DALE ORR
ECONOMIC INSIGHT

daleorr@economicinsight.ca August 2009

The Bank's Optimistic Forecast: What Difference Does it Make?

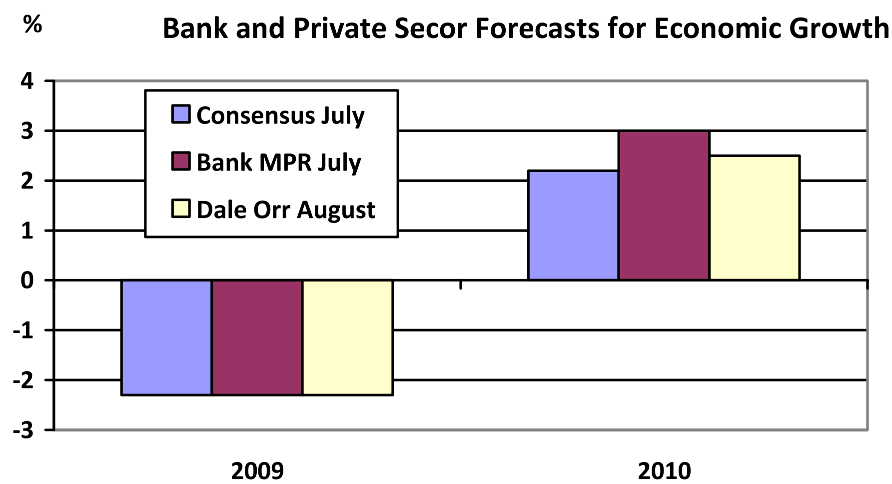
When the Bank of Canada released its Monetary Policy Report (MPR) on July 23 its forecast for economic growth, particularly for 2010, was considered on the optimistic side. As we pull out of this recession it is very difficult to forecast what the pace of recovery will be. The pace, as well as the characteristics, of Canada's economic recovery depend very much on the pace and characteristics of recovery in the U.S. However, the recovery of the Canadian economy also depends very much upon the monetary policy moves taken the Bank of Canada. These monetary policy moves, in turn, depend critically on the forecasts of recovery expected by the Bank.

In its earlier April MPR the Bank had forecast growth of 2.5% for 2010, a forecast above most private sector forecasts at the time. In their July MPR they "declared the recession was over" and moved that forecast up to 3.0%. This paper focuses on the implications for economic policy if the Bank is correct in being more optimistic for the pace of economic recovery in Canada than private sector forecasters are. Specifically, if the Bank is correct in its optimism, can we expect higher interest rates? If the Bank is correct in its optimism, does it mean the government might be able to eliminate the deficit sooner? As well, what if the Bank makes its monetary policy choices based on its optimistic forecasts, and it is wrong?

The Bank's Forecast for Next Year is Relatively Optimistic

Forecasts for Canada's economic growth for 2009 seem to finally have stabilized in the -2.3% range. See chart 1 below. The private sector consensus in July was -2.3%. In their July MPR the Bank moved their forecast for 2009 to -2.3%. I believe that leading forecasters will be keeping their August forecast for 2009 at -2.3%, and that is my current forecast.

Chart 1.



