Economic Commentary

July 15, 2003

Bank of Canada Surprises With a 1/4 % Rate Cut

The Bank of Canada surprised markets this morning by cutting its benchmark target overnight financing rate a quarter of a percentage point to 3.0% from 3.25%. The Canadian dollar plunged on the move falling to .7185 US from .7274 US yesterday.

Although the Bank acknowledges in its announcement that the US and Canadian economies will pick up speed in the second half of the year, it also cited the current softness in the Canadian economy, hit by the slowdown in the US economy, the rise in the loonie, the SARS outbreak and the mad cow breakout in Alberta as reasons for trimming the key short-term interest rate. Judged from all of its pronouncements over the past ten months, this is as much of a 180-degree move as it gets. Either the Bank acknowledges that it was overestimating the threat of inflation before (largely because a huge part of inflation was due to rising car insurance premiums) or it has information that the threat of deflation is much more serious than it previously believed, or it reassessed the effects of the rise in the Canadian dollar and wants to contain the sharp rise in the value of the currency. It is not clear why it chose to cut rates so soon. As I explained in my previous commentary, the logical thing would have been to await data from a more normal period such as the May - June period when much of the one-time "noise" would have washed off the data.

Either way a 1/4% change is marginal in the short-term, yet the decision also indicates that the Bank can be quite flexible and less dogmatic, willing to adjust course in the face of changing circumstances.

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