

TD Economics

Monetary Policy Monitor

June 2, 2009

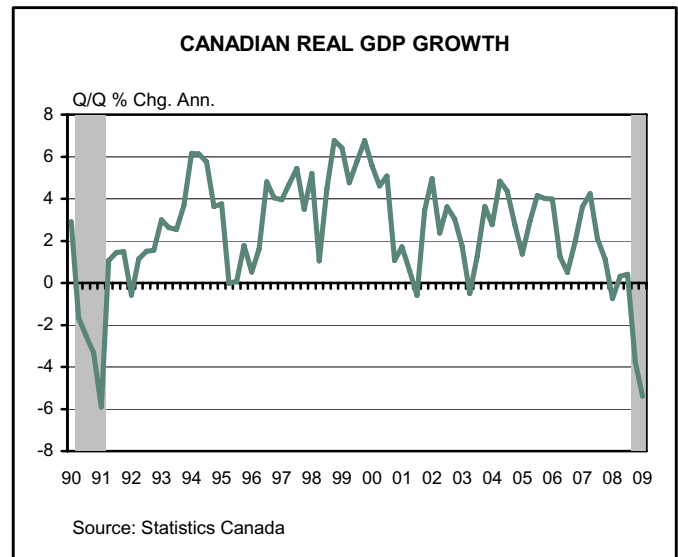
HIGHLIGHTS

- Since the last Bank of Canada FAD, two major themes have emerged. First, some economic data has been not as bad as feared. Second, the currency is on a tear.
- But given the surprisingly transparent commitment in April to keep the overnight rate unchanged at 0.25% until June 2010, we do not think that the outlook has changed sufficiently to sway the Bank from the sidelines, nor does quantitative easing seem likely.
- Given that the decision itself is likely to be a non event, and the Bank of Canada already released its (downwardly) revised forecasts, the focus will turn to parsing the verbiage regarding any unorthodox policy measures.

Recession's Toll Receding

With the first half of 2009 nearly in the rear view mirror, the economic data continues to weave a tale of weakness. This theme is best borne out by the details of the first quarter GDP data. Though not as bad as the Bank of Canada forecast, GDP still managed to contract 5.4% Q/Q, annualized in the first quarter. Canada has now posted two substantial quarters of negative GDP growth, mirroring the pattern and magnitude of the 1991 recession. But there is some comfort in recognizing it could have been much worse, all things considered.

Drilling down into the details, there might be a thin silver lining. Much of the deterioration in GDP was due to the massive inventory draw-down which subtracted 3.3 percentage points off GDP in the first quarter. But considering the headwinds for businesses at this critical juncture, it is not surprising that businesses are loathe to invest in or hold inventories at this time. But despite the run-down in inventories, I/S ratios in both manufacturing and wholesaling remain elevated because sales are falling just as quickly.



Ultimately, inventories will have to be rebuilt when the economy starts to improve and that will add to GDP.

And in line with businesses retrenching on spending, imports of goods and services were also down a staggering 37.8% Q/Q, annualized in the first quarter. And while the export environment is still very weak, the contraction in M&E was the dominant theme and paved the way for a collapse in imports in the first quarter.

Moreover, consumption was weak, but perhaps not as weak as initially thought as personal expenditures on goods and services fell 1.6% Q/Q, annualized in the first quarter. This was not as bad as the 3.1% Q/Q annualized contraction in the fourth quarter and is especially eye catching as job losses in the first quarter were a whopping 273K compared to the 31K lost in the prior quarter.

Looking ahead, while output will still remain well below potential GDP for the next several quarters, the first quarter was likely the worst of the recession. In April, there was a net gain of 35.9K jobs, which will no doubt help matters, though the recent strength of the Canadian dollar might complicate the outlook as any pick-up in cheaper imports might be offset by more expensive exports. But

while there are still some hurdles for the Canadian economy, the largest one has perhaps been cleared.

Fiscal Policy Helps Push a Sputtering Engine

The deterioration in the economic outlook has led to a significant revision in the federal budget deficit. Finance Minister Flaherty recently stated that the deficit could swell to more than \$50 billion as a result of higher than anticipated employment insurance payments and auto sector rescue payments. This is significantly higher than the \$33.7 billion deficit projected in the budget released in January. This comes on the heels of a deficit of \$2.2 billion in the 2008/9 fiscal year. As such, Canada no longer holds a preferred status among the G7 as being the only country with twin surpluses.

