Economic Commentary

February 28, 2005

Bank of Canada to Stand Pat on Key Overnight Rate Again at 2.5%

The Bank of Canada's policy committee is meeting tomorrow and is universally expected to hold its key benchmark overnight rate at 2.5%, the level it has been since October, 2004, after raising it by 50 basis points in July from a post-war low of 2.0%. What is more, the central bank Governor David Dodge has hinted in a recent speech that he will go slow on rate increases this year to give the economy time to adjust to the higher Canadian dollar.

This morning Statistics Canada announced the figures for GDP growth in the fourth quarter of 2004. Canada's economy cooled to a 1.7% annual rate of growth in the last quarter, the slowest pace in more than a year, dragged down by lower exports and higher imports, the lagged effect of a stronger dollar. The economy grew 0.2% in December and registered an annual rate of growth of 2.8% for the year as a whole, up from 2.0% in 2003. Canada's dollar rose to US$0.8532, its highest level in more than ten years in November, 2004, and since has trended lower around the $0.81 level. This morning it is trading just above the 81 cent level.

The central bank's logic in plotting its next interest rate moves is fairly predictable and is fully in line with my November, 2004 forecast for the 2005-2007 period. The surge in the value of the Canadian dollar by 30% since its low in Spring, 2002, is creating a huge drag on the country's growth. As long as the US and global economy were expanding rapidly and as long as commodity prices were rising, the drag was more or less compensated for, with minimal impact on Canada's net exports. But, now, not only has growth in the global economy cooled down from its torrid pace of last year, but commodity prices have leveled-off as well. These factors combined with the fact that the Canadian dollar has broken above the 80 cent level –widely viewed as the purchasing power parity or long-term equilibrium rate- it is starting to take a significant bite off our growth and it is forcing the central bank to factor it in its rate-setting decisions. The fact that the rise in the value of the Canadian dollar is mostly driven by the slump in the value of the US dollar rather than driven by an overly strong rise in domestic demand, has the effect of both keeping growth below potential and holding inflation down, two of the central bank's key target variables in determining monetary policy.

Not only is inflation running at moderate levels, the January headline figure for consumer inflation eased to 2.0% from 2.1% in December, and the more important core rate eased as well to 1.5%, well below the 2.0% target (the mid-point of the 1-3 percentage point band that is used for anchoring inflation in Canada), but employment growth in Canada has stalled over the past three months with an outright decline in jobs reported in January, 2005. Clearly, with growth running below the 3.0% capacity limit, with inflation below target and with zero employment growth, the Bank of Canada is in no hurry to raise interest rates any time soon in this country, despite the fact that south of our border the US federal reserve is under considerable pressure to raise rates to ease inflation there which is running well above 3.0%.

A survey of 21 economists in Canada last week carried out by Bloomberg revealed that not only is the Bank expected to stand pat at tomorrow's meeting, but is widely expected to hold off raising rates until at least the middle of the year, with most forecasters projecting a rise only from September onwards. Although the Bank Governor quelled expectations of a possible rate cut this year in his speech on February 17th, he signaled that he is going to take his time in raising them. At 2.5% short-term rates remain decidedly accommodative for the economy going forward. By delaying the inevitable adjustment towards more neutral settings, the central bank is giving the economy more time to adjust. The future pace of rate increases will therefore depend on how well the Canadian economy responds to the challenges of a stronger dollar and a slowing global economy, as well as the future pace of rate increases south of the border.

All of the above are no news for the foreign exchange market. Evidence of a slowdown in Canada's rate of growth and the drag that a higher dollar is having on our economy are already factored in the currency market. In spite of the above, the Canadian dollar has rebounded in recent trading and is running well above the 81 cent level, where it has traded more or less the past three months. What all this is showing, is that even if the spread between Canadian and US rates turns negative in the short-term, the Canadian dollar will remain strong with the probability of a further appreciation in its value according to my estimation well above 50%.

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