Economic Commentary

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Canadian Economy Closes Year on High Note and Bank of Canada Plans Another Rate Cut on Tuesday

Last Friday morning Statistics Canada released its latest figures on the Canadian economy for the fourth quarter of 2003. Canada's output adjusted for inflation (real GDP) expanded at an annual rate of 3.8%, faster than expected, and slightly below the rate of economic growth in the USA which came in at 4.1% over the same period. Also, the rate of growth for the third quarter was revised upwards to 1.3% from 1.1%. The average rate of growth for the full year came in at 1.7%, about half the 3.3% rate of growth recorded in 2002. This rate of advance was certainly lower than what was being forecast a year ago, but very much in line with the central bank's most recent forecast. Growth in the fourth quarter was driven by a surprise rebound in exports, a modest rise in business capital investment and by a strong rise in inventory accumulation. Consumer and government spending were flat for the quarter.

Although the final number was very good, it masks some significant weakness still in place in the economy. Closer analysis of the data reveals that most of the growth during the quarter –2.7 percentage points out of the 3.8- came from the unintended accumulation of inventories. Producers expanded production during the quarter in anticipation of higher consumer demand that failed to materialize. Actual purchases by consumers, business and government, what is known as final domestic demand rose only by 1.1%, the worst showing in three years and a big step down from the robust 5.5% gain in the third quarter. What this suggests is that unless domestic demand picks up strongly in the current quarter, these same producers will have no choice but to cut back production resulting in weaker growth during the first quarter of 2004.

The GDP report then is fully in line with the Bank of Canada's assessment of the economy, that "additional monetary stimulus would be required to support aggregate demand and return inflation to 2% over the medium term". Thus, as we turn to tomorrow's scheduled rate setting meeting in Ottawa, one can comfortably predict that the central bank will cut its key benchmark overnight rate again by another 25 basis points, following January 20th quarter point cut. This will bring the overnight rate to 2.25% and the prime rate down to 4.00%. On a cumulative basis, this will represent a 50 basis point cut for 2004 on top of the 50 basis point cut the Bank delivered since it reversed its policy direction last July 16th, in all a full one percentage point cut.

Some additional reasons to expect a rate cut tomorrow, are the recent drop in the consumer rate of inflation. On February 20th, Statistics Canada reported that the January year-over-year rate of inflation in Canada fell to 1.2% with the closely watched core rate down to 1.5% from 2.2% in December. With goods prices falling as a result of the appreciation in the Canadian dollar and now with deceleration in prices in the service sector of the economy to 2.4% from 3.5% three months ago, inflation in Canada for most of 2004 is expected to remain well below the 2% target of its 1-3 percent policy band. Since the Bank of Canada is forecasting that the output gap in the economy will not be closed until the end of 2005, at the earliest, there is certainly enough room for a rate cut.

As far as market expectations are concerned a survey of market analysts shows that they are unanimous in the view that a rate cut is imminent and this view is already fully priced in financial markets, including the foreign exchange market where the Canadian dollar has sold off against its US counterpart in recent weeks.

What are the prospects for growth, interest rates and the dollar for the rest of the year? In its latest Monetary Policy Report issued on January 22nd, the Bank of Canada is projecting growth in real GDP of about 3% in the first half, moving up to 3.5% in the second and peaking at 4.0% in 2005. Although last year's sharp appreciation in the value of the Canadian dollar will continue to act as a drag on Canadian growth in 2004, there are also strong off-setting factors at work. The US economy will continue to expand in 2004 and into 2005, running at a 4.5% rate, while continued recovery in the global economy, especially from Japan and China will also contribute to demand here at home. Commodity prices will continue to rise, driven by strong global expansion and this will raise the prices of most of Canada's resources thus offsetting the drag from the currency appreciation. An expansive monetary policy here at home and abroad will boost domestic demand especially in the interest sensitive sectors of consumer durables and housing construction while business capital investment should continue to benefit from lower prices of production machinery and equipment.

Will tomorrow's rate cut be the last one we are going to see in 2004? It is hard to tell at this point. It will depend on how strongly domestic demand responds to lower rates and on how much and how soon it will be impacted from the global expansion. Should growth lag this quarter – and there are reasons why this could happen such as the inventory overhang from the last quarter, the slowdown in employment growth, slowdown in the growth of personal disposable income, a fall in the saving rate which last quarter fell to 2.0% and the sharp rise in consumer indebtedness which last quarter jumped by a record $43 billion- it is certainly possible that the central bank might re-assess its outlook and cut interest rates again, though not at the next meeting which is on April 13th, but at the June 8th meeting. On the other hand, should the economy respond to the past and current policy stimuli as expected in the central bank's current forecast, then there will be no need for further cuts, so we can expect short term rates to stay at 2.25% for the rest of the year. I believe that the odds of the second scenario at this moment *slightly* outweigh the odds of the first, thus I would bet that this will be the last rate cut we are going to see this year,

Turning to the Canadian dollar, we see that after reaching a high of 78.5 US cents in early January it has sold off considerably since the Bank of Canada's January re-assessment of the economic outlook which created the expectation of a half point interest rate cut. After touching a low of 74.0 cents this month the Canadian dollar is trading this morning at 74.95. What all this suggests to me is that the Canadian dollar has fully absorbed the blow from Canada's downshifting and is now poised to recover after tomorrow's rate cut. Barring any negative surprises in our (the Bank of Canada's) forecast in the near future, the latest rate cut should set a floor for the loonie because it will create the expectation that now that rates have been lowered we could expect growth to resume in the economy with positive implications for the direction of our dollar. Thus, in the near future I see the dollar in a trading range of 74.5 to 77.0 cents. On the other hand, should growth in Canada stumble in the near term and the Bank of Canada become forced to cut again in June, we will see renewed weakness in our currency. Longer term, however, the direction the Canadian dollar will take is more a US dollar weakness story than a Canadian growth story. I still believe, that the US dollar is in the middle of a medium term (2-3 year) structural correction that will eventually push the loonie to higher levels.

Lastly, bond prices are trading in uncertain territory, with the yield on 10-year bonds around 4.5% last week and the three month rate at 2.13%, the yield curve remains strongly sloped with a 240 basis point differential. With US 10-year treasuries near 4.0%, it is hard to see how such low yields can be sustained in the long-term. From a fundamental analysis standpoint, bond prices are certainly overvalued posing a serious market risk for holders of such instruments in the long run. On the other hand, with sustained economic expansion in the USA and by extension North America still in doubt, and given that the US is in an election year which makes policy authorities very vigilant against any move that might undermine the bond market and the economic expansion it is hard to assess when and how long term rates will move in the near term.

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