Economic Commentary

September 4, 2002

The Bank of Canada Stands Pat: What is it worried about?

This morning the Bank of Canada surprised markets by opting not to raise its key benchmark overnight financing rate. After hiking it by 75 basis points at each one of the last three rate-setting meetings (from 2.0% in April to 2.75% in July), it chose to stand pat at this meeting despite pronouncements that it would keep raising rates for the rest of the year in a “timely and measured manner” and despite the exceptionally strong growth in output and employment that the Canadian economy has seen over the first half of the year. For its reasons for not raising rates the Bank sited two factors: a) “near term prospects for growth in the United States and the major overseas economies appear to have weakened somewhat” and b) the “increased uncertainty associated with global financial market volatility and the unsettled geopolitical situation”.

For the reasons why the Bank of Canada would have to move more slowly in raising rates one can go back to our previous Commentaries and should not be much of a surprise to the reader. See, for example my February 14th Commentary, which has been attached to this letter. Yes, it is true that Canada’s economy has performed exceptionally well so far. Output in Canada expanded by 6.2%, at annualized rates, in the first quarter and by another 4.3% in the second. Employment has expanded by 326,000 jobs since the beginning of the year. But it is also true that most of the growth in Q2 was recorded during the first month of the quarter. Growth in May and June has been tepid. Also, first half growth benefited from a one-time acceleration in lumber output as producers scrambled to sell lumber to the USA before import duties came into effect. The latest report by Statistics Canada also showed that during the quarter demand fell short of production, which does not bode well for the second half. Moreover, growth in the USA has been significantly lower than Canada’s averaging 5% in Q1 and only 1.1% in Q2, that is a quarter of the growth experienced in Canada during Q2, while job growth has been non-existent, in sharp contrast to what is happening north of the border. Although Canada’s economy will continue to outperform its US counterpart, it cannot continue growing at the same frantic pace it recorded over the first six months as long as growth in the US economy remains tepid.

At its August 13th FOMC meeting the federal reserve shifted its policy bias pointing out that the balance of risks have tilted towards a slowdown in the US economy, thus opening the door to the possibility of an additional rate cut at its September 24th meeting. With short-term interest rate differentials between Canada and the USA already at 100 basis points (2.75% in Canada vs. 1.75% in the USA), if the fed proceeds to cut rates later this month -as is widely expectedand if the BOC were to raise them by a quarter today it would boost the differential to 150 basis points which would put the Bank seriously out of step with other central banks and undermine growth prospects for Canada. The central bank wisely chose to wait and see what the fed decides later this month before resuming its rate hikes, when it meets next on October 16th. This way, if the fed opts for a rate cut in the USA, it may not have to raise interest rates here until at least the December 3rd meeting.

But at the same time, the outlook for global growth has soured. Second quarter growth in Germany, the euro-zone's largest economy, came to only 1.1% while growth in Japan has been far less than believed. The Japanese government late last week revised downward its figures for 2001 and Q1 2002, indicating that output in Japan is still lower than it was before the last recession.

Clearly, global growth is turning out to be significantly below what was being projected earlier in the year, while recent indicators, such as the latest ISM data which have been the softest in months, consumer confidence data that point to continued erosion of consumer confidence and sluggish retail sales data point that the US is at serious risk of a "double-dip" recession. In this context, the Bank should be in no hurry to unwind all the monetary stimulus it gave us last year. Rather it should await further evidence that the economy is strong and the recovery is in full gear before they resume rate hikes. Moreover, the latest inflation indicators suggest that inflation in Canada, although slightly above the 2% target, remains tame for now with little likelihood of taking off in the near term, while in the US, inflation is so low, that more and more analysts are beginning to voice concerns that rather than inflation, ***deflation*** has now become the enemy No. 1 and the federal reserve should shift its focus toward containing it.

Finally, the threat of a meltdown in financial markets should not be underestimated. Corporations have diminished pricing power, corporate profits in the US have yet to show signs of a turnaround, while the banking sector has been coming under increasing stress as it is the one that is now "holding the bag" on hundreds of billions of dollars worth of loans to the telecommunications sector. Add to the above the outside chance of a US strike against Iraq, and you have a potentially lethal brew of risk and uncertainty.

Thus, although the Bank will resume eventually its course of adjusting monetary policy to a more neutral setting it has taken the opportunity to take a breather rather than risk having to reverse course later under the threat of financial and economic turmoil.

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