



TD Economics

Monetary Policy Monitor

April 17, 2008

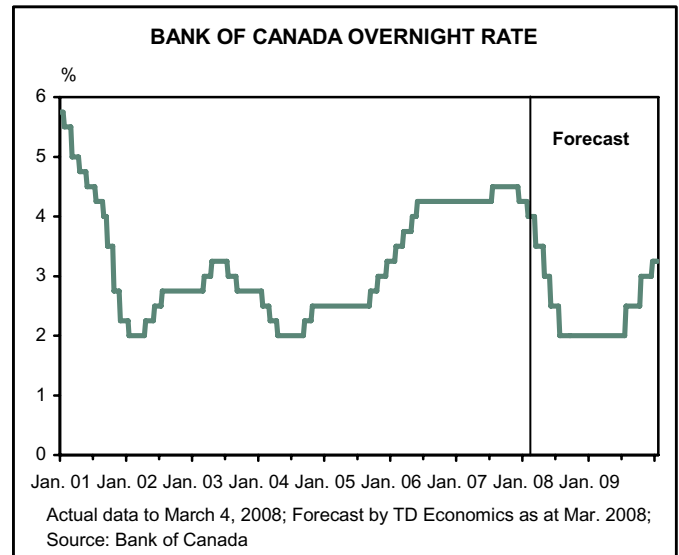
HIGHLIGHTS

- We're expecting to see another 50bps rate cut at the Bank of Canada's next Fixed Announcement Date on April 22.
- While the Canadian economy has held up reasonably well through the first quarter of the year, the real issue is the outlook.
- The weakness in the U.S. economy is eventually going to spill over into Canada, it's just a matter of time. And since the U.S. economy is likely going to take a lot longer to recover than the Bank had initially estimated, that means that the outlook for Canadian GDP growth in 2009 is substantially weaker, providing scope for more aggressive cutting.

Next week brings another Bank of Canada decision date, and for the second meeting in a row, the markets are torn over whether to expect a 25bps or 50bps rate cut. While a rate cut in itself is nearly a sure thing, as Bank officials have stuck to the refrain that "further monetary stimulus is likely to be required," the question is how big.

At the last Fixed Announcement Date (FAD) on March 4, the Bank of Canada proved itself to be forward-looking and initiated a 50bps cut in the overnight rate, the first rate cut of its size since November 2001. We expect the Bank of Canada to take the same strategy at next week's FAD, and pump out 50bps of extra stimulus, to help ward off the negative effects from a slowing U.S. economy. As has been the recent pattern, the outlook for the U.S. economy has only worsened since the last FAD, and we now even have Fed Chairman Bernanke admitting that the U.S. economy could contract in the first half of 2008. And with "contract" being high on the list of the words that the Fed is loathe to use (along with recession and bubble, among others), we know that Chairman Bernanke would not have used it without careful consideration.

Next week's FAD is complicated by the fact that, so



far, the domestic side of the Canadian economy has remained fairly robust. While the 0.7% M/M contraction in December GDP certainly set off some alarm bells, January GDP has since rebounded with a 0.6% M/M gain, and Q1 GDP is not looking like the disaster that it once was. And, over the last couple of weeks we've had some exceptionally strong economic data, including the most recent housing starts, manufacturing, and international trade numbers. This may leave some people wondering why the Bank of Canada is acting with such urgency, with another non-traditional 50bps rate cut. The answer is that monetary policy acts with a lag, so what matters is not what happened to the economy over the last couple of months, but instead where the economy is headed over the next few quarters. And here we believe that the risks lie squarely to the downside due to the floundering U.S. economy, from which the Canadian economy will not escape unscathed. Therefore, the sooner the Bank of Canada can deliver a monetary stimulus cushion, the better.

