Economic Commentary

May 24, 2005

Bank of Canada to Maintain Holding Pattern, at Least for Now

The Bank of Canada is holding its fourth regularly scheduled policy meeting tomorrow and is widely expected to leave its key overnight financing rate unchanged at 2.5%. The reason the Bank has refrained from interest rate increases since October of 2004 has been the dramatic surge in the Canadian dollar the last two years that has had the effect of slowing growth and dampening inflationary pressures in the country. Since a hike in the value of the currency is the equivalent of a hike in interest rates, the Bank has justifiably felt that if it maintained its tightening course it would risk slowing the economy even more. Therefore, it has chosen to slow the pace of interest rate hikes to give the economy more time to adjust to the higher dollar. Yet the Governor David Dodge has been careful to remind market players that the Bank has not given up on its goal of returning rates to a more neutral setting, and that interest rate hikes in the future are on their way.

When the next rate increase will occur is not known. The Bank has given no hints as to when it plans to raise them and I doubt the Bank knows yet when that time will be. The majority view of economists and analysts is that the Bank will resume its rate tightening cycle sometime in the fall, as early as the September 7th meeting or as late as the December 6th meeting. Obviously, between now and then a lot can change that can justify a move by the central bank.

The exchange value of the Canadian dollar has moderated since it peaked at $0.85 cents US in November and is now trading at $0.795 cents, a full 5 cents or 6% lower than then, thus the case for holding off interest rate increases has been weakened. Secondly, April's index of leading economic indicators has posted a strong 0.4% advance, the largest advance since last fall when the Canadian dollar began to retreat from its 12-year high. Demand for labour pulled out of its lethargic start to the year, while domestic spending continued to improve. Six of the ten components rose, one more than in March, while three were unchanged. The housing index was the only component to decline, continuing to back off slowly from its 25-year high set last July. This points to prospects for renewed growth for the balance of the year, which strengthen the case for resuming a rate tightening sooner, than later. Third, since the Bank of Canada last boosted its rate in October, the Federal Reserve has lifted its overnight rate five times to 3.0% on May 3rd, creating a negative yield spread of 50 basis points at the expense of Canadian assets. If the Fed maintains its rate tightening course with a sure 25 basis point hike on June 30th and a probable

hike again on August 9th, the interest differential between Canada and the US may widen to an unsustainable level of 100 basis points by the middle of the summer. How long can rates keep on rising South of our border before the Bank of Canada feels the need to react?

On the other hand it is also true that inflation in Canada remains markedly lower than that in the United States. Canada's year-over-year headline rate of inflation was running at 2.4% in April compared with 3.5% for the U.S.. The core rate dipped last month to 1.7% compared to 2.4% in the U.S. This implies that in terms of real rates, the differential is not as bad as the nominal yields suggest.

Nevertheless, for the short term, the value of the Canadian dollar may continue to retreat against the greenback as the negative CAD-USA interest rate differential grows, as political uncertainty associated with the minority government here in Canada continues, and as commodity prices moderate in response to a slowdown in the global economy. However, Canada's economic fundamentals remain very strong while those of the United States continue to deteriorate. As explained in my previous Commentary the risks of disorderly adjustments to global imbalances put the U.S. Dollar at risk, so don't be surprised if the Greenback retreats to new lows later in the year and conversely the Canadian dollar re-tests the $0.85 cent high by the end of the year. Don't be fooled by the appearances of a resurging US dollar. Right now we are in the calm before the storm.

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