

# TD Economics

## Monetary Policy Monitor

October 17, 2008

### HIGHLIGHTS

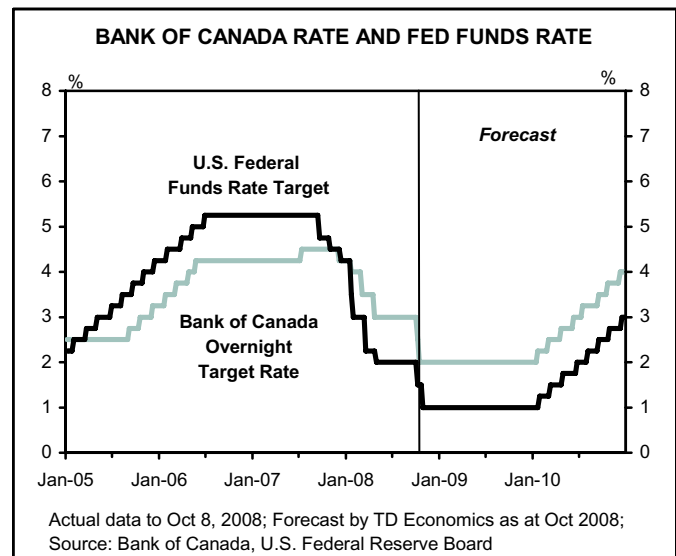
- TD forecasts a 50bp rate cut by the Bank of Canada on October 21st, leaving the overnight rate at 2.00%.
- The three main arguments for easing are U.S. weakness, falling commodities, and deteriorating credit conditions.
- The Bank of Canada has left the door open for more easing when it cited the possibility of “further action.”
- The accompanying statement should acknowledge recent weakness, revise economic forecasts substantially downward, and be vague on future rates.
- The Bank may be reluctant to cut much beyond 2.00% at future decisions.

Over the past two months, central banks and governments around the world have waged an escalating battle against the ravages of the credit crunch. Monetary policy has played a role that – if not quite central – has at least helped to improve market psychology and to provide a cushion for worsening economic conditions.

Canada has fought side-by-side with other nations in this battle, and the Bank of Canada elected to participate in a coordinated 50bp rate cut with other major central banks on October 8<sup>th</sup>. This marked the first Canadian rate cut after three consecutive pauses, and was also the first intermeeting rate cut by the Bank since 2001.

In cutting – and an intermeeting cut at that – the Bank gave out a signal that it has changed its thinking and its outlook, and this leaves the door open for possible further easing.

TD forecasts that the Bank of Canada will elect to ease by a further 50bp on October 21<sup>st</sup>, taking the overnight rate down to 2.00%. This is somewhat bolder than the market consensus, which calls for a 25bp rate cut. There are also those who believe that the overnight rate could remain unchanged at 2.50%. There is thus considerable uncertainty



associated with the coming Bank of Canada decision, though we naturally feel that the odds tilt toward our own view.

The rationale for the TD view, at its essence, is that the U.S. economy is deteriorating, commodity prices are falling, credit conditions have worsened, and all of this has negative repercussions for the Canadian economy and inflation. In turn, the overnight rate needs to be lower than it currently is. And although rates could conceivably be taken down to the appropriate level at a more measured pace than we forecast, there seems to be little value in delaying the stimulus given what is now known.

### More Options Mean More Uncertainty

A great challenge in predicting central bank actions over the duration of the credit crunch has been (and will be) that central banks and governments have greatly expanded their toolkits. No longer does the debate simply concern the magnitude of rate cutting. The range of possibilities simultaneously slices across several fronts, including liquidity injections, fiscal stimulus, money market guarantees, commercial paper purchase programs, deposit and loan guarantees for banks, government purchases of bank assets,

and government injections of equity into banks.