Quacking Like a Recession

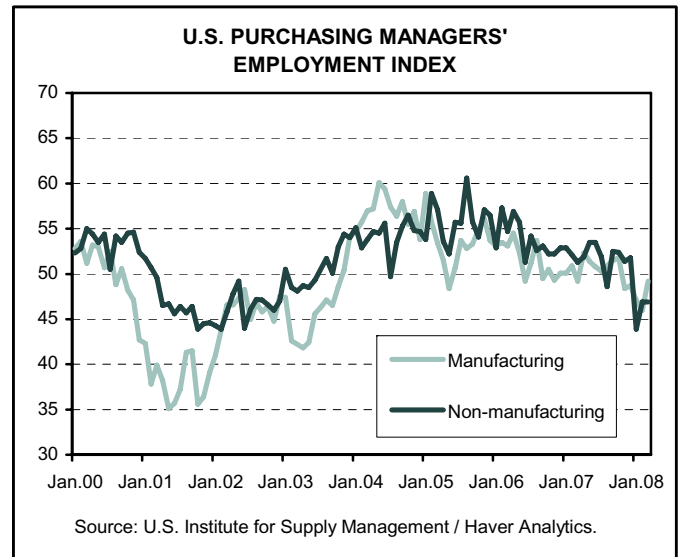
When contemplating the possibility of a recession in the U.S., we're reminded of the old duck test: If it looks

like a duck, swims like a duck, and quacks like a duck, then it's probably a duck. So in the same vein, if it looks like a recession, acts like a recession, and feels like a recession, then it's probably a recession.

While we won't know for certain whether the U.S. is officially in a recession for another few months, after the NBER's Business Cycle Dating Committee delivers a ruling, we think that it's pretty safe to operate under the assumption that the U.S. is, indeed, in the midst of a recession. The data has just been way too weak to suggest otherwise, and is likely to get worse before it gets better.

For one, consumer spending has slowed through the first quarter of the year, with ex-autos, ex-gasoline retail sales having contracted slightly compared to Q4. Strip out the inflationary effect of food prices, and the result would be even worse. Furthermore, the U.S. economy has shed 300K private sector jobs since December. Add this to the fact the both the ISM manufacturing and non-manufacturing indices – a couple of the best cyclical indicators – have been sitting below the all-important 50 mark for the last couple of months, and the U.S. certainly appears to be in recession territory.

We want to be clear here that we don't expect the Canadian economy to join the U.S. and fall into a recession. However, the idea that the Canadian economy is going to decouple from the U.S. is extremely doubtful. If you look at the economic performance over the last 40 years or so, the Canadian economy has never escaped entirely intact when U.S. growth has slowed. For example, during the last U.S. recession, while Canada did manage to avoid an outright recession, it was only just barely, as Canadian



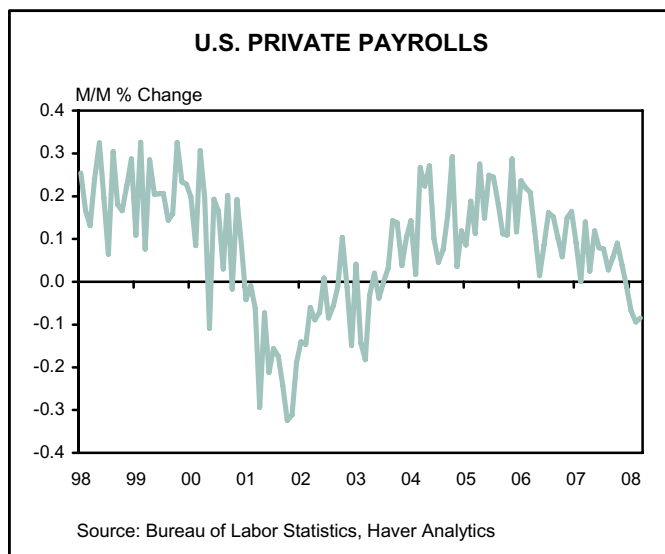
GDP growth slowed to only 0.7% Y/Y in mid-2001.

From a more quantitative standpoint, any reasonable estimates of the linkages between the two countries turn up some pretty high coefficients. We've seen estimates ranging from 0.4 on the low end, to the IMF's estimate of 0.75 only a couple of months ago. Therefore, when U.S. GDP slows by 1%, we would expect to see Canadian GDP slow by between 0.4 and 0.75 percentage points, holding all else constant. So while Canadian economic growth has managed to hang on thus far, and will likely beat the Bank of Canada's estimate of 0.6% growth in Q1, this cannot last, and it's only a matter of time until the U.S. economy pulls the Canadian economy down with it.

