Bank Financial Group

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Commentary

April 21, 2009

BANK OF CANADA CUTS 25 BASIS POINTS, BRINGING OVERNIGHT RATE TO THE FLOOR UNTIL 2010

- **25 basis point cut brings interest rate policy to its effective lower bound at a 0.25% overnight target, and Bank commits to this overnight rate until end of Q2/2010.**
- **As Bank seeks to keep inflation expectations anchored, future monetary stimulus will rest on market interventions and direct injections with this framework to be unveiled on Thursday.**

The Bank of Canada cut 25 basis points, bringing the overnight target to 0.25%. With unprecedented openness, the Bank committed to this interest rate until Q2/2010 in order to anchor longer term interest rates. Having cumulatively eased 425 basis points since December 2007, interest rate policy is at its effective lower bound (a 0% rate would create technical problems – particularly in money markets), and further monetary stimulus will require market interventions and direct injections. The Bank provided immediate measures by extending the duration of its Purchase and Resale Agreements (PRA) and increasing available settlement balances in the Large Value Transfer System (LVTS) to $3 billion. However, the announcement of its framework for Quantitative and Credit Easing (QE/CE) will come in Thursday's Monetary Policy Report (MPR).

Given the deteriorating economic conditions and disinflationary pressures, the cut was in-line with our expectations. As was widely expected, the Bank clarified its economic outlook, observing the intensifying and synchronized global headwinds and revising its forecast for rebound in 2010 downwards from 3.8% to 2.5%. The Bank also forecasts a deeper 3.0% contraction in 2009 – a revision from its January forecast for a 1.2% contraction – and anticipates that recovery won't take hold until Q4/2009. Although also revising potential growth downwards, the Bank's revised forecasts mean a longer and wider output gap, which will levy a protracted downdraft on inflation. To this end, the Bank was very open about its own inflations expectations, anticipating headline CPI inflation to trough at -0.8% in Q3/2009 and crawl back to the 2% target by 2011. In line with its price stability mandate, the Bank must now anchor inflation expectations against the downside.

With terrific transparency, the Bank has made an unprecedented but appropriate commitment to the maintenance of the overnight target until Q2/2010. This certainly buttresses its credibility in counter-acting disinflation. The overnight target most directly acts through traditional lending institutions, but influences pricing in open markets – particularly money markets. However, bank credit continues to flow and the main clog remains in open-market financing, as shown by still wide spreads on medium-term debt. The Bank must act to influence longer term rates.

The main event is now the QE/CE framework to be unveiled in Thursday's MPR. QE involves direct injections into the money supply while CE would target particular clogged markets. The Fed has so far proceeded by purchases of treasuries and certain asset-backed instruments. However, the Bank of England has created precedent for direct purchases of corporate bonds. Although corporate bonds have rallied in past weeks, spreads remain elevated. For Canada, QE/CE does not appear imminent but nonetheless appears likely.

Lastly, while the rate cut will adversely affect bank margins and money markets, the Bank has also narrowed the operating band, lengthened PRA terms, and increased the LVTS settlement balances. The Bank will pay 0.25% on banks' reserves, instead of 0% under the previous framework. By increasing banks' access to overnight borrowing, the enlargened LVTS could theoretically expand the money supply by nearly 4%.

Grant Bishop, Economist 416-982-8063

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