Economic Commentary

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Bank of Canada to Raise Key Financing Rate Tomorrow to 3.5%, More Hikes to Follow

The Bank of Canada is holding its first of eight regularly scheduled meetings of 2006 tomorrow and it is expected to announce another quarter point increase in its target for the overnight rate to 3.5%. Chartered banks are expected to follow by hiking their prime business lending rate to 5.25%.

Last Monday the Bank released the results of its latest survey on business conditions in Canada conducted between November and December among Canada's 100 largest firms. The results show that firms in aggregate remain optimistic about the economic outlook of the economy. Pressures on production capacity and labour shortages remain but are concentrated in Western Canada. Investment intentions remain strong, particularly in the primary sector of the economy with hiring intentions robust across most sectors of the economy. Firms expect output prices to increase at about the same pace over the next twelve months as they did over the previous twelve month period. Inflation expectations have eased somewhat, with three quarters of participants expecting inflation within the Bank's inflation-control target range of 1 to 3 percent.

This morning Statistics Canada released its retail sales figures for November which showed a strong, higher than expected increase of 1.1% in retail sales. Although motor vehicle sales accounted for most of this jump, rising 4.9%, when stripped from the total, retail sales excluding autos still gained a modest 0.1% despite a rather large 3.2 per cent decline in the value of sales at gas stations, the lagged effect of the post-Katrina retrenchment in oil prices. When the volatile impact of prices is excluded, the overall volume of retail sales posted a strong 1.3 per cent increase in November on the back of a 1.5 per cent gain in October. Clearly, these back-to-back increases confirm that the Canadian consumer remains in strong shape and bode well for continued strength in the Canadian economy

Today's solid retail sales report should also be enough to dispel any doubts about the pace of economic expansion on this side of the border, and reinforces the need on the part of the central bank to continue on its campaign to remove monetary policy stimulus out of the economy. Therefore, tomorrow's rate hike looks like a "done deal". As such, I expect at least two more rate hikes at each of the next two meetings of March 7th and April 25th, and possibly one more by the end of May.

Meanwhile on the back of these rate hiking expectations, the Canadian dollar has moved up for a third straight day to $0.87 cents US, close to its recent high of December 14th when it reached the highest point since January 1992. Although across the board weakness of the United States dollar has also been a factor in the loonie's recent run-up as the ECB Chief Economist Otmar Issing reaffirmed the need to raise policy rates to prevent a surge in oil prices from spurring inflation in the eurozone. What this may suggest as we look towards the second half of the year is that if the ECB moves in a more aggressive way while the US takes a breather, it may further weaken the US currency which would push the Canadian currency even higher.

In today's federal elections in Canada the Conservative Party headed by Stephen Harper seems poised to win which may further spur the Canadian dollar. What remains to be seen is whether they will win an absolute majority of seats or try to form a minority government.

Kenneth Matziorinis, Ph.D.
Canbek Economic Consultants Inc.
www.hellascapital.ca/canbekeconomics