

As factories stall, imminent rate hike less likely

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OTTAWA — The unexpected contraction of the Canadian economy in February bolsters the case that the Bank of Canada will delay its long campaign to raise interest rates until the summer.

The Canadian economy shrank in February for the first time in five months, dragged down by the largest retreat of manufacturing activity since the worst stretch of the recession.

Gross domestic product declined 0.2 per cent, after back-to-back gains of 0.5 per cent in December and January, Statistics Canada reported Friday.

That suggests Bank of Canada Governor Mark Carney won't move on lifting the central bank's key interest rate from rock-bottom levels until at least July, economists said.

"Despite the month's mild contraction, the Bank of Canada should still be looking to hike rates in July, as growth is likely to resume going," CIBC World Markets economist Emanuella Enenajor said.

Even with the setback, the Canadian economy is headed for growth of roughly 4 per cent in the first quarter – or twice as fast as the United States.

The weakness in manufacturing is directly tied to the strong Canadian dollar and the slow U.S. recovery.

"Given how closely tied Canada's export sector is to the U.S., much of the weakness in Canadian economic activity in February can be explained by the sharp slowdown in U.S.," said Toronto-Dominion Bank economist Diana Petramala in a research note.

The February number reduces the chance of a rate hike before the summer as Mr. Carney watches for signs that inflation is heating up. In its latest forecast, released in mid-April, the central bank estimated the economy grew at a 4.2-per-cent annualized clip in the first three months of 2011. That forecast may now prove too optimistic, economists said.

The Bank of Canada expects the economy will slow to a 2-per-cent pace in the current quarter because of the soaring dollar's effect on exports and supply-chain disruptions linked to Japan's natural disasters.

More immediately, the monthly decline in GDP could play a role in the federal parties' final attempts to sway voters before Monday's election. With NDP Leader Jack Layton surging in popularity and cruising towards a strong second-place finish, Stephen Harper's Conservatives are making the case that the economy is too fragile to change governments now.

Output by factories and other manufacturers slipped 1.6 per cent in February, the sharpest drop since early 2009 and erasing much of the previous month's 2.5-per-cent gain, as the automotive sector was particularly weak. Wholesale trade fell 1 per cent, and the transportation sector slipped 0.7 per cent. All told, the country's goods-producing industries fell back by 0.6 per cent, while service industries were basically unchanged thanks in part to a strong showing by retailers.

Still, the economy in February was 2.9 per cent bigger than a year earlier, largely on the strength of a 4.9 per cent year-over-year gain for goods producers.

As long as the economy posts a rebound in March, most economists expect the annual pace of growth for the first quarter to still come in close to 4 per cent. Statistics Canada is scheduled to publish the quarterly figure on May 30.

The Bank of Canada's next interest rate decision is the following day. Analysts said Friday that the February GDP report increases the likelihood policy makers will hold their fire until at least July and embark on a gradual tightening campaign, because it suggests the so-called output gap – or slack in the economy – will take longer than expected to chew up. Higher energy costs caused annual inflation to spike in March to the fastest pace in two-and-a-half years, but it's still unclear if that will spur long-lasting broad price gains throughout the economy.

“After a strong showing at the turn of the year, Canadian economic momentum has downshifted,” Benjamin Reitzes, an economist at BMO Nesbitt Burns, said in a note to clients. “Considering the downside risks to Q2 growth, the Bank of Canada’s call for the output gap to close by 2012 Q2 could be at risk. However, with inflation tracking above the (central bank’s) forecast, we anticipate the Bank will restart its tightening program in July – though the risk now appears to be towards a later move.”

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