**BANK OF CANADA**

**Monetary Policy Report: the Bank of Canada is more upbeat and moves the start of the economic recovery up**

The Bank of Canada reiterates its plan to keep key interest rates at their lower bounds until mid-2010

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

- The decline in global production appears to have slowed in the second quarter of 2009, suggesting that economic activity around the world is about to bottom out. Nevertheless, fragility in the global economy persists due to financial deleveraging by banks, households and firms, and adjustments to inventories, employment and capital.

- The easing of the uncertainty weighing on the global economic outlook, combined with the support given to the financial sector, resulted in a tangible improvement in the global financial system in Q2 of 2009. The advances made in making the financial markets operational once more have been uneven, however.

- In Canada, the real GDP contraction in the first quarter of 2009 proved to be smaller than the forecasts the BoC set out in April’s Report. The Canadian economy shrank further in the second quarter, but the pace of the contraction appears to have slowed.

- Improved financial conditions, stronger business and consumer confidence, monetary and fiscal recovery measures, the start of the global economy’s recovery and a turnaround in the terms of trade (increase in commodity prices) are all factors that will encourage renewed positive growth for Canada’s economy in the third quarter of 2009.

- Canada’s real GDP should contract by an annual average of 2.3% this year, then advance by 3.0% in 2010 and 3.5% in 2011.

- As the recession intensified in the first half of 2009, the Canadian economy’s surplus supply grew substantially.

- Inflation as measured by the all-items consumer price index (CPI) should decline again in the third quarter of 2009, bottoming out at -0.7% and returning to the target 2% in the second quarter of 2011. Core inflation (CPIX) should retreat to 1.4% in the fourth quarter of 2009.

**COMMENTS**

On several occasions in the last few months, Canada’s monetary authorities have shown some optimism, a real contrast with the consensus forecast. This spring, the BoC was anticipating a strong economic recovery, with real GDP growth of 4.7% in 2011, progress that was more than twice as fast as its estimated potential. Today’s *Monetary Policy Report* does include a downgrade to this projection, from 4.7% to 3.5%, but only to the benefit of a stronger forecast for economic growth in the next few quarters. The monetary authorities therefore anticipate that Canada’s real GDP could grow by 3.0% next year after declining by 2.3% this year. While this outlook is similar to the latest consensus of private forecasters for this year, there is a substantial difference for next year, with private forecasters on average calling for Canada’s real GDP to rise by only 2.1%. In fact, the BoC’s expectations for real GDP growth in 2010 match the highest forecast of the 14 organizations consulted by the firm Consensus Economics (including Desjardins, Economic Studies).

That said, like the BoC, we see some signs of economic recovery that suggest that the recession will soon be over. Consumer and business confidence has risen substantially in the last few months, financial conditions have improved, raw material prices have recovered, and the impact of monetary easing and fiscal measures should intensify. However, we continue to believe that not only is there still a lot of uncertainty, but it will also take several more quarters to see the last of the profound adjustments under way in the global and Canadian economies. We therefore think that the Canadian economy’s recovery could be more gradual than the BoC expects. In this context, the real GDP could still be in negative territory in the third quarter of 2009. In fact, a return to growth may not occur until next fall. Among other
things, the decline in inventories could continue to impede the real GDP in the coming quarters, as inventory-to-sales ratios remain historically high.

As for inflation, the BoC’s projections overall match our latest forecasts. The surge by total inflation expected as of the end of 2009 could be slightly faster than Canada’s monetary authorities anticipate, however. In fact, the ascent by energy prices noted in the last few months suggests that this component will make a big contribution to the increase in total inflation over the next year.

In closing, although the timing of the start of the economic recovery as well as its scale are uncertain, both the BoC and most private forecasters appear to think that the recession is winding down. To support the recovery, the monetary authorities have repeated that they intend to keep key interest rates at their lower bounds until mid-2010. However, if inflation rises more quickly than the BoC anticipates, the door could gradually open for slightly faster monetary policy firming.

* Compared to the average.
Sources: Bank of Canada and Desjardins, Economic Studies.

![Financial conditions index](image-url)