ALBERTA FINANCE
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Economic Spotlight

Monetary tightening to end in the United States but start in Canada

KEY MESSAGES

Short-term interest rates in the U.S. have risen by 250 basis points to 3.5% from a cyclical low of 1% in June 2004. Rising cost pressures are likely to keep the Federal Reserve Board increasing interest rates over the next two scheduled meetings in 2005. By then, a moderation in economic growth is likely to provide a brake to interest rate increases.

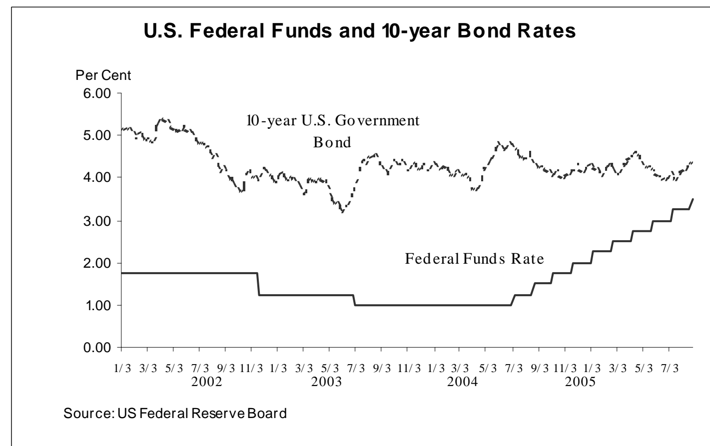
The Bank of Canada has begun to slowly remove the monetary stimulus currently in place. Short-term interest rates in Canada increased 25 basis points on September 7th to 2.75%. Economic growth in Canada is expected to pick-up over the near term as exports have increased in the past three months and the domestic economy remains very strong.

Long-term interest rates have remained low in both Canada and the United States, providing ample support to the economy, especially to housing markets. Strong domestic demand in both Canada and the United States is putting upward pressures on long-term interest rates, which are expected to increase by about 50 basis points.

Recent Trends in Interest Rates

On August 9, 2005, the Federal Reserve Board raised interest rates for the 10th time to bring the overnight rates to 3.5% from 1% in June 2004.

The current tightening cycle in the United States is the only one in the post war period in which long-term interest rates have fallen since the Federal Reserve Board initiated tightening. Even record high oil prices have not affected long-term rates significantly. It seems that the bond market views rising oil prices more of a downside risk to global growth than an upside risk to inflation.



Despite a differential of 100 basis points in U.S. and Canadian short-term rates, differences in long-term rates have been minimal – long-term rates in Canada were 16 basis points lower than those in the United States at the end of second quarter of this year. Government of Canada 10-year bond yields fell steadily from 4.8% in the second quarter of last year to below 4.0% by June 2005. Since then, long-term interest rates have been fluctuating around 4.2%.

World financial markets have become more integrated and as a result, long-term rates tend to respond to changes in global conditions, while trends in national economies impact short-term interest rates. Real economic activity and inflation risks are expected to converge over the

longer term in major industrialized countries. This is evident in the yields adjusted for inflation on long-term bonds in Canada, the United States, France and the United Kingdom, which have been relatively close to each other and behaved similarly since 2002 (Federal Reserve Bank of St. Louis).

A significant increase in global savings is also helping to keep long-term interest rates low. An aging population in a number of industrialized countries has increased retirement savings. In addition, a sharp reversal of capital flows away from emerging and developing economies has increased capital looking for safe investment and higher yields. According to the U.S. Federal Reserve Board, the current account of these countries moved from a deficit of US$88 billion to a surplus of US$253 billion between 1996 and 2004. Most of this money is flowing to the United States, keeping a lid on U.S. long-term interest rates.

Why has the Bank of Canada Delayed Following Rate Increases in the U.S.?

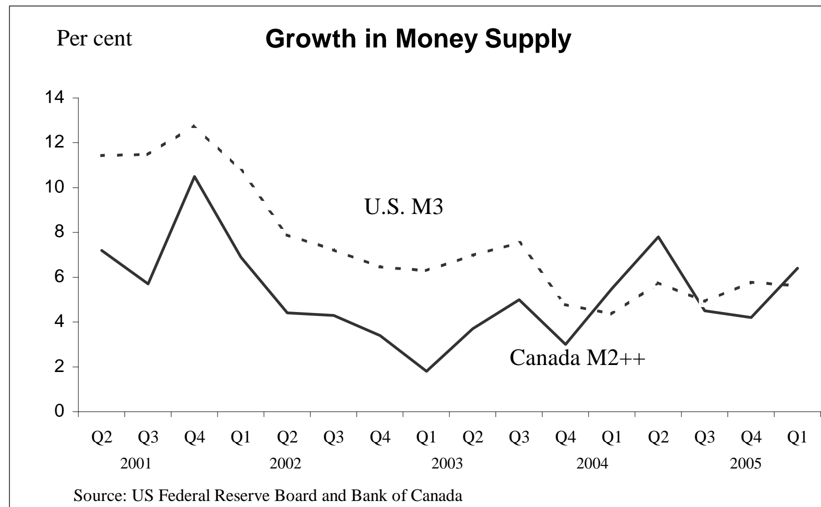
Economic growth in Canada has remained sluggish and has resulted in a significant output gap. In 2004, GDP growth in Canada was only 2.9% versus growth of 4.4% in the United States and was 2.1% in the first quarter of this year, compared to a growth of over 3.8% in the United States. In the second quarter, growth in Canada increased to 3.2% compared to a growth of 3.3% south of the border. The Canadian economy is expected to grow by 2.7%, whereas growth in the U.S. is expected to be 3.5%. In 2006, expectations are that growth in Canada will match that of the United States with growth expected to be 3.3% in both countries.

