Essentials of the Monetary Policy

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BANK OF CANADA

The inflation scenario has been downgraded, but caution is still in order

ACCORDING TO THE BANK OF CANADA (BoC)

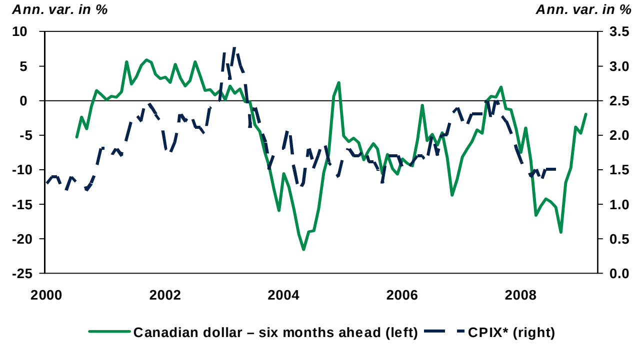
- The target for the overnight rate is steady at 3.00%.
- There is an increased risk of a more pronounced interplay between weakness in the U.S. economy and tightness in credit conditions that could affect the U.S. outlook for 2009.
- Canada's domestic demand has slowed modestly, but remains strong. The level of economic activity is slightly lower than expected in July, but still close to the economy's production capacity.
- Commodity prices have come down but, given tight inventories, commodity prices can be expected to remain volatile.
- Global inflationary pressures remain elevated, with potential implications for import prices and the dynamics of inflation in Canada. However, the recent decline in both spot and futures prices for energy means that the spike in total consumer price index (CPI) inflation expected by the first quarter of 2009 will be lower than projected in July.
- The Bank judges that the current level of the target for the overnight rate remains appropriate.

COMMENTS

As expected, the BoC opted to maintain its key rate at 3.0% this morning. Canada's monetary authorities are signalling that their projections for growth and inflation will be downgraded, but that the monetary bias is neutral.

The BoC is surely delighted to see that "economic theory" has finally won out over speculation: in the context of softening global demand, oil prices were well overvalued. As a result, the upward impacts associated with rising energy prices this summer should start to turn around by the end of the year. For now, however, prudence is required. Movement by energy prices is still highly volatile, and total inflation should stay over 3.0% until 2009. Monetary authorities are also concerned about the repercussions that global inflationary pressures could have on Canadian import prices. Note that the loonie has depreciated substantially since mid-August, and will no longer be putting the brakes on consumer prices here.

Competitive pressures tied to the strong loonie should turn around over the next few months



* Consumer price index excluding the eight most volatile components.
Sources: Datastream and Desjardins, Economic Studies

October's publication of the *Monetary Policy Report* will give us more details about the BoC's projections for growth and inflation, but the risks should be solidly tilted to the downside. Although we were among the most pessimistic in the consensus forecast, on the face of the evidence, we must conclude that annual growth for 2008 will be even weaker than expected. Under the circumstances, the gap between Canadian production and output will widen further, wiping out all of the inflation pressures originating in economic activity here. Should the U.S. slowdown last longer, or should there be a sharp drop in global demand for commodities, the BoC will have all the leeway it needs to engage in a new round of monetary easing.

Implications: As the BoC was not overly pessimistic, our scenario for a status quo in October still holds up. Despite the correction by oil prices, total inflation will stay over 3.0% until 2009. However, we think that the risks are now to the downside and that further interest cuts may be needed later in 2008 and in early 2009.

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NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

EXCERPT FROM THE BANK OF CANADA PRESS RELEASE

BANQUE DU CANADA BANK OF CANADA

"[...] there is an increased risk of a more pronounced interplay between weakness in the U.S. economy and tightness in credit conditions that could affect the U.S. outlook for 2009.

[...] Given tight inventories, commodity prices can be expected to remain volatile. The reduction in commodity prices has been a significant factor in the decline of the Canadian dollar against the U.S. dollar. The weaker global growth and the decline of the Canadian dollar will have opposing effects on the demand for Canadian goods and services.

[...] domestic demand has slowed modestly but remains strong [...] the level of economic activity is slightly lower than expected in July but still close to the economy's production capacity.

Global inflationary pressures remain elevated, with potential implications for import prices and the dynamics of inflation in Canada [...] the recent decline in both spot and futures prices for energy means that the spike in total CPI inflation expected between now and the first quarter of 2009 will be lower than projected in July.

[...] the Bank judges that the current level of the target for the overnight rate remains appropriately accommodative [...]"

Table 1
Schedule and key rates

Date	*Central Bank*	*Decision*	*Rate*
June 2008			
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
July 2008			
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 Canada	s.q.	3.00
15	Bank of Japan	s.q.	0.50
18	Bank of Mexico	+25 b.p.	8.00
23	Reserve Bank of New Zealand	s.q.	8.00
23	Bank of Brazil	+75 b.p.	13.00
August 2008			
5	Reserve Bank of Australia	s.q.	7.25
5	Federal Reserve	s.q.	2.00
7	Bank of England	s.q.	5.00
7	European Central Bank	s.q.	4.25
13	Bank of Norway	s.q.	5.75
15	Bank of Mexico	+25 b.p.	8.25
18	Bank of Japan	s.q.	0.50
September 2008			
2	Reserve Bank of Australia	-25 b.p.	7.00
3	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*
September 2008	
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
October 2008	
2	European Central Bank
6	Bank of Japan
7	Reserve Bank of Australia
9	Bank of England
17	Bank of Mexico
21	Bank of Canada
22	Reserve Bank of New Zealand
23	Bank of Sweden
29	Bank of Norway
29	Bank of Brazil
29	Federal Reserve
30	Bank of Japan
November 2008	
3	Reserve Bank of Australia
6	Bank of England
6	European Central Bank
20	Bank of Japan
28	Bank of Mexico

Source: Desjardins, Economic Studies