Economic Viewpoint
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Five factors that could persuade the Bank of Canada to cut rates

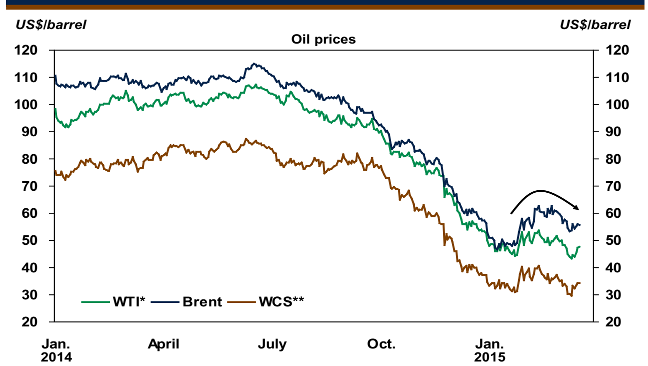
The Bank of Canada (BoC) surprised in January when it announced a rate cut by invoking taking out some insurance, something its risk management framework permits. However, it also surprised in March by standing pat and indicating that a single cut of 25 basis points offered all the requisite insurance, in the face of a macroeconomic shock deemed serious. As it now stands, if macro conditions turn out to be consistent with the scenario formulated by the BoC, all suggests it will leave rates unchanged, likely until well into next year. However, in the current context, one cannot rule out scenarios of further rate cuts. In this *Economic Viewpoint*, we review five risk factors that could prompt the BoC to ease further. Obviously, there are also risk factors that could lead to a faster normalization in rates. However, in the short term, we judge the risk of further cuts to take more importance than the opposite scenario.

After keeping its policy rates untouched for 52 consecutive months, the BoC surprised in January by announcing a rate cut. A few weeks later, amid solidified convictions that another rate cut would be enacted in March, Governor Stephen Poloz once more stunned markets by telegraphing status quo. The BoC has repeatedly affirmed that the oil shock would carry net negative implications for growth. However, the decision not to reduce rates at the March meeting implies that from the BoC's perspective, a cut of only 25 basis points will be capable of mitigating the apprehended consequences of the oil price decline. The central bank is thus conveying the message that conditional on macro dynamics unfolding in a manner reasonably consistent with its forecasts, there shall be no need for further monetary stimulus. However, forecasts are naturally vulnerable to risks, and the materialization of some of these could persuade the BoC to cut rates again. We review some of these risks.

1) A NEW STRETCH OF WEAKNESS IN OIL PRICES

The evolution of oil prices is a critical variable for Canadian monetary policy given the role it plays in the Canadian terms of trade. The surprise decision to cut interest rates in January was predicated on the principle of an insurance policy, to counter the negative effects of the fall in prices on the Canadian economy. A new leg down could thus prompt the BoC to take out more insurance. Between mid-January and early March, oil prices have kept in a relatively narrow range. The price of a barrel of Brent has stood at an average of around US$50, from January 15 to March 6, a level that does not necessarily call into question the assumption of US$60 retained by the BoC concerning the annual average. However, recent weeks have been characterized by a new phase of weakness (graph 1). Global production has shown little respite despite extremely low prices. Recently, the International Energy Agency (IEA) and the Organization of Petroleum Exporting Countries (OPEC) warned about the possibility of another price collapse amid storage capacity depletion. Other factors could adversely affect the price, for example a more pronounced-than-expected demand slowdown from some major consuming countries such as China, or even the United States.

Graph 1 – Oil prices have weakened somewhat recently



* West Texas Intermediate; ** Western Canada Select.
Sources: Bloomberg and Desjardins, Economic Studies

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In a recent *Economic Viewpoint*[1], we have described two alternative scenarios for oil prices, including one of prolonged price weakness. The materialization of such scenario would result in the near-term maintenance of a level of around US$40 for the barrel of WTI (West Texas Intermediate), which would be followed by a relatively rapid rise in 2016. One cannot necessarily rule out a scenario in which prices fall further in the short term, especially if available storage capacity continues to diminish. This would represent a temporary situation, in our opinion, since the ensuing rapid decline in production would help restore equilibrium prices at a higher level. It remains that the increased volatility and uncertainty that would accompany such scenario could constitute enough of a reason for the BoC to increase the degree of accommodation.