Despite the lost cachet, the expansion in government spending will surely help boost GDP down the road. The stimulus that the government has already delivered added to GDP and in the first quarter, and that should easily grow in coming quarters. The mix of loose fiscal and monetary policy offers up a lot of stimulus at a time when the economy truly needs it.

Loonie takes Flight Again

Since the last FAD, the Canadian dollar posted its largest one month rally in May since 1950. Now at over U.S. 0.92¢, it seems that parity with the U.S. dollar is within striking distance. This has been about the only major change in the economic environment since the last FAD. The implications for the economy are profound, as a stronger currency will no doubt deal a heavy blow to Canada's already

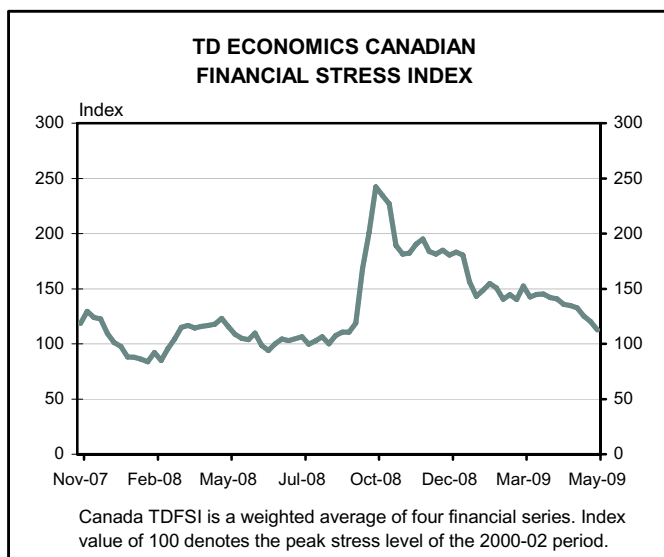
| INDICATORS OF CAPACITY & INFLATION | |
|---|-----------------|
| | Policy Signal** |
| Inflation Measures | ↓ |
| Product Markets | ↓ |
| Labour Markets | ↓ |
| Wages & Costs | ↓ |
| Real Estate | ↓ |
| Inflation Expectations | ↓ |
| ** Indicates suggested direction of overnight target rate | |
| Source: TD Economics | |

beleaguered export sector.

But one consolation is that Canadian dollar's appreciation has been split between fundamentals and flows, with the lion's share attributed to the latter. And for that reason, the Bank of Canada might be willing to looking past the rally in the currency. In terms of the fundamentals, the rally in oil prices has given the loonie some traction. In terms of flows, the resurgence of risk appetite has also helped unwind those risk aversion trades that favoured the U.S. dollar earlier in the quarter. In any event, the high flying loonie will no doubt impact Canada's terms of trade, no matter where the appreciation stems from.

In addition, the impact of a stronger loonie on inflation might not be as pervasive as in the 2007 episode, though as import prices fall, there could be at least some impact on inflation. Looking back to 2007, there was a rather rapid follow-through from the time the Canadian dollar hit parity in September 2007 through the next several months. We still assert that the media played at least some role in pushing retailers to lower prices during that time. And while some prices have undergone a structural change, such as magazine prices that now are only posted in Canadian dollar prices, there could be some modest, additional downward pressure on prices from this surge in the loonie. Ultimately, we do not think the impact will be as profound as in 2007, but it could be noticeable and adds to our broader view that price pressures can abate. Moreover, the Bank of Canada already has a lot of softness baked into their forecast and looks for core CPI to be only 0.9% Y/Y in the fourth quarter of 2009.

On balance, the Bank of Canada is likely to look past the recent appreciation in the loonie when considering possible monetary policy actions for later. Should the appreciation in the Canada continue longer than we expect, or move well past the parity level, there could be some effort to jawbone the currency lower. In our view that is unlikely to happen since Governor Carney's regime has been



marked by a distaste for currency comments. And as such, the Bank's governing council are unlikely to lose a lot of sleep over the matter.