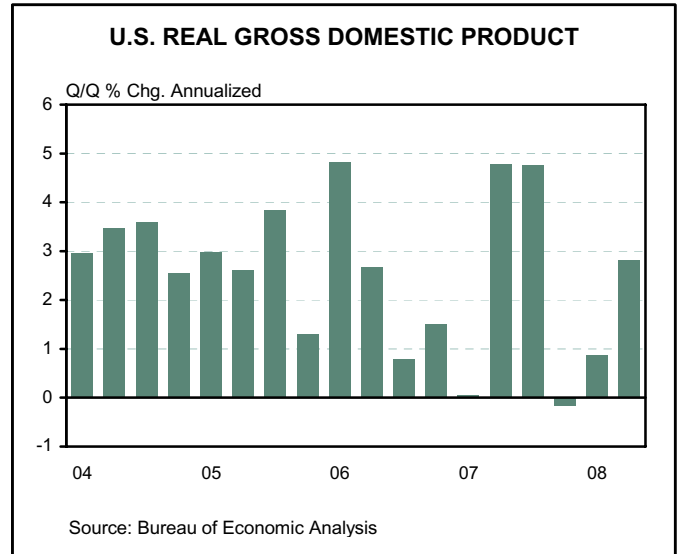
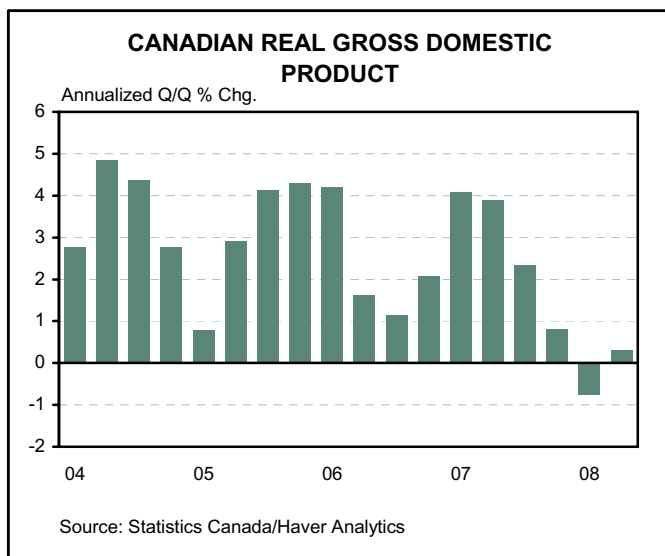
These various options do not serve as perfect substitutes for one another, but more of one does to an extent reduce the need for another. In turn, it is no longer a matter of determining how much “help” an economy needs, but simultaneously how that help will be deployed, and what fraction will come in the form of monetary policy. This is not an exact science.

### Psychology

In times of trouble, central banks cut rates not just to make borrowing less expensive but also to provide a psychological boost to market morale. This was clearly part of the motivation for the recent coordinated easing, which came at a time of extreme market duress. But it is a dangerous game to forecast additional central bank easing on this factor as market conditions can change on a dime, leaving a forecast hanging out on a limb. As a result, while current market psychology makes a further case for easing, this is only a secondary motivation for our Bank of Canada forecast, especially since it is not clear that the Bank of Canada can do much to restore market confidence when it is the entire world that has lost its bearings, with Canada just a bit player.

### Economic Fundamentals

In a fashion, the Canadian economy can be thought of as a haphazard cross between the U.S. and a commodity-oriented nation like Australia. Over the years, this has often made for an uncertain conclusion as the U.S. example has tended to argue for central bank easing while the performance of commodity-oriented countries has argued for tightening. But now that commodity prices are falling



sharply, this has all been turned on its head and both the U.S. link and the commodity link argue in unison for Canadian rate cutting.

More specifically, there are three key arguments for rate cutting by the Bank of Canada: the U.S. economy, commodity prices, and the deteriorating credit crunch. We elaborate on all three here.

TD has long feared for the U.S. economy, and many of these fears have manifested themselves in recent months by way of a U.S. consumer that has begun its long-awaited fall, housing that has again begun to plummet after temporarily clinging to the cliff face, the business sector which is beginning to retrench, and the labour market which is also stumbling. All of this continues to have relevance for Canada through trade ties and financial market links.

