Bank of Canada cuts rates as coronavirus delivers ‘negative shock’

By Bill Curry and Matt Lundy
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The Bank of Canada cut its key interest rate by 50 basis points Wednesday in response to the “material negative shock” of the COVID-19 virus.

The bank lowered its target for the overnight rate to 1.25 per cent, down from 1.75 per cent. The last time the bank announced a rate cut was in 2015.

The move comes one day after G7 finance ministers and central bankers pledged coordinated action in response to the virus. Shortly after Tuesday’s G7 statement, the U.S. Federal Reserve cut its key rate by 50 basis points, to a range of 1 per cent to 1.25 per cent.

In a news release Wednesday, Bank of Canada officials said much has changed since its last interest rate decision in January.

“Before the outbreak, the global economy was showing signs of stabilizing,” the bank said. “However, COVID-19 represents a significant health threat to people in a growing number of countries. In consequence, business activity in some regions has fallen sharply and supply chains have been disrupted.”

Economic fallout from the virus has also led to lower commodity prices and a decline in the value of the Canadian dollar.

“It is likely that as the virus spreads, business and consumer confidence will deteriorate, further depressing activity,” the bank said.

Shortly after the decision, traders were pricing in a 75-per-cent chance the bank will cut rates again at its April 15 meeting.

As coronavirus fears have ramped up, investors have fled to safety in the bond market, pushing yields – which move opposite to prices – to historic lows. The U.S. 10-year Treasury has tumbled below 1 per cent for the first time ever, while Canada’s five-year bond yield, which influences mortgage rates, has ebbed to around 0.8 per cent, its lowest since 2016.

“The Bank of Canada didn’t wait to see the patient ailing before delivering a dose of preventative medicine, but where it goes from here is a matter of epidemiology rather than economics,” Avery Sheneld, chief economist at CIBC Capital Markets, said in a research note. “Like the rest of us, [the Bank] will be watching for news on both the virus and the economy, but it’s reasonable to assume a further 25 [basis point] cut in April, with the rest of this year’s story being dependent on which virus scenario plays out.”

Beyond the virus, the bank listed other factors as contributing to weaker growth. The expected boost from recent resolutions to trade disputes in North America and between the U.S. and China have not materialized.

“In addition, rail line blockades, strikes by Ontario teachers, and winter storms in some regions are dampening economic activity in the first quarter,” the bank said. “In light of all these developments, the outlook is clearly weaker now than it was in January. As the situation evolves, Governing Council stands ready to adjust monetary policy further if required to support economic growth and keep inflation on target.”

“We’ve seen central banks lay down their cards, and now we’ve got to see the government,” said Beata Caranci, chief economist at Toronto-Dominion Bank.

Ms. Caranci suggested fiscal stimulus could take the form of targeted tax breaks for hard-hit industries.

"It doesn't need to be a blanket approach," she added. "It needs to be really thoughtful, and most importantly, it needs to be swift. This is not something you want to be debating for months at a time."

With world interest rates already near historic lows, central bankers have limited room to act in response to a major economic shock like COVID-19. As a result, the international response may need to rely more heavily on fiscal measures – such as tax cuts or new spending – to boost economic growth.

Finance Minister Bill Morneau, who is preparing the Liberal government's 2020 budget, said through a spokesperson this week that federal finances are in a position to provide extra support for the economy if necessary.

The Prime Minister's Office announced Wednesday that a new eight-member cabinet committee focused on COVID-19 will be created and that it will be chaired by Deputy Prime Minister Chrystia Freeland. The committee has a mandate to monitor both the health and economic impacts of the virus and to consider "all possible measures" to prevent and limit its spread in Canada.

Mr. Morneau is a member of the new committee. On Wednesday morning around 11 am eastern, he hosted a conference call with his federal and provincial counterparts to discuss the economic implications of the virus.

U.S. Treasury Secretary Steve Mnuchin was more specific this week, pointing to support for small business and increased spending on infrastructure as potential fiscal measures that could be adopted in Washington if fiscal stimulus is required.

RBC senior economist Josh Nye said a rate cut was expected but markets had not fully priced in a reduction of that size.

"With today's statement leaving the door wide open to further easing, we still think the Bank of Canada is likely to cut in April in addition to today's larger-than-expected move," he said in a note. "But it's the response from other policymakers, particularly fiscal and health authorities, that could do more to cushion the blow as the coronavirus outbreak intensifies."

Bank of Canada Governor Stephen Poloz, whose seven-year term expires in early June, has repeatedly pointed to concerns over elevated household debt levels as a factor for resisting an interest rate cut. Bank officials did not speak publicly Wednesday, but Mr. Poloz is scheduled to deliver a speech and take questions from the media in Toronto Thursday.

Bank of Montreal Chief Economist Doug Porter noted that Wednesday's decision coincides with signs of strength in the Canadian housing market, particularly in Toronto.

"Clearly the bank is making a big trade off here, deciding that the risks of a virus-driven slowdown are much higher than the risks of a raging housing market," he said in a note.