



**Bank
Financial
Group**

TD Economics

Commentary

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BANK OF CANADA LOWERS OVERNIGHT RATE TO 1.00%

- **Overnight interest rate lowered from 1.50% to 1.00%**
- **Communiqué suggests modest further easing**

Recent economic data clearly show a Canadian economy tilting into recession in the fourth quarter of last year, a full year after the start of the U.S. recession. Against this backdrop of continually souring economic news that is unlikely to improve anytime soon, it came as no surprise that the Bank of Canada (BoC) lowered its policy interest rate yet again. The only issue worth debating prior to this decision was with regards to the extent of easing. On that front, the BoC's decision to lower the overnight rate by 50 basis points (bps) was largely in line with market expectations and those of private-sector forecasters, including TD Economics.

In the communiqué accompanying today's decision, the BoC notes that since its last decision to slash the overnight rate by 75bps on December 9th, "the outlook for the global economy has deteriorated [...], with the intensifying financial crisis spilling over into real economic activity". It also cites weakened business and consumer confidence worldwide and the resulting erosion of domestic demand. On the plus side, there is mention that the extraordinary policy actions from governments and central banks "are starting to gain traction, although it will take some time for financial conditions to normalize." All said, the BoC expects Canadian real GDP to contract by 1.2% this year,

which is close to our early December expectation for a 1.4% contraction. The BoC's outlook for real GDP growth of 3.8% in 2010 is, however, significantly ahead of our more cautious call of 2.4% growth. The BoC's latest forecasts will be detailed on Thursday in its *Monetary Policy Report Update*.

As for the inflation outlook, the BoC expects core inflation, which stood at 2.4% as at November, to ease and bottom at 1.1% in the fourth quarter. Total (all-items) inflation is expected to dip into negative territory for the first two quarters of this year as a result of falling energy prices. Both measures of inflation are expected to converge back up to the 2.0% target rate in the first half of 2011.

As the policy interest rate nears closer to an absolute bottom of zero, the BoC is understandably eliminating explicit references to the need for further easing, coaxing the markets towards the end of this aggressive easing cycle – a cumulative 350bps since December 2007. However, consistent with their tone prior to today's decision, the BoC is leaving the door open to further easing. We expect a further 50bps reduction, down to a floor of 0.50%, at the next decision, slated for March 3. Furthermore, given the considerable amount of remaining uncertainty and the fact that the Canadian recession has just started, the policy rate is expected to stay at this record low well into 2010 before inflation starts registering on the radar again.

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