Declining commodity prices – with oil as the clear bellwether – have a double-barreled set of implications for Canada. First, they reduce inflation directly as occurs in all countries. Second, they diminish the Canadian economic outlook insofar as Canada is a net exporter of these products and derives a slight economic advantage when commodity prices are high. Simultaneously, and not at all coincidentally, inflation expectations have diminished, substantially reducing upside inflation risks.

The credit crunch itself has also clearly gotten worse over the past few months, and this means that monetary policy is not working its way as easily through the system to borrowers. In turn, it is as though the central bank has tightened rates. This is difficult to quantify precisely, but the latest downturn in the credit crunch has likely had the impact of at least 25bp in central bank tightening, if not more. In turn, the Bank of Canada may wish to unwind

some of this. But this argument takes a backseat to the plight of the U.S. economy and commodity prices because credit conditions have shown a remarkable and repeated ability to swing sharply back and forth, and the argument for cutting on this factor alone could disappear just as easily as it has arrived.

### Parsing the Bank

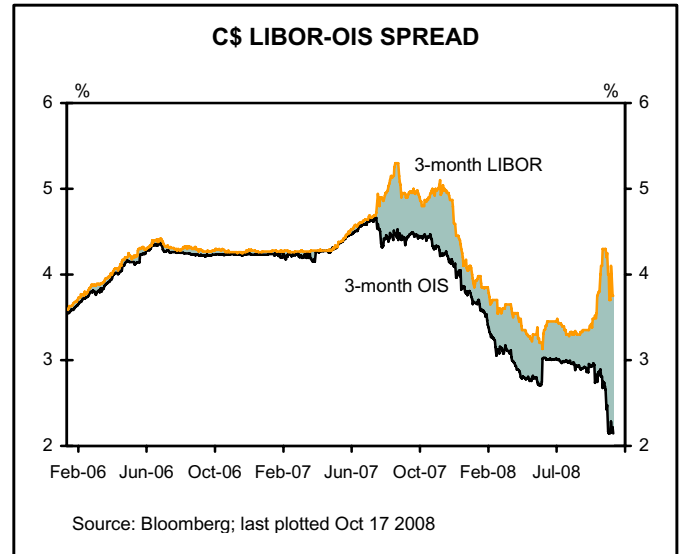
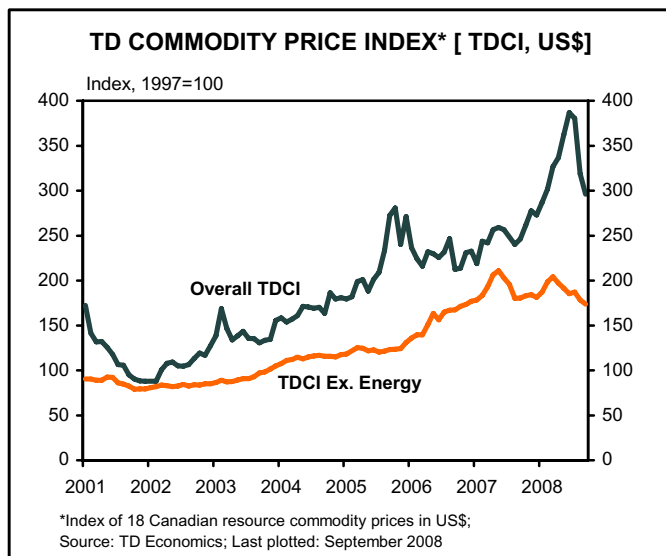
The most recent Bank of Canada rate decision from October 8<sup>th</sup> had a statement attached that gives some sense to the Bank's thinking. The arguments hone quite closely to the ones we have already presented. Namely, "credit conditions in Canada have tightened significantly", "weaker growth in the United States and other important trading partners will increase the drag on the Canadian economy", and "the deterioration of our terms of trade [i.e. falling commodity prices and a falling Canadian dollar] will act to moderate the growth of domestic demand."

