

# Essentials of the Monetary Policy

April 23, 2009

## BANK OF CANADA

### *Monetary Policy Report: the BoC now anticipates a harsher recession... but is still optimistic about the recovery*

#### The inflation projection suggests that the target could be met without resorting to quantitative easing measures

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

- The recession that is battering the world's economy has deepened and become more synchronous since the *Monetary Policy Report Update* appeared last January.
- Deteriorating credit conditions have spread through trade, financial and confidence channels. As a result, the recession in Canada will be deeper than anticipated.
- The economic recovery should, however, be supported by several factors, including the speed and scope of monetary policy measures, the relative efficiency of Canada's financial system, a gradual improvement in financial conditions, the loonie's prior depreciation, sound bank, household and business balance sheets, and the completion of inventory adjustments.
- The BoC thus expects real GDP to contract 3.0% this year, then grow 2.5% next year and 4.7% in 2011.
- The annual core and total consumer price index (CPI) rates should gradually rise, reaching 2% in the third quarter of 2011.
- The target for the overnight rate is now 0.25%. It will stay at this level until the end of the second quarter of 2010, in order to achieve the inflation target.

#### COMMENTS

We have extensively criticized the BoC's January economic scenario, which we judged to be much too optimistic. With the update to their projections presented today, the monetary authorities have removed their rosy glasses, at least to some degree: they are now expecting the recession to be in line with our economic scenario. Canada's real GDP should therefore tumble by about 3% in 2009, posting a record contraction in the first quarter (-7.3%). The BoC is still fairly optimistic about the economic recovery. Mark Carney and his colleagues expect Canada's real GDP to increase by 2.5% in 2010, growth that is almost twice the growth called for in our forecast and that of the International Monetary Fund (IMF).

Profound adjustments are underway in Canada's economy (restructuring auto industry, problems in the forest industry, increase in the household savings rate, drop in real estate prices, consolidating financial markets, etc.), which substantially lowers production's growth potential. The BoC judges that the growth rate of potential output will be 1.2% this year, 1.5% in 2010 and 1.9% in 2011. Now, to achieve economic growth of 2.5% in 2010, as the BoC forecasts, real GDP would have to increase by an average of about 4% a quarter all year long, a pace that is well above potential (1.5%). This type of divergence is usually associated with a very lively economic recovery. However, given the difficulties in the global economy and ongoing problems in the financial markets, most forecasters are of the view that the economic recovery will be moderate in industrialized countries.

As for the inflation outlook, the monetary authorities' projections appear to be realistic. In our view, the deflation anticipated for 2009 could be a little steeper. According to the BoC, the annual change in the total CPI could trough at

#### Comparison of economic forecasts

		2008	2009f	2010f	2011f
BoC's forecasts	Real GDP	0.5%	-3.0%	2.5%	4.7%
	Total inflation rate*	2.3%	0.3%	1.7%	1.9%
Desjardins forecasts	Real GDP	0.5%	-3.0%	1.4%	3.0%
	Total inflation rate	2.3%	-0.1%	1.3%	2.5%
IMF forecasts	Real GDP	0.5%	-2.5%	1.2%	n.a.
	Total inflation rate	2.3%	0.0%	0.5%	n.a.

\* Projections based on quarterly and six-month forecasts; f: forecasts; n.a.: not available.  
Sources: Bank of Canada, International Monetary Fund and Desjardins, Economic Studies

**François Dupuis**  
Vice-President and Chief Economist

**Yves St-Maurice**  
Director and Deputy Chief Economist

**Mathieu D'Anjou**  
Senior Economist

**Benoit P. Durocher**  
Senior Economist

**Martin Lefebvre**  
Senior Economist

**Hendrix Vachon**  
Economist

514-281-2336 or 1 866 866-7000, ext. 2336  
E-mail: [desjardins.economics@desjardins.com](mailto:desjardins.economics@desjardins.com)

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-0.8% in Q3 of 2009. However, the impact of the drop in energy prices and underuse of production capacity could take the total CPI's year-over-year change below the -1% mark. However, deflation should only be a temporary phenomenon and price movement is expected to come back toward the target range in 2010.

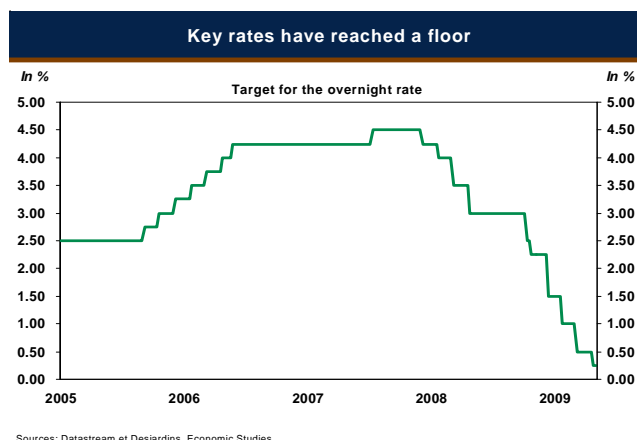
The monetary policy framework struck the financial markets with all the impact of a wet firecracker. The BoC did revise its economic growth outlook downward, but it seems that, because of its recovery forecasts for the end of 2009 and, especially, 2010, it is hesitant to move further ahead in easing the country's monetary conditions.

In fact, the monetary authorities are continuing to take things one step at a time. As the key interest rate was lowered to a floor of 0.25% on Tuesday, the BoC developed its monetary policy one notch further by stating that it was committed to keeping its policy rate at this level until the second quarter of 2010. The BoC thus hopes that longer term interest rates, which represent the averages of current and expected short-term rates (plus term premiums), will decline over the entire interest rate curve.

However, our economic scenario indicates that more aggressive actions will have to be undertaken as quickly as possible to rein in the impact of the decline in economic activity on underlying inflation. As the BoC has revised the economy's growth potential downward, economic growth will not have to be as fast to close the negative output gap, but it would be surprising if this were to happen before 2011 at the earliest. Consequently, the BoC will, sooner or later, have to resign itself to using unconventional "quantitative" tools.

For now, the monetary authorities have only provided us with their framework. The BoC does not spell out what kinds of assets or financing it intends to focus on. The BoC's actions will depend on what effects they have on interest rates for consumer loans (as consumer spending accounts for a large part of the economy), how much the actions help to lift the constraints on the credit markets, and how the exchange rate responds to the drop in returns on Canadian dollar denominated securities.

The following principles will guide the BoC's actions: the focus will be on achieving the inflation target; the measures taken would have to be as neutral as possible in order to limit the risk of distortions in some markets; and the BoC will have to minimize operational risks.



By putting the lower bound of the operating band at the target for the overnight interest rate, the BoC has acquired the tools it needs to technically initiate a quantitative easing policy. In this way, it will, if necessary, be able to swell its balance sheet assets by creating bank reserves. It appears, however, that this will not happen unless the BoC's economic scenario deteriorates further.

**Benoit P. Durocher**  
Senior Economist

**Martin Lefebvre**  
Senior Economist