Economic Commentary

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Bank of Canada Poised to Cut Rates Again

After cutting the trend setting target overnight financing interest rate twice in a row so far this year it looks that the central bank is poised to cut it again for a third time this year by another quarter point (1/4 %) tomorrow when the Bank of Canada holds its third regularly scheduled policy meeting in Ottawa. This will bring Canada's key short-term policy rate to 2.00%, matching the low point of the last rate-easing cycle when it cut its rate to 2.00% on January 15, 2002 in its bid to stave off recession back then. At 2.00% Canada's short term policy rate will still be 100 basis points above its U.S. analog, the fed funds rate which presently stands at a 44-year low of 1.00%, but with this impending rate cut the Bank of Canada will have reversed completely all of the 125 basis point rate tightening which was initiated exactly two years ago when it started raising rates on April 16, 2002 pushing them to a high of 3.25% on April 15, 2003. Exactly a year later, the central bank has been forced to give back all of the tightening it undertook during the previous 12-month period. As of Friday of last week all bank economists and all of Canada's 12 large bond dealers polled by Reuters News Service expect a rate cut tomorrow.

What are the factors responsible for tomorrow's decision? In the most recent period there have been two critical announcements by Statistics Canada that call for a rate cut. The first has been January's GDP figures which showed that Canada's output of goods and services contracted by 0.1%, that was more than was expected. The second piece of economic news came from the monthly labour force survey, the most timely of all economic indicators put out by Stats Can. In both February and March Canada's economy shed jobs, 15,000 jobs were lost in February and another 13,300 in March. While most of the job losses were centered on part-time jobs, -full-time jobs managed a small gain- the overall picture points to a contraction in Canada's GDP for the first quarter of 2004 or at best zero-growth. In the meantime, the rate of consumer inflation in Canada as measured by the CPI decelerated dramatically during the December, 2003 – February 2004 period with head-line inflation falling from 2.0% in December to 0.7% in February while the key core rate of inflation –watched the most by central bankers- declining by half from 2.2% in December to 1.1% in February.

Now lets place the most recent events in the context of the bigger picture. The main factor behind the deceleration in Canada's growth recently has been the 20% meteoric rise last year in the value of the Canadian dollar against its US counterpart. As expected we are now experiencing the lagged effects of this one-time adjustment. As I had argued on a number of occasions in previous commentaries, one of the consequences of a stronger Canadian dollar is going to be lower consumer inflation and lower interest rates. What we are witnessing here is the economy's adjustment to a higher dollar which now the central bank is forced to acknowledge by adjusting rates downwards by more than it had expected six months ago. While the output and employment effects of the adjustment to the stronger external value of the country's currency are only going to be temporary – three to five quarters at most- the inflation and interest rate effects will be more on-going. While output and employment growth will inevitably recover, driven by growth in the US and the global economy, inflation and interest rates will remain under downward pressure for some time to come. Why? Because now that Canadian products cost more on the global market while foreign products cost less at home, it forces Canadian companies to become more competitive. This drives down unit costs of production in Canada and lowers product prices thus keeping inflation very low. This, in turn, forces the central bank to compensate with a more accommodative monetary policy.

In fact, I can identify three reasons why monetary policy in Canada has to stay accommodative in the medium term: First, is the reason mentioned above, namely that with low inflation interest rates can stay low; second, is the fact that the rise in the value of the Canadian dollar has a contractionary effect on the economy and therefore requires that monetary policy stay more expansionary in order to balance out the total effects on the economy and third, government fiscal policy in Canada –with the federal and provincial governments' preoccupation with budget surpluses to pay down the public debt- is mildly contractionary and therefore calls for a more accommodative monetary policy stance on the part of the central bank.

What will happen to Canadian rates when later this year the Federal Reserve in the USA starts to ratchet rates higher? First we will probably see a further narrowing in the Canada-USA short-term interest rate spread to below 100 basis points followed by a gradual but modest rise in rates in Canada. Can the Canadian dollar sustain its present level in an environment where the Canada-USA interest rate differential is narrowing? I believe not only that it can hold its present level, but that it is also capable of advancing further against its US counterpart, and this notwithstanding the eventual rise in US rates. The reason why is that last year's advance in the Canadian dollar had mostly to do with factors external to the Canadian economy, i.e. US dollar weakness and the structural weaknesses of the US economy that will require a weaker US dollar to alleviate. Moreover, we are in the midst of an up-swing in global commodity prices that should last the better part of the next ten years. If this is indeed so, given Canada's profile as a commodity currency, that too is another major influence that will exert up-ward pressure on the value of our currency. In short, the central bank no longer needs to baby-sit the Canadian dollar with higher rates. The Canadian dollar will move higher whether we like it or not while the central bank will have to work overtime to prevent the dis-inflationary effects of this trend to slow down our own economy.

Since markets are more focused on the short-run trends and are overly obsessed with the Fed's next rate hike the short term response will be for markets to expect the Canadian dollar to fall and Canadian rates to rise in tandem with those in the USA. What I am arguing here is that economic adjustments will disappoint those expecting higher rates and a weaker dollar, thus I expect higher volatility. Thus, any major corrections in the Canadian dollar and fixed-income prices should be viewed as buying opportunities for the Canadian investor. The Fed's next moves should not have as significant an effect for Canadian monetary policy as the US economy's problems are deep rooted and will take a long time to solve

Kenneth Matziorinis, Ph.D.
Canbek Economic Consultants Inc.