Observation

June 14, 2011

TD Economics
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HIGHLIGHTS

- TD Economics no longer expects the Bank of Canada to raise interest rates this year.
- The tightening of monetary policy is expected to begin in January 2012, and the overnight rate is only expected to increase to 2.00% next year. The Bank of Canada is then projected to raise the overnight to 3.00% in 2013.
- This delayed and slow rebalancing of monetary policy reflects the risk-filled economic environment, which has reduced confidence in model-based economic projections that predict a closing of the output gap in mid-2012. It also reflects the possibility that there is more slack in the economy and that the 'neutral' level of interest rates is lower than previously thought.
- Well anchored inflation expectations provide the Bank of Canada with additional flexibility to delay tightening policy until the economic uncertainty diminishes.
- With the U.S. Federal Reserve on hold, the Bank of Canada is also constrained in raising interest rates, as widening interest rate spreads would boost the Canadian dollar that is already above parity.

Craig Alexander, SVP and Chief Economist, 416-982-8064
craig.alexander@td.com

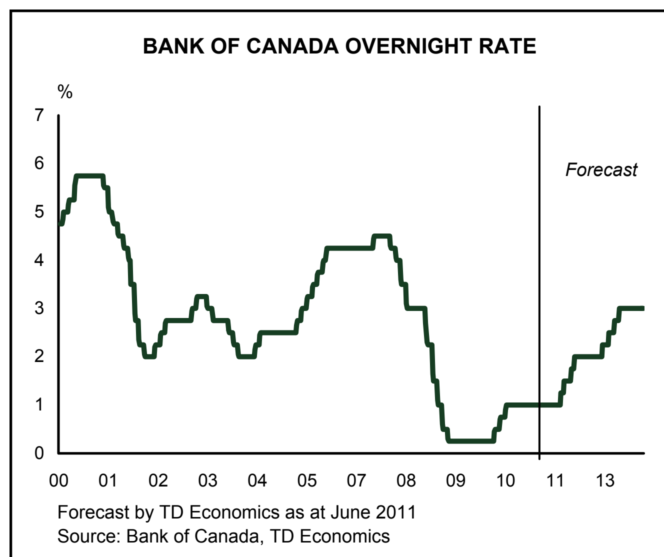
INTEREST RATES IN CANADA TO REMAIN LOWER FOR LONGER

Today, TD Economics released its Quarterly Economic Forecast (QEF) publication, providing updated macroeconomic and financial forecasts for the global, U.S. and Canadian economies. The adjustments to the economic projections for Canada were minimal, but there was a major adjustment in the outlook for monetary policy and interest rates. TD Economics no longer expects the Bank of Canada to raise the overnight rate this year. Instead, the tightening of monetary policy is now anticipated to begin in early 2012, with the overnight rate climbing to only 2.00% by the middle of the year. While the rationale for this forecast is laid out in the QEF, it is worth explaining in greater detail.

The traditional perspective

Prior to the Bank of Canada decision on May 31, we believed that the Bank of Canada would begin raising rates in July and the overnight rate would be lifted to 3.00% by mid-20012. This call was based on the traditional approach to predicting the path of monetary policy based on the economic outlook.

The Bank of Canada has been forecasting that economic growth would remain moderate in the coming quarters and this would lead the output gap to be closed by the middle of next year. At that point in time, they believe inflation would be at the 2% target and economic growth beyond that time would be at the estimated long-term sustainable rate of close to 2%. This would imply that interest rates should be at roughly 'neutral' or at more 'normal' levels by mid-2012.



Forecast by TD Economics as at June 2011
Source: Bank of Canada, TD Economics

However, the neutral level of the overnight is not set in stone. It fluctuates depending on a variety of factors. A working paper by the Bank of Canada in 2004 estimated that the neutral real (i.e. after removing inflation) rate ranged between 2.31% and 3.61% between 1984 and 2002, implying a neutral level of 4.31% to 5.61% if inflation was at 2% -- the current target. In 2004, neutral was estimated in a range of 3.24% and 3.98%. Our call for a July rate hike assumed that neutral was in the range of 3.00% to 4.00%.

