



# TD Economics

## Monetary Policy Monitor

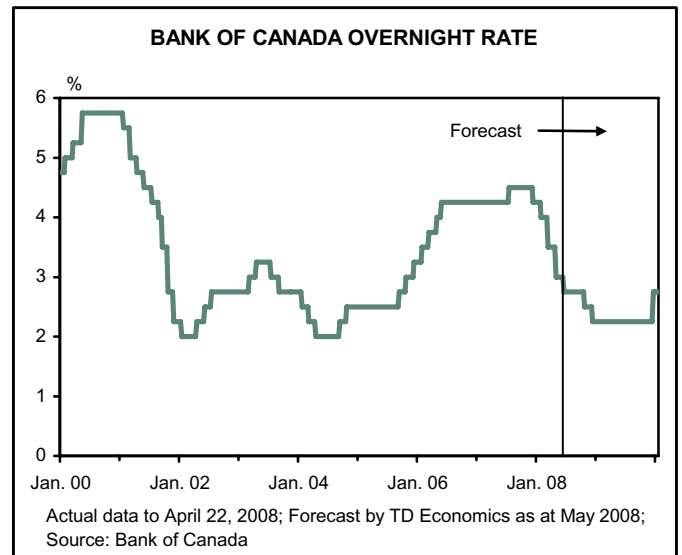
June 5, 2008

### HIGHLIGHTS

- We expect to see the Bank of Canada deliver a moderate 25bps rate cut at the June 10 FAD before moving to the sidelines, for now
- Good arguments can be made for both a 50bps rate cut, with the Canadian economy clearly slowing, or for no move at all, with the potential for higher commodity prices to lead to inflationary pressures
- Governor Carney was fairly hawkish during his last speech on May 22, which suggests that the string of 50bps rate cuts is over, but still made reference to the “timing of further monetary stimulus,” which means that the Bank of Canada has not likely changed its mind about another rate cut at the next FAD
- We expect to see the Bank of Canada cut rates again in the fourth quarter of this year, once it sees that the economic recovery that it had forecast heading into 2009 is not occurring.

Next week brings another Fixed Announcement Date (FAD), and this one is probably a closer call than we've seen for a while. Although there are arguments for each of a 50bps rate cut, a 25bps rate cut, or a pause, we think that the Bank of Canada is going to deliver a 25bps rate cut before moving to the sidelines for a while.

In the Bank's communiqué following the April 22 FAD, it hinted that there are further rate cuts in the pipeline, saying that “some further monetary stimulus will likely be required to achieve the inflation target over the medium term.” However, it added that “the timing of any further monetary stimulus will depend on the evolution of the global economy and domestic demand, and their impact on inflation in Canada.” So the question now is what has happened since April 22, how these events may have differed from the Bank's base case scenario, and what they imply for the path of Canadian interest rates.



### The Case for More Stimulus

The case for a 50bps rate cut is not without merit, since we have seen a substantial amount of weakness in the Canadian economy since the last FAD. For one, we've seen the housing sector slow quite a bit, with housing starts having returned to more normal level and the pace of re-sale activity letting up. Employment growth has also slowed to a more sustainable level as only just over 30K jobs were created in March and April combined, and the unemployment rate climbed by 0.3 percentage points from its low point in February to April. The pace of wage growth for permanent workers also softened from a peak of 4.9% Y/Y in January to only 4.2% Y/Y at its last reading in April.

But the most obvious case for more monetary stimulus is the fact that Canadian GDP declined outright in the first quarter of 2008 at a 0.3% annualized rate. This was not just below the markets' expectations for a 0.4% growth rate, but it was also well below the Bank of Canada's most recent forecast, published on April 24, for 1.0% GDP growth in Q1. Canadian GDP even managed to under-perform U.S. GDP in the first quarter, which came in with a 0.9%

gain, but was also well below that country's potential growth rate. The disappointing GDP outcome essentially closed the Canadian output gap in the first quarter of the year, which is one quarter ahead of when the Bank of Canada estimated that it would occur. And with GDP having contracted in both February and March, the momentum heading into the second quarter is extremely weak, meaning that GDP will likely come well below potential once again in Q2. As a result, the Canadian economy is almost certainly going to move well into excess supply in Q2, which greatly reduces the odds of inflationary pressures building later in the year.