Party like it's 2009

When the Bank of Canada's Governing Council meets in a few days, their rate decision is not going to be based on what's happening in the economy right now, but what the world is going to look like a couple of quarters out, since monetary policy acts with a lag. Therefore they're going to have to fast-forward to the end of two zero zero eight, and party like it's 2009 (with apologies to Prince). In fact, Governor Carney said as much when he spoke to the press during the G7 meetings last weekend. If there was one over-riding theme in his comments, it was that despite the fact that domestic demand in Canada continues to hold up, he's still very concerned about the outlook for growth, and emphasized that the Bank of Canada must be forward-looking.

Governor Carney remarked that while it's easier to get a loan in Canada right now than it is in the United States, there's a risk that lenders will restrict capital and increase

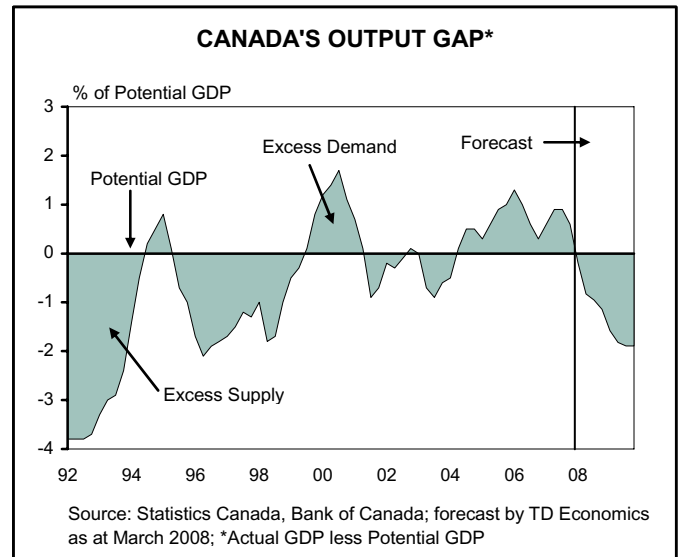


borrowing charges, and “there is a reason to expect tightness.” And, we’ve seen some of that tightness in financing conditions already, judging from the Bank of Canada’s latest Business Outlook Survey. When asked whether terms and conditions for obtaining financing had changed over the last three months, 40.8% of firms reported that conditions had tightened, leaving the balance of opinion (those reporting tightening minus those reporting loosening) at 23.94%.

On the topic of credit markets, Governor Carney said that “the end, which is going to be a ways off, is going to be a world with considerably less leverage.” We agree with his assessment, since just when it appears that credit markets are on the mend, they keep getting hit with yet another wave of problems, causing them to gap out again. No matter where you look - corporate spreads, CDOR-OIS spreads, or spreads between mortgage rates and bond yields – many credit spreads are still much wider than normal, and the end of this credit crunch is clearly still “a ways off.”

Turning to the U.S., Governor Carney said that he was not going to use the “R-word” at all. But keeping with the theme of being forward-looking, he noted that what was more important than determining whether the present growth in the American economy is flat, slightly negative, or slightly positive, was the speed of the recovery as it heads into 2009. He said that he will be watching U.S. consumer spending carefully, and that he expects the economic recovery in the U.S. to be “muted.”

Most significantly of all his comments, Governor Carney said explicitly that “we have to make policy on a forward-



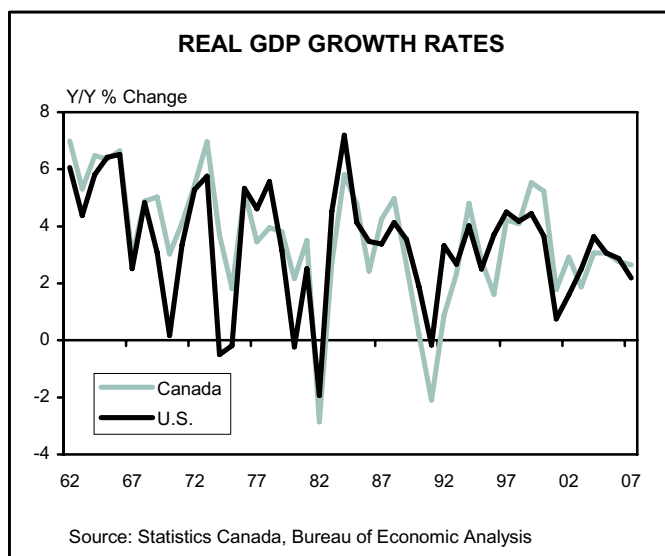
looking basis.” The question now is, looking forward, what are we going to see, and what does it mean for monetary policy?

