

ECONOMIC VIEWPOINT

Is the Bank of Canada Running Out of Arguments?

Concerned about signs of fragility in the Canadian economy, and especially the U.S. protectionist threat, the Bank of Canada (BoC) has taken a particularly cautious tone since the fall. Governor Stephen Poloz has even, on a number of occasions, suggested that a rate cut should not be ruled out. However, on either economic growth, inflation, labour market or housing dynamics, economic indicators have surpassed expectations and quite persistently. This *Economic Viewpoint* looks into whether a change of tone is on the horizon for the BoC. In our opinion, it may be that it recognizes some improvement in the outlook, but it still has good reasons to be cautious.

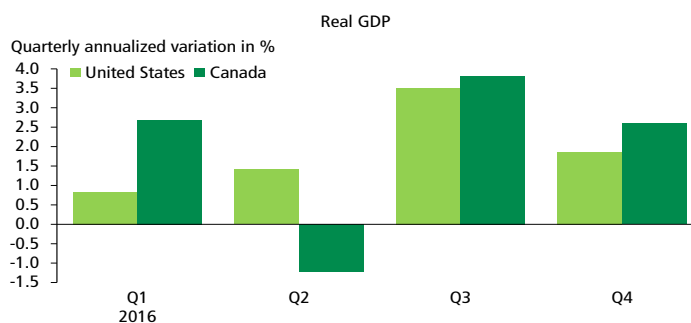
The decision by the Federal Reserve (Fed) to raise its policy rates yesterday was hardly controversial, especially with the stellar performance of the labour market in recent months. In contrast, in Canada, the BoC has maintained a fairly dovish posture. This position nonetheless seems increasingly questionable. The BoC reiterated its rather pessimistic penchant in its latest statement issued on March 1st. It noticeably downplayed some of the more positive outcomes observed recently. The data nonetheless continued to surprise positively subsequently, to the point that investors wonder whether this evidence is not overwhelming enough to force the BoC to take a more neutral stance. After all, if even Mario Draghi gives himself to a little more optimism these days, what would prevent Stephen Poloz from doing the same?

A Canadian Economy That Impressed Recently...

The good news has tended to accumulate recently. Real GDP grew better than expected in the fourth quarter, with an annualized rate of 2.6%. In fact, Canadian growth surpassed that of the United States in all quarters of 2016, except for the second, which was tainted by forest fires in Alberta (graph 1). In the labour market, the divergence theme against the United States was highly defensible at the end of 2016, but job creation exceeded consensus expectations for six consecutive months. The 6-month average of job creation had even tightened to 40,000 in January, an unprecedented level since the crisis. Full-time job creation has improved dramatically in recent months, mirroring the U.S. trend (graph 2), and the unemployment rate of 6.6% sits at the lowest level trough since the crisis (tied with January 2015).

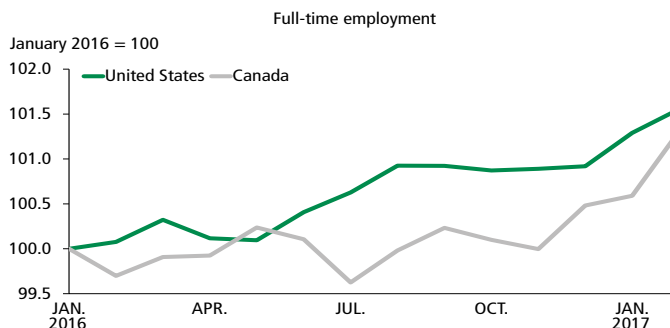
On the inflation front, the underlying inflation measures analyzed by the BoC are below target, but not significantly. If the output gap tightens faster than expected, these measures could well

GRAPH 1
Canadian growth exceeded U.S. growth in nearly every quarter of 2016



Sources: Datastream and Desjardins, Economic Studies

GRAPH 2
Canadian full-time job creation has been catching up



Sources: Bureau of Labor Statistics, Statistics Canada and Desjardins, Economic Studies

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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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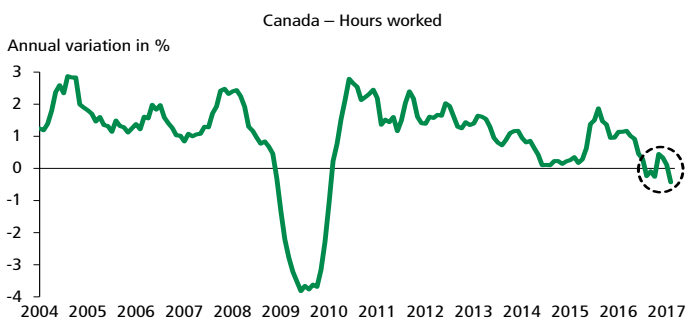
converge towards the 2% target in the not too distant future. Then there is the uncomfortable issue of housing. References to preoccupying household imbalances have all but disappeared from the BoC communiqué since the tightening measures announced by the federal government last fall. However, six months have gone by, and the Toronto market is beginning to be labelled as a bubble. There is speculation that a possible announcement of new macro-prudential measures by the provincial government will be announced.

