

Essentials of the Monetary Policy



Desjardins
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BANK OF CANADA

Monetary Policy Report: the BoC makes drastic changes to its scenario

ACCORDING TO THE BANK OF CANADA (BoC)

- The global and U.S. economies appear to be in recession.
- Tightening in credit conditions, weaker domestic demand and lower commodity prices have darkened the growth and inflation outlooks in Canada.
- Forecast Canadian real GDP growth has been revised downward, from 1.0% to 0.6% for 2008 and from 2.3% to 0.6% for 2009.
- The BoC has lowered its estimate for the growth of potential output to 2.3% in 2008, 2.4% in 2009 and 2.5% in 2010 and 2011.
- The total inflation rate, now 3.5%, should drop below 1% in mid-2009 then go back up to 2% by the end of 2010. The year-over-year change in the core index (CPIX) will stay below 2% until the end of 2010.
- Governments and central banks in industrialized nations have taken a series of measures to stabilize the global financial system and limit repercussions for the real economy.
- The risks to the BoC's scenario are relatively balanced. However, the outlook is surrounded by a great deal of uncertainty.

COMMENTS

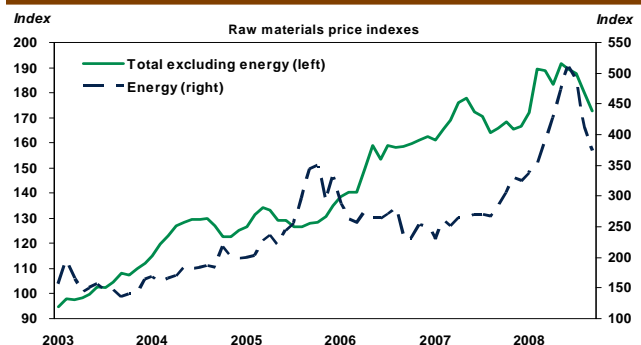
As we expected, the BoC revised its scenario downward substantially. It should be noted that economic conditions have deteriorated a great deal since last July's report was published. September's deepening of the financial crisis had echoes worldwide. The risks of a recession in the United States and, by ricochet, everywhere else in the world have increased. Because it is an open economy, Canada is, naturally, not immune from the darkening economic outlook. The deterioration in foreign trade is being magnified by a slowdown in foreign demand (especially in the United States) and by the drop in global demand for energy and non-energy commodities. The downward impact of the tumble in commodity prices on the Canadian dollar and the slower pace of import growth will still help rein in the contraction in net exports.

Summary of BoC projections

	2008				2009	
	Q1	Q2	Q3	Q4	1st semester	2nd semester
Real GDP	-0.8% (-0.3%)	0.3% (0.8%)	0.8% (1.3%)	-0.4% (1.8%)	0.4% (2.8%)	2.2% (3.2%)
Total CPI*	1.8% (1.8%)	2.3% (2.2%)	3.4% (3.8%)	2.6% (4.1%)	1.7% (3.6%)	1.0% (2.0%)
CPIX	1.4% (1.4%)	1.5% (1.5%)	1.6% (1.5%)	1.8% (1.8%)	1.7% (1.9%)	1.6% (2.0%)

* Consumer price index.
The numbers in parentheses correspond to the projections in the July 2008 Monetary Policy Report Update.
Source: Bank of Canada

Commodity prices have come down sharply



Sources: Statistics Canada and Desjardins, Economic Studies

Domestic demand, which has been the pillar of Canadian economic growth over the last few years, is also showing some signs of flagging. Because the financial crisis deepened, household confidence crumbled further, and consumer spending growth is slowing. What's more, the drop in Canadian export prices has led to a reversal in the country's terms of trade. Canadians will thus no longer benefit from

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the wealth effect associated with the surge in commodity prices. Thus, the BoC expects the real gross domestic income (GDI) to fall 1.9% next year, in stark contrast with the lively growth seen over the last few years. This is likely to translate into slower growth by domestic demand. Lastly, there is concern that the tighter credit conditions being seen in Canada will lead to a more pronounced drop in residential and, in particular, non-residential investment.

As for inflation, the recent decline in energy prices is making the monetary authorities revise their projections downward. The next few months should see the total annual inflation rate come down substantially, as the effects of prior increases in gas prices will be less and less present. The BoC is even anticipating total inflation below the bottom of its target range (1%) in mid-2009. However, the risks of deflation are small, with inflation expected to return toward the mean target (2%) by the end of 2010.

The BoC's new scenario is very similar to our projections. However, keep in mind that the economic and financial context is very uncertain. In our view, the risks are tilted to the downside.

Given inflation's expected decline and the darkening economic outlook, it seems obvious that key rates will be lowered further in the next few months. We are anticipating at least two other 25 basis point rate cuts, at the December and January meetings.

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