Economic Commentary

June 17, 2002

Return to a Growth Path, Good Buy to Low Interest Rates

Canada surprises on the upside having narrowly avoided a recession

After following the US slowdown from the 4^{th} quarter of 2000 to the 3^{rd} quarter of 2001, during which it registered a contraction, Canada's economy turned the corner in the 4^{th} quarter of 2001 on the back of strong consumer spending and went on to consolidate these gains with a broad based expansion registering 6% at annual rates during the first quarter of 2002. By failing to contract for the customary two consecutive quarters it managed to avoid a recession. While the US economy also posted a 5.6% growth in the first quarter of this year, the quality of the growth figures in the US were much weaker. Whereas most of the growth in the US came from technical factors, i.e. a massive reduction in the rate of inventory depletion, Canada's growth came predominantly from a rise in final demand, which rose at 3.6% compared to only 2% in the US. The US did go through a recession, the first in ten years, but this recession was the mildest on record.

Underlining the comparative strength of the Canadian economy is the growth in employment. During the first five months of 2002 Canada's economy created a staggering 237,000 new jobs, a respectable showing for a full year, let alone five months, when the US economy continued to shed jobs until a paltry gain of 47,000 in April and May.

Obviously and as expected, the massive interest rate cuts, the well timed personal income tax cuts, the fall in oil prices and the low Canadian dollar proved successful in shielding Canada's economy from the recession. The fact that the dot.com and information and telecommunications industry collapse was not as focused on Canada as it was on the USA, coupled by the fact that Canada was not the target of the 9/11 terrorist attacks, also helped.

But US recovery remains tepid, dampening prospects for a strong expansion in Canada

Yet the prospects for continued strong expansion in Canada remain hinged on the performance of the US economy, our strongest trading partner which absorbs 85% of our exports. As indicated above, growth in the US economy has not been as strong and the pace of expansion remains uneven. For example, last week US consumer confidence as measured by the University of Michigan's June consumer survey plunged to 90.8 from 96.9 in May, that is the biggest drop since a 9.7-point drop in September, in the aftermath of the terrorist attacks. The growth in retail sales in the US continued to slow as industrial production at factories, utilities and mines registered the weakest gain so far this year.

As we have maintained in previous Commentaries, the strength of the US recovery is expected to be weaker than usual and the economic expansion will take longer to gain hold because the drop in US corporate profits has been the biggest since the Great Depression, the drop in capital spending has been precipitous and has yet to turn around while much of the growth in consumer spending last year, the result of 40-year low interest rates, has been borrowed from this year. With employment growth stalled, with security risks high, with the stock market bubble bust and record low savings rate, US consumers lack the strength to power a strong recovery forward.

The implication of the above for Canada is that if growth for the remainder of the year in the US remains sub-par it will dampen the expansion in our economy.

Bank of Canada begins to tighten monetary stance as US Federal Reserve remains sidelined

Yet in the face of strong economic performance, extremely stimulative monetary policy and stubborn core inflation, the Bank of Canada cannot afford the risk of rising inflation in 2003 and beyond, so it has indicated that it intends to keep on unwinding the monetary policy stimulus that was put in place last year to shield the economy from the contractionary effects of the terrorist attacks and the economic slowdown. On April 16th it broke paths with the Fed in being one of the first central banks in the G-7 to raise interest rates by a quarter of a percentage point and it did so again on June 4th. Since then, it has raised the target for the BOC overnight financing rate to 2.5% from 2.0%. As it stands right now and barring any major disappointments in economic developments, it looks certain that it will keep tightening monetary policy for the rest of the year back to a more neutral stance. This implies that in each of the next four rate setting meetings of the year it will most probably nudge interest rates higher by a quarter of a percentage point each time to bring them up to 3.5% by the end of the year. (The next four meetings are scheduled on July 16th, September 4th, October 16th and December 3rd). Although headline inflation declined to 1% in May from 1.7% in April, core inflation as measured by the Bank of Canada is running at 2.2%, above the mid-point of the 1-3% target range that it considers safe for the economy.

