Economic Commentary

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Bank of Canada Rate Decision Tomorrow: Is the Cup Half Full or Half Empty?

Last Friday Statistics Canada delivered the news on Canada's growth during the third quarter of the year. Growth in real GDP came in at an annualized rate of 1.1% (vs. 8.2% for the USA), rebounding from the second quarter's contraction of –0.7%. On a year-over-year basis, the 12-month rate of growth stands at 1.0%, down from 4.0% in the third quarter of 2002. This is a massive deceleration in the country's output growth over a year period. What is worse, the second quarter's contraction was revised upwards to –0.7% from –0.3% and that of the first quarter downwards to 2.0% from 2.6%. This year Canada narrowly averted another recession, just as it did in 2001 and the growth rate for the year will certainly come in below 1.9%, what was expected on November 3rd when the Finance Minister tabled his Economic Statement to parliament. In the meantime, Canada's rate of consumer inflation continued its downward trend, falling to a year-over-year rate of 1.6% in October from 2.2% in September. On the face of the above one can make an excellent case for the Bank to cut rates tomorrow.

On the other hand, closer inspection of the figures also shows that last month's drop in the inflation rate was entirely due to falling energy prices. The core rate of inflation, which strips out the more volatile energy and food components of the price index actually rose from 1.5% in August to 1.7% in September to 1.8% in October. It is this core rate of inflation that the central banks watches most closely in its rate deliberations. At the same time, final domestic demand for Canadian goods and services rose to 1.4% during the quarter, an annualized rate of almost 6.0%, driven by growth in consumer spending, up 1.2% during the quarter (over 5.0% at an annualized rate) and growth by business capital investment, up 1.5% during the quarter (6.3% annualized rate). During the quarter, a lot of the demand was met by inventory decumulation, resulting in a $3.4 billion drop in inventory. What this means is that Canada's demand continues to be very strong and sooner or later it should result in a sharp pick-up in production, which should boost strongly Canada's rate of growth in the fourth quarter and into the new year.

What the Bank will do tomorrow depends on how they interpret this information, whether they view the economy as being weak or being strong. My view is that Canadian producers chose to be cautious during the quarter, in the face of all the freak events of 2003, which combined to lower growth, and chose not to expand output but liquidate inventories. Since final demand has been strong and gathering steam during the course of 2003, they will have no choice but to boost production this current quarter and then again early next year. When it comes to forecasting the future path of growth it is more important to look at the final demand, which predicts what companies will have to do in the future than the GDP which shows what they did in the past.

Therefore, my view is that when the Bank's governing council convenes tomorrow it will choose to hold the overnight rate unchanged, where it stands right now at 2.75%. This view is what the markets hold when judged by the fact that when Canada's GDP figures were released Friday morning, the Canadian dollar gained three quarters of a cent and made a new high at above 77 cents instead of falling because of the low GDP figures. If markets view the cup half full rather than half empty, then it is my view that the central bank will do the same.

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