In what was likely an effort to keep its options open, the Bank did not provide any clear signal on the path ahead for monetary policy, aside from saying that "The Bank will continue to monitor carefully economic and financial developments, along with the evolution of risks, in judging whether any further action might be required." This hardly guarantees additional rate cuts, but the mention of the possibility of "further action" looks to be a veiled reference to additional easing, and so we take from this that the Bank of Canada is actively contemplating further rate cutting.

### Statement Predictions

We look for the statement to announce a 50bp rate cut and thus a 2.00% overnight rate.

Since the Bank of Canada's October 8<sup>th</sup> decision and



statement came less than two weeks before its next decision, there is little reason to expect a wholesale change in attitude or prose, though the recap of recent developments could be slightly more pessimistic yet as financial markets continue to stumble, the U.S. continues to record poor economic numbers, and commodity prices continue falling.

The statement should be fairly number heavy, as it will provide a sneak preview of the Monetary Policy Report that is released two days later. On the economic outlook, recent Bank comments suggest that the economy is now expected to grow at a below potential pace throughout the entirety of 2009, whereas previously this was only until the midpoint of 2009. The actual GDP forecast should be revised sharply downward. To provide a sense for the possible magnitude, the Bank of Canada's most recent 2009 GDP forecast was 2.3%, whereas TD now forecasts just 1.2% and Consensus Economics points to an average expectation of 1.1%. Presuming the Bank of Canada falls into line, this would represent one of the largest ever downward revisions by the Bank.

The inflation outlook should also be scaled back, in part because the diminished economic outlook should translate into core CPI that remains below potential for somewhat longer than previously assumed – possibly until early 2010 – and partially because recent commodity price declines will push the profile for total CPI sharply downward relative to previous expectations.

The portion of the statement that looks to the future should be rather vague to give the Bank of Canada wiggle room. We do not expect to see any reference to the level of the overnight rate being "appropriately accommodative" (as occurred at the last scheduled rate decision on Sep-

tember 3<sup>rd</sup>) since this would preclude further cutting, which will surely remain at least a possibility. At the same time, we are not convinced that there will be a reiteration of possible “further action”, since the Bank of Canada will not go through the 2.00% barrier lightly. Instead, we expect to see a statement that talks about responding to further developments as needed, without promising much of anything.

### The Path Beyond

Beyond October 21<sup>st</sup>, when we predict 50bp of easing, the path becomes even murkier.

Additional rate cutting – even of an intermeeting and/or coordinated variety – cannot be absolutely ruled out. But nor should it be counted upon, as intermeeting cuts are not the Bank of Canada’s preferred means of operating, and the Bank would not take lightly to cutting the overnight rate below the historical floor of 2.00%.

Moreover, there are reasons to think the Canadian economy and inflation are not quite as bad as they look on the surface, and thus that the scope for additional Bank of Canada easing could become quite limited very quickly.

First, although existing home prices are technically falling and the housing market does need to ease somewhat to return to demographic norms, there is little reason to fear a U.S.-style correction. Lending was never as willy-nilly as in the U.S., and there is little evidence that households are burdened if one examines statistics on mortgage delinquency rates and the debt-service ratio. It is also true that the existing home price data may over-estimate the extent of the correction due to compositional effects.

Second, although Canadian GDP has clearly been quite poor over the first half of 2008, this overstates the situation somewhat as the terms of trade have provided quite a substantial benefit as measured by Gross Domestic Income (GDI), and productivity has also been so abysmally bad that little slack has opened up in the economy despite the poor GDP track record. Indeed, Canada’s unemployment rate is still quite low, and recent employment numbers – if they are to be believed – do not point to persistent job losses (quite the contrary, actually). This does not mean that the future is necessarily bright, but it means that the starting point is not quite as poor as it first appears for Canada.