**The Case for Less Stimulus**

A case can also be made for the Bank of Canada to put an end to its rate cutting cycle, since credit conditions have improved to some degree since the Bank of Canada began cutting rates. The credit crunch continues to abate, with lower spreads on BAs and corporate paper. And last week we finally saw some substantial downward pressure in fixed mortgage rates, with the 5-year rate falling by 34bps and the 1-year rate falling by a whopping 80bps. It appears as if financial conditions have improved sufficiently so that lending institutions are able to pass along part of the benefit that they've seen since the Bank of Canada began cutting rates in December of last year. We think that the effect of the credit crunch is now likely less than the 50-75bps that the Bank estimated in April.

The other reason why the Bank could choose to put rates on hold is that recent trends in inflation are awfully strong, and the Bank could be worried that if prices con-

INDICATORS OF CAPACITY & INFLATION	
	Policy Signal**
Inflation Measures	↓
Product Markets	↓
Labour Markets	↑
Wages & Costs	No change
Real Estate	No change
Inflation Expectations	No change
** Indicates suggested direction of overnight target rate	
Source: TD Economics	

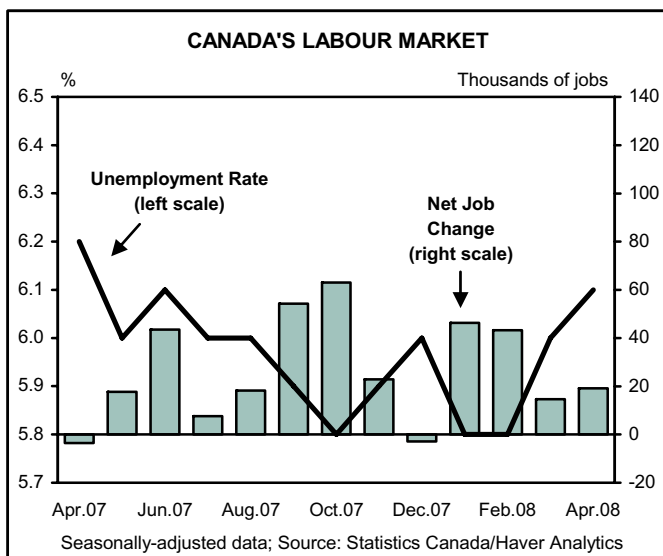
tinue to increase at this pace, then inflation would return to above target in no time at all. In two of the last three months, core CPI has come in with a bigger than average monthly increase, with a 0.3% (seasonally-adjusted) gain in February and a 0.4% gain in April. As a result, the 3- and 6-month annualized trends have increased substantially, admittedly from an unsustainably low pace. However, the 3-month annualized trend in core CPI has now soared to 2.9%, which is its highest rate since April 2007, after which the Bank of Canada moved quickly to indicate that it would be hiking rates in the near future.

Furthermore, we saw a big increase in food prices in April, while up until the prior month, Canada has been more or less immune to the increase in food prices happening in the rest of the world. This is especially concerning for Canada because the definition of core CPI that's used here is a little more complicated than in other countries in that it's not just food and energy prices that are excluded, but instead the prices of the 8 most volatile items. So while prices of fruits and vegetables are 2 of the 8 excluded items, prices of other food items like bread and meat are part of Canadian core CPI, so an increase there can affect monetary policy.

**Carney Communications**

Since the April FAD, we've heard from Governor Carney a couple of times, most recently during his speech to the New York Association for Business Economics on May 22. His remarks at that time were reasonably hawkish, and we think he may have been signalling not only that the next rate cut will be smaller than the last two at only 25bps, but also that the Bank is planning on winding down the rate cutting cycle, at least for now.

