



TD Economics

Special Report

November 20, 2007

UPDATED BANK OF CANADA FORECAST

- We now call for the Bank of Canada to cut the overnight rate by 25bp on December 4th, and again on January 22nd.
- The Canadian dollar is exerting a greater drag than the Bank of Canada had expected, and Canadian inflation continues to trend persistently lower.
- The Bank of Canada itself has increasingly cited downside risks to its forecast, setting the stage for rate cuts.

On October 18th – in its Monetary Policy Report – the Bank of Canada painted a picture of relative serenity for the future. The Canadian dollar was expected to average \$0.98 U.S., oil prices were expected to trend downwards from \$81, the credit crunch was forecast to be no more severe than it was in October, core inflation was expected to trend down towards the 2.0% target by mid-2008, GDP was forecast to grow at a moderate 2.5% in the third quarter of 2007, and – perhaps most notably – “in this base-case projection, there is no change in the policy interest rate.” All of this represented a somewhat perfect world.

Inevitably, most forecasts do not transpire precisely as expected. In the Bank of Canada’s case, several things have derailed the outlook, and the derailment has been almost exclusively to one side of the tracks. The Canadian dollar rose to unprecedented heights, nipping \$1.10 U.S. before retreating back to a still-lofty \$1.02 U.S. Oil prices rose to \$97. The credit crunch intensified once again, with banks reporting a new round of losses, and money market measures slipping. Core inflation has trended down to 1.8%

Y/Y in October, and appears unlikely to come close to hitting the Bank of Canada’s 2.3% inflation assumption for the fourth quarter. Third quarter GDP appears set to be soft, and is unlikely to match the Bank’s 2.5% annualized forecast.

Logically, when economic and market conditions miss the mark, there are implications for inflation and thus for monetary policy. In turn, we believe the Bank of Canada is now likely to cut its target for the overnight rate by 25bp on December 4th, and to enact another 25bp rate cut on January 22nd.

Canadian monetary policy is unusually difficult to forecast right now. Many economic variables – ranging from the Canadian dollar to the unemployment rate – are at multi-decade extremes, which makes their interpretation difficult and contributes to unusually large upside and downside risks. The motivation for the shift in our own Bank of Canada forecast stems from a variety of factors.

Bank of Canada Comments

The Bank of Canada emerged from its October 16th meeting and October 18th Monetary Policy Report with what was essentially a neutral stance, but with “perhaps a slight tilt to the downside.” Since then, the Bank of Canada has hinted in increasingly bold statements at the shifting prospects for Canadian monetary policy.

Initially, the rhetoric was focused upon the strength of the Canadian dollar – an “abnormally” fast appreciation as described by Dodge. Then, Senior Deputy Governor Jenkins noted that “Canada is bearing a disproportionate share of the adjustment”, and that “if recent levels of the Canadian dollar were to persist, the risk is that output and inflation would be significantly lower.” Last weekend,

Governor Dodge spoke at a G20 meeting in South Africa, and he conceded that “it’s quite clear that the downside risks to growth have increased”, that “global financial turbulence... ..is now going to be more prolonged”, and “that clearly poses a risk that we are going to have to take into account when setting our own policy.”

None of this speaks explicitly of rate cuts, but the vigour with which the central bank has hammered home an ever-growing number of dovish observations suggests that rate cuts are not just a real possibility, but increasingly likely.

Canadian Dollar Strength

The recent strength of the Canadian dollar is a key argument in favour of Bank of Canada rate cuts. In generating its October 18th forecast, the Bank had assumed a \$0.98 U.S. average exchange rate. Since then, the currency galloped all the way to an unprecedented \$1.10 U.S., before wafting down to \$1.02 more recently. Even at this new, somewhat less heated level, the Canadian dollar continues to exact a toll on the economy and inflation. Part of the unexpected strength is admittedly related to “Type 1” fundamentals such as stronger oil prices that do not damage the economy. But part of the strength is unquestionably “Type 2”, and bear in mind that the recent softening of the Canadian dollar has been at least partially related to a more pessimistic rate outlook for Canada imposed by the market – a Type 1 depreciation that thus does not get the Canadian dollar off the hook. In short, the Canadian dollar is still several cents stronger than fundamentals support, and this thus argues for easier monetary policy.

