Five ways
that 2017 left its mark

As we head into 2018 we thought it would be helpful to reflect on five of the trends from 2017 that will have a bearing on the economic outlook for 2018 and beyond.

Outside of the NAFTA-related turmoil, which we have written on elsewhere, the biggest and most noticeable surprise likely came from the world of the so-called crypto-currencies as prices for the dominant player, Bitcoin, went vertical through the course of the year. The meteoric rise has left many wondering if crypto-currencies will prove to be kryptonite for some investors. While many things can be said about crypto-currencies – including that they are not currencies – one should separate the object from the technology underlying it which has a very promising future.

Unlike some asset markets, consumer price inflation has been consistently surprising to the downside around the globe. Global supply chains, excess labour market capacity and low inflation expectations have kept inflation in check. For Canada another factor also appears at play – competition in the retail space, first in brick-and-mortar and now online.

The low inflation environment has been reflected in financial markets as longer term interest rates were little changed through 2017, contributing to a flatter yield curve. The Bank of Canada contributed to the flatter curve by moving overnight interest rates up twice in an effort to get in front of any inflationary pressures down the road. The flatter yield curve this late in the business cycle has many worried about the potential of a recession though we see such worries as misplaced.

Rising interest rates along with a number of regulatory moves has finally turned the housing market over though we still expect a cooling rather than a collapsing. Demand indicators have softened which have taken some of the steam out of prices but a sustained cooling in some of the hotter markets will await more supply which has not yet been the focus of policy makers.

Outside of cooling the housing market the other policy focus of the federal government has been to further stimulate the economy. This pro-cyclical fiscal policy comes at expense of balanced budgets which have been either the actual or aspirational goal at the federal level for decades. A fiscal plan based on deficits as far as the eye can see reduces the fiscal flexibility of the government and creates risks that taxes will move higher. This shift at the federal level combined with a number of provincial initiatives and a U.S. administration that is moving taxes lower erodes Canada's relative competitiveness.

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1 A new asset class is born as investors fall in love with crypto-currencies

2017 has been a remarkable year for crypto-currencies, *whose combined market value skyrocketed from just under US$18 billion in early January to almost half a trillion in mid-December.*

***Caveat emptor! Crypto-currencies* don't act as a medium of exchange or store of value but the underlying technology has the potential to transform financial services.**

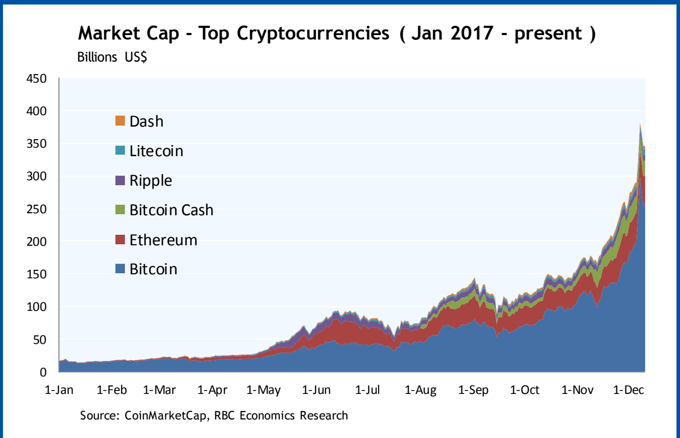
Bitcoin led the pack, accounting for some 60% of the total, although the crypto-currency market also diversified. Bitcoin's made-in-Canada rival, Ethereum, moved from relative obscurity in January (then valued at some US$700 million) to more than US$42 billion in mid-December. The top 99 crypto-currencies behind Bitcoin also saw their combined market share triple.

Is the crypto-currency surge the opening act of a new economic disruption or a fad? *Sceptics, including several at the apex of global finance, have characterized it as a speculative bubble centred on an asset class that lacks intrinsic economic value—i.e. crypto-currencies are not backed by public or private guarantees or collateral, and do not in and of themselves generate new goods and services.*

Advocates point to what they see as the bigger story: the underlying blockchain technology's potential to transform financial services by reducing intermediation costs, speeding transactions and strengthening transparency. They say blockchain will give entrepreneurs and consumers greater ability to personalize the way they raise and deploy capital, conduct payments and manage savings.