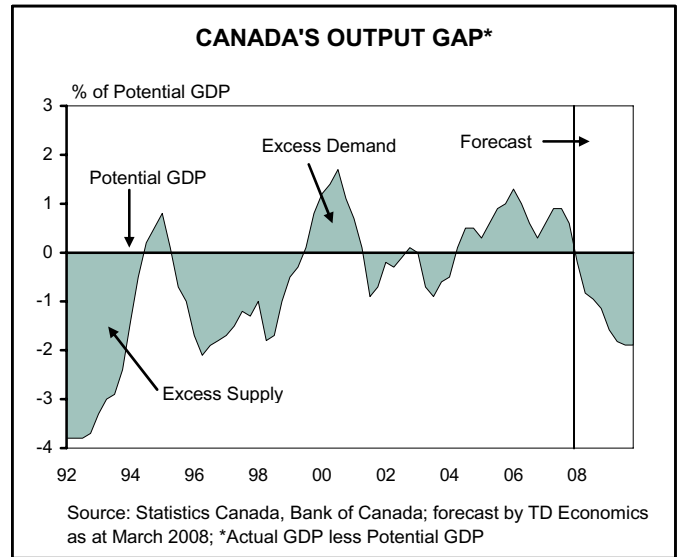
The text of Governor Carney's last speech did not specifically address the outlook for interest rates or the economy. However, he was fairly optimistic on the credit situation in Canada, both compared to a few weeks ago



and compared to other countries. Carney noted that “In Canada, spreads indicative of bank funding costs (such as the spread between 3-month CDOR and the expected overnight rate as measured by 3-month overnight indexed swaps) have fallen markedly over the last few weeks.” And, he added that they “are substantially below equivalent spreads in some other currencies.” Carney also said that “the range of the collateral being pledged [in the term PRA auctions] shows no sign of intensifying liquidity pressures.”

The Q&A following the speech, however, is where we heard Governor Carney’s most important comments on the Bank of Canada’s current view compared to April. To start, Carney did continue to reference “the timing of any further stimulus,” which we think means that the Bank will continue cutting rates at the June 10 FAD. However, we think that the size of the rate cut will be tempered at only 25bps, since Carney seemed to insinuate that the upside risks to the Bank of Canada’s April forecast have been playing out to some extent.

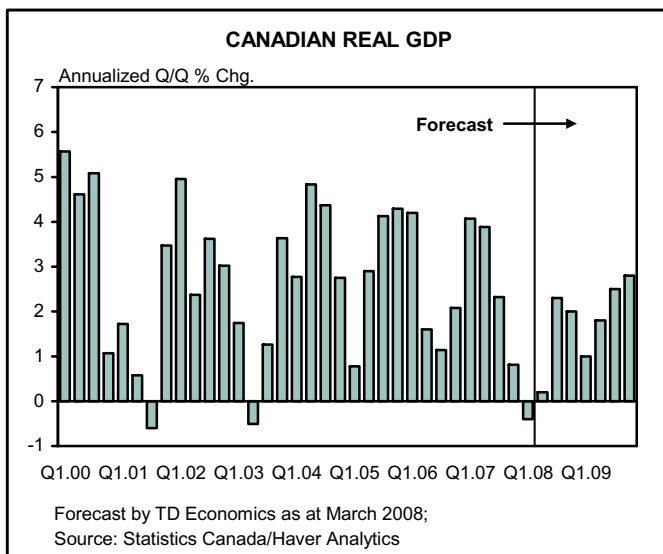
During the question and answer period, Governor Carney was asked about the Bank’s outlook for inflation, given the latest “eye-catching” (those were the reporter’s words) inflation reports. Carney responded first by mentioning that headline inflation is only sitting at 1.7% in Canada, just to put the term “eye-catching” in a global context, and then went on to talk about commodity prices. He mentioned that when the last round of forecasts was published in April, the path of commodity prices was listed as both an upside and a downside risk to the base case scenario. Carney then went on to explain that the com-



modity price chain is different in Canada than in other industrialized countries, since for one, the straight pass-through of commodity prices into consumer prices is a little less, and two, there’s also a big positive income effect in Canada with higher commodity prices, which has implications for domestic demand and inflationary pressures.

