



**Bank
Financial
Group**

TD Economics

Commentary

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MPR EMPHASIZES IMPACT OF PROTRACTED U.S. SLOWDOWN

- **Growth forecasts for U.S. and Canada slashed again**
- **Inflation to stay below 2% target until 2010**
- **More easing to come**

The Bank of Canada's Monetary Policy Report, released today, echoed the tone and message set in the communiqué accompanying Tuesday's 50 basis point interest rate cut. Moreover, the details of today's report confirm that more easing is likely in the pipeline; the question now is just a matter of when and by how much. Following the release of Tuesday's statement, market expectations of further cuts diminished somewhat as analysts focused on several of the wording changes in the recent statement from that in January. In particular, the addition of the word "some" before "further monetary stimulus is likely to be required," in combination with the removal of "in the near term" seemed to cast doubt on the Bank's appetite for additional substantive rate cuts.

Reading between the lines of the MPR, we believe that the case for continued monetary stimulus remains strong. The main thrust of the document is that worsening conditions in the domestic U.S. economy, working in combination with continued problems in credit markets, are expected to bring about a substantial slowdown in global growth. The punch line for Canada is that the slowdown will result in a major hit to Canada's net-exports. Exports are now expected subtract a full 1.3 percentage points from real GDP growth in 2008, revised down substantially from an expected -0.1 percentage point contribution in January. On the positive side, conditions in the domestic economy remain healthy and appear slightly better than previously estimated. All told, with the further deterioration in net-exports, the Bank's forecast for Canadian economic growth is for 1.4% growth in 2008 and 2.4% in 2009. Somewhat blunting their outlook for the domestic economy is their belief that tightened credit conditions will remain a hindrance to firms and households through 2008 and

2009 and not stabilize fully until 2010. In light of this statement, the Bank's forecast for an improvement to 2.4% growth in 2009 may be on the optimistic side and in our view the slowdown in Canada is likely to be more protracted, with growth of 1.1% in 2008 improving to a less energetic pace of 1.8% in 2009.

A key difference between the Bank of Canada's forecasts and our own is how protracted the weakness in the U.S. economy will prove to be. The Bank once again downwardly revised their forecast for U.S. growth and now expects a marginal decline in the U.S. economy in the first half of 2008, followed by gradual improvement thereafter. Conditions in housing and credit markets are expected to remain a drag on growth until the second half of 2009. As a result, the U.S. economy is now forecast to grow by 1.0% in 2008, before improving to 1.7% in 2009. However, given the Bank's belief that the deterioration in credit conditions will persist through 2008 and improve only gradually in 2009, the Bank's forecast for 1.7% growth in 2009 appears to be on the optimistic side. Our own forecast, based on the temporary nature of the U.S. fiscal stimulus and the need for U.S. households to deleverage and rebuild their balance sheets is for a much slower pace of improvement of 1.1% in 2009.

Overall, the details of the MPR are largely supportive of the Bank's recent move to cut interest rates by a super-sized 50 basis points on Tuesday. In terms of the balance of risks to the outlook, in the Bank's view, the upside risks come mainly from continued strong demand from emerging markets keeping upward pressure on commodity prices. The downside risks are from an even longer period of U.S. economic weakness. In our view, the risks appear much less balanced and continued problems in credit markets point to the "evolution of the global economy and domestic demand" strongly supporting a further half point of easing when the Bank meets again on June 10th.

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