Picking Through the Tea Leaves

As we’ve already stated, we’re not forecasting a recession for Canada, but what we are forecasting certainly isn’t pretty either. Canadian GDP is on pace to eke out a half-decent, but below-potential, gain in Q1, but then things will likely turn straight downhill. We’re expecting Q2 to be virtually flat, with the U.S. economy likely contracting in the same quarter. And while the pace of Canadian economic growth should pick up a bit in the second half of the year, thanks to the fiscal stimulus in the U.S., the economy will still likely grow well below potential, and go through another bout of anemic growth in the first half of 2009.

Turning to the output gap, it will likely turn from a position of excess demand to a position of excess supply in the second quarter of 2008. And as the economy continues to grow below potential, and slack continues to build, the output gap is expected to widen to nearly -1.5% of GDP by the end of 2009. This would be the largest amount of excess supply that the Canadian economy has seen in about a decade, and certainly provides rationale for the Bank of Canada to cut rates.

While TD’s forecasts may not line up with the Bank of Canada’s latest forecasts from the January *MPR Update*, we expect to see some significant downward revisions to 2009 economic growth in the next round of the Bank’s forecasts in the April 24 *Monetary Policy Report*. In January, the Bank had expected the slowdown in the U.S. to be relatively brief, and saw GDP growth rebounding to 2.5%



in 2009. As a result, Canadian economic growth was probably overly optimistic, so we expect to see a substantial downward revision to their forecast for 2009 GDP, bringing their numbers more in line with our own. It's going to take longer than the Bank of Canada had originally forecast for the North American economies to get some traction.

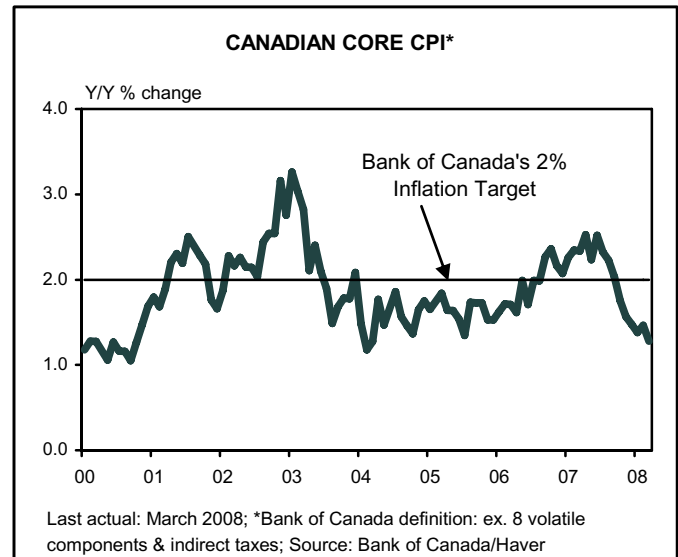
On the subject of inflation, the case for rate cuts is just as clear. The latest inflation data for March saw core CPI fall to 1.3% Y/Y and all-items CPI fall to 1.4% Y/Y, with both numbers coming in softer than the markets had expected. One interesting thing to note is that even excluding the effect of the GST cut earlier this year, which "artificially" subtracts about 0.5 percentage points from all-items CPI, we still have a case where both core and all-items inflation are below the Bank of Canada's 2% target. This is the first time that we've seen this happen since June 2005.

Going forward, we don't expect to see inflation, and core inflation in particular, reignite anytime soon. While part of the downward pressure on inflation is coming from the rapid acceleration of the Canadian dollar in the second half of 2007, and the pressure on Canadian retailers to match the lower U.S. prices, we think that as this effect starts to wane, other downward pressures may take its place.