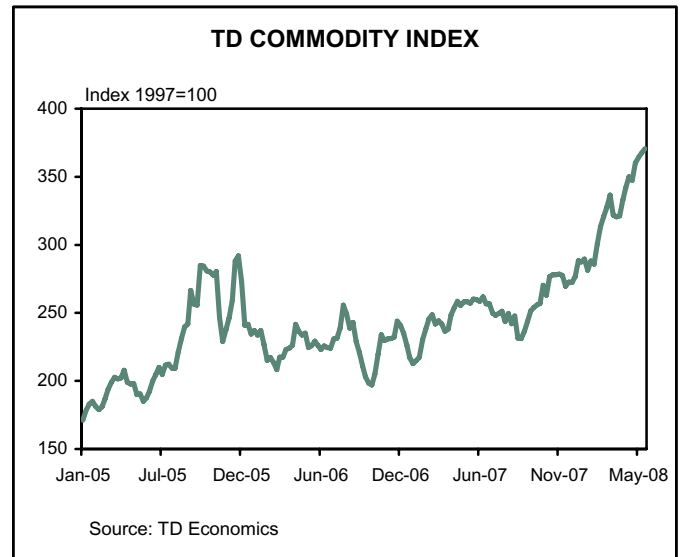
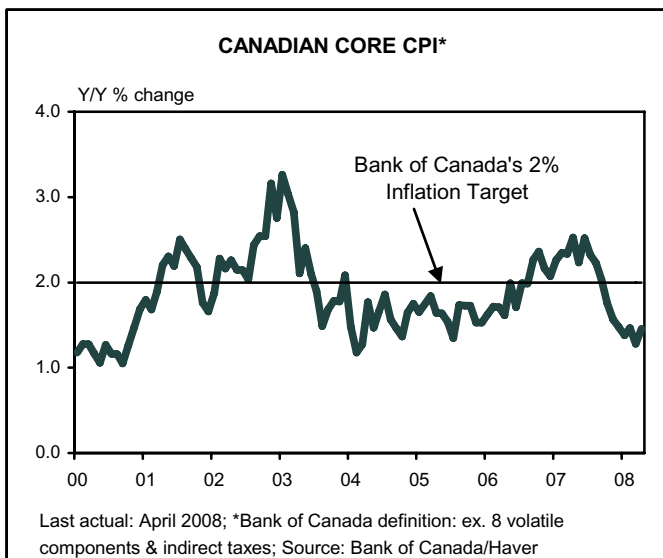
Later on, Governor Carney was asked by a different reporter if the June 10 decision will be a close call (as the minutes from the April 30 FOMC meeting revealed was the case for the Fed). Carney emphasized that since the Bank’s forecasts were made in April, the spike in commodity prices was the biggest surprise, and the most unexpected development. He continued to explain that in April the Bank of Canada noted that the risks surrounding its forecasts were balanced, and that it would take all new information into account to decide the timing of further stimulus.

Putting these comments together, we think that Governor Carney is seriously thinking about the upside risks from higher commodity prices, and that this will limit the extent of how much more cutting the Bank of Canada does in the near term. Since the Bank of Canada all but promised some further rate cutting in its April 22 statement, saying that “some further monetary stimulus will likely be required,” another rate cut is very likely; we don’t think that Governor Carney is especially keen to roil the markets by remaining on hold when there is no real pressing reason to do so. However, given the expected inflationary impact from higher commodity prices, due to both the pass-through to consumer prices and the income effect, we think that the Bank of Canada will be reluctant to deliver any further



50bps rate cuts before having a chance to see how the economy is evolving. Therefore, we think that a middle of the road 25bps rate cut is going to be the outcome of the June 10 FAD.