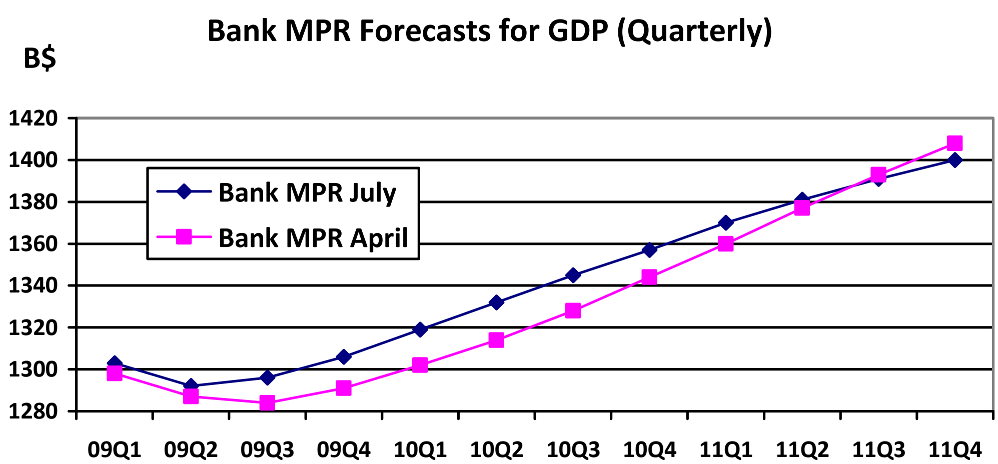
As indicated in Chart 1 above, in July the private sector consensus forecast for 2010 was 2.2%. There has undoubtedly been net positive news over the past month. The Canadian housing market has been performing above expectations, the auto sector appears to be beginning to turn around, credit conditions and the soundness of our financial institutions is shaping up a bit better than expected. Even though July's labor market report was a bit weaker than expected, it is unlikely to overwhelm the net optimism for 2010 that has built up over the past month. On net most forecasters now expect economic growth to turn from negative to positive in this third quarter of 2009. That is, the recession is probably over. I believe most private sector forecasters will be forecasting about 2.5% growth for 2010 in their August updates, and that is my forecast. That is why the Bank's July MPR forecast of 3.0% for 2010 strikes me, and many private sector forecasters, as a bit optimistic.

Examining the Bank's Forecast in More Detail Reveals More Shifting of Growth Than Optimism

Before examining the implications of the Bank's "optimistic" forecast, it is important to look behind the annual average data to examine the quarterly pattern, and to look more closely at its forecast over the entire 2009 through 2011 period.

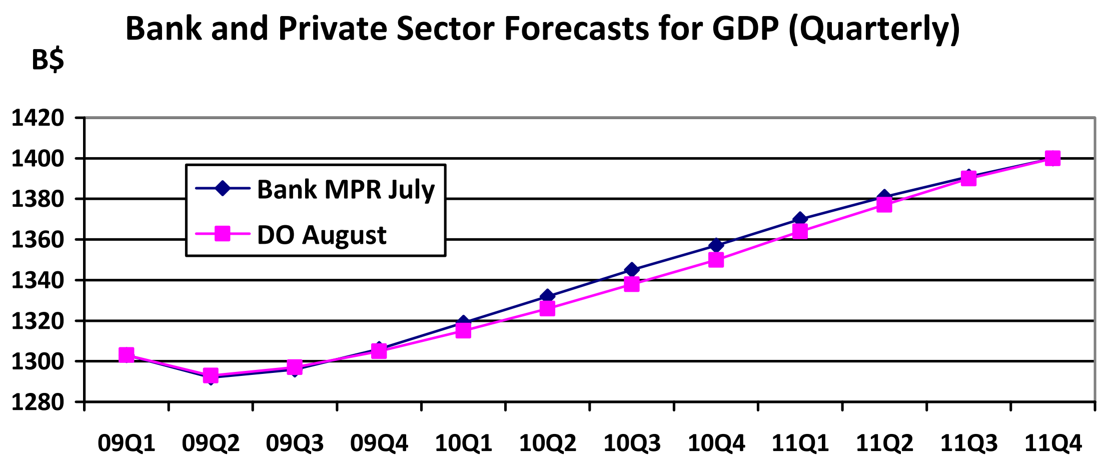
An examination of the quarterly pattern of the Bank's July MPR forecast reveals that between its April MPR and July MPR, while the Bank has revised its forecast upward for 2010, it has significantly changed the profile of growth over the next several years. It is very important to note that the total amount of economic growth from the beginning of 2009 up to second quarter of 2011 is the very same in the July MPR as it is in the earlier April MPR forecast. In both forecasts the economy is forecast to be running at an annualized level of about $1,380 billion (chained 2002$) in mid 2011. See chart 2. Therefore, while the Bank's forecast for economic growth for 2010 is relatively optimistic from most perspectives, a key implication of the Bank's new forecast is that they now expect the economic growth of the next two years to occur sooner than they did before. The economy will be running at a higher level of output from early 2009 up to mid 2011. The economy will not fall as much in early 2009 as earlier feared. However, the pace of economic growth from mid 2009 to mid 2011 will not be quite as strong as forecast in April, resulting in the same level of output by mid 2011. See chart 2.