The Bank of Canada has suggested that even when the output gap is closed, the level of interest rates does not need to be at neutral if there are counter-veiling

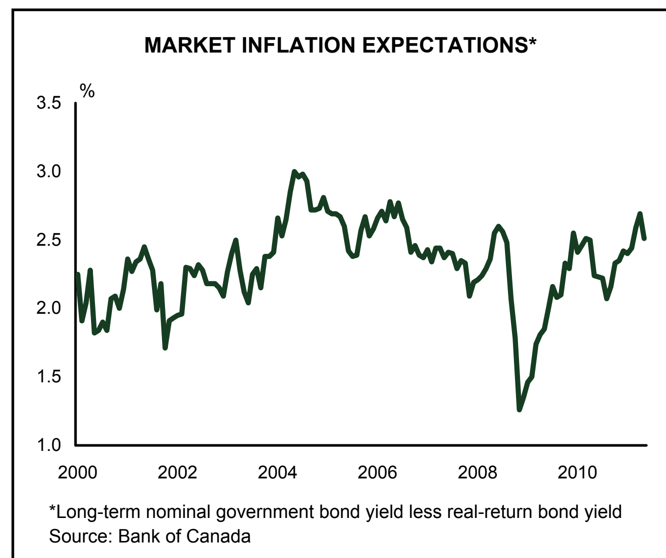
forces acting on the economy. A good example is a Canadian dollar trading at above par, which has deeply eroded the competitiveness of exporters. Accordingly, TD Economics factored in a continuation of the high-flying loonie and reached the conclusion that the overnight rate should be at the bottom end of the neutral range at 3.00% when the slack in the economy was eliminated. Assuming that the Bank would like to rebalance monetary policy in quarter percentage point increments, the pace that financial markets are most comfortable with, working backwards through the calendar of fixed announcement dates led us to believe that the overnight rate would begin rising in July.

Monetary policy in a risk-filled unconventional recovery

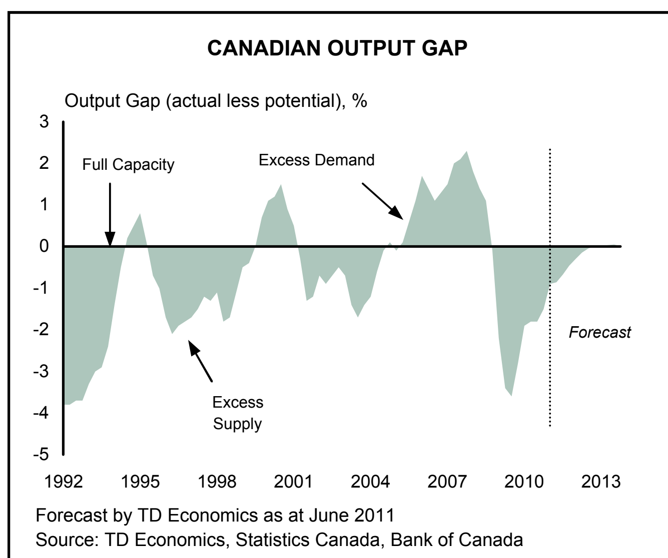
However, we now realize that the traditional framework of thinking about monetary policy fails to account for the atypical economic and financial environment that currently exists. At the most basic level, the world economy has not made as much progress as we had hoped in dealing with the legacies of the financial crisis and recession. This will have an impact on the future conduct of Canadian monetary policy.

The first observation is that inflation expectations are well anchored. The Bank of Canada has developed considerable credibility as an inflation fighter. This means that as the output gap closes, the risks of an inflation problem are limited so long as markets believe that price pressures will ultimately be kept in check. This provides the Bank with flexibility to gauge how global risks are playing out.

The second critical factor is that it is a risk-filled economic environment. There are concerns about how the sovereign debt crisis in Europe will unfold. The main worries are how a debt restructuring would impact European bank balance sheets, whether a restructuring by Greece would set off a series of debt restructurings in other countries, and ultimately whether a Greek restructuring would trigger a new systemic financial crisis. Although Canada has limited direct exposure to the at-risk European debt, the Canadian and U.S. financial systems would be impacted by any significant financial instability that might occur.



*Long-term nominal government bond yield less real-return bond yield
Source: Bank of Canada



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Source: TD Economics, Statistics Canada, Bank of Canada

There is uncertainty over the strength of the U.S. economic recovery and the financial implications of the U.S. fiscal imbalance. Given the enormous inventory of unsold and foreclosed homes, there are clear risks of further home price declines that could weaken consumer spending and constrain the willingness of financial institutions to make new loans. The inability of the U.S. government to develop a credible plan to tackle its fiscal deficit is leading to sovereign debt concerns, which is shocking when one considers that the global financial system uses U.S. dollars as the reserve currency. While a plan of fiscal restraint is needed, the challenge is that it also has to be implemented in a way that does not threaten the economic recovery. Ultimately, the health of the U.S. economy deeply impacts the Canadian economy through its trade linkages.

Then there are concerns about the high level of energy prices that are constraining global economic growth while also adding to inflation pressures. There is the increased political uncertainty in the Middle East. And, there are ongoing efforts by major developing nations to temper their economic growth and rein in inflation. Any of these could impact the shape of the global recovery.