Turning to the accompanying communiqué, we expect to see some significant changes from that of April. For one, we do not expect to see the Bank insinuate that there are further rate cuts coming, so the phrase “some further stimulus will likely be required” and the reference to “the timing of further monetary stimulus” will probably be removed altogether. We also expect to see the Bank repeat that the risks surrounding its forecast appear to be balanced, since although higher commodity prices do fall in the upside risk category, they have obviously not led to stronger domestic demand, since Q1 GDP was so soft. And, as far as any forward-looking language goes, we think that the Bank could choose to take a page from the Fed’s playbook, and say that it will “act as needed,” or something to that effect, to ensure that inflation will return to its 2.0% target in the medium term. However, we don’t expect to see any indication of the timing or direction of the next rate move, since we believe that for the time being, the Bank of Canada would like to sit back and analyze the impact of the stimulus that it has already delivered.



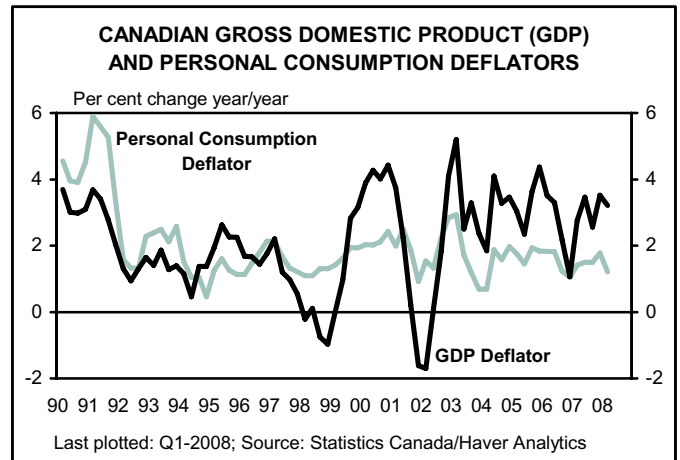
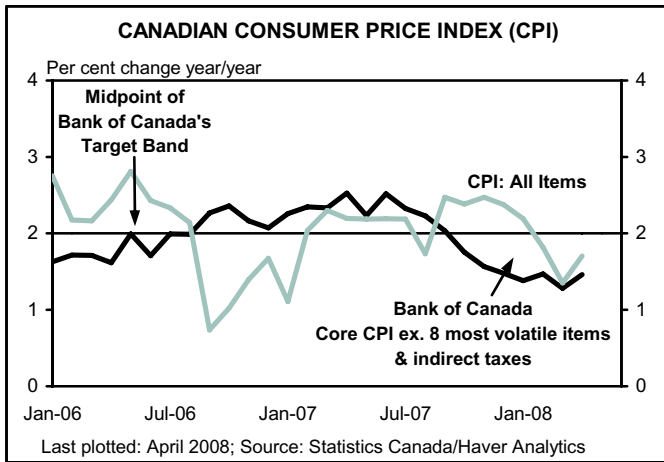
### Fate for Rates in 2008

Although we think that the Bank of Canada will sit on hold for a while after June 10, we don’t think that this will be the last we hear from the Bank for 2008. We still expect to see further rate cuts, but not until the end of the year. In the Bank of Canada’s last MPR, we found its forecast for 2009 to be too optimistic, since it seems to expect a pretty quick turn-around in the Canadian economy. However, we think that the U.S. economy is in for a lengthy period of little-to-no economic growth, with no real recovery in sight until well into 2009. With extremely weak demand from our biggest trading partner, we think that shrinking exports will keep the Canadian economy at a below-potential growth rate for some time, and that before the end of the year, the Bank of Canada will see that the recovery it had hoped for is not occurring. Consequently, we’re expecting to see two more 25bps rate cuts in the last quarter of 2008, with the overnight rate ending the year at 2.25%.

