Economic Commentary

June 04, 2003

BANK OF CANADA HOLDS OFF ON RATES, THE FED AND THE ECB ON TRACK TO CUT RATES BY 50 BASIS POINTS: BULLISH FOR LOONIE, GOOD FOR GLOBAL GROWTH

In its regularly scheduled policy meeting yesterday, the Bank of Canada decided to leave its target overnight financing rate unchanged at 3.25%. The announcement was no surprise as markets had come to expect no rate increase following the release of the soft first quarter GDP figures (which showed that Canada's economy grew at an annualized rate of 2.4% rate in the first quarter, below the 3.0% trend rate) and the release of the April CPI figures which showed a steep fall in the annual rate of inflation to 3.0% from 4.3% in March, and more importantly a drop in the core rate -which the Bank follows closely- to 2.1% from 2.7% in March.

As reasons to hold off on a rate increase the central bank cited i) the fact that inflation declined "more than expected" in April and that both the core and headline inflation will return to 2% "somewhat earlier than expected in April" ; ii) that "continuing weakness in the US and global economy and concerns about the economic impact of SARS point to the likelihood of some near-term softness in the Canadian economy" and iii) "there has also been significant adjustment in the value of the US dollar against major currencies, including the Canadian dollar". What is more important is what the Bank didn't say in its statement. Whereas in past statements it kept reiterating that because of concern over capacity and inflationary pressures it intends on adjusting rates upwards to return monetary policy to a more neutral setting, in its last statement the Bank did not repeat any mention of this, suggesting that at least for now, it sees no reason to raise interest rates any higher in the foreseeable future.

My take on its latest announcement is that at least for now, the Bank has given up on its plans to raise interest rates in Canada until it has more firm and convincing evidence that the North American and global economy is engaged in a solid expansion, something that can only be known by Fall, at the earliest. Furthermore, I believe that the central bank is beginning to be concerned over the steep rise in the value of the Canadian dollar (14% so far this year), which is already putting the breaks on Canadian exports which account for 42% of our GDP. Further interest rate increases risk pushing the value of the Canadian dollar ever higher and therefore putting a huge damper on Canada's growth.

Comments by Federal Reserve chairman Alan Greenspan yesterday on the need to fend off deflationary forces in the USA also reinforced expectations that the Fed, in its next regularly scheduled meeting on the 25th of June will likely cut interest rates once more perhaps by 50 basis points to 0.75%. Should it do so, and I expect that it will, then the differential between Canadian and US rates will widen further to 250 basis points and this will put even more upward pressure on the loonie. Moreover, the European Central Bank (ECB) in its regularly scheduled policy meeting tomorrow is widely expected to cut its policy rate by 50 basis points to 2.0% (from 2.5% now). The prospect of further rate cuts in the euro-zone to revive weak European economy is also adding upward pressure on our currency.

The next meeting of the Bank of Canada is scheduled for July 15th. Between now and then whatever figures are released on the economy are not going to material enough to prompt the Bank to change rates. Thus, if there is going to be a rate increase the earliest possible date is September 3rd, but not likely until October 15th. The person responsible for updating the rate bulletin board can take the summer off.

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