

Essentials of the Monetary Policy

April 24, 2008

BANK OF CANADA

Monetary Policy Report: Growth expectations are revised down

ACCORDING TO THE BANK OF CANADA (BoC)

- The BoC is now projecting a deeper and more protracted slowdown in the U.S. economy. This has direct consequences for the Canadian economic outlook, with declining exports projected to exert a significant drag on growth in 2008.
- The Canadian economy will grow by 1.4% this year, 2.4% in 2009, and 3.3% in 2010.
- The recent price-level adjustments for automobiles and the effect of past changes in indirect taxes will keep measured inflation below target through 2008. The emergence of excess supply in the economy should keep downward pressure on inflation through 2009. There are both upside and downside risks to the new projection for inflation. These risks appear to be balanced.
- Some further monetary stimulus will likely be required. Given the cumulative reduction in the target for the overnight rate of 150 basis points since December, the timing of any further monetary stimulus will depend on the evolution of the global economy and domestic demand, and their impact on inflation in Canada.

COMMENTS

The economic data released since the BoC's last *Monetary Policy Report* show that the Bank was a little too optimistic in its economic forecasts. In the United States, the difficulties were greater than expected, and Canada's monetary authorities now think that Uncle Sam's economy will undergo a slight recession in the first half of 2008. This will have repercussions for the world's other economies, especially industrialized nations, and the forecast for global GDP growth has been trimmed by four tenths of a percentage point to 3.7%.

The darkening outlook for U.S. economic growth will also have consequences for Canada. Foreign trade, already hurt by the strong loonie, will deteriorate further under the impact of a sharper slowdown by U.S. demand. Canada's domestic demand should remain robust, which will offset foreign

trade's negative contribution to economic growth. The Bank of Canada's new scenario is thus for real GDP to grow only 1.4% in 2008, and 2.4% next year. Note that projections established in January's Update were 1.8% for 2008 and 2.8% for 2009.

Overall, the Bank of Canada's projections are very similar to our latest economic scenario for 2008. The case is not the same for next year, as the Bank's forecast for Canadian real GDP growth is higher than ours. The monetary authorities seem to be betting that economic conditions will start to get back to normal as of early 2009. In our view, this is an overly optimistic vision. There is a good chance that the Bank of Canada will make further downward adjustments to its scenario in the next few months.

As for inflation, the Bank projects that growth by the total index could be higher than initially forecast, due to the increase in energy prices. The annual variation by the core index (CPIX) should, however, remain around 1.3% until the end of Q3 of 2008, then gradually climb to 2% in 2010. Note that the drop in automobile prices is responsible for almost half of the reduction in trend inflation since mid-2007.

Summary of the Bank of Canada's projections

	2007	2008		2009		
	4th quarter	1st quarter	2nd quarter	2nd sem.	1st sem.	2nd sem.
Real GDP	0.8% (1.5%)	1.0% (0.6%)	0.3% (2.0%)	1.8% (2.3%)	2.7% (3.1%)	3.3% (3.2%)
Total CPI	2.4% (2.4%)	1.8% (1.7%)	1.7% (1.4%)	1.9% (1.5%)	1.8% (1.9%)	1.8% (2.0%)
CPIX	1.6% (1.6%)	1.4% (1.4%)	1.3% (1.3%)	1.5% (1.6%)	1.7% (1.9%)	1.8% (2.0%)

The numbers in parentheses correspond to the projections in the January 2008 Monetary Policy Report Update.
Source: Bank of Canada

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Contribution to the core index's (CPIX) annual growth rate from Q2 2007 to Q1 2008

Components	Contribution (in percentage points)
Motor vehicles	-0,42
Core food (excludes fruit and vegetables)	-0,13
Durables excluding motor vehicles	-0,12
Electricity	-0,06
Semi-durables	-0,06
Core shelter services (excludes mortgage-interest costs)	-0,04
Core services excluding shelter (excludes intercity transportation and food purchased at restaurants)	-0,04
Non-durables (excludes food, energy, and tobacco)	-0,03
Variation in CPIX	-1,0

Source: Bank of Canada

With many upside risks (strong domestic demand, solid wage gains, weak productivity growth, ongoing pressures on commodities prices) and many downside risks (anaemic growth in the U.S., the difficulties banks are having in raising capital, increased cost of borrowing, lively Canadian dollar), the bank judges that the risks to its inflation scenario are balanced.

Therefore, though the Bank thinks that further monetary stimulus is likely to be required to reach the inflation target over the medium term, it says that the timing of any further rate cut will depend on the evolution of the global and Canadian economies. However, soft inflation (which keeps real interest rates in positive territory) is providing the Bank with all the leeway it needs to lower key rates further. In our opinion, the situation still favours an additional 25 basis point cut at the June 10 meeting.

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