Chart 2



The Bank's July MPR forecast for economic growth over 2009 is very similar to my August forecast . An examination of the quarterly detail reveals the stronger pace of growth forecast by the Bank over 2010. However, this optimism by the Bank for 2010 is accompanied by a relatively weak forecast for 2011. I agree with the Bank's forecast that, by the end of 2011, the Canadian economy will be running at an annualized pace of about $1,400 billion. See Chart 3.

Chart 3.



The Bank's forecast of 3.5% growth for 2011 is scaled down mightily from their April MPR forecast of 4.7%, and is slightly below my forecast of 3.8%, which I believe will be typical of private sector forecasts in August.

What are the Monetary Policy Implications of Stronger Growth Sooner.

In their April MPR the Bank concluded that "….the target overnight rate can be expected to remain at its current level until the end of the second quarter of 2010.." conditional on the outlook for inflation tracking their forecast. The Bank outlined its plan to continue rolling over PRA's. While the Bank outlined its options for quantitative and/or credit easing in the April MPR, it expressed its clear reservations about employing this form of stimulus, saving a serious deterioration in the forecasts for inflation or growth. This fundamental plan for monetary policy, in these key respects as set out in the April MPR, was essentially left unchanged in the July MPR.

However, the economic forecast of the July MPR is changed in some significant ways from the earlier April MPR. Most importantly, as explained above, the economic growth over the 2009 – 2011 period has been shifted significantly forward. As a result the Bank has moved forward the date when they expect the output gap to be closed, from the third quarter of 2011 to the middle of 2011. The date when inflation will return to the 2% target level has been moved forward similarly. In its updated forecast the Bank does not expect core inflation to weaken by nearly as much at its trough in late 2009 as previously. These changes in the economic forecast lead me to expect slightly different monetary policy choices going forward, in spite of the fact the Bank has left their basic policy posture from now until mid 2010 unchanged. Similarly, the fact that the Bank is expecting the economy to be performing at a higher level of output from now to 2011 Q2 implies slightly different monetary policy choices than if the Bank had an economic forecast more similar to that of private sector forecasters. *How will this relatively more optimistic economic forecast affect the monetary policy choices of the Bank over the next year or so?*

In their April MPR the Bank repeated their conditional plan to keep the policy rate at its current 0.25% level until the end of second quarter of 2010. I do not think the changes in the economic forecast between the April and July MPR are sufficiently strong to change the base case expectation on policy rate decisions. Specifically, we should continue to expect the Bank to hold the policy rate at 0.25% through 2010 Q2. However, the probability that the Bank may move a bit sooner has shifted up slightly. More importantly, when the Bank embarks on its tightening cycle in the third quarter of 2010, it can now be expected to proceed at a more vigorous pace.

