Canadian economy slows, but BoC likely to hold rate

By David Parkinson
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Canada's real gross domestic product ground out 1.3-per-cent annualized growth in the third quarter as the weight of global trade wars dragged the economy back to Earth after a high-flying second quarter, but strong demand at home gave economists cause for cautious optimism.

Statistics Canada said weakening exports and falling inventories let the air out of growth, which had spiked to 3.5 per cent in the second quarter, the strongest in two years. The third quarter ended meekly, as September real GDP grew just 0.1 per cent month over month, at the low end of economists' expectations.

But economists took solace in a rebound in domestic demand in the quarter – up 3.2 per cent annualized – as household consumption, residential construction and business investment all accelerated. And they suggested that some elements of the third-quarter slowdown were temporary, as oil production disruptions and the General Motors Co. strike contributed to the weakness in inventories and exports.

"A moderation of Canada's GDP growth was always in the cards after unsustainable gains the prior quarter. But the GDP report was arguably better than expected," Krishen Rangasamy, senior economist at National Bank of Canada, said in a research report. "Domestic demand fired from all cylinders."

The third-quarter GDP report was the last major economic indicator before the Bank of Canada's interest-rate decision next Wednesday. Despite the slowing economic pace, the bank is widely expected to hold its key rate steady at 1.75 per cent, where it has stood for the past 13 months.

Economists suggested that the central bank will be encouraged by the strong domestic demand, as well as surprising strength in business investment, which on a global level has been hurt badly by the deep uncertainty created by the U.S.-China trade war. Non-residential business investment surged 9.5 per cent annualized in the quarter.

The overall third-quarter GDP growth rate of 1.3 per cent was exactly in line with the Bank of Canada's most recent estimate. The bank has also forecast 1.3-per-cent growth in the fourth quarter.

Still, this was the third time in the past four quarters that the economy's pace has been below the Bank of Canada's estimate for so-called potential output growth – the pace at which the economy's capacity to produce goods and services is increasing. With GDP growth expected to be no better in the fourth quarter, the implication is that the economy's excess capacity, often referred to by economists as "slack," is expanding, as actual growth isn't keeping pace with capacity growth. That slack will be a key consideration as the central bank ponders whether it will need to ease interest rates in the coming months.

"The big picture is that growth was a bit below potential in the quarter and over the past year. Given that [third-quarter growth] was right on the BoC's expectation, the result further reduces the already low odds of a rate cut next week. But the mild reading leaves the door ajar in the event of a significant downside surprise in coming months, especially from the trade front," Bank of Montreal chief economist Doug Porter said in a research note.

While economists not long ago believed the Bank of Canada could be prepared to cut its rate as early as January, the consensus now is that a cut is unlikely before the second half of next year – if at all.

“The [economic] data so far has been consistent with the narrative that we will muddle through 2020,” said Frances Donald, chief economist at Manulife Investment Management. She added that the concerns recently voiced by the bank about the impact of rate cuts on already record-high household debt is a signal that “there is an extremely high bar to cut rates.”

“We’d need to see a complete breakdown in growth before they would believe the benefits would outweigh the risks,” she said.

In conjunction with the third-quarter report, Statscan also released revisions to GDP data for the previous three years – including an upgrade to 2017 and 2018 growth, to 3.2 per cent and 2.0 per cent, respectively. Statscan also revised sharply upward its calculations of Canadians’ household savings rate, pegging it at 3.2 per cent – nearly double its previous estimates. Avery Shenfeld, chief economist at Canadian Imperial Bank of Commerce, said the higher savings estimates suggest that households have “a bit more room" for further consumption growth than previously thought.