

## As the Credit Cycle Turns...



**Benjamin Tal**  
**Senior Economist**  
**CIBC World Markets**

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**T**he credit cycle is turning. The Bank of Canada is operating under the assumption that the economy is close to full capacity — pointing to the 30-year low unemployment rate as a reflection of this reality. Furthermore, due to slow productivity growth, the Bank believes that the speed at which the economy can grow without triggering inflation is now 2.5% and not 3% as previously estimated. This means that the Bank has more room to raise rates. How high will interest rates go? The likelihood is that the current monetary policy tightening campaign will be much more muted than it was in the past.

The prospects of rising interest rates along with elevated commodity prices will continue to underpin the Canadian dollar which, in turn, would further hurt activity in the manufacturing sector. So, in many respects, the strong dollar is doing the Bank of Canada's job by slowing down the economy. In addition, the Bank of Canada is facing a difficult dilemma as the national economic figures mask growing regional divergence. The twin effects of high-energy prices and a strong dollar have created two economies in Canada: The West vs. the Rest. Note, for example, that in 2006 economic growth in Alberta might outpace growth in Ontario by a ratio of four to one. And ironically, higher interest rates are much more powerful where they are least needed (Central and Eastern Canada), and less effective in the booming areas (Alberta).

This asymmetrical response to higher interest rates, along with the negative impact of a strong dollar and higher energy prices on overall economic activity will work to limit the need to raise interest rates in the near future. Accordingly, we expect the Bank of Canada to raise rates by only 50-75 basis points in the coming few months, with the dollar remaining at well above the \$0.85 (US) level.

As for long-term rates, the increase here will be even more muted given the diminishing correlation between short and long-term interest rates. In other words, major global economic factors such as the globalization and the Walmartization of the North American economy, work to keep inflation at bay. And with inflation low, long-term rates are not rising as quickly as they did in previous cycles. So, short-term rates are no longer the main drivers of long-term rates. Accordingly, expect the 5-year rate to rise by no more than 25-30 basis points in the coming few months before leveling off.

While most observers focus on the upcoming rate hikes by the Bank of Canada, it is important to note that if indeed the Canadian dollar continues to appreciate (a real possibility), real estate activity levels off (very likely) and elevated energy prices continue to squeeze the pricing power of consumers, then by 2007 we might be talking about rate cuts, not rate hikes.