Bank of Canada's dovish shift

The Bank of Canada has left interest rates unchanged as widely expected, but the accompanying statement includes a dovish shift that reinforces our view that they are gearing up for a rate cut

Bank of Canada Governor, Stephen Poloz

No policy change, but external risks are rising

At the July monetary policy meeting, the Bank of Canada suggested there was little prospect of any near-term policy change. However, today's statement warned that "the US-China trade conflict has escalated, world trade has contracted and business investment has weakened. This is weighing more heavily on global economic momentum than the Bank had projected in its July Monetary Policy Report".

While domestic activity had been stronger than expected, some of this was going to be "temporary" – such as the restarting of production at various oil fields. Moreover, the weakness in consumer spending caught them by surprise with the BoC expecting "economic activity to slow in the second half of the year". The recent pick-up in inflation is also "largely because of temporary factors".

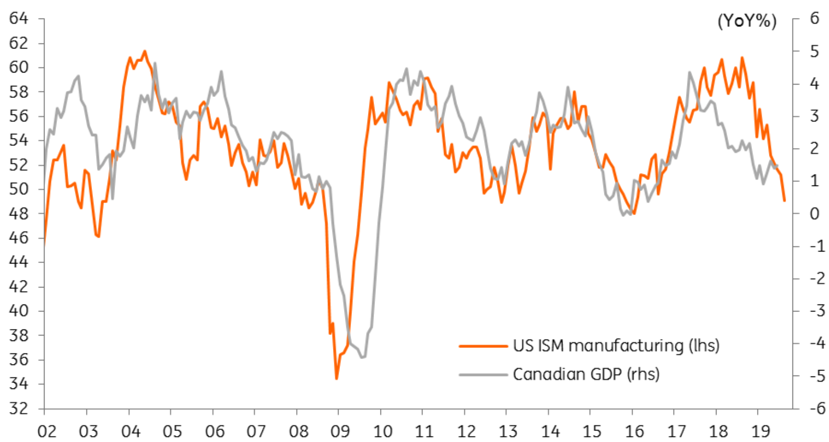
They conclude that "the current degree of monetary policy stimulus remains appropriate", but warn that “escalating trade conflicts and related uncertainty are taking a toll on the global and Canadian economies”.

While we think the statement suggests growing caution at the BoC regarding the economic outlook and hints at a dovish shift, the market has taken it in stride with bond yields barely changed and the Canadian dollar a touch firmer.

Where the US goes, Canada typically follows

Amid the global clamor for looser monetary policy we suspect that the Bank of Canada will cut interest rates this year with a move certainly possible in October. Yesterday’s ISM index from the US was particularly worrying as where this index goes the Canadian economy usually quickly follows. After all, the Canadian economy is relatively open with trade accounting for more than 30% of economic activity versus little more than 10% for the US. Canada is also more dependent on commodities for a significant proportion of its output with mineral extraction and agriculture representing more than 10% of the economy.

ISM fall points to Canadian slowdown



Source: Macrobond, ING

BoC set to act swiftly, but modestly

At the moment the market is pricing in around a 55% probability of a 25bp rate cut in October, whereas the latest survey of analysts by Bloomberg continues to peg stable rates through this year and next. Given Canada’s trade and commodity exposure and with little prospect of an imminent easing in trade and global growth concerns, we recently changed our view to a 30 October cut and that call remains valid.

After all, the BoC’s has a tendency to move swiftly after signaling a shift in thinking. In this regard think back to 2015 when the BoC rapidly changed its tune and cut rates in response to plunging oil prices and the fears for what it might mean for the broader economy. We also remember 2017, when it surprised with a September hike after already hiking rates in July. Swift, but modest action seems to be the BoC's mantra.

How the US-China dialogue plays out will be critical. For now though we would point out that the BoC was far less aggressive in hiking rates than the Federal Reserve over the past couple of years. As such, there is arguably less need for a significant corrective move lower in rates. Hence our view that this would be a one-off rate cut.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com