Credit Markets on the Mend

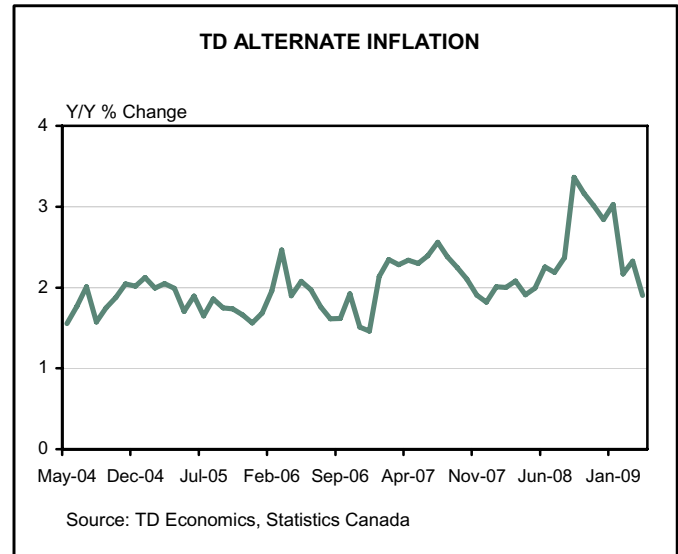
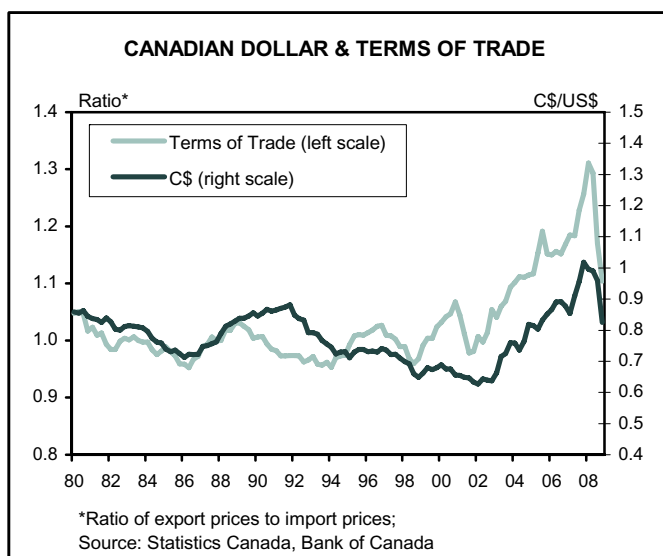
Adding to the case for holding rates steady is the improvement in various credit market metrics. Short term bank funding has shown signs of stabilization as the 3 month CDOR-OIS spread seems to be trending around 20bps which is well off the peaks in the fourth quarter of 2008. This improvement applies to the term market as well. The 5 year Canadian corporate A yield spread against a comparable government of Canada bond has narrowed to 272 bps in late May from a peak of 394 bps at the end of January 2009.

Costly Stimulus

A further argument against quantitative easing is that there are very prohibitive costs associated with implementing a quantitative easing policy. By our calculations, it would cost in the neighbourhood of \$1 billion to get one basis point of easing via quantitative easing measures. As such, the Bank of Canada would have to massively expand its balance sheet by more than 30% to finance only 25bps of easing. It simply is not worth it, now more than ever, as the likelihood of a substantial downside surprise in growth relative to the Bank of Canada's (already dour) forecast is low.

Recent Comments Suggest a Steady as She Goes Approach

Although the formal comments from Bank of Canada



officials have been rather sparse in the intermeeting period, what has been said has suggested no deviation from the April 21st commitment to keep rates steady.

When Deputy Governor Murray spoke in mid May he not only suggested there was no deviation from the April 21 FAD, but also that “central banks are not out of ammunition.” The latter statement is not to suggest that quantitative easing is in the making, but rather that the tools of QE are available should they become necessary. As we have asserted earlier, the likelihood of having to use those alternative tools seems to be receding as the economy and credit conditions continue to regain their footing. It will be a while before the output gap is closed and credit is back to historical trends, but neither is it in free fall.

Parsing the Statement

With no change to the overnight rate expected, all the focus will be on the statement. We expect the Bank to retain its commitment to keep the overnight rate at 0.25% until June 2010. In fact, the Bank was rather explicit on this matter and assured markets that as long as the overnight rate was steady, it “will continue to provide such guidance in its scheduled interest rate announcements as long as the overnight rate is at the effective lower bound.”

There might be a nod to the somewhat better tone of the economic data of late, but the Bank is unlikely to make any measurable changes to the outlook. The Monetary Policy Report followed the last BoC meeting and that included downward revisions to the outlook and there has only been a smattering of data that has been a tad more optimistic than expected. Before making any significant

changes in the verbiage of the outlook, the Bank will no doubt want to see a consistent stream of decent data.

