Economic Commentary

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Bank Of Canada Expected to Cut Rates by 1/4 % to 2.75% on Wednesday, September 3rd

Following on its surprise move in July to trim the target rate for the overnight financing rate, the Bank of Canada is widely expected by both economic analysts and the markets to cut its rate again when it holds its next regularly scheduled policy meeting this Wednesday, September 3rd. The Bank is very likely to cut rates by another quarter point, which will bring its key benchmark policy rate to 2.75%.

Last Friday Statistics Canada released its estimate for the second quarter rate of growth. It showed that Canada's economy contracted during the quarter at an annualized rate of 0.3%. The reasons for this sharp fall off in Canada's growth over the first half of this year are twofold: First, the lagged effects of the sharp appreciation in the value of the Canadian dollar have cut into Canada's exports to the USA as has the slowdown in the US economy over the past year. This effect was fully expected from the beginning of the year given Canada's overwhelming reliance on the US market for its exports and was largely factored into the previous forecasts.

What was not expected and were not factored in to the earlier forecasts, was the second set of reasons. Canada this year has been hit by a series of freak negative hits on its economy. First was the lumber dispute and the punitive tariffs that the US levied against Canada's lumber exports. Then followed the SARS incident in Toronto in April, only to be followed by the appearance of a single case of mad cow decease in Alberta, which led to a complete and unjustifiably prolonged shutdown of Canada's beef and live cattle exports to the world. As if these freak one-time incidents were not enough, in July and August Canada was hit by forest fires in British Columbia, and an electric power blackout in Ontario! Last week the US announced that it will slap punitive duties on Canada's wheat exports as well. As long as I have been a practicing economist, a period spanning 25 years, I do not recall a single year when so many freak events have ganged up on Canada's economy at the same time.

All these events have had the effect of taking a serious bite out of Canada's growth, mostly in the second quarter of the year. The silver lining to this story is that the negative effects of these events are temporary and they do not affect the underlying trends in the economy, which are quite positive. Consumer and investor confidence remain strong just as are retail sales (grew 2.7% during the quarter), construction, the housing sector and business investment, which are doing much better than the USA. One should not contrast

Canada's performance to the US during the second quarter, because the US growth has been boosted by a number of artificial factors such as spending on the war in Iraq, tax cuts and unsustainably low interest rates, not to mention the positive effects on the US of the lumber and beef bans on Canadian exports which have stimulated US production.

Also positive is the fact that the US economy is beginning to grow again, which will help pull up Canada's exports and therefore its growth rate as we move forward. At the Canadian Association of Business Economics (CABE) policy meeting at Kingston last week I was treated to an extremely bullish forecast by Macroeconomics Advisors Chief Economist Chris Varvares. Growth, as we move forward over the next twelve months is likely to surprise us on the up side and this bodes well for Canada's economy.

Turning to the Canadian dollar, the question is will it sell-off further from its 71-72 cent trading range or will it recover back to 75 cents. My view is that the recent correction was expected because the US dollar had sold-off too fast and had to retrace some of that loss, especially now that the US economy is expected to over-perform the global economy over the next twelve months. But when we look at the fundamentals, there are not many positive factors to support it in the medium run. The US economy is experiencing huge and growing budget deficits which eventually will put even more pressure on long-term rates and push down US bond prices. The US economy is also experiencing a huge and unsustainable current account deficit, which is near 5% of GDP. Deflation remains the bigger of the two risks and only a further depreciation in the value of the US dollar will help trim this deficit and sustain the rate of change in prices on the positive side. Given Canada's positive fundamentals, (budget surpluses, falling public debt-to-GDP ratio, falling external debt-to-GDP ratio, current account surpluses), I believe that it is only a matter of time before we see the Canadian dollar surge higher.

The future direction of the value of the Canadian dollar will be driven mostly by forces external to Canada. It is what will happen to the US dollar that will drive the Canadian dollar. In my view, the US buck is in the same place it was in the late 1960s, just before the 1971 crisis and devaluation against European currencies. Only that this time it is China instead of Germany that will be forced to revalue the yuan, and the other East Asian currencies will follow it on the way up in a major international monetary crisis and re-alignment of currencies reminiscent of what happened in the early 1970s. The casualty of course will be the US dollar with a de-facto depreciation.

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