TD Economics

Commentary

March 4, 2008

BANK OF CANADA CUTS HALF POINT TO COMBAT FALLOUT FROM U.S. SLUMP

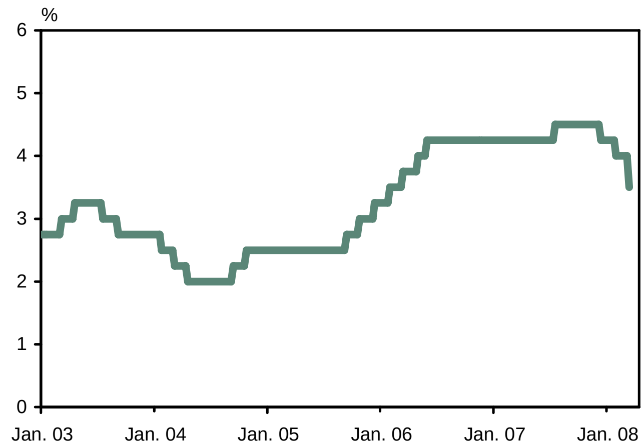
- **Overnight target rate lowered 50bps to 3.50%**
- **Further policy easing to come**

In a widely anticipated move, the Bank of Canada elected to deliver a larger-than-normal 50 basis point cut to its overnight target rate in response to the recent signs of weakening economic conditions. Much will likely be made of the more forceful easing at the first interest rate announcement by new Governor Mark Carney, but the reality is that the decision to be more aggressive probably had nothing to do with the change in leadership at the Bank. Indeed, while economists and financial markets had debated in recent weeks about whether the monetary authority would deliver a traditional quarter point or greater half point reduction, yesterday's extremely weak Canadian economic figures for the fourth quarter and December, combined with the overwhelming evidence of deteriorating economic conditions in the United States, virtually made the decision to ease a half point a slam dunk.

The rationale for the aggressive easing was laid out clearly in the communiqué, and the dominant theme is that Canada cannot escape the fallout from the U.S. economic slump, which has contributed to the strength in the Canadian dollar and has led to weaker demand for Canadian exports. The Bank noted that, "the U.S. economy is likely to experience a deeper and more prolonged slowdown". "The deterioration in the economic and financial conditions in the United States can be expected to have significant spillover effects on the global economy".

Canada's economy is heavily leveraged to trade with the United States, so the prospects for the U.S. pose "important downside risks to Canada's economic outlook". News that Canadian economic growth slowed from an annualized 3.0% in Q3 to 0.8% in Q4 on a deep contraction in exports highlights this relationship. Moreover, with Canadian real GDP declining 0.7% in December, the economy will be hard pressed to avoid contracting in the first quarter of 2008 and economic growth is likely to remain weak for much of the coming year.

BANK OF CANADA OVERNIGHT RATE



Actual data to Mar. 4, 2008; Source: Bank of Canada

Fortunately, inflation in Canada is under wraps. The Bank's last projection was for headline and core CPI inflation to fall below 1.5% by the middle of the year and only return to the 2% target by the end of 2009. In today's communiqué the Bank stated that the risks to their inflation projection have clearly shifted to the downside. This has provided the monetary authority with the flexibility to lower rates and based on the today's statement there is likely more easing to come. Based on the dovish tone to today's communiqué, TD Economics expects a further half point cut at the next rate annoucement on April 22. That action would take the overnight rate down to 3.00%, which would put monetary policy in a highly stimulative stance that should help the economy weather the headwinds coming from the United States.

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