



**Bank
Financial
Group**

TD Economics

Commentary

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BANK OF CANADA NOT DONE IN CUTTING RATES

- **Bank of Canada cuts by 25 basis points**
- **Bank to cut 50bps on March 4th and 25bps on April 22nd**

The Bank of Canada cut the overnight rate this morning by a quarter-point to 4.00%. This was broadly in line with market expectations; however speculation was building in the days leading up to the meeting that the Bank might be more aggressive given that financial market confidence had been severely undermined by the prospects of a U.S. recession and the possibility of some contagion to the global economy. Speculation of a more aggressive Bank of Canada decision climaxed when the Federal Reserve caught financial markets completely off guard this morning with an inter-meeting cut of 75 basis points. Nevertheless, the Bank stuck to their guns with a more measured approach, reflecting their view that domestic demand on this side of the border is expected to remain strong. However, the Bank made it quite clear in this morning's communication that they are prepared to deliver more rate cuts down the road when they stated that "further monetary stimulus is likely to be required in the near term to keep aggregate supply and demand in balance and to return inflation to target over the medium term".

We believe the next move on March 4th will be a more aggressive 50 basis point cut. That rate decision will probably not be the result of slumping domestic demand. So far, the domestic side of the Canadian economy appears well grounded. In today's communiqué, the Bank noted that despite tighter credit conditions, strength in domestic demand is expected to remain supported by continued income growth associated with the increase in commodity prices since October, which has led to further gains in our terms of trade." It is also important to remember that unlike their American counterparts, Canadians are not get-

ting hit on both ends of their asset portfolios. Home prices remain on the upswing in most major urban centers, and there is little concern that the Canadian housing market will start to mirror the slump in the U.S. In fact, we believe national home prices will rise at a rate of 5-7% in 2008, compared to a U.S. market that will likely absorb losses of around 5% or more.

However, we believe that by the next meeting, data on the U.S. economy will provide a smoking gun, showing clear signs of a sharp economic slowdown. Given that inflationary pressures remain well in hand, a 50 basis point cut would provide much-needed insurance against the degree to which a U.S. economic downturn would lap onto Canadian shores. Certainly, inflation will not provide a barrier to a more aggressive Bank of Canada. The central bank has indicated that increased competitive pressures in the retail sector and the one percentage point GST cut at the start of the year will cause both core and total CPI inflation to fall below 1.5% by the middle of this year before returning to their 2% target by the end of 2009.

Following the March 4th meeting, there is the potential for another 25 basis point cut. However, given the degree of economic uncertainty on both sides of the border, the extent of additional easing will be highly dependent on how developments in the U.S. unfold and whether financial market confidence remains in question.

Some of the guessing on the Bank's views will be answered on Thursday when they release the update to the Monetary Policy Report (10:30ET). This report will lay out the Bank's downgraded views on Canadian and American economic growth alongside a more detailed assessment of the current economic and financial environment.

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