In the Bank of Canada's latest Business Outlook Survey, we saw evidence that some of the excess demand and the Canadian economy is finally beginning to dissipate. The percentage of firms reporting labour shortages fell from 41.0% to 30.0%, well below the long-run average level of about 40%. Furthermore, the fraction of firms reporting some or significant difficulty in meeting demand fell from 60.0% in the prior survey, which was an all-time high, to 44.1% in the latest survey, the lowest level since 2005. And, the balance of opinion on future sales growth fell below zero for the first time since 2001, indicating that firms aren't very optimistic about the level of activity going forward.

25 Will Deprive... Don't Be Thrifty, Cut by 50

We're now in a situation where some serious economic slack is beginning to build. Inflation should stay in check, and we're not expecting core CPI to return to the Bank's



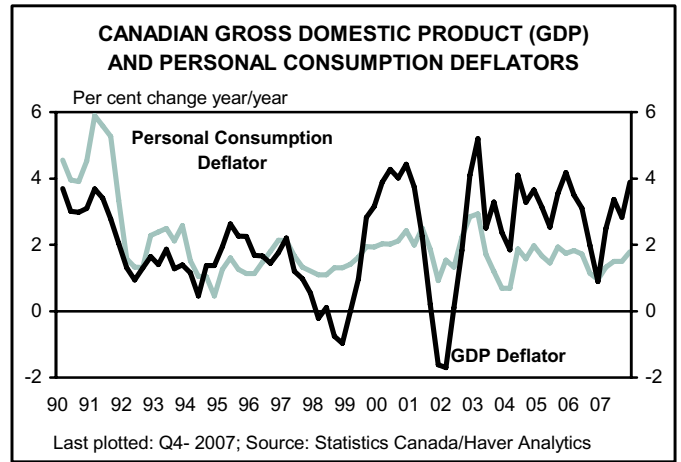
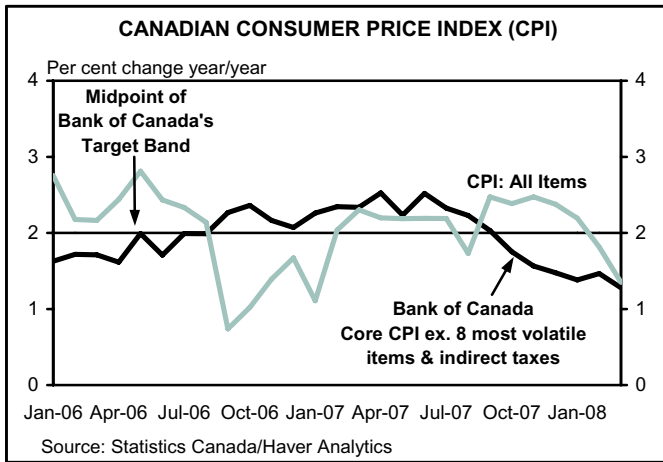
2.0% target until the tail-end of 2009. The case for rate cuts is clear, with the only question being how big.

Thus far in the cycle, the Bank of Canada has only cut rates by a total of 100bps, which is pretty paltry compared to past rate-cutting cycles. With the economic storm that's brewing in the U.S. and the high probability of substantial pass-through to the Canadian economy, the Bank of Canada may still be behind the curve. And given Governor Carney's extremely dovish comments last weekend, he's clearly very worried about the outlook. We're expecting to see some substantial downward revisions to the Bank of Canada's GDP forecast for 2009 when the *Monetary Policy Report* is published on April 24, which justifies a lot more rate cutting than what the Bank has done so far. With inflation still well below the Bank of Canada's target, they clearly have plenty of room to maneuver in delivering further monetary stimulus. Consequently, we think that they will choose to cut rates by another 50bps at next week's FAD, and will continue to signal that more rate cuts are on their way. Ultimately we expect to see the overnight rate hit a floor of 2.0% by mid-year, giving the Canadian economy some much-needed stimulus to get through the upcoming slowdown in growth, and to eventually get inflation back to the Bank's 2.0% target.

