – a "detour," as one top bank official put it. Speaking at the World Economic Forum in Davos on Jan. 23, Mr. Poloz told CNN that pessimism about the global economy was "overdone."

The bank has a more sombre take now. The slowdown that began at the end of last year was "sharper and more broadly based," the bank said in a statement that accompanied its latest rate decision. That has created additional slack in the economy, it says.

Sébastien Lavoie, chief economist at Laurentian Bank Securities, said the central bank is now "adjusting to the fading momentum."

The Canadian dollar fell about half a cent in the wake of the bank's announcement, trading at 74.46 US cents.

Trade figures released Wednesday underscore how low oil prices have battered Canada's export-dependent economy, pushing the trade deficit to a record high. Statistics Canada reported that the trade gap swelled to $4.59-billion as the value of exports tumbled on weak crude prices.

Also on Wednesday, the Organization for Economic Co-operation and Development slashed its forecast for Canadian growth this year to 1.5 per cent, from 2.2 per cent. Canada's economy grew at an annual pace of just 0.4 per cent in the fourth quarter of last year. That is nearly a full percentage-point slower than what the central bank expected.

The Bank of Canada blames "multiple" factors for its new and much darker outlook, including trade tensions and a deeper global slowdown.

"While the sources of moderation appear to be multiple, trade tensions and uncertainty are weighing heavily on confidence and economic activity," the bank said.

The central bank acknowledged "progress" in ongoing U.S.-China trade negotiations. Reports suggest both sides are prepared to remove tariffs on hundreds of billions of dollars of each other's exports. Other problems remain unresolved, including Brexit, U.S. ratification of the U.S.-Mexico-Canada Agreement, and U.S. steel and aluminum tariffs.

The bank said the economic stall justifies keeping its key interest rate below the estimated neutral range of between 2.5 per cent and 3.5 per cent for now. That is the level where rates neither speed up nor slow economic activity. "Given the mixed picture that the data present, it will take time to gauge the persistence of below-potential growth," the bank said.

But unlike the U.S. Federal Reserve, which has acknowledged that it could move rates in either direction, the Bank of Canada is still talking about future rate increases.

The bank's current forecast of modest 1.7-per-cent growth in 2019 is headed for a downgrade. The slowdown in Canada's economy has been dramatic – from 3-per-cent growth in 2017, to 2 per cent in 2018 and weaker still this year. The bank's more downbeat outlook is expected to be reflected in the bank's next quarterly forecast, due out April 24, coinciding with its next rate decision.

Economists say the Bank of Canada has been slow to recognize that the economy was decelerating as it pursued a policy of raising rates. The bank has hiked its key rate five times since mid-2017, to 1.75 per cent, but has been on hold since last October.