

BANK OF CANADA LEAVES OVERNIGHT RATE UNCHANGED

- **The Bank of Canada kept rates at their effective lower bound of 0.25% and reiterated its conditional commitment to do so until mid-2010**

As widely expected, the Bank of Canada held the target for the overnight rate at 0.25%, and reiterated its commitment to keep rates at their effective lower bound through the second quarter of 2010. The Bank's decision is consistent with a tepid start to the Canadian recovery, as a 0.4% growth rate in the third quarter of 2009 fell short of the Bank's own projection. The Bank does recognize that developments on the global economic landscape have been slightly more positive than they had anticipated in October. However, these developments did not warrant any revisions to the Canadian economic outlook, and the significant amount of "fragilities" that remain are good justifications to keep rates at their lower effective bound in the near term.

On the inflation front, while headline inflation has grown in-line with the Bank's projections, core inflation has been slightly stronger. However, they continue to believe that the inflation rate will remain below the 2% target until mid-2011. The Bank stated that risks to the inflation outlook remain balanced, and have not changed since October's MPR. Just to reiterate, the upside risks are stronger than expected global and domestic demand, and the downside risks are persistent strength in the Canadian dollar, and a more protracted global recovery.

Even though the Canadian economy edged out of recession in the third quarter, the rate of growth was nothing to

write home about, and certainly not enough to encourage the Bank of Canada to move off the sidelines. Much in line with the Bank's October outlook, the composition of economic growth has shifted away from net exports, to final domestic demand – a trend driven by the recent strength in the Canadian dollar. As such, the tepid third quarter is a reminder of the challenges that the Canadian economy will face along the road to recovery, in particular due to the negative ramifications of a strengthening Canadian dollar. Like the Bank of Canada we believe that the Canadian recovery will strengthen through 2010, however as long as these fragilities remain the Bank of Canada will not be swayed to move quickly with interest rate hikes.

Unlike the Bank we put slightly more weight on the downside risks associated with a mild U.S. recovery coupled with a strengthening Canadian dollar. As such, the Bank's projection for 3.0% growth in 2010 and 3.3% in 2011 is still slightly more optimistic than our forecast for growth of 2.7% and 3.0% 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 second quarter of 2012, two quarters later than the Bank of Canada's 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.

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