

# Economic Commentary

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## **CENTRAL BANK HIKES THE KEY OVERNIGHT RATE BY 1/4% TO 3.0%**

The Bank of Canada announced this morning that it is raising its target for the overnight rate by one-quarter of one percentage point to 3 per cent. The operating band for the overnight rate is correspondingly increased, and the Bank Rate is now 3 1/4 per cent. The decision to raise rates was somewhat difficult to make because figures published by Statistics Canada Friday morning had shown that growth in Canada in the 4th quarter had decelerated faster than analysts had expected to 1.6%. In a survey conducted last Friday afternoon following the release of these disappointing figures MMS International found that money market dealers expected the Bank of Canada to leave rates unchanged by a margin of two to one. However, the Bank of Canada did the right thing in raising rates today as predicted in my Economic Commentary last Thursday morning.

The Bank of Canada had to act because monetary policy in Canada has remained far too stimulative for too long. In the meantime, geopolitical uncertainties are proving to be intractable with no sight of dissipating in the near future. If the Bank continues to wait for these risks to dissipate before it raises rates it risks letting inflation expectations out of the bag in which case when the inevitable time arrives it will have to resort to drastic rate hiking action. By undertaking action sooner than later it gives it more chance to stay in control and this reduces the risks of drastic rate hikes down the road.

Secondly, the rate hike decision, which was widely expected by currency traders validated last week's gains in the exchange value of the Canadian dollar which rose above the 67 cent mark last week. Had it disappointed currency traders the Canadian dollar would have sold off badly this week. By raising rates it helps support the value of the dollar, which in itself, is a dis-inflationary measure by lowering the prices of imported goods, and is equivalent to a rate hike. The combined effect of higher interest rates and a higher dollar will help put the breaks on rising inflation and will reduce the necessity of raising rates too much down the road.

Thirdly, the Bank's priority is first on the domestic environment and second on the international global uncertainty. The Bank cannot afford to ignore the needs of the domestic economy to help the international and the US economy in particular in the name of "geopolitical uncertainty". Today's action sends a powerful message to world financial markets and currency traders in particular that global softness and uncertainty will not prevent it from doing what it has to if it is appropriate to Canada's circumstances.

In Canada we are experiencing core inflation of 3.3% which is well above the 2% target. The Canadian economy's growth has remained far above the rest of the world -it averaged 3.4% last year and is close to potential output. Despite the 4th quarter's slowdown to 1.6%, final demand edged up in the quarter to a 3.4% annualized rate! Fiscal policy at the same time is gearing up with a 20% hike in federal spending this year and next which will support domestic demand while Canada's fundamentals remain some of the strongest in the industrial world with budget and trade surpluses, productivity growth, employment growth and personal income growth. Moreover, Canada's position as a net energy exporter insulates us from the recessionary effects of rising energy prices. Clearly, the risk is not with lower growth but with higher inflation. Even at this new level, monetary policy in Canada remains stimulative, thus, further reductions in monetary stimulus will be required to return inflation to the target over the medium term. At this point it seems likely that the Bank will move to nudge rates up by another quarter point when it holds its next regularly scheduled meeting on April 15th, 2003.

From the point of view of our Canadian dollar, today's announcement is excellent news because it suggests a de-coupling of Canadian monetary policy from its US counterpart. Short-term rates now in Canada will be 175 basis points above those in the US (the fed funds rate is 1.25%), which increase the carry in favour of Canadian-denominated financial instruments. Global asset managers cannot afford to ignore Canadian fixed-income instruments any longer and the probability of further gains in the value of the Canadian dollar has increased significantly. A higher dollar to 70-72 cent range should not have a significant negative impact on our international competitiveness but it can go a long way towards moderating inflation in the medium term and therefore mitigates the necessity for much higher interest rates down the road. It also raises our international buying power, a development that has been long in coming.

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