Economic Commentary

October 18, 2004

Bank of Canada to Raise Benchmark Rate Tomorrow by 1/4 of a Percent to 2.5%

The Bank of Canada is holding its next interest rate-setting meeting tomorrow morning. All indications are that it will raise its benchmark overnight financing rate by another quarter of a percentage point, which will bring it to 2.5%. On September 8th, the central bank embarked on a new rate tightening cycle when it upped its rate from 2.0%, a generation low.

The reason why the Bank finds it necessary to start raising rates is pretty obvious at this point. Canada's economy has been expanding strongly again, expanding an annualized rate of 4.3% in the second quarter and at a very healthy 3.0% year-over-year rate. The economic news since its last meeting have been consistent with the view that Canada's economy is on a sustained growth path and does not need any more monetary policy accommodation. In September, the economy created 43,000 jobs and the unemployment rate fell to 7.1%. Last Friday's news showed that factory shipments continue to rise which suggests that the third quarter's growth will come to well above the 3.0% annual rate which is considered the economy's cruising limit. Since the economy is quickly approaching its potential output, the central bank has no choice but to take steps to remove the monetary policy stimulus that was there over the past year and a half. Sheryl Kennedy, one of the Bank's deputy Governors said as much in a recent speech. "In the future we will have to reduce the degree of monetary stimulus to prevent an intensification of inflationary pressures and to favour sustained growth", she said. Surveys of money market and bond analysts late last week by Reuters and Bloomberg confirm the same, with all analysts expecting a rate hike tomorrow.

Where analysts begin to part in their expectations is about what the Bank will do in its final rate-setting meeting of the year scheduled for December 7th. About half the analysts expect that the Bank might take a breather at that meeting, and continue with its rate hiking early next year. As I explained in my September 7th Economic Commentary, central banks on both sides of the border might want to take a break, to see where the economy is going before they continue with their rate tightening cycle. Most analysts expect that the Fed will raise its fed funds rate by a quarter of a point at its November 10th meeting to 2.0%, but leave rates unchanged in its last meeting on December 14th. The main reason why the Fed might opt for such a move is that the US economy has not been doing as well with job creation much weaker than expected. With rising oil prices acting as a tax increase on the US consumer, there are good reasons that the Fed might want to go slow for a while, now that it has reloaded its gun so to speak by bringing rates back up to a more palatable 2.0% level. On our side of the border, the main reason why the Bank of Canada might want to take a break is the recent appreciation in the value of the Canadian dollar, which is now trading just below the 80 cent US level. As our currency rises, the price of our exports become more expensive while the price of our imports become less expensive, and this acts as a dampener on economic activity at home. If the Fed chooses to stand pat in December, makes it easier for the Bank of Canada to do the same while a further rise in Canadian rates -while the US poses- runs the risk of triggering a sharp further appreciation in the value of the Canadian dollar to 82 cents US.

Although we will most probably see Canadian rates continue to climb next year, the central bank might want to do it more slowly, especially if problems south of the border persist, the US dollar continues to weaken and inflation remains subdued. Besides, the continuing rise in the price of oil has not led so far to any sustained run-up in prices, but on the other hand has been curbing the growth in consumer spending which accounts for over 60% of aggregate demand in the economy.

Kenneth Matziorinis, Ph.D.
Canbek Economic Consultants Inc.
canbekeconomics@videotron.ca