

Economic Commentary

December 7, 2004

Bank of Canada Keeps Target for the Overnight Rate at 2.5 %

The Bank of Canada announced this morning that they decided to keep the target for the key monetary policy rate at 2.5%. In the press release accompanying the announcement the Bank said that:

“Information received since the October Monetary Policy Report (MPR) suggests that economic activity in Canada has been broadly in line with the Bank's expectations, with core inflation remaining below the 2 per cent inflation target. Although oil prices have declined, global economic growth prospects have moderated slightly. The U.S. dollar has depreciated further against major floating currencies, including the Canadian dollar. If exchange rates were to persist at current levels, and if all other economic and financial factors were to remain unchanged, there would be a dampening effect on aggregate demand for Canadian goods and services.”

The Bank of Canada is adjusting its assessment of the economic outlook on the economy in line with our November **Canadian Economic Outlook** and heeded our warnings expressed in our October 18th **Economic Commentary** that by pursuing an aggressive rate tightening path it runs the risk of pushing the Canadian dollar to higher levels and thereby undermining external demand for Canadian products. As we have been arguing all along, an appreciation in the value of the Canadian dollar is equivalent to a tighter monetary policy. Since US dollar weakness is pushing the Canadian dollar higher, there is less of a need to raise rates on this side of the border.

The Bank has done well in holding pat at this meeting because it gives the economy more time to adjust to the higher exchange rate while it hedges its options for the future course of monetary policy. The central bank's next policy meeting is set for January 25, 2005 while the next quarterly assessment of economic conditions and prospects on the Canadian economy (MPR) will be published on January 27, 2005.

On the other hand, the Fed, which holds in next regularly scheduled policy meeting on December 14th, seems less likely to do the same. Although leading economic indicators suggest that growth in the US economy is slowing down, the Fed is in need to raise interest rates further to bolster the attractiveness of US dollar holdings and reduce the risk of a disorderly drop in the value of the US greenback. Thus expect Canada-US spreads to narrow as we move forward.

Today's action by the Bank of Canada –in conjunction with a rate hike in the US next week- should prove sufficient to hold down any further increases in the value of the Canadian dollar which should trade in a \$0.81 - \$0.84 cent range in the near future. However, look out for further weakness in the US dollar to inevitably force our currency higher next year and don't be surprised if at some point next year Canada-US spreads turn negative.

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