



**Bank
Financial
Group**

TD Economics

Commentary

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BANK OF CANADA CUTS EXPECTED 50 BASIS POINTS, PROMISING FRAMEWORK FOR QUANTITATIVE EASING

- **As widely anticipated, overnight rate cut by 50 bps, bringing target to 0.50%**
- **Bank of Canada signals that the rate will remain at this level or lower into 2010 and promises a framework for quantitative easing on April 23rd.**

As widely expected, the Bank of Canada delivered a 50 basis point cut, bringing its overnight rate to 0.50%. With the output gap widening, core inflation having tracked below the 2% target, and financial stress persisting, the Bank had every reason to cut. In particular, lending from Canada's core financial institutions perseveres, but wide spreads and tight credit persist on open markets. Recognizing the scarce room for traditional monetary policy to ease, the Bank explicitly cited the possibility of future credit and quantitative easing and promised a framework in its April Monetary Policy Report. Nonetheless, Canada's monetary policy alone cannot cure unresolved systemic risks that continue to plague international financial markets.

The Bank's communiqué focused attention to our international linkages and the external drivers of Canada's recession, noting the particular challenge from "the nature of the U.S. recession, with very weak auto and housing sectors" and the prerequisite of stabilization in global financial markets before Canada can rebound. The Bank endorsed timely and worldwide resolution of the paralyzing uncertainties around troubled banks' toxic assets as the lynchpin for a return to financial stability. With U.S. consumers dogged by a steep and ongoing contraction, Canada's export sector has drooped behind. The Bank notes the shock to domestic wealth resulting from protracted and deepening financial instability internationally. Going forward, diminished household wealth will weigh down domestic consumption, further widening the output gap.

The Bank believes that "the output gap will not begin to close until early 2010." The Bank's revised outlook for growth will not be clarified until April, and, as of January, the Bank forecast 3.8% growth for 2010. While this will presumably be revised downward, the Bank's 2010 outlook will likely remain optimistic relative to our projected 1.4% rebound (our Quarterly Economic Forecast will be released March 12). The widening output gap will provide an additional downdraft to core inflation, already having tracked below the Bank's 2% target in January. The Bank's announcements have become increasingly transparent, and this communiqué provided a clear statement of its policy stance, relating that "the overnight rate can be expected to remain at this level or lower until there are clear signs that excess capacity is being taken up." **Going forward, facing a widening output gap and disinflationary pressures, we see an increasing tilt towards a further 25 basis point cut. This would place the overnight rate's ultimate floor at 0.25%, and we expect not to see the overnight rate raised until the latter half of 2010.**

Perhaps most important in the communiqué was the statement that quantitative easing is being explicitly examined. Governor Carney has hinted strongly at the Bank's "considerable flexibility" in his recent remarks. The communiqué brought clarity that the Bank was considering such action down the road, but would establish a well-considered policy framework before proceeding. Setting an April release date for a framework provides excellent transparency on Bank thinking, but also signals that, if required, less traditional measures will not likely be undertaken until the spring.

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