The need for a policy response has become more urgent. *Governments, regulators and central banks are working to understand and manage the macro-prudential, market conduct, consumer protection and security issues raised by the emergence of crypto-currencies. 2017 brought several key issues to the fore:*

- *Are crypto-currencies money? The Bank of Canada's Senior Deputy Governor Carolyn Wilkins recently suggested that they are not, in that they do not fulfill the primary purposes of money as a medium of exchange or store of value. If crypto-currencies become more money-like, what will it mean for the sovereign role of central banks in managing the money supply, setting interest rates and controlling inflation?*



- *Is the crypto-currency marketplace safe for consumers? Some US$300 million in value in a major crypto-currency was accidentally lost this year due to software glitches. Canadian securities regulators are paying attention to the types of frameworks that will be needed to manage crypto-currencies responsibly. For instance, the OSC approved an "initial coin offering" (ICO) in October that waived certain requirements under its "regulatory sandbox" approach to fin-tech innovation, while still generally considering coin offerings as securities (and to which securities law would apply).*

- *Can governments regulate the crypto-currency and blockchain financial ecosystem and not stifle innovation? Recently, China curtailed crypto-currency exchanges, whereas Japan recognized Bitcoin as an official form of payment. As the pre-financial crisis experience shows "bad innovation" is possible however Canada risks losing out if it fails to nurture an ecosystem that evolves into a foundational aspect of the future economy.*

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2 What's driving inflation has become increasingly complicated

Growth in Canadian consumer prices slowed in 2017 even as strong economic growth has left the economy butting up against long-run capacity limits. Consumer prices should rise as the economy approaches capacity, labour markets improve, and growth in consumer spending begins to outstrip supply. So why hasn't that happened this time?

If inflation is weak for reasons that have nothing to do with demand – as seems the case now – keeping monetary policy too stimulative for too long runs the risk of boosting asset prices instead.

Is the problem a lack of demand?

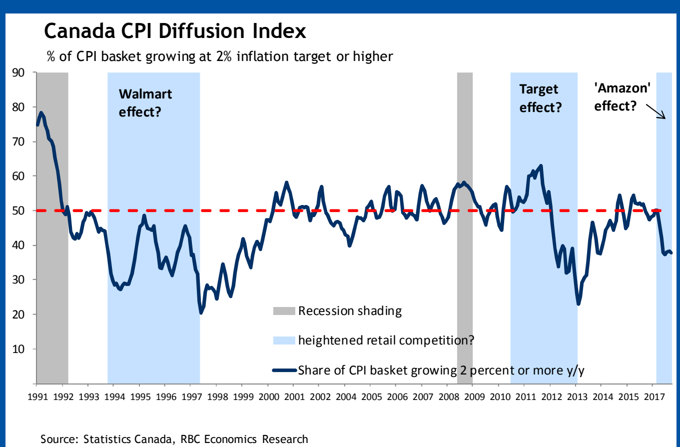
No. Consumer spending hit its highest share of GDP since 1965 in 2016. The 4.2% per-quarter average increase in spending in the first three quarters of 2017 was the strongest stretch since before the 2008/09 recession. Sales of motor vehicles are on track to easily set an all-time annual sales record in 2017… for a fifth consecutive year. Given rising household debt levels, the larger concern is that households are spending too much, not too little.

'Transitory' factors?

Inflation lags the economic cycle, so underperformance to-date could in part simply be a result of past rather than present economic weakness. Short-run price trends also often have nothing to do with the health of the economy. 'Transitory' factors like government-mandated electricity price cuts in Ontario this year, for example, aren't a reflection of current consumer demand.

The 'Amazon' Effect?

It is also worth noting that the periods with the most broadly-based 'disinflation' in Canada over the last few decades were not during recessions but rather when competitive pressures were particularly intense. That included the expansion of Walmart into Canada in the latter half of the 1990s and the more recent attempted expansion of Target.



One theory is that competition from online retailers may just be the latest form of retail competition to weigh on Canadian price growth. Growth in online retailing has been shockingly strong. 'E-commerce' sales have averaged 39% above year ago levels in 2017 to-date compared to a 6½% increase in 'brick and mortar' store sales. The share of sales coming from Canadian retailers online is still very low – just 2½% in the monthly retail sales data – but the threat to traditional in-store sales seems pretty clear.

What does it all mean for monetary policy? Can we have our cake and eat it too?

