

CANADA ECONOMIC WEEKLY



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Canada Economic Perspectives

Inoculating Canada from US Pain

We view the Bank of Canada's recent rate cut as the first in a series of moves meant to inoculate Canada from US economic ills. For investors attempting to forecast the future path of Canadian interest rates, the bank's statement made clear that its primary focus will be on economic prospects in the US, followed by inflation in Canada, then Canadian GDP growth in the near term.

As we suggested in our last commentary, inflation in Canada has been more benign than the bank expected, thanks largely to a strong Canadian dollar. Despite continuing strength in domestic spending, these tame inflation trends have given policymakers the leeway to lower rates and should remain a factor driving future rate policy.

At the same time, the downside risks stemming from stress in global financial markets and the US slowdown have increased. In fact, the statement accompanying the central bank's rate cut this week specifically mentioned that the downward pressure on export growth resulting from weakening US demand was a major concern.

We do not expect the Bank of Canada to match the US Federal Reserve cut for cut in coming months. Nevertheless, the Fed's more aggressive stance this week suggests that the Bank of Canada can easily trim official rates by another 50 basis points and even more if Canadian domestic demand falters. For now, we look for Canada's GDP growth to come in around 2.5% in 2008—with most of that strength coming in the second half of the year.

We are a bit more sanguine than other forecasters about the Canadian economy, for several reasons. First, we do not expect the US to slip into recession, especially given the Fed's recent aggressive rate cut and the likely passage of a fiscal stimulus program. Both actions should provide some comfort to Bank of Canada policymakers. Any strengthening in the

US economy would also reduce the need for further monetary stimulus in Canada. With the recent cash infusions in both countries, we think that the first quarter of this year will mark the trough in GDP growth in Canada.

In addition to the country's stable domestic demand trends, the external-account story may not subtract as much from growth as some anticipate. On the import side, consumer-goods imports have already slowed (**Display 1**). Though export growth will also moderate, sluggish imports will reduce the net drag on economic growth as a whole.

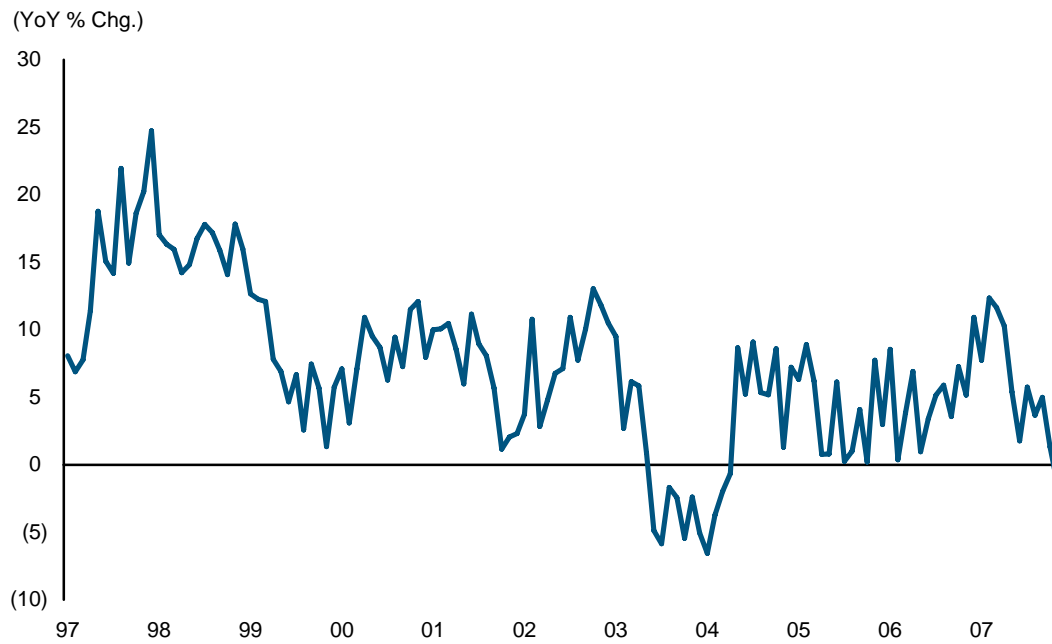
With weaker US demand cutting into exports of autos, machinery and industrial goods, energy exports are once again growing as a percentage of the total, from 17.6% last January to 20% at the end of November.

This point does not appear to be factored into forecasts highlighting the impact from a falling trade surplus. The rising energy-export component should help mitigate the steeper declines in other export categories more strongly affected by the US slowdown. Though US energy usage is likely to decline along with economic activity and, thus, curb demand for Canadian energy products, we expect the continuing growth in Canadian oil-sands production to offset some—if not all—of this impact (**Display 2**).

All in all, we doubt trade will be much of an impediment to Canadian economic growth, thus reducing the need for more aggressive monetary remedies from the Bank of Canada.

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Display 1: Consumer Imports Are Falling Growth of Consumer Imports, Excluding Autos



Source: Haver Analytics and Statistics Canada

Imports of consumer goods other than cars are falling, indicating some consumer caution.

Display 2: Energy Exports Will Help Buoy External Accounts Growth of Energy Exports



Source: Haver Analytics and Statistics Canada

As the US economy weakens, Canadian energy exports will represent a bigger percentage of the total, helping to stem a dramatic slowdown in overall export growth.