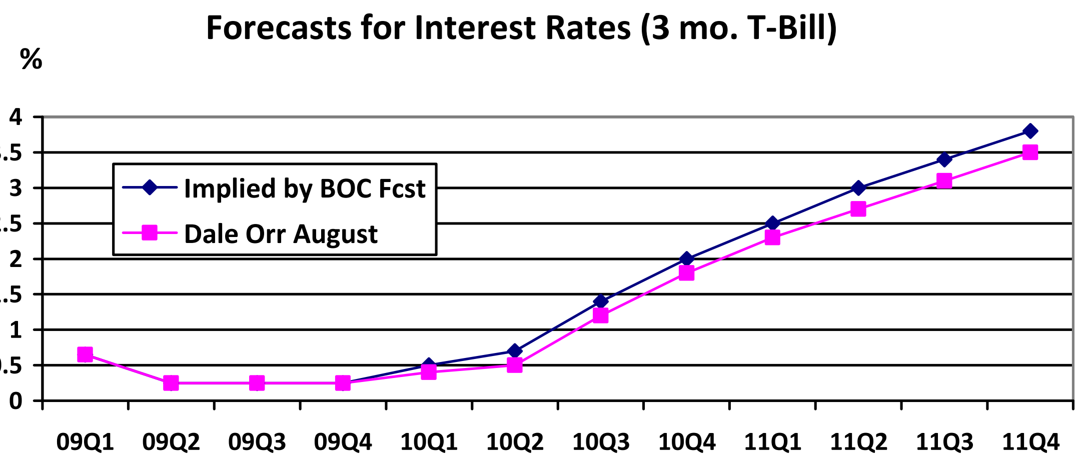
With the output gap expected to close in mid 2011, the Bank should be expected to move the policy rate from the 0.25% level to the long term equilibrium level in the 4.0% to 4.5% range by 2013. The movements in the 3 mo. T-Bill rate can be expected to be very similar to those of the Bank's policy rate, with the exception that the T-Bill rate would move up slightly before the Bank rate is expected to move up.

My forecast of August expects the 3 mo. T-bill rate to average a shade under 1.0% for 2010, 2.9% for 2011, rising to 3.8% in 2012 before settling at its equilibrium level of 4.4% in 2013. The stronger pace of economic growth over the next year forecast by the Bank, with the resultant closing of the output gap a bit sooner and inflation being a bit stronger over the next year, implies slightly more vigorous interest rate increases over the next two years.

How much the more vigorous economic forecast of the Bank would accelerate the monetary tightening schedule is a judgment call. Recall that, as far as interest rates are concerned, the Bank only commented on their conditional plan to keep the policy rate at the 0.25% level through 2010 Q2.

However, chart 4 illustrates roughly what seems to be implied by the July MPR economic forecast.

Chart 4



To be specific, if the Bank is basing its interest rate decisions on its July MPR economic forecast, as opposed to my August economic forecast (which I believe typical of upcoming updates from leading private sector forecasters), then the 3 mo. T Bill rate will average just above 1% in 2010 instead of just below 1%. It will average about 3.2% in 2011 instead of about 2.9%. The move from today's .25% to the 2013 average of 4.4% will be accelerated. For example, in 2012 my average is 3.9% relative to the 4.1% from the Bank's economic forecast, but in each scenario the average for 2013 is 4.4%.

The implication of the Bank's forecast of stronger economic growth over the next year is, not surprisingly, slightly higher interest rates over the 2010 through 2012 period. If the Bank is correct in their forecast they will nip off some inflation that might have occurred had they been acting on the basis of a less optimistic economic forecast. Conversely, the danger of acting on a forecast of accelerated growth which turns out to be too optimistic is that some much needed economic growth over the recovery period will be delayed.

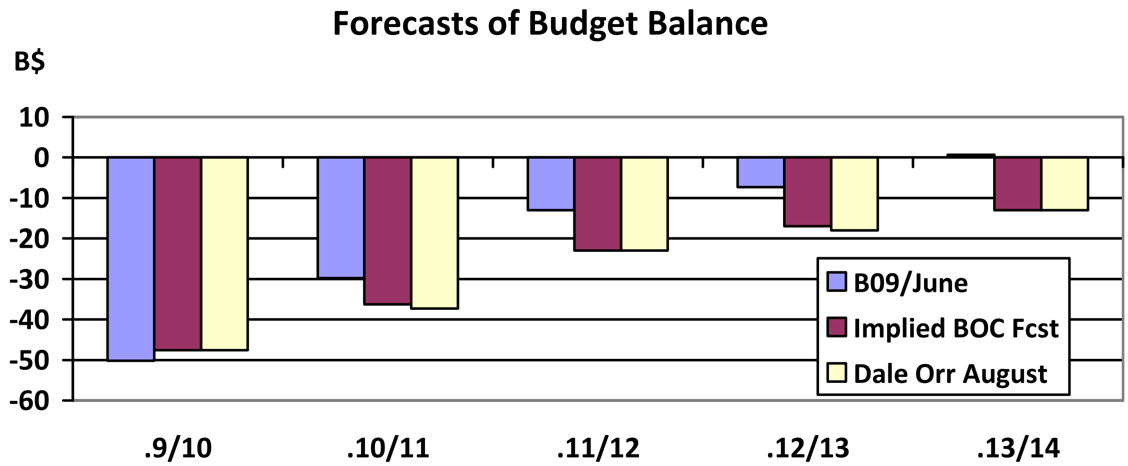
Fiscal Policy Implications of the Bank's Relatively Optimistic Economic Forecast

