Economic Commentary

July 14, 2003

BANK OF CANADA LIKELY TO STAND PAT ON RATES TOMORROW

The Bank of Canada's monetary policy committee will meet tomorrow and hand down its latest decision regarding the course of interest rates in Canada. My expectation is that they will leave interest rates unchanged at the current 3.25% level (5% prime). Despite the poor showing of the March - April economic figures the fact remains that this period was tainted by the effects of the war in Iraq, the SARS outbreak in Toronto and the mad cow incident in Western Canada. As all three of these factors have one-time transient effects, the central bank has to await results from a more normal period like May and June. The May employment figures released last Friday were extremely encouraging, so is the fact that the US economy is expected to pick up strength in the second half of the year and that the Canadian dollar has given back some of its recent gains against the USD. The central bank needs to see the May GDP report to be released at the end of July and the inflation data for June to be released in the third week of July before it can reach a decision on what to do about interest rates in Canada.

Thus the Bank of Canada will play it safe tomorrow, leaving rates the same. If convincing evidence starts accumulating between tomorrow and the end-of August that the economy is seriously weakening, only then might it decide to cut rates, and this at the September 3rd meeting. Even then, I believe that the Canadian economy will surprise forecasters on the up-side.

The higher Canadian dollar is not as bad a problem as it is made out to be in the press. What hurts Canadian exports is more the "volume" effects, the result of a slow moving US economy, rather than the "price" effect, which can be absorbed through lower profit margins of Canadian corporations. A stronger loonie also means a weaker greenback. A weaker US dollar helps revive the US economy and by extension boosts our exports to the US. In effect, a low US dollar works in favour of Canadian exports and therefore a stronger Canadian economy. Also, we must not forget that John Manley delivered a 20% boost in government spending last February. Strong domestic demand will be the driving force in Canada's economy over the next few years. In conjunction with still strong pent-up demand, the result of the mini-depression of the 1990s (1989-1996) and low interest rates, I fail to see why Canada's economy should not continue to perform well -despite the higher dollar. Add to this the election of a federalist government in Quebec (a quarter of Canada's economy) and the transfer of power to Paul Martin in November, Canada's prospects have not looked as good since the 1950s!

One important note of caution however, watch out for bonds. I think they are in overbought territory and the risk of a significant fall in bond prices is rising by the week.

Kenneth Matziorinis, Ph.D.
Canbek Economic Consultants Inc.