Third, Canadian inflation is not quite as meek as it first appears. Yes, core CPI is just 1.7% Y/Y, but the Bank of

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	

Canada has emphasized repeatedly that it views this measure to be biased by a one-time currency shock that it would prefer to look through. There is also the upside risk associated with the recent weakness of the Canadian dollar (though one imagines the Bank of Canada will elect to at least partially “look through” this as well). At the same time, the Bank has made a point of emphasizing alternate measures of core inflation, all of which are above 2%, with the favored reweighted mean CPI measure clocking in at a big 2.8% according to our calculations. Again, this does not preclude rate cutting, especially since these numbers should trend down with commodity prices and a weakening economy. But it suggests that the starting point requires somewhat more caution than one might first imagine.

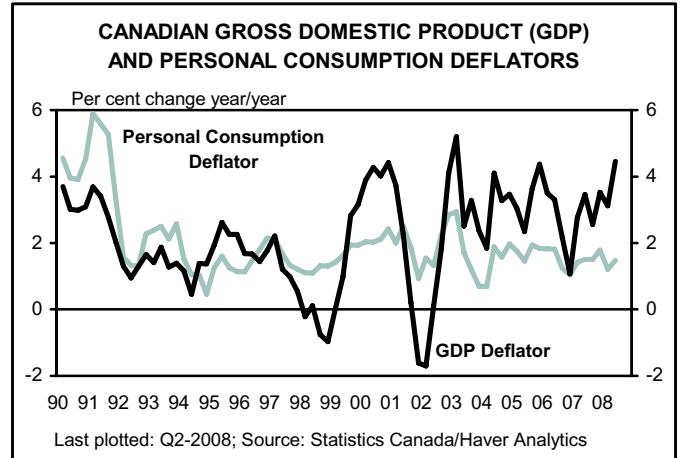
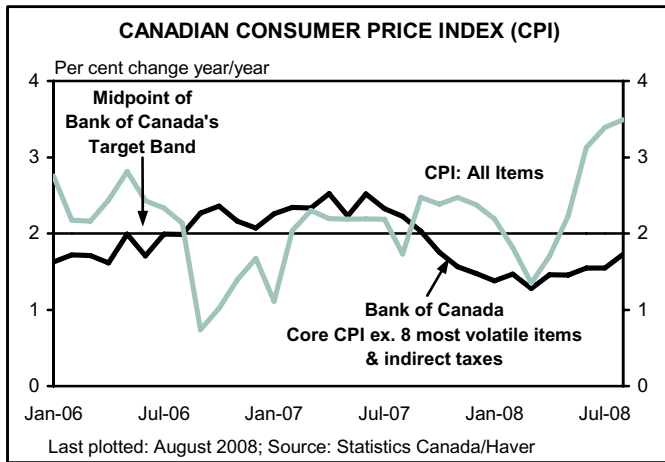
All of this is to say that the overnight rate may not need to go below the 2.00% that we target for it. This puts TD in the unusual position of having a rate cut forecast that is bolder than the market in the near term, but that is more cautious in the medium term. Again, we believe there is little reason to lollygag on the way down, but that there are reasons not to take the rate too low. Also, there is an interesting pattern of central banks slightly favoring “round” numbers like 1.00%, 2.00%, 3.00%, etc, as their ultimate resting points over irregular numbers.

In the end, the only thing that remains crystal clear is that economic and market conditions will continue to mutate rapidly, which presents larger-than-usual risks extending in both directions. While the U.S. economy itself seems to be somewhat like a freight train on a fairly clear and unalterable path downward, commodity and credit market conditions can change on a dime, for better or for worse. Caution is warranted.

