Bank Financial Group

TD Economics

Commentary

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MPR UPDATE SUGGESTS BANK NOT DONE CUTTING RATES

- **Bank scales back GDP growth forecasts for Canada and the U.S.**
- **Outlook is consistent with 75 basis points in cuts to come**

The Bank of Canada released the update to the Monetary Policy Report (MPR) this morning, confirming that it has dramatically lowered its forecasts for U.S. and Canadian economic growth for 2008. Today's update remains consistent with our view that the Bank of Canada will be cutting by an additional 75 basis points over the next two meetings.

It appears that the two key downside risks cited in the October MPR have become realities. The first risk was that "prices for consumer goods could be lower than projected if competitive pressures induce a greater pass-through of the exchange rate appreciation." The realization of this risk largely explains why the core rate of inflation was 0.6 percentage points lower in the fourth quarter of 2007 than the Bank had projected in October. By the same token, they now believe core inflation will not rise back to the 2% target until the end of 2009. This is in stark contrast to the October MPR when the central bank believed that the core rate of inflation would remain above 2% through mid-2008. The lack of any significant inflationary pressures in the current cycle certainly provides the Bank with the breathing room needed for further rate cuts, and even in a more aggressive fashion. It is one of the key reasons that support our view that the Bank will cut the overnight rate by 50 basis point come March 4th.

The second key risk cited in the October MPR was that a "more pronounced slowdown in the U.S. housing sector could have a larger-than-projected impact on consumption, further reducing U.S. demand for Canadian exports." And, this too has become a reality. In response, the Bank has lowered their GDP growth forecast for the U.S. to 1.5% from 2.1% for 2008, which has obvious negative ramifications for Canada's export sector.

In addition to these risks being realized, the Canadian economy continues to feel the impact of tightening credit conditions. The Bank judges that the spread between the effective household borrowing cost and the overnight rate has risen by 20-25 basis points since October. Meanwhile, that for businesses has increased by 15-20 basis points.

Putting it all together, the combination of below-target inflation, tighter credit conditions and stronger headwinds on the export sector has prompted the Bank of Canada to slash the 2008 GDP growth forecast for Canada to 1.8% from 2.3%, with much of the weakness concentrated in the near-term. It's little wonder why they stated on Tuesday that "further monetary stimulus is likely to be required in the near-term."

Fortunately, unlike our neighbors to the south, Canada's domestic demand platform is fundamentally sound, suggesting that the Bank will not be following the U.S. in terms of the magnitude of rate cuts. We anticipated 75 basis points in rate cuts from the Bank of Canada over the next two meetings, bringing the overnight rate to 3.25%. In contrast, by the end of the Fed's rate-cutting cycle – which we believe will be in March – the fed funds rate will likely come to rest at 2.75%.

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