Domestically, the Bank is assessing how much drag the Canadian dollar is having on exports. It also needs to take

into account that the loss of government stimulus is acting as a drag on the economy and governments (at both the federal and provincial level), who are now turning their attention to deficit reduction. There is also the consideration of the impact of Japan's natural disaster on global supply chains, including in North America.

It is also possible that the neutral level of interests is much lower than previously thought. The reality is that we are not really out of the financial crisis. The economic contraction has ended, but the legacies of the downturn will be with us for a long time, and this may mean that neutral is in the range of 2.00% to 3.00% at the moment.

Moreover, the fiscal policy response has created its own enormous imbalances. And, the recent slump in U.S. economic growth highlights just how fragile the recovery actually is. All of this argues for the continuation of accommodative monetary policy throughout the developed world.

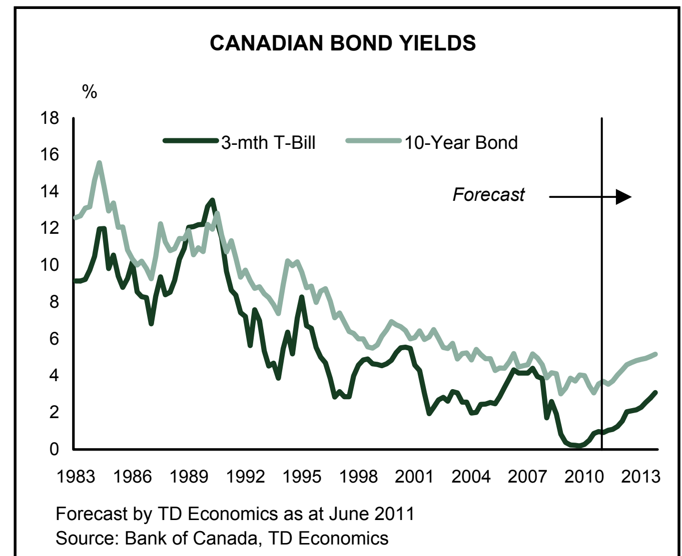
The implication is simple: there is enormous uncertainty about how economic and financial events will unfold. This means that the Bank of Canada has less confidence in its model-based forecasts. In stats-speak, there are enormous confidence intervals around the base case projections. It is also likely that the Bank perceives the risks to be asymmetric, in other words the downside outcomes are far more worrying than the upside possibilities.

Policy to be tightened in a step-wise fashion

So, the Bank needs greater clarity around how the risks are unfolding before acting. It is anyone's guess when that will be, but we are paid to guess. Many of risks are political in nature. How European governments and America deal with their public finances and how events play out in the Middle East are truly unpredictable. Outside politics, evidence of improving economic conditions in the United States will probably not arrive, given how lagged the data are, before October. The Bank doesn't tend to start rate tightening cycles in December, so it may wish to wait until January before pulling the trigger.

Then there is the issue of how high rates will climb when the tightening occurs. To be clear, the assessment of risks may be reduced, but they won't go away quickly. There is also considerable difficulty in measuring just how much slack there is in the economy. And, a bit softer economic growth than anticipated could easily mean that the output gap does not close until the end of next year.

Our intuition is that the Bank will not raise rates steadily towards neutral. It hiked the overnight rate from 0.25% to 1.00% and then paused. We think they could raise rates from 1.00% to 2.00% and then stop again to assess how the economy responds and how international events are unfolding. Such a pause would last several months. So, if they started in January, four quarter percentage point hikes would get them to 2.00% by the middle of next year. They could then wait for some time before going up to 3.00%. This very gradualist approach also has the benefit of limiting the upward pressure on the Canadian dollar, and it is clear from Bank of Canada speeches that the central bank is concerned about how high the currency gets.



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Conclusion: low rates for a long time

To be clear, it is very difficult to predict the path of monetary policy in the current environment. The Bank stated in its last communiqué that, "some of the considerable monetary policy stimulus currently in place will be eventually withdrawn." We would put the emphasis on 'eventually' and only 'some'. There are two primary risks to our assessment that rates will remain low for longer. First, there is the possibility that the more accommodative-than-previously anticipated stance to monetary policy fuels stronger domestic demand, which then induces the need for higher rates. Our base-case expectation is that heavily indebted consumers will not ramp up there spending. Second, there is the question of how inflation expectations evolve. If solid economic data leads markets to fret about the Bank falling behind the inflation curve, then all bets are off and the central bank will start hiking. The credibility of an inflation fighter is too valuable to lose. However, so long as inflation expectations are in check, the Bank seems inclined to wait until the risks have diminished before rebalancing policy and is comfortable with keeping interest rates at highly simulative levels for quite some time.

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