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Please Reply to the TORONTO OFFICE

BY EMAIL AND COURIER

March 12, 2008
Our File No. 2060604

Public Information
Bank of Canada
234 Wellington Street
Ottawa, Ontario, Canada
K1A 0G9

Dear Sir/Madam:

Re: Effect on Bank of Canada Monetary Policy of Pervasive Corporate Tax Changes

We are counsel to the School Energy Coalition, a coalition of all 5000 publicly-funded schools (elementary, middle, secondary, adult ed, and special) in the province of Ontario. Our role is to participate in the regulatory process relating to energy costs on behalf of the schools, who are, as you can imagine, substantial energy users.

During the course of a current proceeding before the Ontario Energy Board, it has become important to us to understand the Bank of Canada's use of monetary policy tools in the context of inflation changes caused by fiscal policy measures. In particular, we are concerned to understand the Bank's approach to pervasive changes in corporate income and capital taxes across Canada, and the inflation impacts those may otherwise cause. We have analysed the Bank's extensive public material on its policies, and formed our own conclusion as to how the Bank would respond. With your permission, we would like to describe that conclusion, and ask you whether we are correct or, if not, how we are mistaken.

As we understand it, the Bank adjusts its inflation measure – core CPI – to back out the impact of changes in indirect taxes, such as the recent GST reduction, but does not make any explicit adjustment for changes in direct taxes such as income taxes. Further, as we understand it the Bank has entered into an agreement in 2006 with the government of Canada under which, within the previous 1% to 3% inflation range, the Bank will use its monetary policy tools to try to maintain core CPI at 2% during the five year period commencing in 2006. Finally, we understand that the Bank's concern is to manage long-term inflation expectations, rather than short-term fluctuations in prices within the economy.

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The government of Canada has announced reductions in corporate income taxes in each of 2008 through 2012, and most provinces have or are expected to announce a similar series of reductions, plus reductions in capital taxes on corporate assets.

Based on this background, we have concluded as follows:

1. Faced with a short-term reduction in inflation due to a one-time reduction in corporate income taxes or capital taxes, the Bank would not likely try to correct for it through monetary policy levers. Any reduction in prices arising out of the tax reduction would be short-lived, and under the “no regrets” approach to inflation targeting, it would not be a concern. All other things being equal, the Bank could expect inflation to return to normal in the following years, so long-term expectations would not be affected. A 2008 inflation rate of 1.5%, for example, would not be a problem if investors already understand that in 2009 and beyond it will be back to 2% without any Bank intervention.
2. Conversely, if the Bank is faced with a series of reductions in inflation arising out of corporate income tax or capital tax cuts over several years, it may have to take action to adjust for those counter-inflationary pressures, to avoid a long-term change in inflation expectations. For example, if as a result of tax cuts inflation in the period 2008 through 2012 was 1.5%, the Bank would have to be concerned with whether that created a “new normal”, unsustainable after 2012 without further tax cuts. To prevent that change in long-term expectations, the Bank would consider interest rate adjustments designed to keep the inflation rate on the 2% target.

We should tell you that our conclusions above are, in part, influenced by the fact that, in a review of inflation forecasting in the private sector over the past decade or more, during which there have been a number of changes in direct taxes, we have not seen any forecasts that reflect a change in the inflation expectation as a result of changes in direct taxes (increases or decreases). It is common to see forecasters refer to changes in indirect taxes, but - to give you one example - after the government announced their corporate tax reductions last year, virtually all forecasters continued to forecast a long-term inflation rate of 2%. We have assumed that this is because the forecasters expect the Bank to bring inflation back to target, so tax changes will in the end not have a material impact.

We understand that this is quite a complicated area, and that there are actually no simple answers. We also understand that there is no guarantee that tax cuts will, in the short term, actually reduce inflation, since in fact they could have a stimulative effect that pushes inflation higher - at least in the short and medium term - depending on the available capacity in the economy and other factors.

That having been said, if it is possible to let us know whether our understanding of the Bank’s approach, at a high level, is conceptually correct, that would help us to understand the interaction between fiscal policy, monetary policy, and inflation for the purposes of our regulatory proceedings.

As this matter is the subject of an Ontario Board hearing in the last week of March, your assistance in providing a response as soon as you possibly can would be very much appreciated.

Please feel free to call the undersigned at 416-804-2767 in relation to this, either for further explanation or otherwise.

Thank you in advance for your assistance.

Yours very truly,

SHIBLEY RIGHTON LLP

A handwritten signature in black ink, appearing to read 'Jay Shepherd', is written over a light blue rectangular background.

Jay Shepherd

cc: Mark Carney, Bank of Canada (courier)
Dr. Walid Hejazi, UofT Rotman (email)
Dr. George Georgopolous, York (email)
Bob Williams, School Energy Coalition (email)