



BANK OF CANADA

Future rate cuts could be more substantial!

ACCORDING TO THE BANK OF CANADA (BoC)

- The difficulties afflicting the world's financial markets worsened recently, and could last longer than forecast.
- Although the strain on the money markets has eased, financial institutions and non-financial corporate borrowers have seen credit spreads widen substantially since October's Report.
- The outlook for economic growth in the United States is much grimmer at this point.
- In 2008, the pace of Canada's economy will be slower than forecast last October.
- The economy is still operating above production capacity. The impacts of the deteriorating economic outlook in the United States will help intensify downward pressure on export growth. Domestic demand should remain robust, however.
- Inflation is below the projections set out in the October Report, primarily due to intensifying competitive pressure in the retail trade sector due to the Canadian dollar's appreciation. Both total and core consumer price index inflation should fall below 1.5% by mid-2008.
- Further monetary stimulus is likely to be required in the near term.

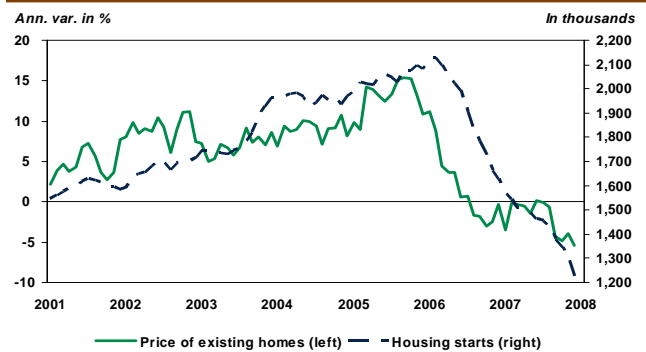
COMMENTS

The BoC showed reserve with the 25 basis point cut to the key rate ordered on Tuesday. However, its short-term economic projections suggest that the pace of monetary easing will accelerate in the next few months. Clearly, the U.S. Federal Reserve's surprise 75 basis point cut on Tuesday morning, and the strong likelihood of an additional 50 point cut next Wednesday, will have a big influence on the BoC's future decisions.

In our opinion, however, it is the preponderance of downside risks that will prod the BoC to bring its key rates down further and faster than we had preciously anticipated.

The BoC made some fairly substantial changes to its economic scenario. In the United States, the housing sector's decline is deeper than expected (Graph 1). The drop in home values and tightening credit conditions should further moderate growth by domestic demand.

Graph 1 – U.S. housing market situation is crumbling



Sources: U.S. Census Bureau and Desjardins, Economic Studies

The U.S. real GDP could only grow 1.5% in 2008, meaning an average annualized increase of just 0.5% in the first two quarters of the year. This scenario is very close to a U.S. recession which, according to the usual definition, corresponds to two consecutive negative quarters.

In Canada, the deeper than forecast slowdown by the U.S. economy will of course have major repercussions for foreign trade. The problems with Canadian exports could therefore be greater than initially thought (Graph 2).

Although the BoC still believes that domestic demand will remain strong, the weaker outlook for foreign trade means that its outlook for real GDP is being revised downward. Real GDP is thus forecast to expand by 1.8% in 2008 and 2.8% in 2009 (Table 1). Note that, in October, the monetary

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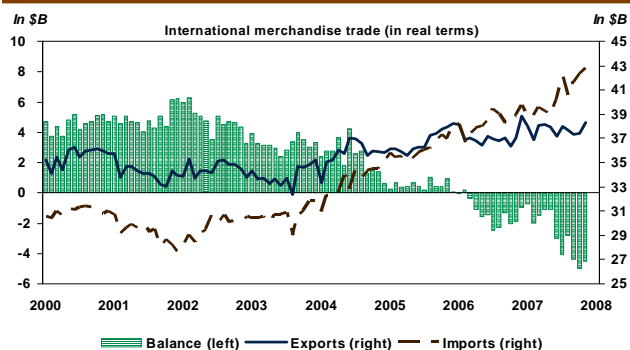
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Graph 2 – The U.S. economic slowdown is intensifying the problems in Canadian exports



Sources: Statistics Canada and Desjardins, Economic Studies

Table 1 – The Bank of Canada's economic outlook

Annual real GDP growth (%)				
	2006	2007f	2008f	2009f
Canada	2.8	2.6	1.8	2.8
United States	2.9	2.2	1.5	2.5
European Union	2.9	2.7	1.8	1.9
Japan	2.4	1.9	1.6	1.8
China and Asian NIES*	10.0	10.1	9.3	7.9
World	5.4	5.3	4.6	4.3

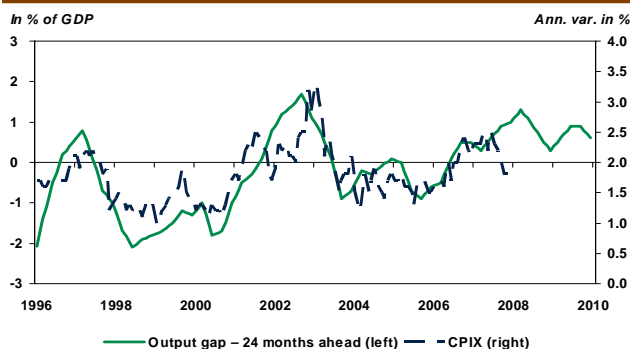
Summary of projections for the Canadian outlook						
	2007		2008		2009	
	Q3	Q4	Q1	Q2	Q3 & Q4	
Real GDP (quarterly ann. var. in %)	2.9	1.5	0.6	2.0	2.3	3.2
Global CPI (ann. var. in %)	2.2	2.4	1.7	1.4	1.5	1.9
CPIX (ann. var. in %)	2.2	1.6	1.4	1.3	1.6	1.9

* Newly industrializing economy.
f: forecasts
Source: Bank of Canada

authorities' scenario was for 2008's economic growth to be 2.3%.

For now, nothing is stopping the BoC from proceeding with bigger rate cuts. Some inflation pressures do remain, of course: The economy is still operating above production potential (Graph 3), labour market conditions remain tight, and real wages are rising.

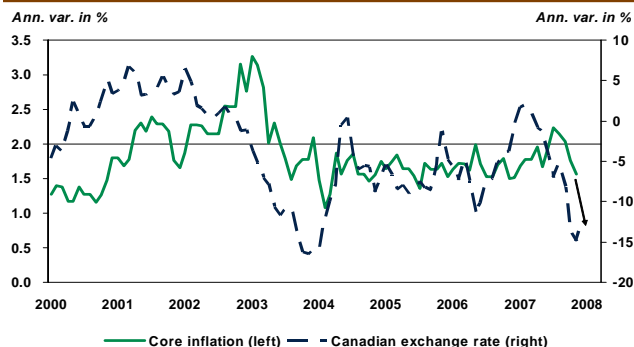
Graph 3 – Inflation pressures underlying the solid performance of Canada's domestic demand...



Sources: Datastream and Desjardins, Economic Studies

Yet the downward revisions to growth should lead to a slight excess in supply as of the second quarter of 2008. What's more, intensifying competitive pressure associated with the strong loonie should offset the inflation risks stemming from the domestic economy's solid performance (Graph 4).

Graph 4 – ... should be offset by the intensified competitive pressure stemming from the strong loonie



Sources: Statistique Canada and Desjardins, Economic Studies

As a result, total and core inflation will drop to close to 1.5% by mid-2008, giving the BoC the leeway it needs to lower its interest rates further to limit the risks of a sharper slowdown.

Implications: In light of the latest data, we now believe that interest rates will come down to 3.0% over the next three meetings, with a 50 basis point cut at the March meeting.

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