Economic Commentary

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Bank of Canada Poised to Raise Rates Tomorrow: The Beginning of a New Rate Hiking Cycle?

The Bank of Canada is holding its regularly scheduled interest rate-setting meeting on Wednesday morning, September 8th. The consensus view is that it will hike the key policy rate by a quarter of a point, which will bring the target overnight lending rate to 2.25%. It should be remembered that the Bank was forced to unwind the previous rate hiking cycle, which saw the overnight rate rise from 2.0% on January 15, 2002 to 3.25% on April 15, 2003. Since then, because the Canadian economy was hit by the freak one time events of SARS, the lumber dispute, mad-cow disease, forest fires, power blackout and of course the 20% jump in the Canadian dollar, the Bank was forced to undo all of the rate hikes which brought the policy rate back down to the previous generation low of 2.0% on April 13th, 2004.

On August 31st Statistics Canada released the GDP figures for the second quarter of 2004. The output of goods and services, adjusted for inflation, advanced at a buoyant 4.3% annualized rate, the best showing since the first quarter of 2002. The year-over-year change in real GDP reached 3.0% -the economy's speed limit- after hitting a low of 1.3% in the third quarter of 2003 and trailing at an unspectacular rate of 1.7% in each of the two previous quarters. Growth during the quarter was driven by a 5.0% gain in exports, 21.6% at an annualized rate –the strongest gain in over seven years! Business capital investment and housing investment also advanced, albeit at a more moderate pace than the first quarter while inventory accumulation was small. Manufacturing and industrial production were up and so were corporate profits, government revenues and household disposable income. The only soft spot was the deceleration in consumer spending which rose by a slight 0.3% during the quarter compared to 0.8% in each of the two previous quarters. By comparison, the US economy advanced at a 2.8% pace during the quarter compared to Canada's 4.3%, however, the most recent signs from the USA point to an acceleration in the pace of growth during the current quarter.

On the inflation front, economy-wide prices, as measured by the chain price index for GDP, were up 1.4% -the fastest pace in five quarters- and pushed the year-over-year GDP price deflator –the economy's broadest measure of inflation- to 3.5%! Much of this increase is a consequence of skyrocketing commodity prices, the effect of an expanding global economy and energy shortages. Likewise, the effect upon consumer prices has been substantial, with headline inflation now running at 2.3%. Core inflation, which removes the effects of the most volatile components like food and energy, has been on an upward trend this year rising from a low of 1.3% in the first quarter to 1.9% right now. Although still under the 2.0% midpoint of the central bank's 1-3 per cent policy target range, the trend is definitely upwards which calls for preemptive action should the pace of economic growth continue to advance.

To put the latest economic news in perspective, the Canadian economy seems to have weathered with flying colours all of the calamities that fate threw on Canada in 2003 including the most significant shock of all, the nearly 20% jump in the value of the Canadian dollar. Despite the appreciation of our currency, our exports are up, corporate profitability is up and employment is up. In contrast to all the Kassandras who were forecasting doom and gloom flowing from the recessionary effects in the advance of the Canadian dollar, this analyst was the first last year –see my March 4, 2003 and July 14, 2003 Economic Commentaries- to shrug-off these concerns pointing out that it is not the "price effect" of the Canadian dollar that should worry us but the "volume effect" on our exports. As long as the US and global economies continue to expand –and a lower US dollar helps facilitate this- Canada's exports should not be at risk. Besides, as I had argued repeatedly, a higher loonie will push inflation down in Canada and force the central bank to lower interest rates, which it did.

Now that we have pretty much absorbed most of the shocks we are left with a domestic economy that is expanding at a strong pace, with healthy fundamentals such as trade and budget surpluses, in an international environment where the US economy is growing at a healthy pace and a broader global economy which, in spite of uneven growth (Asia and China in particular growing faster than Europe and South America) is growing at a solid pace. In this broader context the Bank of Canada has little choice but to begin removing at least some of the monetary stimulus that has been in place over the past four years. The rising inflation trend coupled with the fact that the Canadian economy at current rates should reach its potential by the middle of next year clearly calls for a rate hike. Even if inflation remains subdued in the near term, prudent inflation risk management also calls for a rate hike as an insurance against the risk of future inflation. Therefore, we can say that barring any external shocks to the system, we are at the beginning of a new rate hiking or monetary tightening cycle.

How long can we expect this cycle to run and how much of an increase in rates should we expect to see? Usually, monetary policy adjustment cycles last from one to two years depending on the underlying conditions in the economy. I will not attempt to forecast this right now because there are too many variables that are unknown. Likewise with how high the overnight rate will rise. Economists are currently forecasting a doubling in the overnight rate to 4.0% by this time next year. I can forecast with confidence that the overnight will rise by at least 50 basis points by the end of this year and by at least another 50 basis points early next year. Anything more will depend on a number of risk factors that cannot be forecasted, most notably: 1) What will happen with the US dollar. US dollar weakness could drive the loonie even hire to as much as 80 cents and more and this alone will dampen part of the interest rate hikes on this side of the border; 2) The state of the US economy. If growth slows down or they run into economic shocks stemming from the huge US budget and trade deficits, the Fed might be forced to ease to prop up the economy or instead, if foreign central banks, particularly the Asian banks stop buying the US treasury bonds that finance the twin deficits, the Fed might be forced to raise interest rates which will throw the North American and probably the global economy back into a recession; remember that according to the political economy cycle, the first two years of a presidency are marked with deteriorating economic conditions while the second two years with improving conditions. Now we are about to enter the turbulent period; 3) The course of oil prices and geopolitical developments in the Middle East and other parts of the world especially with respect to the rising and unpredictable nature of international terrorism. I believe that there are many surprises that await us over the next year, which will affect the course of economic developments. Therefore a more prudent stand in forecasting is called for here.

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