Essentials of the Monetary Policy

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BANK OF CANADA

Key rates come down another 50 basis points

As in the U.S. and Japan, quantitative monetary policy is being considered

ACCORDING TO THE BANK OF CANADA (BoC)

- The target for the overnight rate has been lowered by 50 basis points to 0.50%.
- The outlook for the global economy has continued to deteriorate, with weaker-than-expected activity in major economies.
- Stabilization of the global financial system remains a precondition for the global and Canadian economic recoveries.
- National accounts data for the fourth quarter of 2008 and other indicators of aggregate demand point to a sharper decline in Canadian economic activity and a larger output gap through the first half of 2009 than the Bank forecast in January. These factors imply a slightly lower profile for core inflation than was projected in January.
- Once the global financial system stabilizes and global growth recovers, the underlying strength of the Canadian economy and financial sector should ensure a more rapid recovery in Canada than in most other industrialized economies.
- The target for the overnight rate can be expected to remain at this level or lower at least until there are clear signs that excess supply in the economy is being taken up. Given the low level of the target for the overnight rate, the Bank is refining the approach it would take to provide additional monetary stimulus, if required, through credit and quantitative easing.

COMMENTS

As most analysts had predicted, the BoC lowered its key rate this morning, taking it to just 0.50%. The BoC has not completely closed the door on another key rate cut, but it is fully aware that the effect of a further reduction would be very marginal. Instead, the statement tells us that the BoC is in the process of creating a framework for using new measures to continue to support the country's economy and financial market. This new framework will be set out in the *Monetary Policy Report* to be released on April 23.

We can therefore expect the BoC to use various non-traditional measures in the next few months. Already, this morning, in announcing that its key rates will stay at the current level or lower for a long time, it is attempting to bring down the entire Canadian rate curve, rather than simply the short-term rates. The next step could involve granting credit, especially to businesses, which could be done with the target for the overnight rate kept at 0.50%. Lastly, the final option would be true quantitative easing, which involves expanding the monetary base. In that case, the key rates would have to come down to zero.

The BoC is fully aware of the deterioration in Canada's economy. It is clear that it realizes that its optimistic economic scenario, which called for real GDP to contract by 1.2% in 2009, followed by a big 3.8% rebound in 2010, will have to be revised downward substantially. However, for now, it seems to be banking on Canada's economy recovering in a fairly vigorous manner.

According to the BoC, the latest economic statistics suggest a core inflation profile that is slightly lower than what had been projected in January. In our view, core inflation could therefore fall below the bottom of the BoC's target range (1%), while total inflation could slide into negative territory.

Implications: The BoC will have to keep its key rate at 0.50% for several quarters and try to support the economy and financial system using non-traditional tools, such as extending credit directly. Nevertheless, we cannot rule out zero rates and a true quantitative policy, if these new tools prove inadequate.

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EXCERPT FROM THE BANK OF CANADA PRESS RELEASE

"[...] The outlook for the global economy has continued to deteriorate since the Bank's January *Monetary Policy Report Update*, with weaker-than-expected activity in major economies [...]

Stabilization of the global financial system remains a precondition for the global and Canadian economic recoveries [...]

National accounts data for the fourth quarter of 2008 and other indicators of aggregate demand point to a sharper decline in Canadian economic activity and a larger output gap through the first half of 2009 than projected in January [...] These factors imply a slightly lower profile for core inflation than was projected in the January *MPRU*.

[...] Once the global financial system stabilizes and global growth recovers, the underlying strength of the Canadian economy and financial sector should ensure a more rapid recovery in Canada than in most other industrialized economies.

The Bank's decision to lower its policy rate by 50 basis points today brings the cumulative monetary policy easing to 400 basis points since December 2007. Consistent with returning total CPI inflation to 2 per cent, the target for the overnight rate can be expected to remain at this level or lower at least until there are clear signs that excess supply in the economy is being taken up.

Given the low level of the target for the overnight rate, the Bank is refining the approach it would take to provide additional monetary stimulus, if required, through credit and quantitative easing. In its April *Monetary Policy Report*, the Bank will outline a framework for the possible use of such measures [...]"

Table 1
Schedule and key rates

Date	Central Bank	Decision	Rate
December 2008			
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
21	Bank of Brazil	-100 b.p.	12.75
21	Bank of Japan	s.q.	0.10
28	Reserve Bank of New Zealand	-150 b.p.	3.50
28	Federal Reserve	s.q.	0.00 / 0.25
February 2008			
3	Reserve Bank of Australia	-100 b.p.	3.25
4	Bank of Norway	-50 b.p.	2.50
5	Bank of England	-50 b.p.	1.00
5	European Central Bank	s.q.	2.00
11	Bank of Sweden	-100 b.p.	1.00
18	Bank of Japan	s.q.	0.10
20	Bank of Mexico	-25 b.p.	7.50
March 2008			
2	Reserve Bank of Australia	s.q.	3.25
3	Bank of Canada	-50 b.p.	0.50

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

Table 2
Coming soon

Date	Central Bank
March 2009	
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
17	Bank of Mexico
20	Bank of Sweden
21	Bank of Canada
28	Bank of Japan
29	Bank of Brazil
29	Federal Reserve
30	Reserve Bank of New Zealand
May 2009	
5	Reserve Bank of Australia
6	Bank of Norway
7	Bank of England
12	European Central Bank
12	Bank of Mexico
22	Bank of Japan

Source: Desjardins, Economic Studies