

# Economic Commentary

July 16, 2002

## **Bank of Canada Raises Overnight Rate to 2.75%, 1/4 Point Hike**

The Bank of Canada announced this morning that it increased its target for the overnight money market rate to 2.75% from 2.5%. The rise in rates was fully expected so it is no surprise. Chartered banks will adjust their prime lending rate to 4.5% starting tomorrow.

The latest increase brings the differential against the US fed funds rate to a full 100 basis points (fed funds remains at 1.75%) and has given a further boost to the Canadian dollar which rose by more than a quarter of a cent this morning.

Although the Bank is expected to keep raising short term rates in Canada in each of the next three regularly scheduled rate setting meetings, with the next meeting being scheduled for September 4th, it moderated somewhat its stance today. It reiterated the positive risk of the expansion exceeding expectations in Canada and posing a higher risk for inflation but at the same time it indicated that the Canadian economy is also facing a negative risk. The risk that the corporate accounting scandals south of the border and the weakening stock market might sabotage further consumer and investor confidence leading to a slowdown in the economic expansion that is underway in the US. This could drag down growth in Canada in the second half of the year.

This latest qualification opens the door to the possibility that the Bank might skip some of the rate increases it has been planning for the rest of the year. I expect another quarter point increase in September and perhaps October. Past that, any additional rate increases are now in doubt. They will depend on how strong the pace of expansion will remain in the USA and Canada in the third quarter. In the meantime, Fed Chairman Greenspan indicated in Congressional testimony that corporate scandals might hinder the recovery in the US.

The euro reached parity to the US dollar yesterday, the first time since February, 2000, amid a drop in world investor confidence in the US dollar, a process that I believe will continue for the balance of the year with positive consequences for the euro as well as the Canadian dollar.

Kenneth Matziorinis, Ph.D.

**Canbek Economic Consultants Inc.**