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Bank of Canada cuts outlook on export worries, housing crackdown

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- Bank of Canada holds key rate at 0.5 per cent, cuts GDP forecast to 1.1 per cent in 2016 and 2 per cent in 2017.
- Ottawa's mortgage insurance crackdown will knock 0.3 per cent off GDP by end of 2018.
- Canadian economy won't reach full capacity until mid-2018, delaying future rate hikes.
- Weaker business investment, U.S. election angst and protectionism are weighing on Canadian exports.

The Bank of Canada is chopping its forecast for the Canadian economy again, blaming a combination sluggish exports, Ottawa's crackdown on risky mortgage lending and nervousness about the U.S. election.

The darker outlook comes as the central bank kept its key interest unchanged Wednesday at an ultra-low 0.5 per cent, where it's been since July 2015.

"The federal government's new measures to promote stability in Canada's housing market are likely to restrain residential investment, while dampening household vulnerabilities," the bank said in its rate-decision statement. "Recent export data are improving but are not strong enough to make up for ground lost during the first half of 2016."

The bank's more pessimistic tone suggests rate hikes are still a long way off in Canada, and that a rate cut is not out of the question. The central bank said its inflation outlook remains "roughly balanced, albeit in a context of heightened uncertainty."

Indeed, Bank of Canada Governor Stephen Poloz told reporters in Ottawa that the bank's governing council "actively discussed adding more monetary stimulus" in the lead-up to Wednesday's decision, but opted not to in light of significant economic uncertainty.

"This is a bank that has precisely zero appetite for rate hikes, and seems to be keeping a flame alive for the possibility of rate cuts, should the need arise," Bank of Montreal chief economist Douglas Porter said in a research note.

Earlier this month, federal Finance Minister Bill Morneau announced moves to tighten access to mortgage insurance as well as a crackdown on real estate speculators who duck paying capital gains taxes.

The bank says the federal efforts to cool the housing market will shave up to 0.3 per cent a year from economic growth by 2018. Housing resale activity in particular could take a hit.

Overall, the Bank of Canada now expects the economy to grow 1.1 per cent this year and 2 per in 2017, down from its July projection of 1.3 per cent and 2.2 per cent respectively, according to its latest monetary policy report, released Wednesday.

As well, the bank said the economy won't get back to full capacity until "around mid-2018" – at least half a year later than its July estimate of the "end of 2017."

This delay suggests it could be another two years before the bank starts trying to push up interest rates – a timetable that now puts it well behind the U.S. Federal Reserve and could keep the value of the Canadian dollar low. The dollar was trading at roughly 76 cent (U.S.) before Wednesday's rate decision.

The postponed return to full capacity also raises the chances that the bank could cut its benchmark rate in the coming months, as it did twice in 2015, if the economy takes turn for the worse.

On the positive side, the bank suggested that the worst may be over from the severe hit Canada's economy took due to the collapse in commodity prices. And it remains confident that global economy will "regain momentum" over the next two years.

The downgraded forecast marks the latest is a series of disappointments for Mr. Poloz, who has repeatedly predicted that an imminent rebound in non-resource exports would lift the country out of its economic funk.

The bank's latest forecast slashes expected export growth by a full percentage point in 2017 and 2018. And that could shave roughly 0.5 per cent off gross domestic product.

Wednesday's report from the bank provides an extensive explanation for why that has not yet happened.

One of the biggest mysteries is why Canada's exports haven't hitched themselves to the recovery in the U.S. – the destination for nearly three-quarters of Canadian goods exports. The Bank of Canada blames weaker than expected U.S. business investment and more pronounced competitive challenges.

"U.S. non-energy goods imports from Canada have stagnated, while those from competing countries have increased," the bank said. While a cheaper Canadian dollar has made exports more competitive, the currencies of other countries, including Mexico, have declined even more, the bank pointed out in its report.

The central bank now expects U.S. business investment to grow just three per cent over the next two years, down from a previous estimate of four per cent, due to greater uncertainty. “This has important implications for Canadian exports, given the trade-intensive nature of investment,” the bank said.

The Bank of Canada said a trend towards smaller new homes in the U.S. and the imminent threat of duties on Canadian softwood lumber could also hurt exports. It also said rising non-tariff barriers and uncertainty about the fate of trade agreements, such as the Canada-Europe free trade deal and the Trans Pacific Partnership, may also be to blame.