It is tempting to argue that low inflation – whatever the cause – means central banks are free to leave interest rates lower for longer. We would add a simple point of caution. If inflation is weak for reasons that have nothing to do with consumer demand – as seems the case now – keeping monetary policy too stimulative for too long runs the risk of unintentionally boosting asset prices instead. There hasn't been a significant consumer price inflation problem in Canada – or most other advanced economies – since the early 1990s. There have, nonetheless, been periods of significant economic weakness, often tied in one way or another to an asset price bubble. Think 2006 U.S. house prices, 2009 Greek government bonds, or 1999 internet stocks. The obvious concern in Canada is that low interest rates have stoked unsustainable demand for housing in some regions and contributed to rising household leverage. Yes, inflation is important and central banks are right to worry about it but so is financial stability.

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3 Two rate hikes in Canada were a big surprise. But so is the flattening yield curve

A flat yield curve is often seen as a harbinger of recession. So were this year's rate hikes a policy mistake? We don't think so.

The Bank of Canada's two rate hikes were a big surprise. *At the beginning of the year we thought the central bank would hold interest rates steady throughout 2017—they had, after all, weighed another rate cut toward the end of 2016. But the Canadian economy's strong performance through mid-year prompted a stark change in tone from the Governing Council and they followed through with back-to-back rate increases in the third quarter. Rather than focus on this shift in monetary policy, we'd like to point out* **another interest rate story that stood out this year—the flattening yield curve.**

If you'd told us that the Bank of Canada would raise rates twice and maintain a tightening bias, we would have been **surprised to see 10-year bond yields closing out 2017 below 2%***—up less than 20 basis points from where they started the year. The yield on 2-year government bonds, in contrast, has jumped alongside the bank's policy rate, doubling this year to around 1½%. That leaves the spread between the two at its narrowest in a decade. A flat yield curve is often seen as a harbinger of recession, when markets think central banks will have to start easing monetary policy to combat a slowing economy. So were this year's rate hikes a policy mistake that the Bank of Canada will soon have to reverse? We don't think so. There are a few reasons why longer term interest rates have remained low this year—none of which point to an impending recession.*

Lack of inflation is weighing on nominal bond yields. *For an economy that is now running at its longer run capacity limits, inflation remains surprisingly subdued. As a result, markets are pricing in a relatively low inflation premium on longer term bonds. Even with oil prices hitting a 2½-year high, investors continue to bet inflation will run below the Bank of Canada's 2% target for some time.*

Canada's yield curve flattened significantly this year...

Source: Bank of Canada, RBC Economics Research

Markets are adjusting to a lower 'neutral' policy rate. *In April, the Bank of Canada once again marked down their estimate of the policy rate that is neither stimulative nor contractionary in the longer run—they now think 'neutral' is somewhere between 2½ and 3½%. It also sounds like they don't plan on getting there anytime soon. The bank is concerned that rising interest rates will have a greater impact on the economy than in the past due to high household debt levels. Translation: fewer hikes are needed before monetary policy moves from accommodative to tight. So relatively low longer term bond yields don't necessarily reflect an expectation that policy is set to ease—just that rates won't have to increase much in the coming years.*

Other central banks keep buying assets. *Sure, the US Federal Reserve started tapering reinvestment in 2017. But the very gradual process means their balance sheet will remain sizeable for years to come. Meanwhile, the European Central Bank and Bank of Japan continue to expand their quantitative easing programs, putting additional downward pressure on term premiums globally. As long as large central bank balance sheets keep markets awash with liquidity, the markup for longer term bonds is likely to remain low—even in countries like Canada where QE isn't playing a direct role.*

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4 Canada's housing market finally starts to cool, but for how long?

In August, Canada's housing market finally embarked on the long-elusive 'landing' this year. Well, in some parts of the country at least. And it took forceful intervention by policymakers to get it to lose altitude.

The fundamental question is whether these policies are the most effective in getting housing markets in balance. Policymakers took aim at housing demand but should concentrate more of their efforts on supply.

2017 was mostly the story of Ontario—and more precisely the Greater Toronto Area and nearby cities. The year started in a very uncomfortable spot. Frenzied bidding wars were commonplace. Market dynamics were perverse: the more prices rose, the more buyers came in (afraid of being priced out) and sellers stayed out (earning a good return by just waiting). Prices skyrocketed by 30% year over year, which clearly threatened the stability of the market.

Vancouver was in this very situation a little less than year earlier. And part of the response from the BC government came in the form of a 15% tax on homes purchased by foreign nationals. This intervention sent a strong signal to all speculators who ran quickly to the sidelines. Prices moderated—reaching single-digit rates of increase by the middle of 2017.

