Economic Commentary

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Bank of Canada Likely to Cut Overnight Rate Tomorrow by ¼ %

The Bank of Canada is holding its first of eight rate-setting meetings of 2004 tomorrow morning and is widely expected to cut its key overnight financing rate by one quarter of one percentage point to 2.5%, down from 2.75% currently.

The key reasons for expecting a rate cut are the weaker than expected economic data that have been coming through the last few weeks including last week's key trade report that showed a drop in Canada's exports and trade surplus for November to $4.3 billion from $5.1 the month before. The evidence suggests that in spite of a strong recovery in the US and global demand, the impact has yet to flow through to the output side of the Canadian economy while the effects of the 22% appreciation in the value of the Canadian dollar last year continue to extract their toll on Canadian exports and corporate profits. Given the lingering effects of the mad-cow case, the BC forest fires, the lumber dispute, the power outage and SARS last year, the economy remains weaker than expected and can benefit from a further easing in interest rates.

In its December 2nd announcement the central bank hinted at the possibility of a further rate cut early in the new year if the Canadian economy remained weaker than expected. The past two weeks, both the Governor and the Deputy Governor Longworth have indicated that growth in Canada is coming in below Bank of Canada expectations, which suggest that an easing is in the offing.

Late last week forward money market rates were pricing in a 85% probability of a rate cut while the recent correction in the value of the Canadian dollar suggests that the foreign exchange market has become resigned to a rate cut as well.

Looking forward at the next rate-setting meeting on March 2, 2004, the street bias is for an additional quarter point cut in the overnight rate to 2.25%. Should the two back-to-back rate cuts expected by markets materialize, the prime rate is going to be cut to 4.0%, below the level at the beginning of 2003.

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