The Bank of Canada targets inflation to achieve sustainable growth in output and employment. Since the inflation targeting was adopted in the early 1990s, inflation in Canada has remained fairly stable. Large deviations have occurred due to swings in the price of oil and other commodities. As a result, the Bank has focused on core inflation measures for operational purposes. Inflation targeting has allowed the Bank to deal with the sharp currency appreciation in the past four years.

The output gap – the difference between what the economy is capable of producing and what it actually produces – is a key indicator of inflationary pressures in the economy. For example, the potential output is expected to grow around 3% per year, reflecting a 1% growth in the labour force and 2% growth in productivity. A negative output gap indicates unused capacity and tends to exert downward pressures on inflation. The Bank of Canada estimated that the economy was operating below capacity in 2004 and the first two quarters of this year. As a result, the Bank ran an accommodative monetary policy as the economy, especially the export sector, adjusted to the rising value of the Canadian dollar. The Canadian economy is expected to be operating close to its capacity over the near term. The unemployment rate in Canada at 6.8% is close to its 30-year low and industrial capacity utilization rate in Canada is close to its five-year low. The Bank of Canada has stated very clearly that it needs to slowly remove some monetary stimulus in the near term.

Although there is considerable slippage between growth in money supply and GDP, greater complexities in money supply growth have made it more difficult to use monetary aggregates as guides to monetary policy. Nonetheless, growth in the broad measures of money supply does provide an indication of trends in GDP growth over the medium term. Growth in money supply in line with nominal GDP growth of around 5% is considered to be consistent with sustainable non-inflationary real growth in the long term. In Canada, the broader aggregates M2++ grew at a non-inflationary rate of 5.1% in 2004 and by 6.5% in the first quarter of 2005, indicating an

economy that is growing close to its capacity and at a faster pace than in 2004 and 2003. However, the broader aggregate of money supply in the United States, M3, shows a slowing of growth in money supply in late 2004, indicating an economy that is likely to post slower growth.



Outlook for Short-Term Interest Rates

Despite higher oil prices, inflation remains under control, although rapidly rising house prices have become a factor in influencing interest rates. In the first seven months of 2005, the US CPI rose at 3% seasonally adjusted annual rate, up slightly from an increase of 2.7% in all of 2004. Excluding food and energy, the CPI increased by 2.2%, the same rate as for all of 2004. Alan Greenspan has expressed concerns about “speculative fervor” in some local housing markets. The Federal Reserve Board may pause on interest rate hikes to lessen adverse economic impacts caused by Hurricane Katrina.

At present, the U.S. Federal Reserve Board is likely to raise interest rates on the remaining two scheduled meetings in 2005, bringing short-term rates to 4% by the end of this year. After that, the U.S. monetary authorities are likely to take a pause to assess the impacts of monetary tightening over the past 18 months.

Low long-term rates have supported domestic demand in the United States and Canada, bolstering the housing market and consumer spending. If long-term interest rates do not increase, short-term rates must increase more to cool the red-hot housing market in the U.S. and, to a lesser extent, in Canada. The Bank of Canada increased interest rates on September 7, 2005 and will likely continue with quarter point rate increases over the next two scheduled meetings in 2005. Although, the continued strength in the Canadian dollar may force the Bank to stay on sidelines in part of 2006, the overnight rate is expected to reach around 4% by the end of 2006.

Trends in real GDP growth have been the main determinant of short-term interest rates among major industrialized countries. Strong domestic demand led the United States to initiate tightening in 2004, whereas weaker growth in Canada allowed the Bank of Canada to stay on hold until now. At the same time, continued slower growth in the EU area has forced the European Central Bank to keep a lid on rates despite the Bank’s ongoing preoccupation with inflation. The Bank of England made its first cut in the current cycle in response to weak domestic demand on August 4, 2005 in response to slowing real growth. The British economy grew by 1.7% in the second quarter of 2005 over the same quarter in 2004, the smallest annual gain in 12 years.

Outlook For Long term Interest Rates

Long-term interest rates are expected to increase by about one-half of a percentage points by the end of 2006. Adverse inflation surprises, a further weakening of the U.S. dollar, a portfolio shift

out of the U.S. dollar and increased long-term borrowing by the private sector can exert upward pressures on long-term interest rates. Most forecasting agencies are calling for long-term rates to increase between 4.7% and 5% by the end 2006 and early 2007. Some, such as the Deutsche Bank, are calling for long-term interest rates to rise to 5.5% by the second quarter of 2006.

Conclusion

Short-term interest rates are expected to rise in Canada over the near term, while increases in U.S. short-term interest rates are nearing an end. However, long-term interest rates are expected to increase in both Canada and the United States over the course of this year and next.

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