Economic Commentary

September 5, 2005

Bank of Canada to Tighten its Key Policy Rate in the Midst of Uncertainty Brought by Hurricane Katrina

The Bank of Canada is expected to nudge up the target for the overnight rate on Wednesday by a quarter of a point to 2.75%. This will be the first time since October 2004 that Canada's central bank will move to tighten its key policy rate. With three scheduled meetings left for the balance of the year, the market is expecting a 50 basis point increase by the end of the year to 3.0%, that is, to act in two of the three planned meetings.

The news coming out of Canada in recent weeks can only be described as bullish. Retail sales increased by 1.1% in June, a reading stronger than expected; the index of leading economic indicators rose a strong .3% in July; consumer inflation rose .2%, less than expected; the Conference Board index of consumer confidence rose by one full point to 123.9 in July and the federal government reported a bloated June budget surplus of $1.7 billion, up 54% when compared to June, 2004. To cap all these favourable news, Statistics Canada released on August 31st its GDP report that showed that Canada's economy expanded at an annualized rate of 3.2% during the second quarter, higher than previously forecast. While at the beginning of the year economists expected growth in the US to outpace that of Canada by more than half a percentage point, now it looks like Canada's economy is growing as fast as the USA. With growth running at a downwardly revised rate of 3.3% in the US over the same period, the impact of hurricane Katrina is expected to shave as much as half a percentage point from US growth in the fourth quarter of this year.

In the face of these numbers it is hard to see why the Bank of Canada would not resume its plan to reduce the monetary stimulus that has been in place over the past eleven months. Besides, in its recent monetary policy announcement, the Bank stated that, "some reduction in the amount of monetary stimulus will be required in the *near term* to keep aggregate demand and supply in balance and inflation on target". This implies that the Bank is ready to move as early as this week.

As predicted in my previous commentaries and mirroring the above developments, the Canadian dollar has rallied again and is a whisker away from its previous high of $0.85 cents recorded in November of last year. My assessment is that over the next few days the Canadian loonie has the potential to break the previous high and move higher. If it does, the next high that we can expect to see will be the $0.88 - $0.89 cent level later this year.

With the central bank on course to tighten monetary conditions and in the context of a global commodity boom especially with rising oil prices, this should exert further upward pressure on the Canadian dollar. The damage caused by hurricane Katrina on the Gulf of Mexico coastal region of the US on off-shore oil-drilling platforms, oil-loading and oil refining installations, which account for more than 10% of US production and refining capacity, has the potential to send the Canadian dollar flying higher.

Katrina, has also introduced a significant degree of uncertainty on every one's plans and that includes central bankers. The catastrophic impact of Katrina on New Orleans and the other towns and cities of the US South has already been billed as the largest natural disaster in US history. Given that it also struck the most important oil artery of the US oil grid, it has worrisome implications for the economy as a whole that, as of the writing of this commentary, still remain unknown, due to the lack of information that has come out so far. Since the global oil industry is already producing at its maximum capacity, this hit comes at the worse possible time for the US and world economy. With outright shortages of refined products in many parts of the South, gasoline prices have jumped above the psychological threshold that most economists consider as the tipping point that can knock the US economy off its growth course.

If we put together the direct effects of the catastrophe -which Macroeconomic Advisers LLC estimate to average between 0.5 and 0.7 per cent of GDP in the second half of the year- along with the indirect effects that will spill on consumer confidence by the shock of the jump in gasoline and home heating prices, the US economy may slow unexpectedly. The danger is that If gasoline prices stay high for longer than a month consumers may be forced to cut back spending enough to result in an economic slowdown that is worse than anyone could have imagined before the storm. To mitigate the effects of the crisis President Bush and the IEA have agreed to release supplies from strategic oil reserves and Canada and OPEC to raise production, but the action may not be enough to prevent major damage to the economy if much of the refining capacity remains idle a month from now.

Although it is still too early to judge what the full effects will be, President Bush has already had lunch with Fed Chairman Alan Greenspan to discuss the options. It is very possible that when the Fed holds its policy meeting on September 20th, it might decide to take a pause in its planned rate hikes. Moreover, how the supply interruption in the US will affect the global demand/supply balance and the impact on energy prices, inflation, and global demand and how it will influence the policy decisions of central banks is still too early to call. Another natural disaster or terrorist strike in an oil producing region can easily send the world into its worse energy crisis since the 1970s. Lets hope that this will not be the case this time around.

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