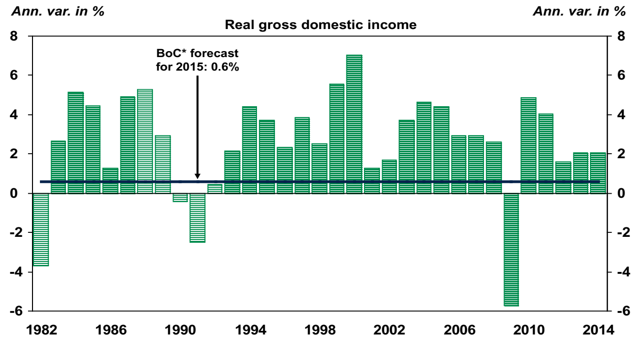
2) A MORE PRONOUNCED-THAN-EXPECTED INCOME SHOCK

The BoC has insisted on the heavy toll the oil price shock would exact on incomes. In a direct sense, this refers to the income of oil workers and the profits of oil producers. In both cases, the oil price rise of recent years had resulted in a significant contribution to revenues, which spread to the whole economy via multiplication. The Canadian economy is currently experiencing the flip side of this coin, and the BoC estimates that the equivalent of a full year worth of income growth might be lost.

Real gross domestic income (GDI) is a concept of economic growth that adjusts the evolution of real GDP to account for variations in the terms of trade[2]. The BoC has significantly revised down its forecast for real gross domestic income growth to reflect the ongoing terms of trade shock. As of January it expected GDI growth of just 0.6%, a level so low that it has rarely been experienced outside of a recession setting (graph 2). Nonetheless giving some credence to this assumption, real GDI fell 0.7% annualized in the fourth quarter of 2014 (graph 3), while the available data for the first quarter of 2015 points to a new contraction.

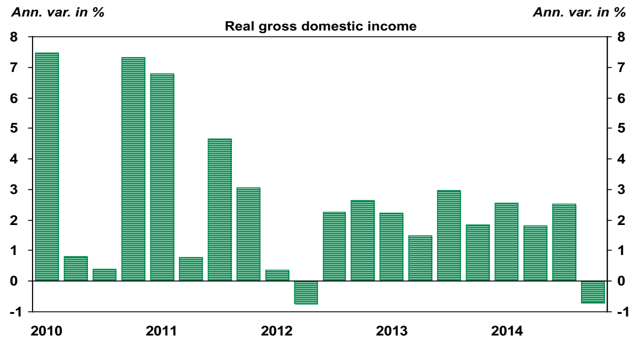
Although the BoC has already greatly tempered its expectations regarding the evolution of gross domestic income (it was expecting growth of 2.7% for 2015 last July), weaker oil prices could elicit another downward revision to its forecasts. This being said, a scenario whereby oil prices are roughly in line with the BoC's estimate but income growth is penalized more heavily than envisioned, is not entirely

Graph 2 – Gross domestic income growth as weak as being expected by the BoC* has rarely been seen in expansion



* Bank of Canada.
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 3 – Gross domestic income growth flipped to negative territory in the fourth quarter



Sources: Statistics Canada and Desjardins, Economic Studies

implausible. Signs confirming the materialization of such risk could result in the BoC cutting rates again.

3) A GENERALIZED REAL ESTATE CORRECTION

We expect that most oil-producing provinces will experience fairly serious slowdowns in 2015. For now, economic indicators from these regions are rather mixed, but we nevertheless discern signs of a macroeconomic shock within the real estate market. From their peak of last October, property sales have plunged 35% in Alberta. In Saskatchewan, we witness a 24% drop from the September peak in sales in this province.

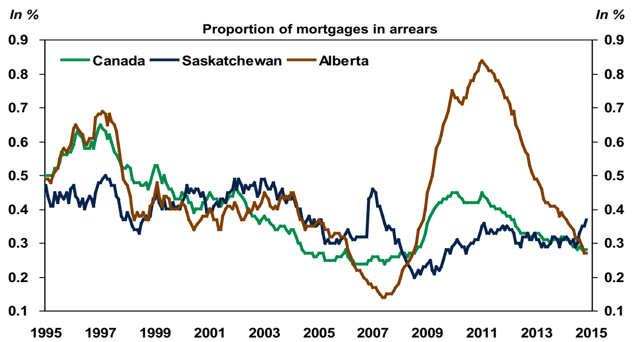
While spectacular, these dynamics are not surprising. A context such as the one that is being expected in oil-producing provinces is usually synonymous with job losses and rising household financial difficulties. Depending on the severity of the impact, this can cause financial institutions to record losses on certain loans and tighten their lending requirements. There is a risk that such decisions are not confined to the regions concerned and that credit availability is restricted across the country. This situation would exacerbate the economic slowdown, as was observed in the United States during the late crisis.