This past April, it was Ontario government's turn to step in. It took a page from its BC counterpart by introducing a 15% tax on non-resident speculators but also presented 15 other measures addressing issues on both the demand and supply sides of housing. The GTA market reacted swiftly to the Fair Housing Plan. Listings surged. Home resales plummeted between April and July. In just a few months, the GTA market was back in balance. Sanity returned. Prices began to moderate. A modest rebound in activity since August tells us that the market isn't in a death spiral. It's been a healthy correction.

Yet Vancouver's experience this year teaches us that the effect of this type of policy intervention wears off over time. Home resale activity in Vancouver picked up again since spring and prices recently re-accelerated somewhat.

The rebound in activity since August in the GTA may be an early sign that the effect of the Fair Housing Plan is wearing off too. Could this be the extent of the market's landing or just a burst ahead of the regulatory tightening that comes into effect January 1, 2018?

Time will tell but a more fundamental question is whether these policies are the most effective in getting housing markets in balance. Before speculative behavior became a primary source of heat, it was a shortage of supply—especially of low-rise units—that put a fire under both markets. Policymakers at the provincial and municipal levels put forth various initiatives to address supply issues in the past year, from taxing empty units to curbing short-term rentals, expediting housing development approval and punishing developers 'sitting' on land approved for development. It's too early to tell if these measures will be successful. Tackling the supply side of the market takes longer to have an impact. Certainly, the tightening of conditions in Vancouver since mid-year suggests that some obstacles remain.

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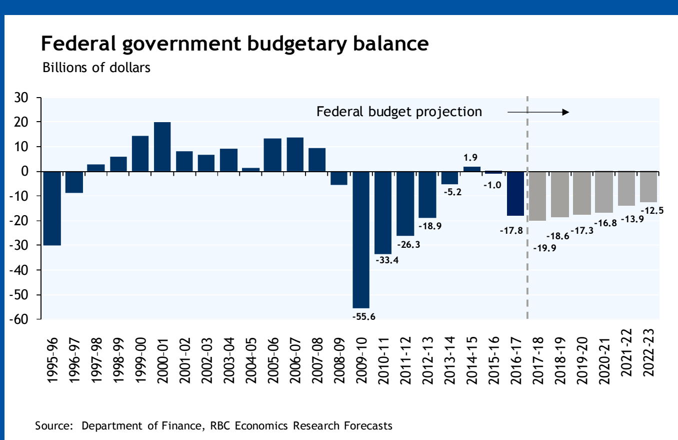
5 What's the real cost of an unanchored federal fiscal policy?

Every Canadian fiscal plan since the 1990s has included either an explicit or aspirational goal of returning to budget balance—until now. While our fiscal house is on a much more solid foundation than it was then, there are many reasons to worry about a plan that involves deficits as far as the eye can see. One of the biggest: what it means for Canadian competitiveness.

In hindsight, we should have spent more time worrying about how we would harm our competitiveness...sometimes the bigger threats are from within.

The economy is currently pressing up against capacity limits which suggests a pro-cyclical fiscal stance is neither needed nor desired as it raises inflationary risks and potentially crowds out private sector activity. The risk of such policy is that it puts additional upward pressure on interest rates. The Bank of Canada raised interest rates this year by 50 basis points which by their calculations translates into a hit to Canadian growth of about ½% -- exactly the magnitude the federal government estimates their actions added to growth. Policy-makers in Ottawa are moving in opposite directions right now.

The bigger worry, however, is what the "deficits forever" projections mean for Canadian competiveness. The large spending plans underlying the deficit profile suggests the risks for Canadian taxes are to the upside in the years ahead. We have already seen the move to higher personal income taxes at the federal level which, combined with provincial changes leaves marginal tax rates above 50% in most provinces, will make it more challenging to attract the best and brightest in the global talent competition. The launch of federal government's pan-Canadian framework for carbon pricing is intended to be revenue neutral at the federal level but the provinces see the initiative to take more money out of the economy and allocate as they see fit. This year the four provinces that have launched carbon pricing will raise about $5 billion, double the revenue take from only two years ago.



Higher personal taxes and rising carbon pricing combined with minimum wage hikes, increased corporate taxation and high electricity rates in some provinces all put additional pressure on the competitiveness of Canadian businesses. A year ago the worry was about what the new U.S. administration would mean for the relative competitiveness of Canadian businesses vis-à-vis the U.S. In hindsight, we should have spent more time worrying about how we would harm our competiveness...sometimes the bigger threats are from within.

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