

July 15, 2008



## BANK OF CANADA

### The door is open for a period of monetary stability in Canada

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

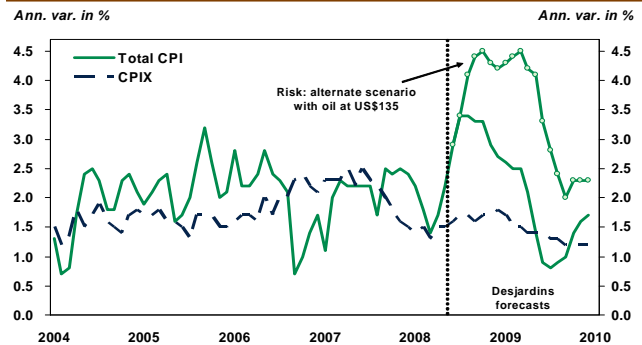
- The target for the overnight rate remains at 3.0%.
- High terms of trade, accommodative monetary policy, and a gradual recovery in the U.S. economy are expected to put the economy's growth rate above production potential early in 2009. Canadian real GDP should grow 1.0% in 2008, 2.3% in 2009 and 3.3% in 2010.
- Assuming energy prices remain at current levels, total consumer price index (CPI) inflation should rise temporarily above 4%, peaking in the first quarter of 2009.
- As energy prices stabilize and with inflation expectations remaining anchored, total CPI inflation should converge to core inflation at the 2% target in the second half of 2009.
- Against this backdrop, the Bank judges that the current level of the target for the overnight rate remains appropriate.

#### COMMENTS

This time, the Bank did not cause any surprises in keeping its key rate at 3.0%, as projected by all 28 forecasters in the consensus. The surge by energy prices is a concern, but underlying inflation is contained for now, and there are many downside risks to economic growth.

The latest turn taken by events, with another wave of pessimism about the banking sector, shows that the credit crisis is nowhere near over and the monetary status quo could last for several more months. Of course, given persisting high oil prices, the BoC upgraded its total inflation projection, potentially to more than one percentage point higher than the top of its target range. However, it expects the effects to be temporary, with stabilizing oil prices quickly bringing inflation back in line with the core index. As a result, monetary policy will continue to be conducted in relation to how underlying inflation behaves. Underlying inflation is a result of the pressure on Canada's aggregate demand. We believe that the Canadian economy's current softness will allow core inflation to stay in the lower part of the BoC's target range until 2009.

#### The increase in oil prices results in an upward revision of total inflation projection



Sources: Statistics Canada and Desjardins, Economic Studies

Already, the first-quarter contraction in economic activity (-0.3%) has led to slight excess supply, and there is nothing to show that economic growth has bounced back to any extent this spring. The domestic economy is still sound, but the labour market is cresting, and faster inflation is having negative repercussions on households' real wage growth. Moreover, Canada's foreign trade sector is still vulnerable to the U.S. economic slowdown and the strong loonie.

**Implications:** The BoC seems to be saying that it is comfortable with a temporary acceleration by core inflation above the 3% ceiling. So, unless there is a sustained increase in oil prices over the next few months, it is unlikely the Bank will try to change its monetary policy. The most likely avenue is an extended status quo.

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**EXCERPT FROM THE BANK OF CANADA PRESS RELEASE  
JULY 15, 2008**


"[...] Although Canadian economic growth in the first quarter was weaker than expected, final domestic demand continues to expand at a solid pace. The economy is judged to have moved into slight excess supply in the second quarter of this year; excess supply is expected to increase over the balance of the year. High terms of trade, accommodative monetary policy, and a gradual recovery in the U.S. economy are expected to generate above-potential growth starting early next year, bringing the economy back to full capacity around mid-2010. Canadian GDP is projected to grow by 1.0 per cent in 2008, 2.3 per cent in 2009, and 3.3 per cent in 2010.

Total CPI inflation over the next year is expected to be much higher than projected at the time of the *April Report*. Assuming energy prices follow current futures prices over the projection period, total CPI inflation is projected to rise temporarily above 4 per cent, peaking in the first quarter of 2009. As energy prices stabilize and with medium-term inflation expectations remaining well anchored, total inflation is then projected to converge to the core rate of inflation at the 2 per cent target in the second half of 2009. Core inflation is projected to remain well contained and broadly in line with earlier expectations, averaging close to 1.5 per cent through the third quarter of this year and then rising to 2 per cent in the second half of 2009.

[...] Against this backdrop, the Bank judges that the current level of the target for the overnight rate remains appropriate. The Bank will continue to monitor carefully the evolution of risks, together with economic and financial developments in the Canadian and global economies, and set monetary policy consistent with achieving the inflation target over the medium term. [...]"

**Table 1  
Schedule and key rates**

Date	Central Bank	Decision	Rate
<b>April 2008</b>			
23	Bank of Sweden	s.q.	4.25
29	Bank of Japan	s.q.	0.50
30	Federal Reserve	-25 b.p.	2.00
<b>May 2008</b>			
6	Reserve Bank of Australia	s.q.	7.25
8	Bank of England	s.q.	5.00
8	European Central Bank	s.q.	4.00
16	Bank of Mexico	s.q.	7.50
19	Bank of Japan	s.q.	0.50
28	Bank of Norway	s.q.	5.50
<b>June 2008</b>			
3	Reserve Bank of Australia	s.q.	7.25
4	Reserve Bank of New Zealand	s.q.	8.25
4	Bank of Brazil	+50 b.p.	12.25
5	Bank of England	s.q.	5.00
5	European Central Bank	s.q.	4.00
10	Bank of Canada	s.q.	3.00
12	Bank of Japan	s.q.	0.50
19	Swiss National Bank	s.q.	2.75
20	Bank of Mexico	+25 b.p.	7.75
25	Bank of Norway	+25 b.p.	5.75
25	Federal Reserve	s.q.	2.00
<b>July 2008</b>			
1	Reserve Bank of Australia	s.q.	7.25
3	European Central Bank	+25 b.p.	4.25
3	Bank of Sweden	+25 b.p.	4.50
10	Bank of England	s.q.	5.00
15	Bank of Japan	s.q.	0.50
15	Bank of Canada	s.q.	3.00

s.q.: status quo; b.p. : basis points  
Source: Desjardins, Economic Studies

**Table 2  
Coming soon**

Date	Central Bank
<b>July 2008</b>	
18	Bank of Mexico
23	Reserve Bank of New Zealand
23	Bank of Brazil
<b>August 2008</b>	
5	Reserve Bank of Australia
5	Federal Reserve
7	Bank of England
13	Bank of Norway
15	Bank of Mexico
18	Bank of Japan
<b>September 2008</b>	
2	Reserve Bank of Australia
3	Bank of Canada
4	Bank of England
4	European Central Bank
4	Bank of Sweden
10	Reserve Bank of New Zealand
10	Bank of Brazil
16	Bank of Japan
16	Federal Reserve
18	Swiss National Bank
19	Bank of Mexico
24	Bank of Norway
<b>October 2008</b>	
2	European Central Bank
6	Bank of Japan
7	Reserve Bank of Australia
9	Bank of England
17	Bank of Mexico

Source: Desjardins, Economic Studies