

## CAPITAL MARKETS RESEARCH

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## Special Report: BoC On Hold For A Long Time Yet, As Spare Capacity Grows

- **We think the Canadian economy will remain soft enough such that it underperforms the speed limit to growth and builds more spare capacity over time. That should remain broadly disinflationary in support of a potentially very long pause on policy rates.**

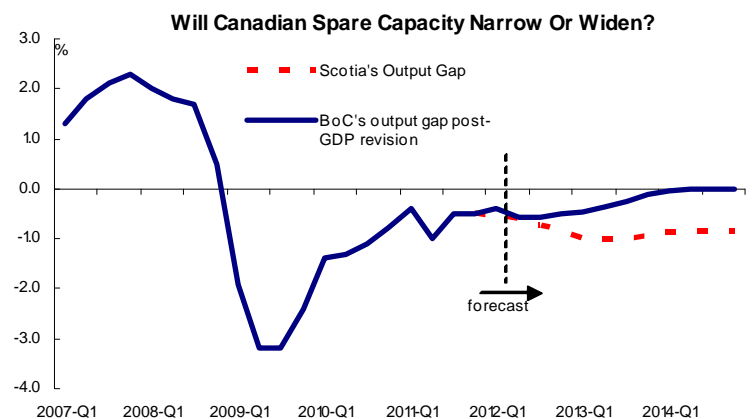
We have revised our Bank of Canada forecast and now anticipate that the BoC will be on hold until 2014 compared to our earlier 2013Q3 view. At this point a policy hold until early 2014 is our best guess, but while the two tail risks are significant, we think there remains a fatter-tail case to be made for what is possibly a considerably longer hold even after our forecast change. This keeps us at odds with the consensus of Canadian economists.

While geopolitical risks are likely to remain a key factor for a long time yet, the heart of the matter concerns a variable drawn from the domestic economy: the output gap. Of all major global central banks, the BoC is among the most likely to explain much of what it does within the output gap framework and how it relates to its 2% inflation target. It is for this reason that differences between our growth forecasts for the Canadian economy and the BoC's are important insofar as they translate into very different outcomes for the balance of supply and demand conditions in the Canadian economy.

The difference of opinion is showcased in chart 1. Whereas the BoC argues that spare capacity will be fully eliminated by the end of 2013, we argue that spare capacity will keep growing straight through until at least the end of 2013 and then persist at relatively high levels into 2014.

Chart 2 explains why we differ on the output gap with most of the difference to be pegged upon forecast differences in 2012-13. We haven't quibbled with the BoC's forecast for potential growth that they have pegged at 2% or slightly higher in each of 2012-14. Our difference of opinion lies in actual GDP growth forecasts. Scotia Economics is materially lower than the BoC's growth forecast for every quarter throughout 2012-13 by between a half and three quarters for a percentage point in each quarter, and then compounded quarterly. There are clearly risks to both our forecasts and the BoC's and only time will tell which one turns out to be closest to the mark (or neither), but our more subdued growth outlook translates into more spare capacity for a longer period of time than the BoC anticipates.

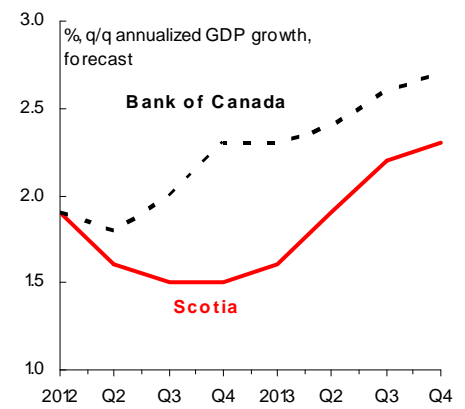
**Chart 1**



Source: Bank of Canada, Statistics Canada, Scotia Economics.

**Chart 2**

### BoC More Optimistic Than Scotia



Source: Bank of Canada, Scotia Economics.

### Scotia Economics

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More slack for longer than the BoC forecasts would imply that the BoC will not exceed — and may persistently fall short of — its forecast for headline and core inflation to return to the 2% target by 2013H2. What's more, the BoC's forecast return to the inflation target assumes "...a gradual reduction in monetary stimulus over the projection horizon, consistent with achieving the inflation target." What we are saying is that the BoC's inflation target will not be sustainably challenged *even in the absence of monetary tightening*.

Additional considerations clearly must include the likelihood that the BoC is restrained from policy tightening by the Federal Reserve's prolonged rate hold and the likelihood of a persistent easing bias via the impact that a further overnight spread widening would have upon the Canadian dollar and hence the country's export competitiveness. We also anticipate that the broad tone of geopolitical and economic developments will continue to face downside risks throughout our forecast horizon.