

## **BANK OF CANADA HOLDS STEADY WITH A SLIGHTLY MORE PESSIMISTIC TONE**

- **Bank of Canada holds rates steady at their effective lower bound of 0.25%**
- **The strengthening Canadian dollar remains the key downside risk to the medium-term outlook**

As widely expected, the Bank of Canada held the target for the overnight rate at 0.25%, consistent with its conditional commitment to keep rates at their effective lower bound through to the second quarter of 2010. While the Bank of Canada stated that improvements in global and financial markets have been better than it expected in July's monetary policy report, "fragilities still remain".

While the Bank of Canada remained optimistic on economic performance for the second half of 2009, it seemed to take a more pessimistic view on medium-term prospects for the Canadian economy. The Bank stated the stronger performance in the second half of 2009 will be driven by "monetary and fiscal stimulus, increased household wealth, improving financial conditions, higher commodity prices, and stronger business and consumer confidence". However, the negative impact that the strength in the Canadian dollar will have on exports will more than offset these improvements, and as such, the Bank of Canada has slightly lowered its growth projection for 2011 to 3.3%, down from 3.5%. As such, it now anticipates that the economy will reach full capacity, and inflation will reach the Bank's target in the third quarter of 2011, one quarter later than in the July MPR. The Bank of Canada continued to communicate that the risks to the "inflation projection are tilted slightly to the downside".

Today's announcement laid to rest any speculation that Canada would follow Australia's lead and hike rates sooner than expected. While, like Australia, Canadian economic growth is being bolstered by commodity markets, unlike Australia, Canada did suffer a deep, but short U.S. led recession, and is still struggling with the ramifications of that downturn. The Bank of Canada would want to solidify a recovery first, as hiking too soon could be just as risky as

hiking too late. Even though the outlook for the domestic economy has improved significantly from the last rate announcement, data released over the past month has proven that the Canadian economy is still grappling with soft domestic demand. This has kept inflation under wraps with the Bank of Canada's core measure well under its 2.0% target, despite extraordinarily low policy rates.

While our outlook for 2009 is much in line with that of the Bank of Canada's, we are expecting a more mild recovery in 2010 and 2011, with growth of 2.5% and 3.1%, respectively. Our forecast is consistent with an output gap that finally closes – and with inflation reaching the Bank of Canada's 2.0% target – in the first quarter of 2012 – a quarter later than the Bank of Canada's own projection. As such, we believe that the Bank of Canada will stay put past its conditional commitment of June 2010, and the first rate hike will not come until the fourth quarter of next year.

But of course there are always downside and upside risks to every forecast. We have outlined an overheated Canadian existing housing market as a risk that may lead the Bank of Canada to act sooner and more aggressively if a bubble materializes out of the recent momentum in the housing market. However, the Bank of Canada made no mention of this possibility in today's announcement, and like many statements made by the Bank, we believe that the strength in the housing market is temporary, and should cool by as early as November. In the meantime, one key downside risk that has materialized so far is the rise in the Canadian dollar, which traded at \$0.96 U.S. following the Bank of Canada's announcement. Even though the Canadian currency has been partly driven by relatively favourable fundamentals, it will be a medium term obstacle for economic growth as it is projected to move past parity by mid-2010.

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