Economic Commentary

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BANK OF CANADA LIKELY TO RAISE INTEREST RATES NEXT WEEK!

Statistics Canada announced this morning that Canada's annual inflation rate hit 4.5% in January on a y-o-y basis, a level above what most analysts had expected and above December's 3.9% rate. This has placed Canada's overall inflation rate at the highest level since 1991. While energy and gasoline prices accounted for two thirds of this hike (over the past 12 months energy prices rose 15.3% and gasoline prices rose 25.1%), the headline inflation rate has remained well above the Bank of Canada's 1-3 target range for some time now which is increasing the risks that at some point it might fuel inflationary increases in other sectors of the economy. The central bank's closely watched core rate of inflation -which strips out the more volatile components including energy- is now running at 3.3%.

The Governor of the Bank of Canada David Dodge and other senior officials have been signaling over the past few months their intention to start raising interest rates in order to prevent a flare-up in inflation down the road. Even the former Governor John Crow came out publicly earlier this week with a statement that the central bank has room to raise interest rates in the face of higher inflation.

The only factor that has impeded the central bank from raising rates sooner has been the heightened "geopolitical uncertainties" arising from the Iraq crisis. However, Canada's economy has remained strong last year growing faster than any of the G-7 group of nations, which creates less of a need to keep interest rates so low. Moreover, John Manley's latest federal budget is providing a major stimulus to the economy with a 20% hike in federal program spending which should boost growth over 2003 and 2004. This boost from the fiscal side lessens the need for support from the monetary side and therefore gives more room to the central bank to fight inflation by hiking interest rates when it holds its next regularly scheduled meeting on Tuesday (March 4th), and this despite the "geopolitical uncertainties" confronting the world economy.

Most analysts including myself expect the Bank of Canada to hike rates by 25 (maybe even 50) basis points next week. This is also the view of currency traders who following the strong federal budget have driven the value of the Canadian dollar above the 67cent mark last week. With interest rates in Canada already well above those in the US, the needed tightening in monetary policy relative to the US is expected to send the differential over the US even higher in the next few months giving support to the Canadian dollar.

Tomorrow Statistics Canada will report on Canada's GDP for the fourth quarter and the whole year of 2002. Although growth in the second half has been slowing, the figures are not expected to show a decline so significant as to prompt the central bank to wait. Therefore, it is my opinion that the risk of not acting on inflation right now significantly exceeds the risk of recession and therefore I expect a rise in rates.

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