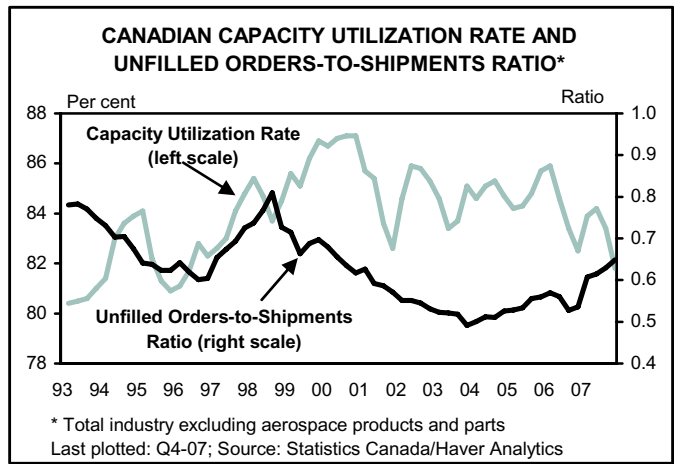
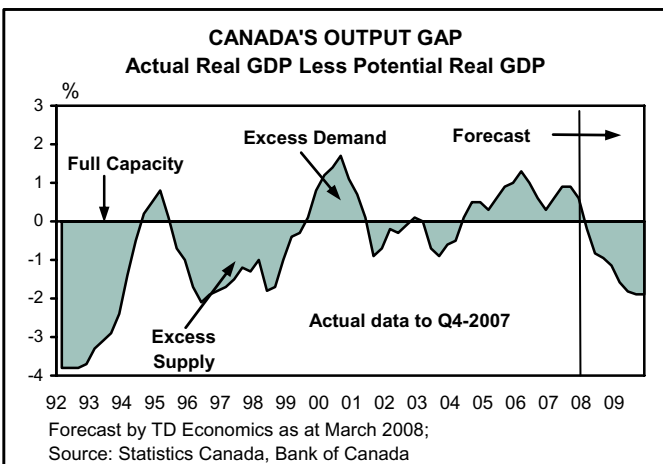
Jacqui Douglas
Economics Strategist
TD Securities
416-982-7784

The information contained in this report has been prepared for the information of our customers by TD Bank Financial Group. The information has been drawn from sources believed to be reliable, but the accuracy or completeness of the information is not guaranteed, nor in providing it does TD Bank Financial Group assume any responsibility or liability.

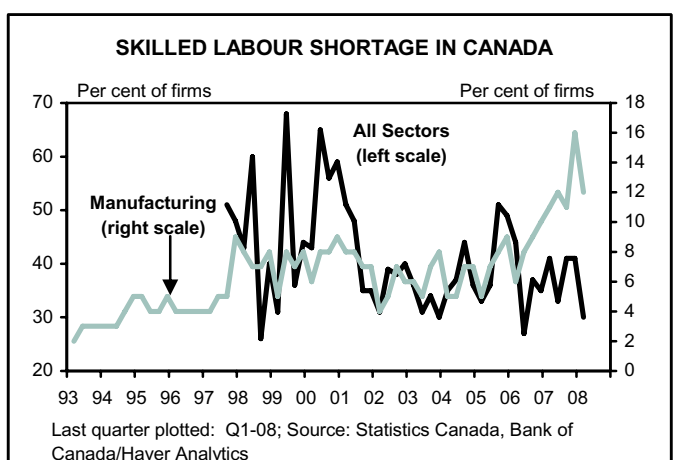
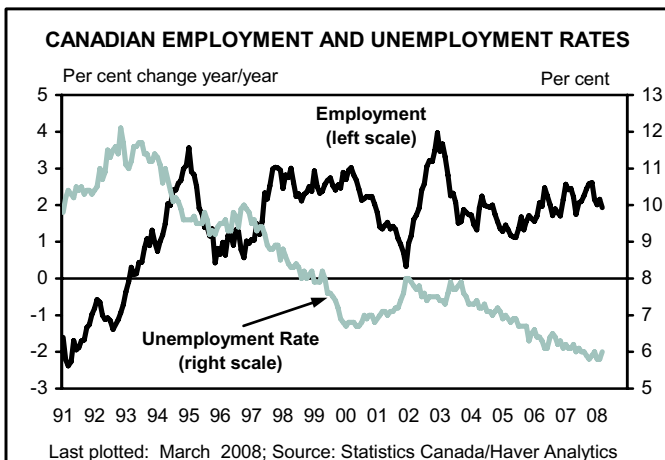
INFLATION MEASURES



