



**Bank
Financial
Group**

TD Economics

Commentary

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BANK OF CANADA CUTS 25, MORE EASING TO COME

- **Overnight rate at 2.25%, down from 2.5%**
- **Further monetary stimulus likely to be necessary**
- **Bank of Canada sees core inflation remaining under 2.0% until end of 2010**

The Bank of Canada (BoC) cut interest rates by 25 basis points today. While this may have disappointed those who had been expecting a larger 50 basis point reduction, this is likely not the final cut from the BoC. First, the Bank of Canada reduced its forecasts for economic growth by a startling degree, now expecting GDP growth of 0.6% in both 2008 and 2009 (down from 1.0% and 2.3% respectively). Second, the BoC's forward looking statement was much less guarded than we have come to expect, stating that "further monetary stimulus will likely be required to achieve the 2 per cent inflation target over the medium term."

Much has changed since the Bank's last announcement date in early September. Foremost, the global credit crunch erupted into a full blown crisis. As the crisis moved from the U.S. to Europe, the risks of a severe global economic downturn led to increasingly more drastic actions by policy makers the world-over. Liquidity injections by central banks would no longer be enough. Instead, governments outside Canada have become major shareholders in a number of financial institutions and in order to keep credit flowing have provided expansive guarantees to both bank deposits and bank lending. While these actions have led to a recent narrowing in credit spreads, this remains the key source of uncertainty for the global economic outlook and one that we and the Bank of Canada will be paying close attention to.

Even while Canada has avoided many of the problems facing other industrialized countries, we are still a small, open economy dependent on the flow of goods, services and credit. A global recession is now very much in the cards and will hit hard against Canada's export sector. As credit tightens the risks to Canada's domestic economy have also risen markedly. Higher costs of wholesale funding push up lending costs for Canadian banks, households and businesses. Finally, falling commodity prices hit our terms-of-trade, weaken income growth and threaten to derail investment.

As an inflation targeting central bank, the Bank of Canada relates all of this back to its outlook for inflation. The deleveraging of financial institutions, the waning global outlook and falling commodity prices have all but removed any significant inflationary threats from the near-term horizon. The BoC now expects core inflation to remain below its target of 2.0% until the end of 2010. Falling commodity prices have also led to a peak in total inflation in the current quarter and an expected deceleration to below 1% by mid-2009. Further details on the Bank of Canada's outlook will be released on Thursday with the Monetary Policy Update and we look forward to seeing their thoughts on the quarterly pattern of both economic growth and inflation as we head into 2009. The bottom line is with inflation threats diminishing and risks to growth increasing, the Bank of Canada's decisions become easier. We continue to expect further easing, which along with other concerted actions by policy makers in Canada and abroad, should pave the way for an eventual recovery.

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