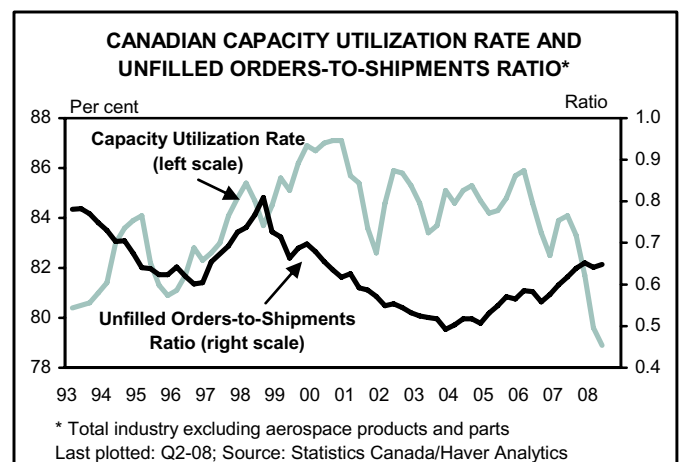
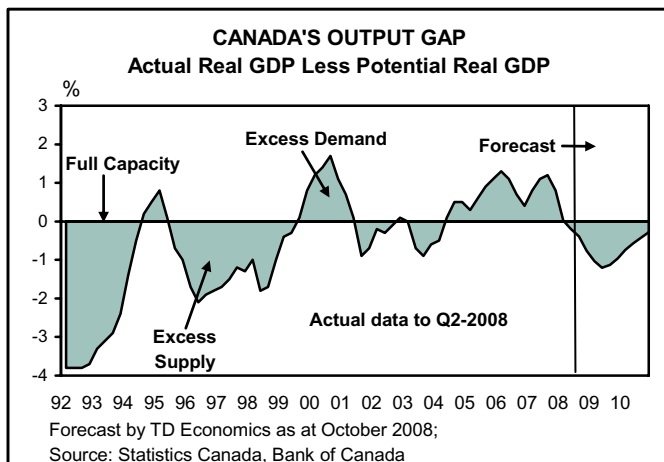
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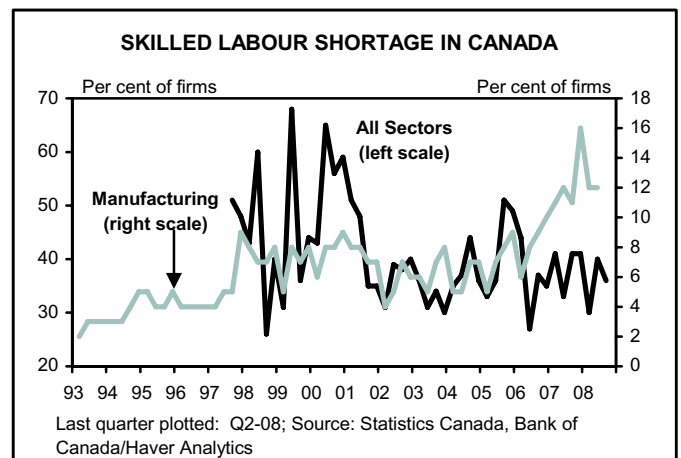
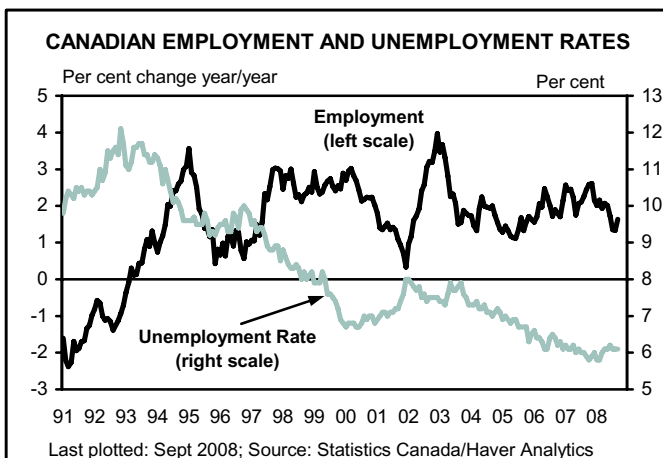
## INFLATION MEASURES