Credit Crunch

The credit crunch has arguably remained somewhat more profound than the Bank of Canada had first expected in October. The Bank had estimated that credit conditions were roughly 25bp tighter than pre-crunch. This estimate is probably not far off of reality, though certain credit spreads have marched wider in recent weeks, suggesting that that estimate may be slightly on the low side. Of equal concern have been the substantial bank losses reported in the U.S., with the potential ramifications on the real economy that extend from that.

Lower Inflation

Canadian inflation has been surprising in its weakness, providing a main buttress for Bank of Canada rate cuts. Core CPI now rests at just 1.8% Y/Y, down substantially

from a peak of 2.5% earlier in the year, and the lowest level in well over a year. This is also notable because it is now beneath the Bank of Canada’s all-important 2.0% target. In sharp contrast to this recent development, the Bank of Canada had assumed that core CPI would average 2.3% in the fourth quarter of 2007 – an outcome that now appears improbable.

What is more, the recent monthly trend in core inflation remains quite soft. On a seasonally adjusted basis, the annualized six-month trend in core CPI is just 1.3%, and the three-month annualized trend is an even lower 0.7%. These hardly speak to inflationary pressures.

The inflation story has been a peculiar one recently. Contrary to conventional economic theory, hot wage and unit labour cost growth combined with tight business conditions and strong money supply growth have clearly not translated into significant inflationary pressures. The effect of these variables simply appears to be somewhat muted at present. It is possible that this is linked to a growing academic literature suggesting that the Phillips Curve is flatter than it once was – roughly speaking, that the unemployment rate needs to fall further through NAIRU than was once necessary to generate inflationary pressures.

By contrast, recent Canadian dollar strength may be appearing more profoundly than expected in the inflation numbers – but in a deflationary capacity. This is in part due to a greater-than-expected run-up in the currency, but is also related to what appears to be a sizeable passthrough – one potentially more powerful than recent studies on the subject would have suggested.

Slower Growth

The Bank of Canada is on record with an increasingly pessimistic attitude toward global, U.S., and Canadian economic growth since its October 18th announcement.

Governor Dodge noted that global financial turmoil is likely to be prolonged, presumably with some impact on the economy. Deputy Governor Duguay commented on November 20th that “the weakening of prospects for the U.S. economy is another issue.” As noted earlier, Senior Deputy Governor Jenkins has said that “if recent levels of the Canadian dollar were to persist, the risk is that output and inflation would be significantly lower.”

The economic evidence appears to square fairly well with these comments. Canadian net exports are likely to exert a sufficiently large drag that Canadian third quarter

GDP is unlikely to grow by the 2.5% annualized assumed by the Bank of Canada.

It may also be fair to say that – from a somewhat longer-term perspective – much of the strength currently supporting the Canadian domestic economy may not last indefinitely. Residential construction strength should soften modestly, simply to the point of returning the level of activity to a somewhat more sustainable environment (and in the process, ceasing to contribute to economic growth). It is also reasonable to wonder whether the commodity price surge will continue forever. Let us be clear that this does not mean that commodity prices should drop back to the level of a few years ago. Instead, it merely means that if oil prices cease to rise by 65% Y/Y (as they have over the past year), the pace of economic growth in Canada's resource sector might revert to a more normal – and slower – pace. Similarly, though overall job growth in Canada has remained top-notch, most of the recent hiring has not come from the private-sector (and hiring plans in Canada do now seem to be somewhat softer), suggesting a limit to how much longer the robust job gains can continue.

It is equally true that Canada's manufacturing and forestry firms have struggled for some time now, and are unlikely to turn the corner given soft U.S. demand and the strength of the currency. Even a hypothetical drop in the Canadian dollar would be unlikely to return Canada's manufacturing industry back to its pre-2003 heyday. Jobs that have been lost are unlikely to return now that they have firmly settled into lower cost regions.

Risks to View

Let us be clear that we are not throwing our previous assessment – that there is a lot to be positive about Canada – completely under the bus. It is absolutely true that the Canadian labour market is stunningly strong, that housing has been robust, that the outlook for consumer spending is solid, and that money supply growth is robust. But these factors increasingly appear to be swamped by the remarkable strength of the currency, the depth of the credit crunch, and persistent softness in the U.S.

