Economic Commentary

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North American Growth Exceeds Expectations but Monetary Tightening to Continue

This morning Statistics Canada and the Bureau of Economic Analysis of the US Department of Commerce released their latest figures for economic growth In Canada and the United States. During the third quarter that ended on September 30th, Canadian output expanded at an annualized rate of 3.6%, up from 3.4% in the second quarter and 2.0% in the first. Year-over-year growth is running at an annual pace of 2.8% and expected to close the year at about 3.0%. South of the border, US growth accelerated to a revised rate of 4.3% in the third quarter, up from 3.3% in the second and 3.8% in the first. Year-over-year growth is running at a 3.7% pace and expected to close the year at an average rate of 3.7%. The performance of both economies has baulked expectations for slower growth stemming from a stronger currency in Canada and rising interest rates and mounting trade deficit in the US.

Consumer inflation on both sides of the border has reseeded from the post-Katrina's high September levels while consumer confidence has rebounded strongly following the steep retreat of September and October. Headline consumer inflation in Canada reseeded in October to an annual rate of 2.6%, down from 3.4% in September. Core inflation in Canada is running at a moderate rate of 1.5% – 1.7% depending on whether you use the Statistics Canada or the Bank of Canada measure of core inflation. In the US, headline inflation has also reseeded from an annual rate of 4.9% in September to 4.3% in October, but the core rate is running at a subdued pace of only 2.1%, down from 2.2% in September. It is actually remarkable that so far the energy-driven spike in headline line inflation has not spilled over to other sectors of the economy, although there are increasing signs that it might do so over the next few months if oil prices remain high and if winter temperatures turn colder.

As good as the news about the previous quarter have been, we are now two thirds along the fourth quarter of the year and there are increasing signs that the growth rate will start to slow as we head into the new year. Although the economy's momentum assures continued growth for the current quarter and the first half of next year, the probability that the North-American economy will begin to slowdown substantially in the second half of next year is rising. On the Canadian side, most of the up-side gains were centered on Canada's energy sector, while growth in the manufacturing and retail trade sectors has been extremely soft over the first nine months of the year. With our currency trading at the USD 0.85 cents plus level and significantly stronger against the euro the yen, and most world currencies, it continues to undermine Canada's global competitiveness despite the resilience that our economy has shown so far.

In the United States there are more reasons for concern. Consumer spending is showing signs of deceleration, especially when one strips out auto sales that were driven by a wave of sales incentives. Higher energy prices are taking a big bite out of consumer purchasing power while higher interest rates and slowing growth in disposable income are exerting increasing restraint on the ability of US consumers to maintain their spending spree. Another area of concern is the US housing market, which is showing increasing signs that the housing boom has crested and is about to correct. Although new-home sales rose to a new record level in October and average house prices jumped to a new high of $277,700, sales of existing homes declined by a steeper-than-expected rate of 2.7%. Moreover, the inventory of unsold houses is at the highest level since 1986, the time it takes to sell a house has increased and housing affordability has reached a 14-year low. Most troubling of all remains the serious savings-investment balance. With a budget deficit of 4% and a current account deficit of 6.5%, the US is continuing to spend much more than it earns. It is only a matter of time before these fiscal and trade imbalances will be redressed, either by controlled policy-induced measures or by non-controlled market-driven forces.

Most of all, the Fed has been gradually removing the monetary stimulus that has been the primary driver of US economic growth over the past five years, raising rates from 1.0% in June of 2004 to 4.0% last month. With markets firmly expecting the key US policy rate to rise to 4.25% on December 13th and 4.5% by January 31st, 2006, the economy is sure to slow down. If rates climb higher in the first half of next year under the Chairmanship of the newly appointed Governor Ben Bernanke, which is the most likely probability, one cannot but expect a slowdown in the rate of economic growth toward the 3.0% level by the end of next year at best, if not lower if other unfavourable factors intervene.

On the north side of the border, the Bank of Canada has initiated its long awaited stimulus-unwinding move by boosting the overnight rate from 2.5% in September to 3.0% in October. When it meets next week on December 6th, it is sure to raise the rate again to 3.25% and to continue raising it early next year to at least 3.75% by April. Meanwhile the ECB’s President Jean-Claude Trichet has signaled his intention to start adjusting rates upwards in the eurozone as early as tomorrow morning when the policy council meets, and then move them up to about 2.75% by the third quarter of next year.

The implication of these policy moves by central banks which are in addition to those already made by the Bank of England and the Reserve Bank of Australia last year is that by removing the monetary policy stimulus from the economy they will remove one of the major drivers that has sustained growth in the North American and by extension the world economy. Let’s hope that the effect will be to produce an orderly slowdown in these economies instead of something more abrupt.

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