BoC follows Fed’s lead with 50 basis point cut

At its scheduled meeting the day after the Fed’s emergency rate cut, the Bank of Canada followed the Fed’s lead and lowered its overnight rate by 1/2 percent to 1.25%. That was at the upper end of market expectations—for our part, we had revised our call to a 25 basis point reduction in March and again in April. While the Fed’s sizeable cut may have forced the BoC’s hand to some extent, it’s also likely that Governing Council opted for a larger move to get ahead of what it called “a material negative shock to the Canadian and global outlooks” from COVID-19. The bank noted that business activity has fallen sharply in some regions (outside of Canada) and supply chains have been disrupted. Resulting declines in commodity prices and tightening financial conditions will weigh on the domestic economy, and as the virus spreads, the BoC said it’s likely that lower business and consumer confidence will further depress activity.

Alongside its rate cut, we think the BoC ‘said the right things’ in an effort to shore up confidence. The policy statement clearly left the door open to additional easing, noting the bank “stands ready to adjust monetary policy further if required.” It also said it “will continue to ensure the Canadian financial system has sufficient liquidity” and coordinate with other G7 central banks and fiscal authorities. Compared with the Fed a day earlier the differences were subtle, but we think the BoC’s apparent readiness to lower rates further and/or supply liquidity was the kind of message investors wanted to hear. It didn’t seem to have a sustained impact on markets, though.

BoC ignoring household vulnerabilities?

We expect the BoC will act on its guidance and lower the overnight rate again in April (this time by a more conventional 25 basis points). There is risk of further easing, but as with the Fed we think other policymakers—including fiscal authorities—will need to step up to the plate to ease the impact of the outbreak and any containment measures. Deputy Prime Minister Freeland is chairing a coronavirus cabinet committee, and Finance Minister Morneau said the government will provide support to Canadians who have to be quarantined. Details have been light, though, and it’s unclear whether a more fulsome plan will be held off until the upcoming federal budget (likely late-March or early-April). Easing the burden on monetary policy is desirable given already elevated household vulnerabilities, even if—as Governor Poloz argued in the case of a confidence shock—lower interest rates “will actually help to stabilize the housing market, rather than contribute to froth.”

More transitory disruptions hit Canada’s economy

The COVID-19 outbreak was a key driver of the BoC’s decision to lower rates—particularly the size of the move. But a softer growth backdrop outside of potential coronavirus effects was also a factor. While GDP growth in Q4/19 was in line with the BoC’s expectations (coming in at a three-and-a-half year low of 0.3%) it noted the composition was different with both business investment and exports weakening. The central bank had been encouraged by stronger investment in Q3/19 but that was fully retraced in Q4/19, and Statistics Canada’s annual survey of capex intentions showed private investment was expected to increase by just 1% this year (the slowest since 2016).

Canada’s economy also continues to be beset by transitory factors. A Canadian rail strike, US auto strike, pipeline shutdown, and early winter on the Prairies all trimmed Q4/19 growth (though we agree with the BoC’s assessment that growth would have been below 1% even without those factors). In Q1/20, we think rail blockades that lasted more than two weeks in February—disrupting shipments across the country and leading to complaints from businesses and layoffs at some rail operators—shaved about 0.3 ppts off annualized GDP growth. Teachers’ strikes in Ontario and winter storms also weighed on activity. For a central bank that was already contemplating easing, a sluggish start to the year would likely have prompted a rate cut (we had said April) regardless of the coronavirus outbreak. Adding in the anticipated effects of the outbreak and containment measures (again, these estimates are subject to a high degree of uncertainty) we think Canadian GDP won’t see much of a rebound in Q1/20 (+0.8% annualized) before growth slows again in Q2/20 (+0.3%). Even with an assumed return to near-2% growth in the second half of the year, GDP for 2020 as a whole would be up just 1% from last year.

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