

# Essentials of the Monetary Policy



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## BANK OF CANADA

### The *Monetary Policy Report (MPR)* points to an extended key rate *status quo*, with a slight tilt to the downside

#### ACCORDING TO THE BANK OF CANADA (BoC)

- The Canadian economy is now operating further above potential.
- Canada's real GDP growth has been revised to 2.6% for 2007, 2.3% for 2008 and 2.5% for 2009 (previously 2.5%, 2.6% and 2.4%).
- In a scenario in which the key rate is stable, the darkening outlook for the U.S., the high loonie price and tighter credit conditions will largely offset the greater strength of domestic demand.
- Core inflation should gradually decline to the 2% target by the second half of 2008 and stay there until the end of the forecast period.
- The risks to the inflation projection are relatively balanced, although there is perhaps a tilt to the downside.

#### COMMENTS

The downward revision to the Bank's economic outlook is food for thought. With forecast growth of only 2.3% next year, the monetary authorities' outlook is below the consensus of private sector forecasters. While the overall picture for the Canadian economy is essentially the same, some downside risks appear to have expanded.

More specifically, the BoC is indicating that a greater-than-forecast correction by the U.S. housing market and substantial appreciation by the loonie vs. the American dollar will intensify the struggles in foreign trade. Over the summer, the Canadian dollar evolved in a range that was well above the range the BoC established in July, forcing the Bank to revise its forecast downward. Now, at close to US\$1.03 at the time of writing, it would not be surprising for the loonie to once again be higher than the average of US\$0.98 set in the October *MPR*. Local determinants for the loonie are still

positive and, unless the Fed changes course, the greenback should remain on its downward trend, though its pace will surely be slower.

The BoC is also concerned about the adverse impacts of a slowdown in credit on consumer spending and corporate investment. Not only has the cost of borrowing from financial institutions gone up, but credit conditions have tightened. For now, it is still hard to pinpoint the extent and duration of this phenomenon.

The fact that the downside risks have increased slightly has repercussions for the BoC's inflation projections. The total annual inflation rate is thus expected to fall to the mean target, 2%, in the second half of 2008. In the meantime, the annual change in the total CPI could be 3% on average in the fourth quarter of 2007, due to a base effect associated with energy prices.

**Implications:** October's *MPR* seems to confirm that the likeliest path for Canada's monetary policy is an extension of the current *status quo*. However, as the risks are slightly more to the downside, the probability is that the BoC won't hesitate to ease its key rate if there is a strong correction by the U.S. housing market or an unexpected surge by the loonie.

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