Another risk to our updated view is that the Bank of Canada has a general preference for shifting monetary policy gears when it issues its quarterly Monetary Policy Report. This report will not be issued in December, and thus presents a scenario in which the Bank might choose to wait until January to rejig its view. Given the unusual

circumstances that prevail presently and the speed with which they have arisen, we suspect a December rate cut is nonetheless still on the table.

A final fair-sized risk is that if the Canadian dollar were to fall substantially – dipping back below parity without Type 1 rationale to force it there – the case for rate cuts would begin to diminish. To the extent that the argument for cuts is multi-pronged, spanning not just a strong Canadian dollar but also U.S. weakness and credit crunch woes, this would not be a game-changer unless the drop were to be truly substantial or paired in some fashion with some other improvement to the Canadian economic outlook.

Not Just Likely, But Justifiable

We have argued that we believe the Bank of Canada is likely to cut the overnight rate beginning in December. But so far, we have shied away from a judgement call on this likely policy action. We should emphasize that we believe rate cuts not just to be the likely move but also to be the correct move. There are two key reasons for this.

The first reason is that the Bank of Canada is mandated to pursue an inflation target of 2.0%. To the extent that core inflation is clearly trending below that level with little probability of bouncing sharply back, rate cuts are justified. This trumps all other considerations.

Second, the Bank of Canada has some room to manoeuvre given the inherent inexactness of monetary policy and the unusual uncertainty associated with the economic outlook. In this context, it might make sense to err at the margin on the side of slightly lower rates given the unusual burden being felt by Canada's manufacturing sector. The Bank of Canada is surely sympathetic to the sectors hard hit by the appreciation of the Canadian dollar. This sympathy was likely limited as the Canadian dollar drifted upwards from its incredibly low levels of 2002 towards the \$0.80 U.S. to \$0.90 U.S. level. But now that the Canadian dollar has plowed well through that zone – especially given the unprecedented velocity of the move – it has become increasingly unrealistic for Canadian exporters to compete effectively with the U.S., let alone with developing nations. Consider, for instance, that Canada's private sector productivity is roughly 80-85% of U.S. levels. This makes Canadian products by necessity roughly 20% more expensive than their U.S. equivalents. Manufacturing output lost today is unlikely to return tomorrow, even if the currency were to return to the \$0.80-\$0.90 U.S. zone. Thus, there

exists an asymmetric incentive to ease on this factor, even though this is clearly not the Bank of Canada's main driver.

Implications for the Canadian Dollar

There appears to be a view in the market that a change in the overnight rate would have a dramatic influence on the Canadian dollar. While this is certainly possible given the recent wild swings in the currency market on the thinnest veneer of information, a large swing would not be consistent with the historical record. Generally, rate changes have only a minor impact on the currency, and the rate cuts that we predict would be unlikely to swing the Canadian dollar by more than a few cents at most. And given the huge volatility in commodity prices recently, it is just as likely that a sizeable commodity move – one way or the other – would dwarf the impact on the currency stemming from monetary policy.

U.S. View

We would be remiss in addressing our Canadian view without touching at least briefly upon our U.S. monetary policy assumptions. Somewhat contrary to market expectations, we do not look for any further Fed rate cuts. The Fed signalled future pauses on October 31st, indeed it characterized the decision to cut on that date as “a close call”. One Fed voter dissented on the last rate cut, and recent Fed speeches have argued against rate cuts. The real

economy is hardly booming in the U.S. (though third quarter growth of 3.9% with a likely upward revision imminent is not bad at all), but nor is it recessionary. We continue to expect a very soft housing market to have only limited impact on consumer spending, and for booming exports (driven by the soft U.S. dollar) to add justification to this review. Meanwhile, commodity price gains and U.S. dollar weakness keep inflation fears on the front-burner and thus reduce the odds of further Fed rate cuts.

Though it might seem strange to argue for Bank of Canada rate cuts partnered with U.S. pauses given the relative economic landscape of the two countries, the salient point to recognize is that the Canadian dollar is proving deflationary in Canada while the U.S. dollar is proving inflationary in the U.S. Combine this with the 75bp of rate cuts the U.S. has already enacted and the further 50bp of U.S. easing associated with the discount rate cut, and our Canadian forecast suddenly seems much less contentious.

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