

Essentials of the Monetary Policy

January 20, 2009

BANK OF CANADA

Key rates go to a historic low and the door is still open...

ACCORDING TO THE BANK OF CANADA (BoC)

- The target for the overnight rate is lowered by 50 basis points to 1.00%.
- The outlook for the global economy has deteriorated, with the intensifying financial crisis spilling over into real economic activity.
- There are signs that the extraordinary measures are starting to gain traction, although it will take some time for financial conditions to normalize.
- Canadian exports are down sharply, and domestic demand is shrinking as the result of declines in real income, household wealth, and consumer confidence.
- Canada's economy is expected to contract until mid-2009, with the annual average real GDP growth rate dropping by 1.2%. Real GDP is expected to rebound and record a 3.8% increase in 2010.
- Core consumer price inflation should reach a low of 1.1% in the final quarter of 2009. Total CPI inflation should be negative for two quarters in 2009.
- The BoC will continue to monitor carefully the economic and financial developments in judging to what extent further monetary stimulus will be required to achieve the 2% target over the medium term.

COMMENTS

As the broad majority of forecasters had anticipated, the economy's ongoing deterioration prompted the BoC to lower its key rate to 1.00% this morning, the lowest level ever recorded here. This takes the monetary stimulus ordered since last October to 200 basis points.

We are at a point where a recession can no longer be avoided, but the impact of public policy will determine how much of a recovery will be seen by year's end. The BoC seems very optimistic about this point. Of course, efforts by monetary authorities (ongoing) and governments (announced) are unprecedented and should eventually lead to a big turnaround, but the tough financial context and rapid deterioration in the economic outlook call for prudence.

Consumer confidence is nearing historic lows, the labour market is deteriorating quickly and the housing market is correcting in several parts of the country. Due to negative wealth effects, Canadian households are seeing their situations deteriorate and a tough period, characterized by tightening credit conditions, could force them to save more. The recession is now taking hold worldwide, so it is unlikely that demand for commodities will have a positive influence on Canada's economy in 2009.

Under these circumstances, the Canadian economy's output gap will continue to deepen, completely wiping out inflation pressure in Canada as a result. With the sharp drop in oil prices and the impacts of the economic downturn, the annual decline in total inflation is likely to hold below the BoC's target range (1% to 3%) until 2010, with an incursion below 0% in the first half of 2009.

With a monetary policy not as effective as hoped for, given the credit crisis' impacts on retail rates, it will be necessary to lower the target for the key rate further to keep real interest rates as low as possible.

Implications: In our opinion, the risks are still broadly tilted to the downside. To limit the severity of the Canadian recession and get core inflation back into line with the mean target over the medium range, it seems clear that further rate cuts will be ordered in the next few months. We are now anticipating a rate of 0.50% as of March of 2009.

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EXCERPT FROM THE BANK OF CANADA PRESS RELEASE


“[...] lowering its target for the overnight rate by one-half of a percentage point to 1 per cent [...]

The outlook for the global economy has deteriorated [...] with the intensifying financial crisis spilling over into real economic activity [...]

[...] There are signs that these extraordinary measures are starting to gain traction, although it will take some time for financial conditions to normalize [...]

Canadian exports are down sharply, and domestic demand is shrinking as a result of declines in real income, household wealth, and consumer and business confidence. Canada’s economy is projected to contract through mid-2009, with real GDP dropping by 1.2 per cent this year on an annual average basis [...] real GDP is expected to rebound, growing by 3.8 per cent in 2010.

A wider output gap through 2009 and modest decreases in housing prices should cause core CPI inflation to ease, bottoming at 1.1 per cent in the fourth quarter. Total CPI inflation is expected to dip below zero for two quarters in 2009 [...]

[...] the Bank will continue to monitor carefully economic and financial developments in judging to what extent further monetary stimulus will be required to achieve the 2 per cent target over the medium term [...]

**Table 1
Schedule and key rates**

Date	Central Bank	Decision	Rate
October 2008			
29	Bank of Brazil	s.q.	13.75
29	Federal Reserve	-50 b.p.	1.00
30	Bank of Japan	-20 b.p.	0.30
November 2008			
3	Reserve Bank of Australia	-75 b.p.	5.25
6	Bank of England	-150 b.p.	3.00
6	European Central Bank	-50 b.p.	3.25
6	Swiss National Bank	-50 b.p.	2.00
20	Bank of Japan	s.q.	0.30
20	Swiss National Bank	-100 b.p.	1.00
28	Bank of Mexico	s.q.	8.25
December 2008			
1	Reserve Bank of Australia	-100 b.p.	4.25
1	Bank of Japan	s.q.	0.30
3	Reserve Bank of New Zealand	-150 b.p.	5.00
4	Bank of England	-100 b.p.	2.00
4	European Central Bank	-75 b.p.	2.50
4	Bank of Sweden	-175 b.p.	2.00
9	Bank of Canada	-75 b.p.	1.50
10	Bank of Brazil	s.q.	13.75
11	Swiss National Bank	-50 b.p.	0.50
16	Federal Reserve	-100 b.p. / -75 b.p.	0.00 / 0.25
17	Bank of Norway	-175 b.p.	3.00
18	Bank of Japan	-20 b.p.	0.10
January 2009			
8	Bank of England	-50 b.p.	1.50
15	European Central Bank	-50 b.p.	2.00
16	Bank of Mexico	-50 b.p.	7.75
20	Bank of Canada	-50 b.p.	1.00

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

**Table 2
Coming soon**

Date	Central Bank
January 2009	
21	Bank of Brazil
22	Bank of Japan
28	Federal Reserve
29	Reserve Bank of New Zealand
February 2009	
3	Reserve Bank of Australia
4	Bank of Norway
5	Bank of England
5	European Central Bank
10	Bank of Sweden
19	Bank of Japan
12	Bank of Mexico
March 2009	
3	Reserve Bank of Australia
3	Bank of Canada
5	Bank of England
5	European Central Bank
11	Bank of Brazil
12	Reserve Bank of New Zealand
12	Swiss National Bank
17	Bank of Japan
17	Federal Reserve
20	Bank of Mexico
25	Bank of Norway
April 2009	
2	European Central Bank
7	Reserve Bank of Australia
7	Bank of Japan
9	Bank of England

Source: Desjardins, Economic Studies