The Bank of Canada reduces its policy interest rates once again

- The overnight rate and the Bank Rate were lowered by 25 basis points each, to 2.50% and 2.75%, respectively. This is the third decrease in the last six months.
- As a result, the prime rate of Caisse centrale Desjardins and the major Canadian banks will drop from 4.50% to 4.25%.

1) According to the Bank of Canada, the underlying price pressures and the presence of spare capacity indicate that core inflation will likely remain under 2% until the end of 2005.
2) The rapid appreciation of the loonie slowed the expansion of aggregate demand by lessening our exports and strengthening our imports.
3) Recently published data for the fourth quarter indicate domestic demand falling slightly short of the Bank’s latest forecasts. Consequently, the output gap at the end of 2003 seems greater than what our central bank was expecting.

Conclusion: As anticipated, the Bank of Canada opted for an additional decrease in its policy interest rates this morning. Based on the Canadian economy’s recent development, it seems more and more likely that economic growth will barely reach its potential during the fourth quarter of 2003. Specifically, the current output gap will persist longer than expected. Remember that only just a few weeks ago, those in charge of monetary policy anticipated a narrowing of the output gap as of the fourth quarter of 2003. In this context, fears of accelerated inflation will be virtually non-existent for nearly two years. With this morning’s decrease, the gap between the Canadian and American overnight rate targets is at 1.50%. It seems that the inflation situation will be very similar in the United States and Canada during the coming months. As a result, we believe that the difference between North American policy interest rates is still much too high, which has an adverse effect on the Canadian economy. This difference must be minimized gradually in the next few months. Since the American policy interest rates will surely remain stable for most of 2004, the Bank of Canada should respond by new rate cuts in upcoming months.