

Essentials of the Monetary Policy

October 22, 2009

BANK OF CANADA

Monetary Policy Report: Canada appears to have returned to growth

The BoC is short on caution in developing its outlook for Canada's economy

ACCORDING TO THE BANK OF CANADA (BoC)

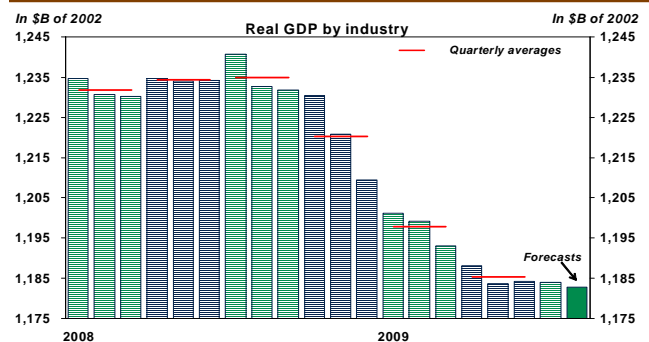
- Canada has resumed growth, thanks to monetary and fiscal stimulus, increased household wealth, improving financial conditions, higher commodity prices and stronger business and consumer confidence.
- Growth will be slightly higher than expected in the second half of 2009, but slightly lower after that. The Canadian dollar's current strength is expected to more than fully offset the favourable developments since July.
- The real GDP could grow 2.0% (quarterly annualized) in the third quarter of 2009, a slightly higher projection than established last July (+1.3%). The auto industry alone could generate a real GDP increase of about 1.5% for the quarter.
- 2009 should end with a Canadian real GDP contraction of 2.4%, followed by an increase of 3.0% in 2010 and 3.3% in 2011.
- The output gap should stand at about -3.5% in the third quarter. This negative gap should be closed in the third quarter of 2011, given slower growth by production potential and the real GDP growth the Bank projects for the coming quarters.
- The total annual inflation rate should climb to 1.0% in the fourth quarter of 2009 and return to the 2% mean target in the third quarter of 2011. The annual change in the Bank of Canada's core index should bottom out at 1.4% in Q4 of 2009 due to excess supply in the economy. After that, it should return to the target 2% in Q3 of 2011.
- Downside risks to the inflation projection are slightly more dominant, given that the key interest rate is at its lower bound.

COMMENTS

We are skeptical regarding the Bank of Canada's forecasts for the Canadian economy's movement in the coming quarters. The 1.3% increase (quarterly annualized) that the Bank of Canada initially forecast for the real GDP in the third quarter already seemed optimistic, and the monetary authorities have now raised the target to 2.0%. According to our estimates, the real GDP by industry would have to rise by about 0.6% in August and September to achieve this kind

of growth for the third quarter as a whole. Note that real GDP by industry fell 0.04% in July; we have to look back to December 2006, when the Canadian economy was in full swing, for a monthly gain of at least 0.6% by real GDP by industry. Given that the Canadian economy is still undergoing a variety of adjustments, this outlook seems optimistic. Moreover, even though August's real GDP by industry data will only be released on October 30, recent developments for most of the economic indicators are painting a rather modest picture for Canada's output in August. According to our estimate, as well as that of the currently available consensus forecast, everything suggests that the change in the real GDP by industry will still be close to zero for August. If these forecasts prove accurate, the real GDP by industry would then have to rebound by 1.8% in September to achieve the 2.0% increase the Bank of Canada is forecasting for the third quarter as a whole. This type of growth in a single month is, of course, highly optimistic.

Towards a sluggish third quarter?



Sources: Statistics Canada and Desjardins, Economic Studies

In short, it would have been better for the Bank of Canada to be more prudent in setting its economic scenario, as is the custom at central banks. For our part, we are keeping our

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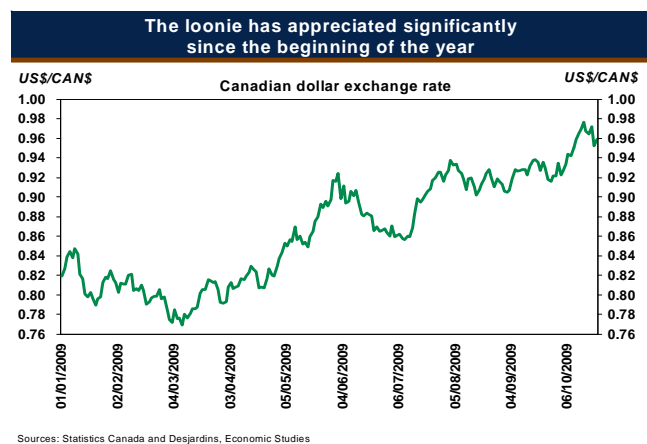
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forecast of a real GDP almost unchanged for the whole of Q3 of 2009, with the possibility of a very slight pullback during that time, extending the recession by a few months. For 2009 as a whole, our scenario calls for Canada's real GDP to contract by 2.7%, followed by growth of 2.1% next year. The Bank of Canada does not seem to be overflowing with caution when it comes to the scope of the recovery, either. According to the latest consensus forecast, Canada's real GDP could grow by 2.4% in 2010, a much smaller advance than the Bank is forecasting (3.0%).

Yet a little reserve could have been called for, given the loonie's recent rise. On the monetary authorities' own admission, the Canadian dollar's appreciation could seriously hamper foreign trade, to the point of offsetting the spinoffs from strengthening domestic demand. Moreover, the loonie's appreciation seems to have been broadly dependent on the greenback's generalized depreciation and not due to any real improvement in Canada's economic conditions. It could therefore seriously damage the growth outlook.



As for inflation, although relatively realistic, the Bank of Canada's projections seem to be slightly biased to the upside, compared with our estimates. Core inflation could slow further than the monetary authorities project, a gap that stems from our difference of opinion regarding the strength of Canada's economy in the coming quarters. Under the circumstances, the Bank of Canada seems likely to keep its key interest rates at their lower bounds until at least mid-2010.

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