[1] Desjardins, Economic Studies, *Economic Viewpoint*, "Where will oil prices go now?," February 16 2015, www.desjardins.com/ressources/pdf/pv150216-e.pdf?resVer=1424111285000.

[2] The terms of trade are defined as the ratio of export prices to import prices.

A carbon copy of the U.S. housing debacle remains a rather remote risk but it bears noting that Alberta and Saskatchewan are the only provinces where mortgages without full recourse clauses are permitted. A fall in property prices in these provinces could have a significant impact on the financial results of exposed financial institutions, if accompanied by an increase in mortgage defaults. It is hardly reassuring to observe that arrears on mortgages rose much more rapidly in Alberta than nationwide during the last recession (graph 4). More reassuring is the fact that in Alberta, high loan-to-value mortgages are mandatorily full-recourse, which significantly reduces the risk of an insidious escalation of default rates in the province.

Graph 4 – Alberta had experienced a greater increase in arrears during the last recession



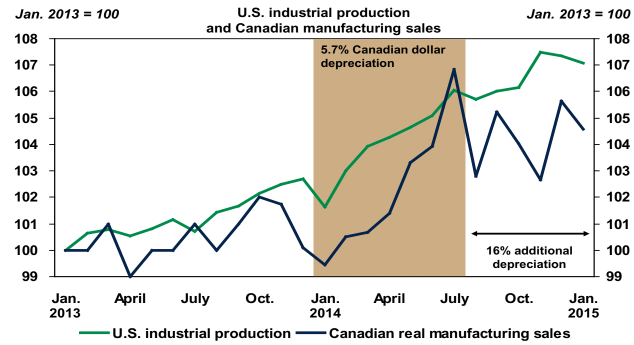
Sources: Canadian Bankers Association and Desjardins, Economic Studies

Ultimately, one can still assume that signs fueling concerns of a severe housing correction and a tightening of financial conditions would be serious enough factors to bring the BoC to lower its policy rates again.

4) SLUGGISH GROWTH TRANSITION

Theoretically, the depreciation of the currency is a promising development for Canadian exports, particularly for manufactured goods. In reality, the results are mixed so far. After having benefited from the depreciation of the Canadian dollar in the first half of 2014, real Canadian manufacturing shipments have been confined to a choppy corridor. That is to say, after adjusting for the impact of the oil price drop on nominal shipments for some of the most sensitive manufacturing industries (i.e. petroleum product refining), manufacturing sales volumes have been essentially treading water since the middle of 2014. This is despite the roughly 16% depreciation in the exchange rate from July 2014 to January 2015 inclusively (graph 5). The United States cannot be blamed. Quite to the contrary, U.S. economic growth and industrial production have been solid through this period, while U.S. real imports rose an annualized 4.7% in the second half of 2015, best performance since 2010.

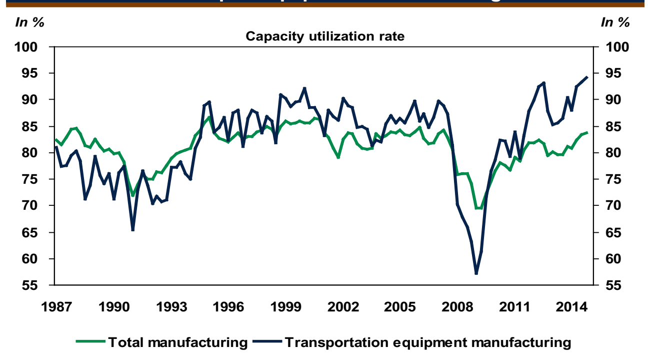
Graph 5 – After an encouraging first half of 2014, volumes of manufacturing sales have fizzled



Sources: Federal Reserve, Statistics Canada and Desjardins, Economic Studies

Capacity constraints could partly explain the recent setbacks of Canadian manufacturers. The capacity utilization rate in the manufacturing sector has reached 83.7% in the fourth quarter of 2014, the highest level in seven years. In the manufacturing of transportation equipment, for example, the utilization rate rose to 94.1%, the most acute instance of capacity squeeze since the start of the data series in 1987 (graph 6).

