Economic Commentary

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Bank of Canada Confirms Improved Outlook for Canadian Economy

Yesterday morning the Bank of Canada released its semi-annual Monetary Policy Report that is issued every April and October. The Bank maintained its July forecast for economic growth this year at 2.0% but up-graded its forecast for 2004 to 3.25%, this is up 1/4 of a percent from its July forecast. It projects growth will average 3.0% in the second half of 2003. At the same time, the Bank projects that inflation will average 1.5% in the second half of 2003 and decrease to 1.0% for the whole of 2004, this is below the mid-point of its 1%-3% target range and it only expects the inflation rate to return to its target of 2.0 by the middle of 2005. Its inflation forecast is markedly lower than what it anticipated in its April report.

The Bank shied away from providing any indication of what it will do about interest rates, citing uncertainty over the conflicting effects that the appreciated Canadian dollar and the pick up in growth in the US and global economy will exert on Canada. For the text of the press release summarizing the central bank's report open the attachment below. In my view, what all this translates to is at best an increased probability of an additional cut in rates early next year or at least a reduced probability of raising rates until the end of 2004!

It is interesting that the Bank is beginning to show a more relaxed attitude over the contractionary effects of Canada's appreciating currency on domestic demand and production and seems comfortable that it should not derail Canada's growth prospects. Yesterday, the Canadian dollar registered a new 10-year high rising to 76.69 US cents from 75.99 the day before, this is a 20% appreciation so far this year.

Since the Canadian dollar started appreciating strongly against its US counterpart I have strongly maintained the view that we do not need to be overly concerned over its negative effects on our economy. In my May 7, 2003 Economic Commentary I argued that far from slowing down Canada's economy, to the contrary the rising loonie will lower Canada's rate of inflation and permit further reductions in short-term interest rates and this is exactly what has happened since then. Furthermore, I went so far as to argue that a stronger loonie is good for Canada because it lowers the cost of imported production machinery and equipment and increases the need for productivity-enhancing business capital investment expenditures, which stimulates demand and increases productivity. Moreover, I was the only economist who argued at the time that the level of Canada's currency is less important an issue than the rate of growth in the US, Canada's largest export market. Recently I have seen the

Royal Bank's chief economist arrive to this view and I now read that even the Bank of Canada, in its econometric model, shows that Canada's exports are less sensitive to the price effect of the currency but more sensitive to the volume effect of US and global economic growth. Thus, a lower US dollar (higher Canadian dollar) far from damaging Canada's growth prospects will actually support growth in Canada, because it stimulates US growth, which in turn is good for Canada! Now, I see that even the Bank of Canada is beginning to see the merits of this argument.

I have not been at all surprised by the dramatic ascent in the Canadian dollar. Even when it corrected from its 75-cent level I held the view that it was going to go above the 75 cent mark before the end of this year. Now I see it at 80 US cents by early next year and I would venture to say that don't be surprised if you see the Canadian dollar at 90 cents by the end of 2005!

What shapes my view on the Canadian dollar are the following arguments. First, the purchasing power parity (PPP) value for the Canadian dollar is between 78 and 82 cents anyway. This is what most econometric models estimate the "true" long-run value of the Canadian dollar to be. So, the dollar is only returning to a more reasonable valuation after years of being strongly undervalued. Second, what most “special interest”-driven commentators who fill the pages of newspapers and the airwaves don't comprehend, is that the value of the Canadian dollar is more the result of global forces outside the control of Canadian policy makers and far less the product of a "made-in-Canada" policy induced solution. Remember that Canada's economy accounts for about 3% of global GDP. With such a small, but open economy, we cannot really control the value of our currency. Third, the real culprit behind the recent advance in the Canadian dollar is the already weak and weakening, by-the-month, US economic fundamentals. The US has a huge problem of twin current account and budget deficits, which are only made worse by the Bush administration's multi-year tax reduction package, the war against terrorism and continued economic expansion. If the current account deficit already exceeds 5% of GDP, it will only rise if the US economy continues to expand.

Actually, to eliminate the current account deficit either one of the following three things need to happen: 1) the US economy contracts enough to reduce imports to the same level as exports; 2) the global economy expands dramatically so that US exports can rise to the same level as imports or 3) the US administration allows the exchange value of the currency to fall in order to stimulate exports and lower imports. Scenario 1) is out of the question; scenario 2) is not feasible. The only remaining option is to let the value of the US dollar fall. History shows that these currency adjustments work slowly and with long lags, which is to say that the adjustment is already late in coming, we are seeing only the beginning of this adjustment, and this adjustment will go on for many years, (like three possibly five or six years) and the exchange rate continues to depreciate even after the economy has returned to balance or surpluses. In other

words, be prepared for a long drawn-out adjustment period. In the meantime, one must understand the nature of the adjustment process itself. Currencies always overshoot, in either direction. Thus just as the Canadian dollar fell more than it should have in the 1990s, over the next few years it will rise more than it should, and this no one, not even the Bank of Canada can control!

Finally, now that Canada's fundamentals have improved so much, the rise in the Canadian dollar is a for told conclusion, For example, this morning the Finance Minister John Manley announced that for the fiscal year just ended Canada recorded a $7 billion budget surplus, making Canada the only country in the G7 to be in such a position. We continue to enjoy a healthy current account surplus, our external debt has fallen dramatically from 44% of GDP in 1994 to 18% in 2002, while the US external debt continues to rise dramatically. Domestic demand is now firing in all cylinders, with personal consumption, investment and government demand in full throttle. The adjustment process in the up-ward movement in the Canadian dollar will be eased by low if absent inflationary pressures and a very low cost of capital environment, both conditions, the result of the strong dollar. Facilitated with a pick up in productivity growth –which is always what happens when the currency appreciates- and a return to more stable political conditions, the result of the defeat of the separatist government in Quebec and a more cooperative environment in federal-provincial relations, the result of the election of Jean Charest in Quebec City and soon Paul Martin in Ottawa, the preconditions for growth and prosperity are at last in place for the first time in over 80 years.

If the above assessment sounds too optimistic, I need to let you know that over the last 25 years spanning my career as an economist I have never seen more favourable conditions put in place in Canada’s economy. If I am optimistic now, I was very pessimistic in the late 1980s and early 1990s, so me view is not a one sided or rosy view.

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