Bank of Canada assumes a “decidedly neutral” policy stance

Our Take

Markets were prepared for the Bank to leave the overnight rate at 0.5% today however they were less certain about how they would characterize the outlook. Ever cautious, policymakers highlighted risks to the outlook and the persistence of economic slack although now expect output gap will close sooner than they did in January. The updates to their forecasts included a boost to Q1-2017 real GDP growth 3.8% from 2.5% following January’s surprisingly robust performance. This upgrade looks to be largely responsible for the bump up in the Bank’s 2017 growth projection to 2.6% from 2.1%. Conversely, the Bank downgraded its forecast for 2018 to 1.9% from 2.1% with the newly minted 2019 projection coming in at 1.8%, although growth will exceed potential in both years.

The key take-aways:

- Material slack exists although the estimate of the output gap was 0.75% at the end of the first quarter, markedly below January’s 1.25% estimate for the end of 2016
- The economy’s potential growth rate has been lowered to account for weak investment though is expected to gradually recover from 2017’s 1.3% estimate
- Underlying inflation and wages remain subdued and the headline rate is projected to hold around the 2% target over forecast horizon
- Economic growth has been stronger than anticipated but the composition uneven. More moderate gains are expected and the drivers of growth will transition and be more broadly based going forward. The key driver of the 2017 forecast upgrade was robust housing market activity in Q1.
- Given the uncertain outlook about shifts in trade policy, the Bank’s projections incorporate “at least some of the adverse impact of elevated uncertainty” including a 0.2 ppt cut to export growth and a 0.5 ppt hit to investment in both 2017 and 2018.

The Bank incorporated the string of recent strong reports into its near term forecast however remains reluctant to extrapolate this strengthening. Rather the report highlights that temporary factors underpinned the uptick and concludes that it’s “too early” to say the economy will stay on this firmer growth trajectory. That said, the Bank pulled forward the absorption of current slack in the economy to the first half of next year. Today’s update shows growth running above potential in 2018 and 2019, implying the economy will shift into excess demand. However given the risk that external uncertainties and the attendant downward impact on growth will play out, there is little focus on this. Should these pressures fail to materialize, however, the current outlook implies policy will need to tighten.

Today’s report aimed to balance the recent strengthening in growth and potential headwinds associated with shifting trade policies leading the Governor to characterize the Bank’s stance as “decidedly neutral.” As a result, we continue to expect the overnight rate will remain at 0.5% in 2017.

Dawn Desjardins, Deputy Chief Economist (416) 974-6919, dawn.desjardins@rbc.com
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