BANK OF CANADA

The BoC lowers its key rate to 4.25% due to the proliferation of downside risks

ACCORDING TO THE BANK OF CANADA (BoC)

• The target for the overnight rate has been lowered 25 basis points to 4.25%.
• Increased competitive pressures related to the strong loonie led to slower than forecast progress by inflation.
• The Canadian economy continues to operate above its production capacity.
• However, the difficulties facing global financial markets have worsened and should persist for a longer period of time than expected, and credit conditions have tightened.
• The Bank judges that the balance of risks associated with the inflation projection has shifted to the downside.

COMMENTS

Taking action that is clearly preventive, the BoC kept pace with the U.S. Federal Reserve and cut its key rate by 25 basis points this morning. Note that this first decrease since April of 2004 comes at a time when Canadian domestic demand is going strong. The action should please those who have been asking the BoC for monetary easing for some time.

Surely, the darkening outlook held the most weight in the BoC decision, and the Bank seems to have taken advantage of it to avoid being out of sync with market expectations. Specifically, the troubles associated with the liquidity crisis have worsened, causing bank financing costs to increase and credit conditions to tighten further. Parallel to that, the risks to the outlook for demand for Canadian exports have intensified due to the ongoing American housing sector correction. The loonie’s recent correction is welcome, but it remains at a high level and its adverse impacts on Canada’s foreign trade will continue to be felt. Canadian consumers and businesses have already taken advantage of their increased buying power, with imports advancing almost eight times faster than exports this summer.

In the end, it was good performance by inflation that allowed the BoC to outstrip our projection and lower its key rate prior to January of 2008. Total and core inflation were weaker than forecast in October, due to heightened competitive effects associated with our currency’s vitality. With the loonie settling in above parity in November, downside pressure on consumer prices are likely to continue. This should allow the BoC to further ease its monetary policy in the next few months to keep the economy from slowing sharply.

With the ongoing U.S. slowdown, downward pressure on Canada’s net exports and the unsustainable pace of stockpiling here, we now expect two more rate cuts, in January and March. This would take the target for the overnight rate to 3.75%.

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[...] However, both total CPI inflation and core inflation in October, at 2.4 per cent and 1.8 per cent respectively, were below the Bank’s expectations, reflecting increased competitive pressures related to the level of the Canadian dollar. The Bank now expects inflation over the next several months to be lower than was projected in the MPR. In the context of exceptional volatility in global financial markets, the Canadian dollar spiked well above parity with the U.S. dollar in November, but it has recently traded closer to the 98-cent-U.S. level assumed in the October MPR.

Overall, the Canadian economy continues to operate above its production capacity. Given the strength of domestic demand and weak productivity growth, there continue to be upside risks to the Bank’s inflation projection.

However, other developments since October suggest that the downside risks to the Bank’s inflation projection have increased. Global financial market difficulties related to the valuation of structured products and anticipated losses on U.S. sub-prime mortgages have worsened since mid-October, and are expected to persist for a longer period of time. In these circumstances, bank funding costs have increased globally and in Canada, and credit conditions have tightened further. There is an increased risk to the prospects for demand for Canadian exports as the outlook for the U.S. economy, and in particular the U.S. housing sector, has weakened. [...]