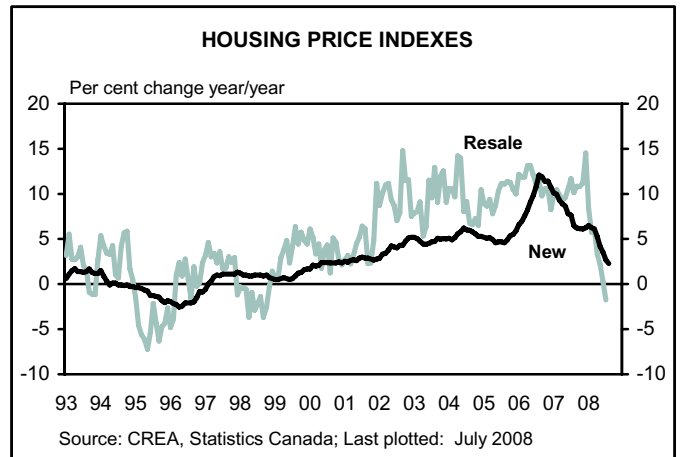
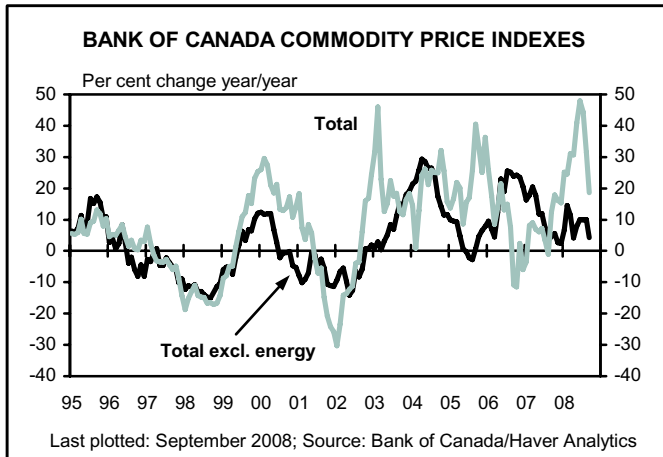
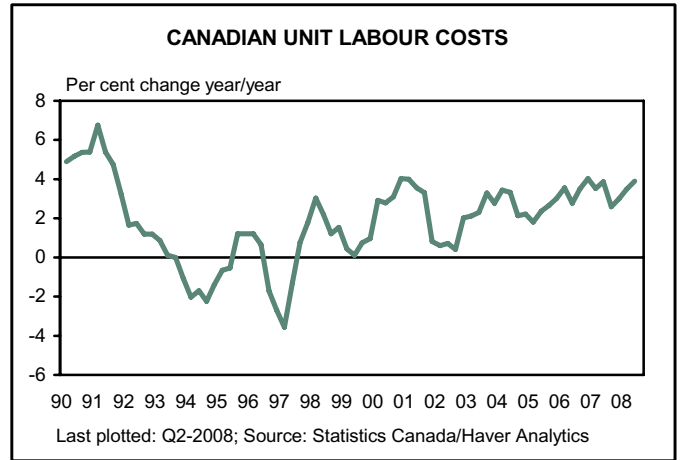
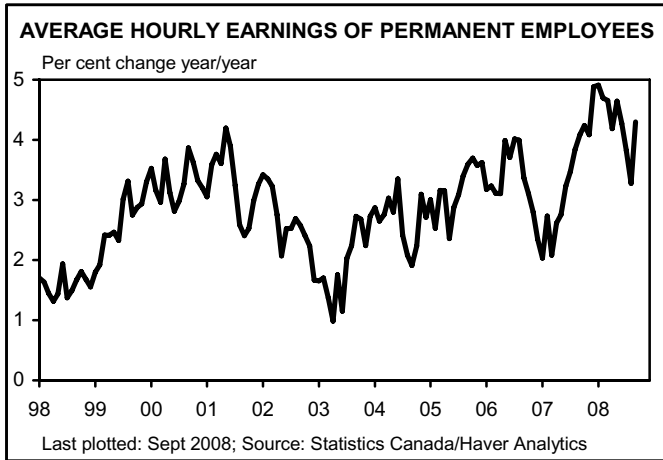
## PRODUCT MARKET



## LABOUR MARKET



## WAGES, COSTS AND REAL ESTATE



## INFLATION EXPECTATIONS