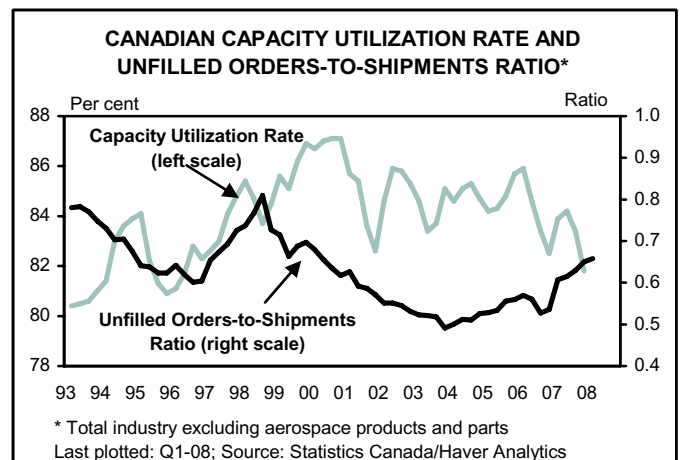
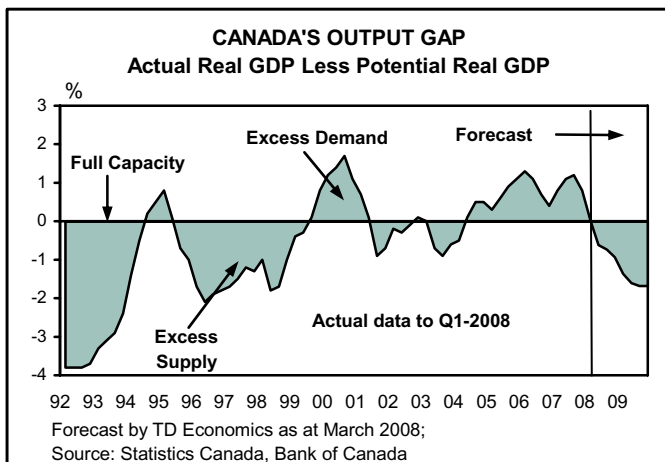
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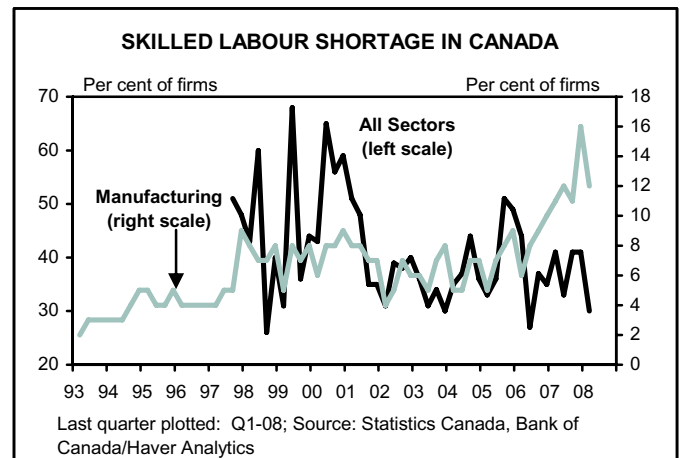
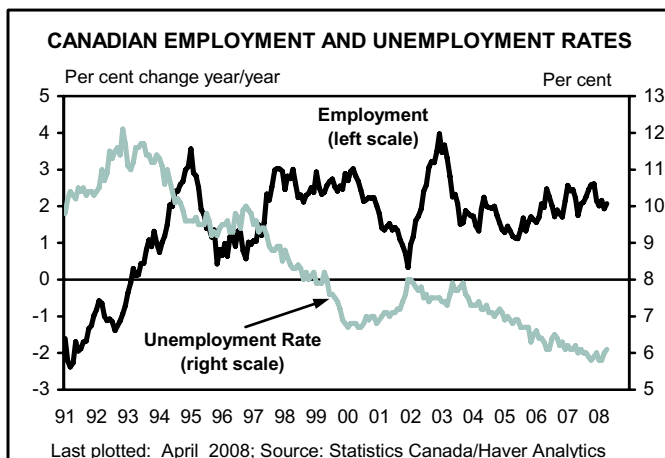
## INFLATION MEASURES