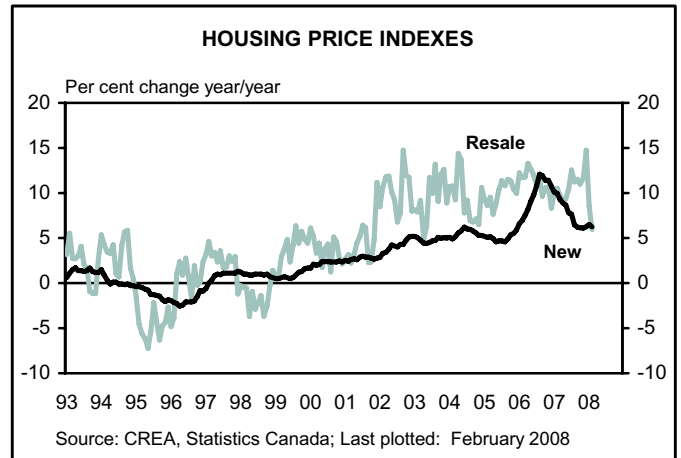
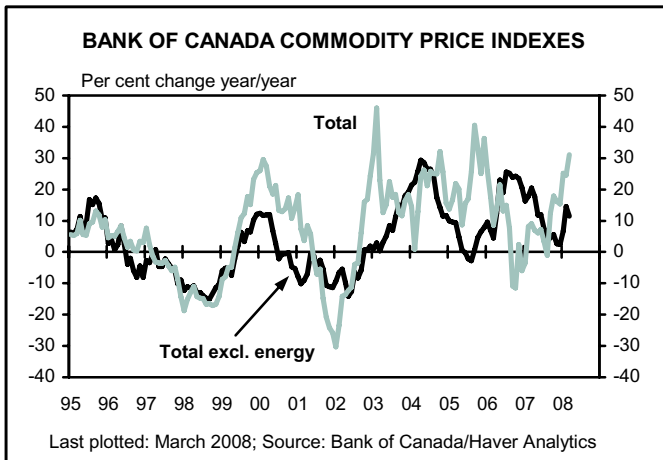
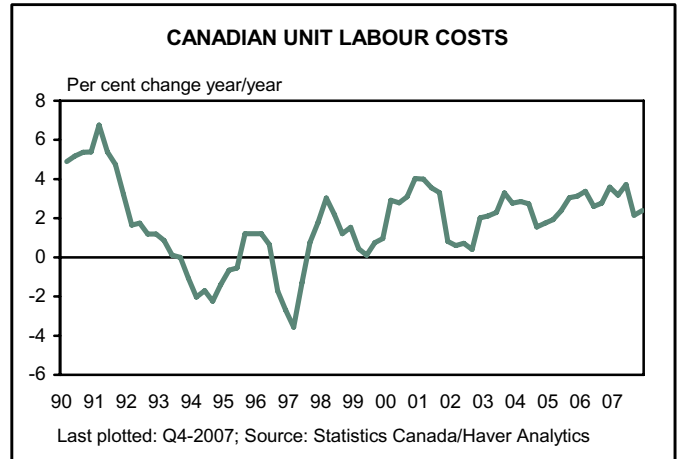
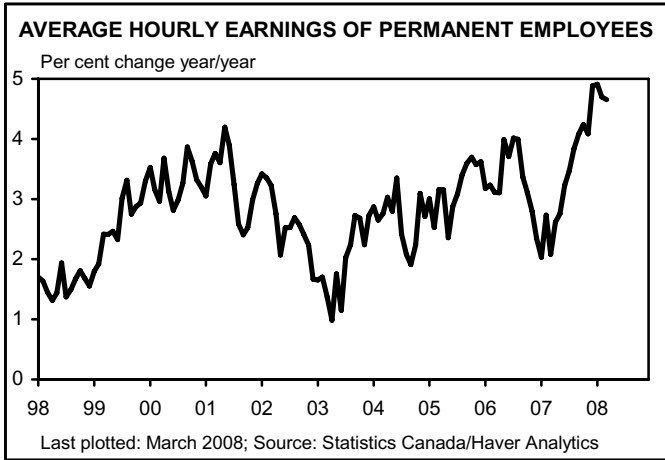
PRODUCT MARKET



LABOUR MARKET



WAGES, COSTS AND REAL ESTATE



INFLATION EXPECTATIONS

