The Bank of Canada Lowers Its Key Interest Rates… and Ends the Period of Loosening Monetary Policy

In brief:
The overnight rate and the discount rate went down by 25 basis points each—to 2.00% and 2.25% respectively. The prime rate moved from 4.00% to 3.75%.
1) The Canadian economy continues to adjust to developments in the international situation as well as the realignment of currencies while many businesses are having to adapt to a higher loonie.
2) The recent reductions in key interest rates facilitate the necessary adjustments and support aggregate demand.
3) The Bank’s economic forecast has changed very little since publication of the Monetary Policy Report Update last January. The next Monetary Policy Report will be published this Thursday.
4) The Bank of Canada is much more explicit regarding the bias of its monetary policy: “The risks to the outlook now appear balanced.”

Conclusion: Our central bank has opted for a further reduction of its key interest rates, the third since the beginning of the year and the fifth since July 2003, which should continue to stimulate domestic demand. Note that, with this morning’s reduction, the overnight target rate returns to the same level as at the beginning of 2002—close to the discount rate’s historic low. This support for aggregate demand should help our economy to overcome that negative effects of the strong rise in value of the Canadian dollar.

In the past, the Bank of Canada has often been criticized for its lack of clarity with regard to its views on the future direction of its monetary policy. That said, today’s press release appears to remedy the situation by stating, “The risks to the outlook now appear balanced.” In short, this morning’s reduction is likely to be the last. It must be remembered that the international context has greatly improved over the last few weeks. With the exception of the European Central Bank, which is supposed to reduce its guide rates by another 50 basis points between now and the summer, many large central banks are already positioning themselves for a tightening of their monetary conditions. While the increase in interest key rates has already begun in the United Kingdom and Australia, everything points to the US Federal Reserve starting to hike its Fed fund rate as soon as the presidential election is over, perhaps even before if upcoming economic data continues to exceed expectations. In Canada, on the other hand, the hike in key rates should materialize somewhat later—starting in the winter of 2005. That means that, between now and then, we will see a period of status quo in our key rates.