Essentials of the Monetary Policy

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BANK OF CANADA

The strong loonie gives the BoC the necessary leeway to keep rates at current level until June 2010

ACCORDING TO THE BANK OF CANADA (BoC)

- The recent indicators point to a worldwide recovery, following a deep, synchronous recession.
- Canada has also returned to growth. However, heightened volatility and persistent strength in the Canadian dollar are working to slow growth and subdue inflation pressures. The BoC expects that, over time, the dollar's current strength will more than fully offset the impacts of the favourable developments noted since July.
- The BoC now projects that the output gap will be closed in the third quarter of 2011, one quarter later than it had projected in July. It also expects inflation to return to the 2% target in the third quarter of 2011, also one quarter later than the July projection.
- Conditional on the outlook for inflation, the target overnight rate can be expected to stay at its current level until the end of the second quarter of 2010 in order to achieve the inflation target.

COMMENTS

As expected, the BoC left its key interest rate unchanged at a trough of 0.25% this morning. However, the optimism monetary authorities had been showing in recent months has given way to greater caution. The fact is that the latest economic data are painting a more mixed picture of the situation. If, overall, the BoC's projections have proven accurate with respect to growth in the second quarter and movement by inflation, the outlook is still being impinged by the impact of the strong Canadian dollar on foreign trade and inflation.

The high Canadian dollar, which had been a risk at September's meeting, is now such a drag on growth and inflation that the Bank thinks it will more than fully offset the impacts of the positive developments recorded since July.

The BoC is maintaining its stance as to the possibility of stronger growth than initially forecast for the second half of 2009. However, this will have to translate into a sharp rebound in economic activity in the year's last quarter as the statistics for the summer indicate stagnation.[1] We already know that the tumble by net exports is making a very negative contribution to real GDP growth in the third quarter, but domestic demand does not appear to be as strong as we might think. Let us hope that the jump in confidence and lively job creation seen in the last few months will allow the real estate market's recent improvement to continue and retail sales to strengthen.

Despite lower growth potential, on the heels of a recession and a number of structural adjustments, the softness of the expected recovery means that the output gap will not be closed until the third quarter of 2011. Under these circumstances, the inflation pressures underlying economic activity will remain subdued, giving the BoC greater flexibility in conducting its monetary policy. The loonie's strength is only exacerbating the situation and the BoC had to make a point of showing its concern about the currency in order to not to trigger a further rise in market interest rates.

Implications: Canada should be growing again in the second half of the year, but the recovery is still in its very early stages. With non-energy inflation not troubling at all, the BoC has the leeway it needs to keep its key rate where it is until the second half of 2010.

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[1] The *Monetary Policy Report* to be released on October 22 will provide us with more details.

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EXCERPT FROM THE BANK OF CANADA PRESS RELEASE

"[...] Recent indicators point to the start of a global recovery from a deep, synchronous recession [...] although significant fragilities remain.

A recovery in economic activity is also under way in Canada. This resumption of growth is supported by monetary and fiscal stimulus, increased household wealth, improving financial conditions, higher commodity prices, and stronger business and consumer confidence. However, heightened volatility and persistent strength in the Canadian dollar are working to slow growth and subdue inflation pressures. The current strength in the dollar is expected, over time, to more than fully offset the favourable developments since July.

Given all of these factors [...] Growth is expected to be slightly higher in the second half of this year than previously projected but to average slightly lower over the balance of the projection period. The Canadian economy is projected to grow by 3.0 per cent in 2010 and 3.3 per cent in 2011, after contracting by 2.4 per cent this year [...]

The Bank now expects that the output gap will be closed in the third quarter of 2011, one quarter later than it had projected in July. Correspondingly, inflation is also expected to return to the 2 per cent target in the third quarter of 2011, one quarter later than in July's projection [...]"

Table 1
Schedule and key rates

Date	*Central Bank*	*Decision*	*Rate*
August 2008			
4	Reserve Bank of Australia	s.q.	3.00
6	European Central Bank	s.q.	1.00
6	Bank of England	s.q.	0.50
10	Bank of Japan	s.q.	0.10
12	Bank of Norway	s.q.	1.25
12	Federal Reserve	s.q.	0.00 / 0.25
21	Bank of Mexico	s.q.	4.50
September 2008			
1	Reserve Bank of Australia	s.q.	3.00
2	Bank of Brazil	s.q.	8.75
3	European Central Bank	s.q.	1.00
3	Bank of Sweden	s.q.	0.25
9	Reserve Bank of New Zealand	s.q.	2.50
10	Bank of England	s.q.	0.50
10	Bank of Canada	s.q.	0.25
16	Bank of Japan	s.q.	0.10
17	Swiss National Bank	s.q.	0.25
18	Bank of Mexico	s.q.	4.50
23	Bank of Norway	s.q.	1.25
23	Federal Reserve	s.q.	0.00 / 0.25
October 2008			
5	Reserve Bank of Australia	+25 b.p.	3.25
8	European Central Bank	s.q.	1.00
8	Bank of England	s.q.	0.50
13	Bank of Japan	s.q.	0.10
16	Bank of Mexico	s.q.	4.50
20	Bank of Canada	s.q.	0.25

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

Table 2
Coming soon

Date	*Central Bank*
October 2009	
21	Bank of Brazil
22	Bank of Sweden
28	Bank of Norway
28	Reserve Bank of New Zealand
29	Bank of Japan
November 2009	
2	Reserve Bank of Australia
4	Federal Reserve
5	European Central Bank
5	Bank of England
19	Bank of Japan
27	Bank of Mexico
30	Reserve Bank of Australia
December 2009	
3	European Central Bank
8	Bank of Canada
9	Reserve Bank of New Zealand
9	Bank of Brazil
10	Bank of England
10	Swiss National Bank
16	Bank of Norway
16	Bank of Sweden
16	Federal Reserve
17	Bank of Japan
January 2010	
7	Bank of England
14	European Central Bank
19	Bank of Canada
25	Bank of Japan

Source: Desjardins, Economic Studies