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BoC: Still on hold on external headwinds.

BoC continues to hold policy rate. Unsurprisingly, the BoC maintained the overnight rate target at 1%, where it has been since September 2010, on worsening global conditions and tame domestic growth. While overnight swap activity yesterday showed markets had priced in 34 basis points of easing by the end of 2012, BoC governor Mark Carney's policy statement suggested that tightening is the more likely scenario in the coming months—contingent on the global backdrop.

Global risks building. The BoC recognizes that the global outlook for economic growth has deteriorated since the previous rate decision in April. Eurozone risks are transpiring—political, economic, and financial. Emerging market growth is slowing more rapidly and more broadly than expected. As a result, commodity prices have declined. The U.S. economy, the destination of 70 percent of Canadian exports, is expanding only at a "modest" pace. The BoC notes that risks on external headwinds are skewed to the downside.

Domestic imbalances persist. While growth was only 1.9% at an annualized pace in Q1—well below the BoC 2.5% forecast—the central bank stated that the "underlying economic momentum" in the economy was close to expectations. However, the growth profile is not balanced: fiscal expenditures are flat while net exports struggle in the face of weak external demand and a strong currency. Investment was the main contributor to growth in the first quarter, as domestic consumption increased at the slowest rate in 3 years. The BoC is especially concerned about strong housing activity and rising household debt levels.

Price pressures remain subdued. The inflation profile is softer than expected on easing gasoline and commodity prices. While the BoC expects headline CPI to hover just below the 2% target in the short term, core inflation should remain fairly close to the target over the projection horizon. The BoC stated that Canada continues to operate with a small amount of excess capacity—suggesting that activity is not at a pace where it would put undue upward pressure on prices.

Up or down from here? The policy statement outlines the dichotomy facing Canada. External conditions, particularly in the Eurozone, currently dominate global financial markets. An exit by one or more periphery nations from the Eurozone would likely trigger a financial crisis and result in central banks around the globe cutting rates. However, Canada faces an overheated housing market and households which continue to add leverage to balance sheets in the low interest rate environment. Ideally, abstracting from external headwinds, the BoC would like to offer forward guidance about the path of interest rates and enact gradual, predictable rate hikes. The resulting tighter credit market would help to gently deflate home prices and stem imprudent borrowing activity. The recent volatile swap market suggests that markets are not yet sure which conditions will dominate.

The DE forecast is unchanged: rates will likely remain on hold at least until the end of 2012 as global and domestic conditions roughly offset. Carney, also chair of the Financial Stability Board, puts an utmost priority on clear communication. At the last BoC meeting, he first suggested the possibility of rate hikes. The BoC may view that it would be too distressing to markets to change its tone so quickly—however, anytime that a financial crisis becomes a possibility, risks tilt towards easing.

The next BoC rate decision is July 17, which will be accompanied by the quarterly Monetary Policy Report.