That said, there may still be some nuances to watch for. Given the stickiness of inflation and that fact that it has not slipped as much as expected even with so much slack developing in the economy, the Bank could revise the wording on its inflation bias. In the April FAD communiqué, the Bank noted that “the overall risks to its inflation projection are tilted slightly to the downside.” The Bank might either remove that statement entirely or soften the wording as inflation has not lost as much traction as forecasts predicted.

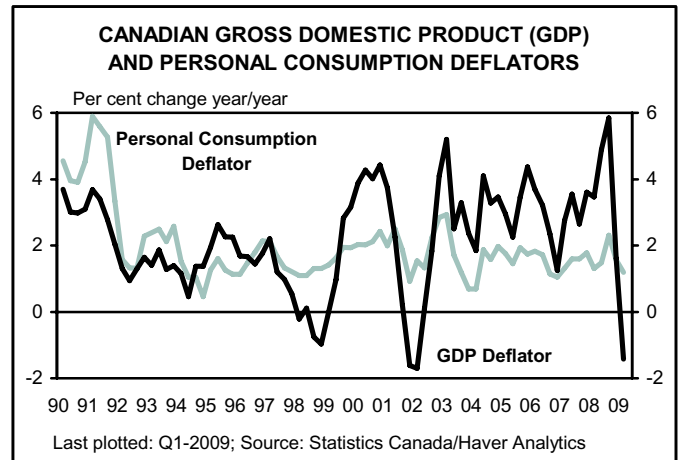
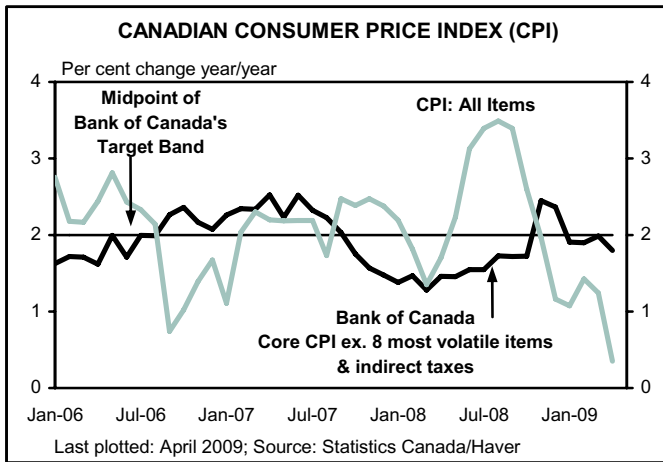
Moreover, how the Bank treads around in the issue of quantitative easing will be important. They stated through recent rhetoric that they are not out of bullets, and in the last statement, noted that “the Bank retains considerable flexibility in the conduct of monetary policy at low interest rates.” This is likely to remain. But it is also clear (though

not stated) that they would prefer to use alternative policy measures only in the most dire of situations. And given the slow repair still evolving in currency markets, there is little to suggest that the Bank will need to pull out the big QE guns anytime soon.

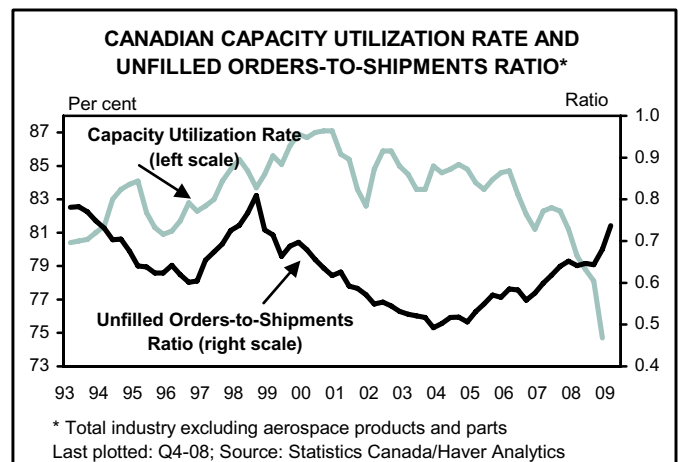
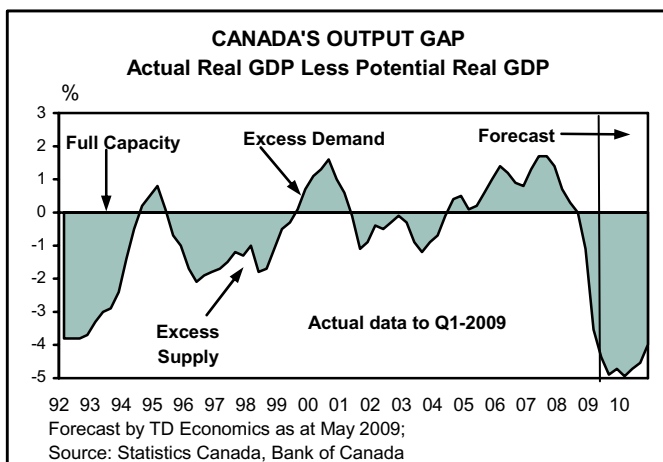
Lastly, if the Bank does mention anything about the currency, it would most likely be factual and descriptive and not necessarily with the intent to sway the currency. When the Canadian dollar was near parity in 2007, Governor Dodge only said the following at a speech on September 27. “In recent days, the Canadian dollar has moved sharply above the trading range assumed in the July *MPRU*, and we need to look at the causes of this strengthening, should it persist. And, as always, we need to assess the effect of movements in the exchange rate on the balance of aggregate demand and supply in the Canadian economy.” We might not even get that much out of Governor Carney this time around.