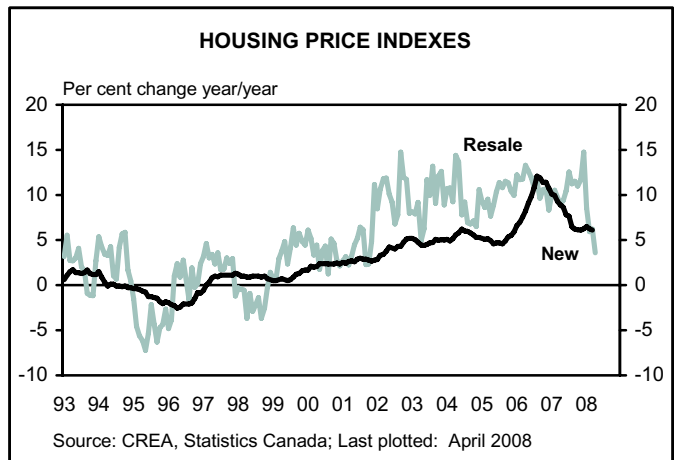
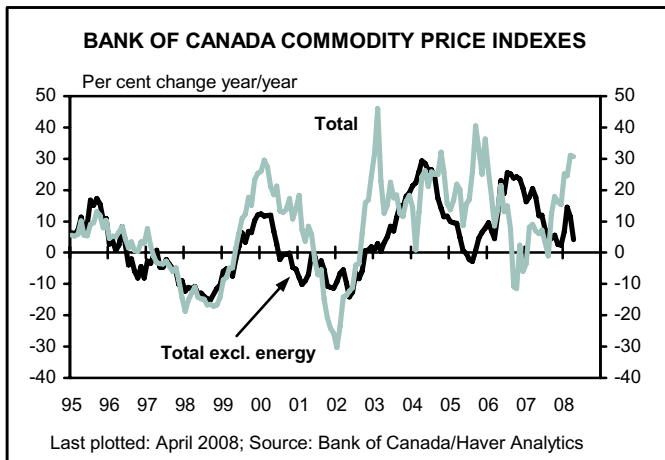
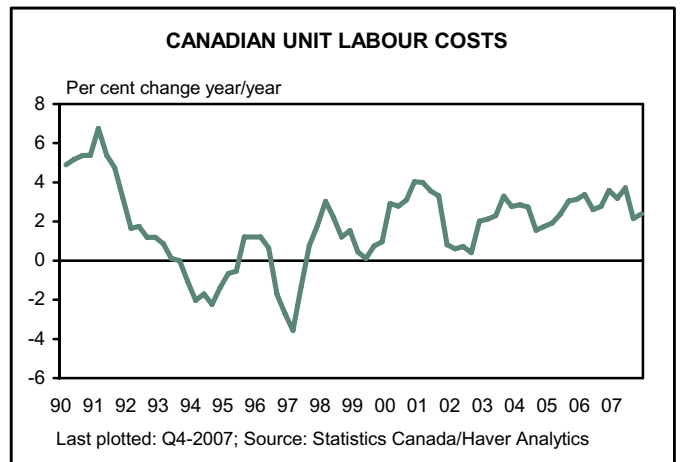
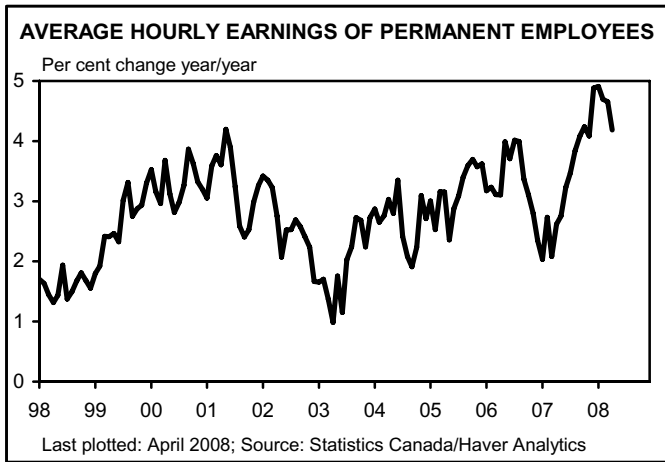
## PRODUCT MARKET



## LABOUR MARKET



## WAGES, COSTS AND REAL ESTATE



## INFLATION EXPECTATIONS