In the meantime, the Federal Reserve has kept the fed funds rate at 1.75% -a forty year low- and is not expected to raise interest rates until at least the August 13th FOMC meeting. This means that the Fed is most likely to sit through the upcoming June 26th meeting, and might postpone adjusting rates until September. As explained in previous Commentaries, the Fed will wait before it starts raising rates until a sustainable and meaningful economic expansion is underway. So far, the economy has yet to achieve these conditions. In the meantime with tame inflation, the Fed continues to have room to keep interest rates from rising.

How long can the Bank of Canada keep raising interest rates while the Fed holds them steady?

The Bank of Canada's mandate is to take whatever steps are appropriate to ensure price stability in Canada. Although its capacity to lower rates below the level prevailing in the US is limited by the repercussions such action would have on our currency, the opposite, does not apply. As long as it is not the US raising rates, the BOC has no limitations to raising interest rates above prevailing levels in the US. Thus even though the Fed has chosen to leave any rate increases on hold, the BOC is free to pursue the monetary policy stance it believes is most appropriate for Canada's circumstances.

This having been said, however, there are limiting forces at work. To the extent that sluggish growth in the US dampens growth in Canada for the rest of the year, a moderation in the rate of expansion later this year might persuade the BOC to pause the rate tightening process. Moreover, if the Canadian dollar appreciates against its US counterpart as a result of the growing positive interest differential in Canada's favour, that too might persuade the BOC to moderate its rate tightening stance. Either way, even if this scenario does unfold it will be some time before it registers on the economic indicators, which means that the odds that the benchmark target overnight rate will rise to 3.5% by the end of the year are quite high. On the other hand, although rates will rise somewhat further into 2003, I do not believe that they will have to rise as much as in previous rate hiking cycles or as much as markets anticipate them to rise right now. Somehow I sense that a combination of low inflation, high productivity growth and high consumer interest rate sensitivity will prevent rates from rising as much this time around, although only time will tell.

Global recovery is underway and US expansion should eventually take hold in the second half of the year

Aided with record low interest rates and inflation the global economy now seems to be on its way toward a complete recovery, with growth resuming in Japan, Europe and South-East Asia in addition to North America. Although the US looks more likely to follow than lead this new expansion cycle, most analysts expect that the US economy will grow sufficiently fast as not to threaten or derail Canada's expansion. However, this expansion will require additional help in the form of a lower US dollar.

But the US dollar will under-perform as other currencies recover

After rising continuously over the past seven years the US dollar now seems poised for a correction. First of all, the high US dollar has undermined the competitiveness of US manufacturers. Today, the US more than at any other time since the early 1990s needs a lower dollar to compete internationally. Second, and even more important is the fact that US-dollar denominated returns have come way down from their highs in the mid to late 1990s. As such global money managers are beginning to pare down their exposure to US-dollar assets and as they do capital inflows into the US have begun to fall. Sooner or later, reduced capital inflows will either provoke a recession or instead a drop in the value of the US dollar. Since February, the value of the euro has risen by more than 7% against the US dollar while commodity linked currencies such as the Aussie and New Zealand dollar have staged dramatic recoveries. We have also witnessed a recovery in the value of our own Canadian dollar, which has climbed from record low 61.5 cents in January to 65.5 cents in May.

And the Canadian dollar should shine

For the Canadian dollar to rise significantly and on a sustainable basis two factors must fall in place: First the stance of monetary policy in Canada must become more restrictive relative to that in the USA which implies higher positive interest differentials relative to the US and Second, a sustained global expansion should get underway that will increase demand for commodities and therefore raise commodity prices. For the first time since the late 1980s we can see prospects of both conditions being simultaneously fulfilled. As Canada's economy begins to outperform its US counterpart and as the wounds of the 1990s restructuring heal in Canada we do not need an expansionary monetary policy to keep the Canadian economy going. With sustainable public sector surpluses assured, Canada can re-balance its fiscal-monetary policy mix by loosening the fiscal while tightening the monetary. We have waited a long time for this day, but I believe that this day has finally come. I expect a significant and sustained rise in the value of the Canadian dollar to well above 70 cents by 2004.

Kenneth Matziorinis, Ph.D.
Canbek Economic Consultants Inc.