Charmaine Buskas
Senior Economics Strategist
TD Securities
416-982-3297

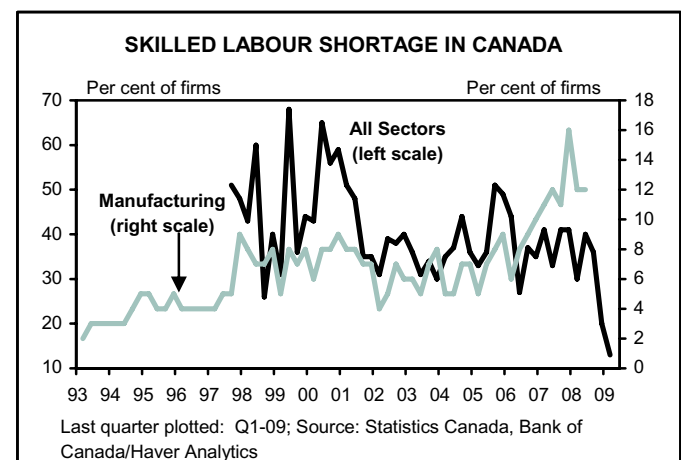
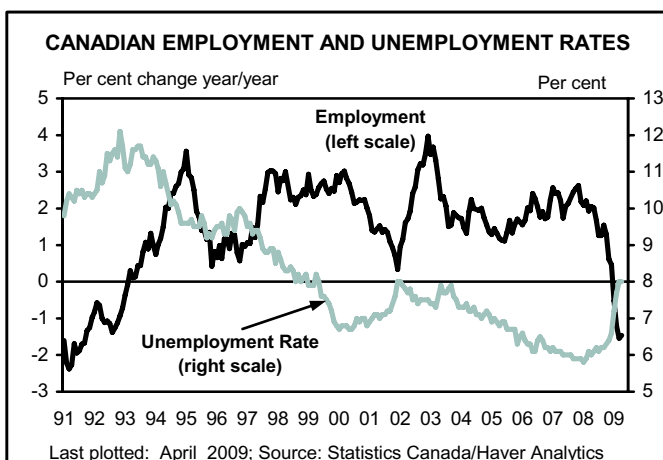
INFLATION MEASURES