The BoC does prefer for these risks to be addressed this way, rather than by monetary policy, but this does not mean that it does not bear some moral-suasion responsibility. If recent developments prompt BoC officials to assume that mantle again, it will for all intents and purposes represent the death knell of the easing bias that appeared in October and was reaffirmed in January.

... But Still a Lot of Work To Do

One cannot necessarily assume a significant shift in the BoC's messaging as granted, as there are a number of issues it should continue to stress. One is the weakness in hours worked in Canada. Hours improved in February, with a monthly increase of 0.2%, but the pace of -0.3% year-on-year is undeniably disappointing (graph 3). There is thus a marked divergence between dynamics in employment and in hours. Hours worked are nonetheless important because they are the measure of labour input used in many conventional models. In addition, the February *Labour Force Survey* has also shown that hourly wages are moving at an annual rate of just 1.1%, which is below inflation.

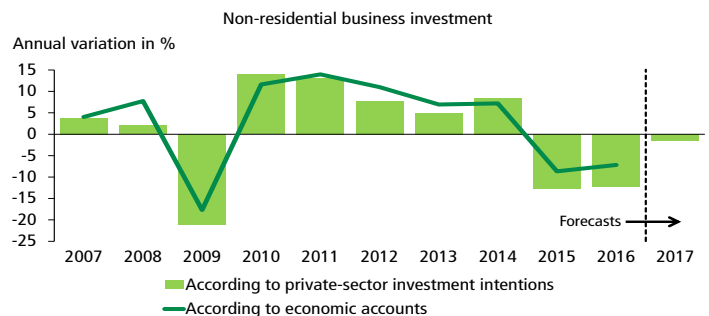
GRAPH 3
Preoccupying trend in hours worked



Sources: Statistics Canada and Desjardins, Economic Studies

Another aspect that remains unsatisfactory is private investment. Statistics Canada's annual survey of investment intentions revealed that they remain downward in the private sector, although less so than in 2015 and 2016 (graph 4). However, the element that leaves pensive is the most diffuse character of weakness. In 2015 and 2016, cuts in investment budgets in

GRAPH 4
Business investment could contract for a third consecutive year



Sources: Statistics Canada and Desjardins, Economic Studies

the energy sector accounted for much of the decline. In 2015, 55% of sectors increased their spending, and in 2016 it was half. By contrast, according to intentions unveiled for 2017, intentions are up in only 35% of sectors. The expected increase in public investment will help offset this weakness. However, the sustainable growth idealized by the BoC implies an enhanced contribution from private investment and a simultaneous moderation of the contributions from households and real estate. Success still seems a long way off on this front.

In terms of international trade, although net exports made a strong contribution to GDP growth in the fourth quarter, this was mainly due to one-off factors. Real exports increased in only two of the five months to February. Compared to the previous two years, the currency was not as supportive in 2016. As the BoC pointed out, the Canadian dollar appreciated against most currencies last year, including those of countries competing in the U.S. market. This trend has nonetheless reversed somewhat since January.

The Biggest of Imponderables

Above all, the protectionist movement in the United States remains the main concern. The threat, even to Canada, has not disappeared convincingly. Since the inauguration day, the U.S. administration's rhetoric has fluctuated between reassuring comments about maintaining trade relations with Canada and, somewhat inconsistently, a strong prioritization of American interests. The proposed Border Adjustment Tax remains controversial. Even though the President and his Treasury Secretary have expressed some reservations about this key element of the Republican Blueprint, it would be foolish to assume that Washington is somehow predictable. A Border Adjustment Tax as outlined by the Republicans would severely hamper the competitiveness of Canadian exporters. This would come on top of the erosion in tax competitiveness for Canadian companies, with the reforms that are on the horizon in Washington. A significant depreciation of the currency would be required to mitigate all these effects.

Conclusion

The BoC would be disingenuous not to adjust its tone with respect to some of the recent macro dynamics in Canada, but that being said, there are still valid sources of concerns to be found when scratching below the surface. Meanwhile, the trade policy risks are very real, and the BoC cannot afford carelessness on this file. The passage of a Border Adjustment Tax would likely usher in monetary easing in Canada, regardless of the latest statistics, if only for preventative purposes (as the Bank of England did last summer in the wake of Brexit). For these reasons, while Stephen Poloz may acknowledge some of the recent developments, he might not be ready to jettison his easing bias just yet. We shall find out more decisively on March 28th, when he delivers his next speech.

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