Bank of Canada holds rates steady, trims short-term forecasts as global worries mount

By David Parkinson

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The Bank of Canada warned that the Canadian economy is under growing pressure from the deepening global economic malaise, as it trimmed its short-term growth forecasts but once again stopped short of cutting interest rates.

In its first rate decision following a lengthy self-imposed quiet period during the federal election campaign, the central bank held its key rate steady at 1.75 per cent, unchanged over the past year. But in a generally downbeat statement, it warned that the global economic outlook "has weakened further," and "Canada has not been immune to these developments."

"Growth in Canada is expected to slow in the second half of the year to a rate below its potential," the bank said. In its quarterly outlook report released in conjunction with the rate decision, it cut its third-quarter growth estimate to 1.3 per cent annualized – from 1.5 per cent in its previous forecast, in July – and projected the same 1.3-per-cent pace for the fourth quarter.

The bank noted that the global slowdown, fuelled by deep uncertainty over the U.S.-China trade dispute, has been "most pronounced" in business investment and exports – which is where its impact is surfaced in the Canadian economy. The bank expects that both of these components of the economy "are likely to contract" in the second half of the year, though it believes growth will return in 2020. It added that the global slowdown is weighing on commodity prices, adding further pressure to Canada's economy.

But the central bank also noted that despite the commodity weakness, the Canadian dollar has remained strong against its U.S. counterpart and "has strengthened against other currencies". That's a consequence of the Bank of Canada maintaining stable rates while other central banks have cut.

The Canadian dollar fell on the comments to 76 US cents from 76.45 US cents prior to the announcement.

"The door was left ajar for a cut down the road," said CIBC chief economist Avery Shenfeld, who still believes the Bank of Canada will have to cut its rate early next year. "Their conclusion is that they can stand pat, but will be watching for the potential for contagion from manufacturing and capital spending into other segments of the economy that have been providing support."

For all of 2019, the bank raised its growth forecast to 1.5 per cent from 1.3 per cent, reflecting a short-lived growth spurt of 3.7 per cent in the second quarter, fuelled by temporary factors. But it trimmed its 2020 and 2021 growth projections to 1.7 per cent and 1.8 per cent, respectively, from the July forecasts of 1.9 per cent and 2 per cent.

The bank also expressed renewed concerns about household debts, as weak global bond markets drove down market interest rates over the summer and sparked a new wave of mortgage borrowing.

"The bank continues to monitor the evolution of financial vulnerabilities in light of lower mortgage rates and past changes to housing market policies," it said.

Nevertheless, it believes that the Canadian economy is still operating close to its full potential, particularly outside the energy sector, and that the small output gap that remains will inch closed over the next two years. It added that the labour market remains strong and wage growth is picking up, and that consumer spending and housing show solid strength. For those reasons, the central bank continued to hold its key interest rate steady, despite rate cuts at the U.S. Federal Reserve and other leading central banks in recent months.

But the bank's Governing Council – the decision-making body made up of Governor Stephen Poloz and his deputies – has grown more concerned about how long Canada's broader economy can ward off the global pressures.

"Governing Council is mindful that the resilience of Canada's economy will be increasingly tested as trade conflicts and uncertainty persist," the bank said. In considering future interest-rate policy, it said, "the bank will be monitoring the extent to which the global slowdown spreads beyond manufacturing and investment."

The bank's concern over the global trade risk was evident in its quarterly Monetary Policy Report, in which it dedicated a special section calculating the potential damage from an ongoing U.S.-China trade war and a resulting deepening global slowdown. "The effects on Canada could be significant," it said. It estimated that such a severe global slump could sap about 4.5 per cent from Canada's real gross domestic product by the end of 2021, and could knock 15 per cent off the value of the Canadian dollar.

However, it added, "a global macroeconomic policy response" – in the form of rate cuts and fiscal stimulus – "could greatly reduce the degree of slowdown."