In the January 2009 Budget the government did forecast that the recession would result in deficits over the 2009/10 through 2012/13 period. However, a key feature of Budget 2009 was the government's plan to eliminate the deficit by 2013/14. Since January the forecast for the depth of this year's recession and its impact on government revenues has worsened significantly. In my July Special Issues paper "Can We Balance the Budget: When How?" I provided an updated economic and fiscal forecast. This forecast concluded that, on the basis of an updated economic forecast, the government cannot come near meeting their target of eliminating the deficit in 2013/14. In fact, they should expect a deficit in the range of $17 billion in 2013/14 and, if they do not raise taxes or cut spending from current plans, they are unlikely to balance the budget before 2019/20.

As explained above in this current paper, over the past month we have received, on net, uplifting economic news and August forecasts will be slightly stronger than July forecasts, particularly for 2010. To be specific, my current August forecast calls for nominal GDP (the general tax base) to be about 1.3% higher in 2013 than was forecast in July, primarily due to stronger real growth in 2010. This higher level of nominal GDP in 2013 can be expected to provide the federal government with about $4 billion more revenues than earlier forecast. This implies a deficit of about $13 billion in 2013/14 as opposed to the $17 billion earlier forecast. However, even this $13 billion is far from the small surplus for 2013/14 forecast in Budget 2009.

I next examine the impact of the Bank of Canada's more optimistic July MPR forecast on the fiscal forecast. Specifically, I substitute their real growth forecast over the 2009 – 2011 period, keeping all other data unchanged. Using the Bank's July MPR economic growth forecast rather than my August forecast implies slightly stronger federal government revenues for 2010/2011. Specifically, my August forecast is for a deficit of $37 billion in 2010/11, the Bank's economic forecast implies a deficit of $36 billion. Each of these is significantly worse than the $30 billion forecast in Budget 2009, but slightly better than the $41 billion recently forecast by the Parliamentary Budget Office.

Chart 5



Note the B09/June forecast is the B09 forecast as updated for 2009/10 in June

Recall that the Bank forecast the same level of output for the economy by the end of 2011 as my August forecast (Chart 3). As a result, the forecast for federal government revenues for 2013/14, as well as the deficit implied by the Bank's forecast, are the same as my August forecast. Specifically, even when we substitute the Bank's more optimistic (for 2010) forecast for my August forecast, we still forecast a deficit of $13 billion for 2013/14. These two forecasts, both more optimistic than my July forecast, move up the date of deficit elimination by one year, from 2019/20.

It must be emphasized that these are the fiscal implications from these economic forecasts. Economic forecasts have been unusually volatile over the past year. It is of course possible that by the time the government updates its fiscal forecast with their Fall Economic and Fiscal Update, both the economic and fiscal forecast could be stronger or weaker.

I conclude that using the more optimistic August economic forecast, or even using the more optimistic Bank of Canada July MPR economic forecast, leaves the key fiscal policy conclusions unchanged. The government will have a deficit far larger in 2010/11 than they have yet publicly recognized. On the basis of current, even optimistic economic forecasts, they will not come near eliminating the deficit as planned in 2013/14. Without significant tax increases, which they have vowed are out of the question, they are unlikely to eliminate the deficit for almost another decade.