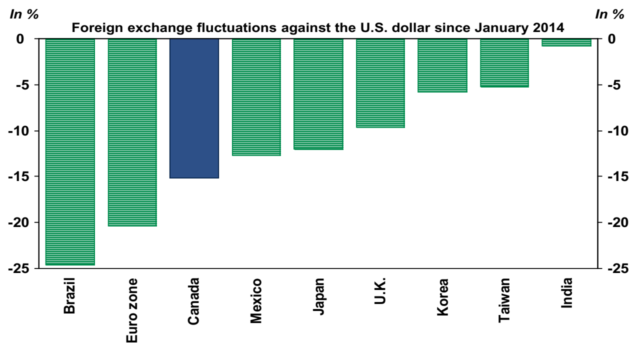
Graph 6 – The capacity utilization rate has increased, particularly in transport equipment manufacturing



Sources: Statistics Canada and Desjardins, Economic Studies

To the extent that demand conditions are reasonably favourable, this should normally be positive news for business investment but neither should the current global context be overlooked. Even with a weaker currency, Canadian producers are not necessarily more competitive. Many other countries have experienced an equivalent or greater depreciation of their exchange rates recently (graph 7 on page 4). Moreover, some industries facing secular decline, such as pulp and paper, or textiles, are unlikely to be standing at the doorstep of a major renaissance. More value-added industries should ultimately carry the baton but given the inconsistency of the global recovery so far, uncertainty remains about the timing at which decision makers in

Graph 7 – Canadian exporters are not alone benefitting from a weaker currency



Sources: Bloomberg and Desjardins, Economic Studies

these industries will have accumulated a sufficient level of confidence to invest on a sustained basis.

Much less uncertain is the fact that the energy sector will offer a radically lower contribution to total investment growth over the coming quarters. It follows that there is a non-negligible risk that the economy finds itself confronted with a capex void. This is a key element that could prompt the BoC to cut rates, in an attempt to offset the growth shortfall.

5) A MAJOR U.S. SLOWDOWN

The U.S. economy has showed convincing signals in 2014 and all indicated that it had reached a higher growth trajectory. Job creation dynamics have remained constructive since the beginning of 2015, but this has not been the case of most other indicators (graph 8). We have revised down our forecast for real GDP growth in the first quarter of the year, now expecting 1.4%.

Graph 8 – Economic indicators perform poorly at present in the United States

Sources: Citigroup, Datastream and Desjardins, Economic Studies

Consumption seems particularly amorphous since the beginning of the year, which is all the more surprising given that hires are still in full swing, gasoline prices still low, and that weak inflation translates into increasing real incomes. Business investment is not exactly gleaming, while the strong dollar acts as a significant impediment to the profitability of U.S. multinationals. Although we believe that the first quarter may prove to be a weather-induced soft patch similar to that of last year, a scenario in which domestic demand sluggishness among our main trading partner came to be prolonged, would carry adverse implications for Canadian export prospects.

In such scenario, the Federal Reserve would keep interest rates unchanged for an extended period, which would weaken the U.S. dollar. In isolation, the upshot would be a stronger Canadian dollar, impeding further on exports. The impact on the currency could however be mitigated by lower oil prices; a less vigorous U.S. economy would indeed carry negative implications on global oil demand, pushing prices down and capping the Canadian dollar. But much beyond the currency effects, U.S. growth is a crucial underpinning of Canadian economic performance. If doubts on the United States come to be amplified, the BoC might well see it appropriate to increase the degree of monetary stimulus.

CONCLUSION

It should be noted that this analysis focuses on the risks of rate cuts, but there are also risks of rate hikes. For example, if non-energy companies begin investing with more enthusiasm, if Western economies show more resilience than expected, or if inflationary pressures associated with the exchange rate pass-through intensify, it might be considered that the economy no longer needs the crutch it was offered in January. To some extent, the behavior of households could also be an influential variable. For instance, intensifying competition between mortgage lenders and an associated acceleration of household debt could be part of the considerations prompting the BoC to accelerate the normalization of rates. This is especially true as unduly prolonging accommodation could inflate household liabilities further, rendering their finances more vulnerable to the eventual monetary tightening.

Putting it all together, the current situation indicates that the BoC should keep the status quo, while monitoring closely the evolution of the risk factors aforementioned. This is our base case. That said, when considering the various alternatives, in the short term, the risk of a further rate cut appears to take more importance than that of a return to 1%. For instance, high household debt seemed an incontrovertible argument against a rate cut, which did not prevent the BoC to act by invoking the concept of insurance.

Regarding inflation, although the weakening of the currency naturally leads to higher import prices, the BoC tends to ascribe this effect to the realm of transitory phenomena, not likely to convert into runaway inflation expectations. In general, given the proximity of the zero lower bound on interest rates, the BoC does not hesitate to admit that it is much more tormented by a hypothetical deflation scenario than that of high inflation. Thus, the bar seems placed relatively high for a rate hike to occur in the short term. By contrast, the possibility that further eases are enacted cannot be neglected.

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