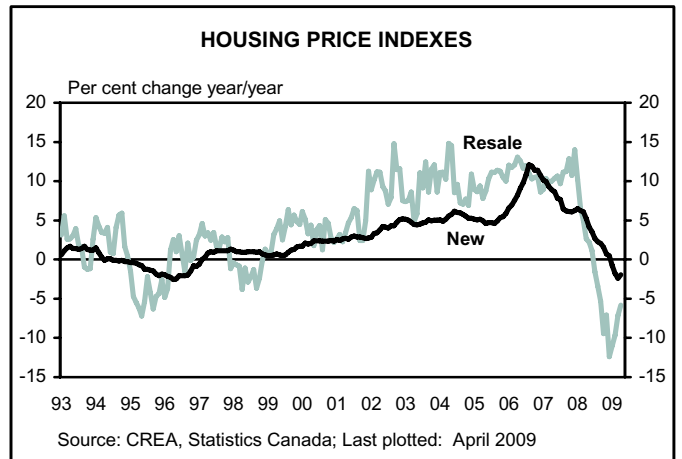
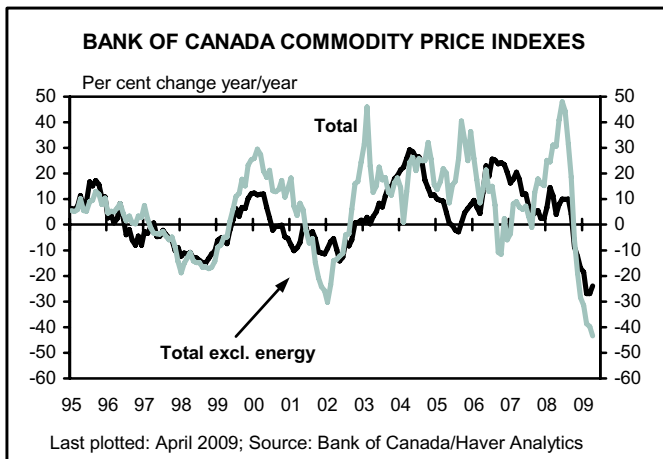
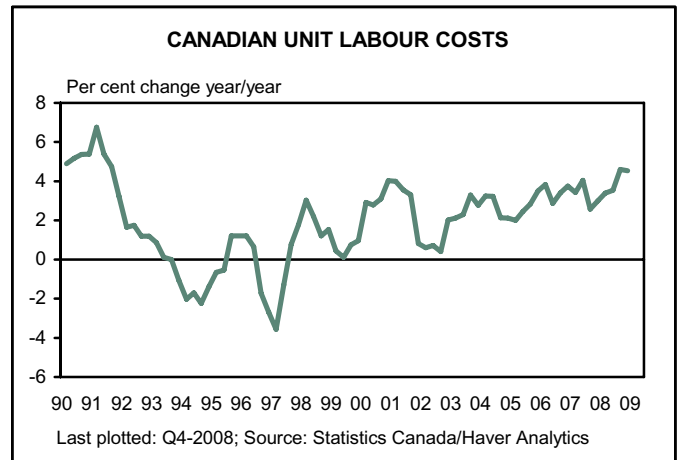
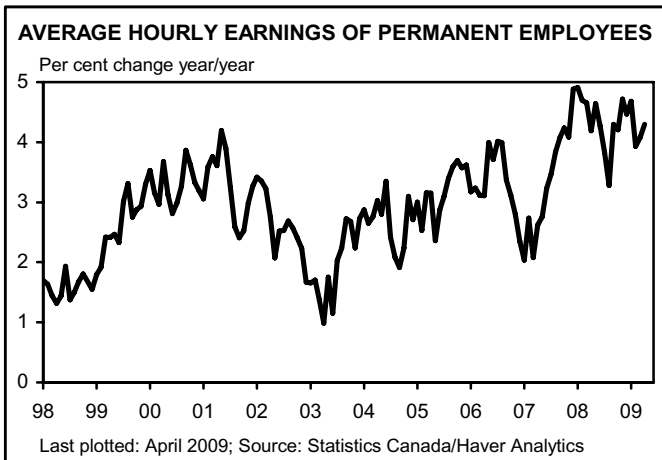
PRODUCT MARKET



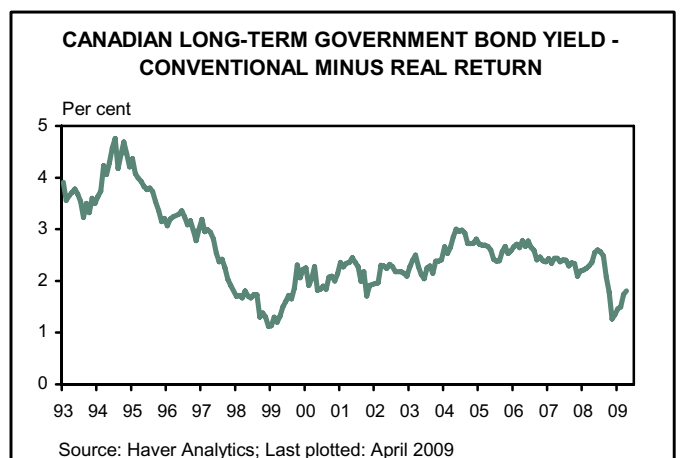
LABOUR MARKET



WAGES, COSTS AND REAL ESTATE



INFLATION EXPECTATIONS



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