



The 1% Solution?

The Bank of Canada cut its key overnight lending rate 50 basis points to 1.0% today, bringing cumulative rate cuts to 350 bps since the rate-cutting cycle began in Dec/07. While the vast majority of analysts were calling for the 50 bp cut, the market was leaning much more heavily to a 75 bp slice. Notably, the tone of the statement, while providing no big surprises, clearly suggests the Bank is receptive to further rate cuts, but such is not a foregone conclusion.

Some key quotes: *“The outlook for the global economy has deteriorated since the Bank's December interest rate announcement, with the intensifying financial crisis spilling over into real economic activity. Heightened uncertainty is undermining business and household confidence worldwide and further eroding domestic demand. Major advanced economies, including Canada's, are now in recession”*. The outlook was already quite gloomy in early December—we had just seen the deep job losses for November—and the Bank says the outlook has deteriorated further since then.

“Stabilization of the global financial system is a precondition for economic recovery. To that end, governments and central banks are taking bold and concerted policy actions. There are signs that these extraordinary measures are starting to gain traction, although it will take some time for financial conditions to normalize.” The Bank also highlighted the fact that fiscal policy is also kicking into gear worldwide; the Bank may want to see the degree of stimulus in next week's budget before fully committing to additional rate moves. Meantime, there was nary a hint of any new unconventional policy moves by the Bank.

“Canada's economy is projected to contract through mid-2009, with real GDP dropping by 1.2 per cent this year on an annual average basis. As policy actions begin to take hold in Canada and globally, and with support from the past depreciation of the Canadian dollar, real GDP is expected to rebound, growing by 3.8 per cent in 2010.” The 1.2% drop in 2009 GDP is almost exactly in line with our latest call (-1.3% ... though that's subject to downside revision). What really stands out is their call for 3.8% growth in 2010, revised up from 3.4% in October, and about double our view. The big bounce helps explain why the Bank sees inflation getting back towards target by 2011.

“...the Bank will continue to monitor carefully economic and financial developments in judging to what extent further monetary stimulus will be required to achieve the 2 per cent target over the medium term.” Importantly, this is almost the same statement as in December. So, the Bank has left the door open for the possibility of further rate cuts, and with a wave of ugly data no doubt bearing down on the Canadian economy and markets reeling yet again, a move below 1% looks increasingly likely.

Bottom Line: The Bank's actions and words were almost exactly in line with expectations of the forecasting community, and the Bank's near-term economic forecasts closely mirror ours. If global financial markets continue to stagger in the coming weeks, the Bank still has the room and the willingness to cut further as the need arises.

Douglas Porter, 416-359-4887