Economic Commentary

July 11, 2005

Bank of Canada to Maintain Holding Pattern, But Not For Long

The Bank of Canada is holding it's fifth meeting of the year tomorrow and is widely expected to hold the target key policy-setting overnight borrowing rate at 2.5%. On Thursday, July 14th it will issue its mid-year Up-date of the Monetary Policy Report where more clues as to its future moves should become available. Whatever the content of its statement will be tomorrow or Thursday, there is a lot of information out on the state of Canada's economy to allow us to predict that the end of the holding period is coming to an end. The odds of a resumption of the rate tightening have been steadily increasing with each new economic report, which have shown that Canada's economy is performing better than the central bank itself had forecast back in April.

Last Friday Statistics Canada announced that Canada added 14,200 new jobs in June which brought the unemployment rate down to 6.7%, the lowest level since June of 2000 –a 29-year low! Canada has been expanding steadily since April, 1991 and has entered it's 15th year of uninterrupted economic expansion, the longest in the history of the country! With stronger than expected output growth in April, a pick-up in the index of leading economic indicators, the Canadian economy is on course to record a strong second quarter. Although the numbers will not be fully available until August 31st , the prospects for continued growth until the end of the year and beyond are looking much better. The foreign exchange market, looking at this favourable picture, have pushed the value of the loonie higher, above the US 82 cent level for the first time since the end of March.

Also last Friday the Royal Bank of Canada issued its latest forecast on Canada's economy. It concluded what I have been saying for some time, that the domestic side of Canada's economy is strong enough to counter the dilution of its net export sector from the rising loonie and slowdown in the global economy. To quote from the report, "Canada's domestic economy has been running at full speed mitigating the drop in net exports". "Pent-up demand accumulated in the 1990s, a favourable interest rate environment, a solid labour market and rising corporate profits have pushed growth in consumer spending and business machinery and equipment investment to near decade highs". It forecasts 2.7% growth in 2005 and 3.2% in 2006.

Canada’s economic position stands in stark contrast to that of the United States. After having gone through its own “vicious cycle” in the 1990s Canada’s economy this decade has entered a “virtuous cycle”. Public sector surpluses, falling public and external debt levels, trade surpluses and low inflation have led to lower interest rates, strong growth and a rising currency. The appreciating dollar keeps inflation in check and allows the central bank to maintain interest rates below levels in the USA while budget surpluses and strong corporate profits have increased the nation’s saving rate as a share of GDP, making Canada less dependent on the rest of the world and therefore more resilient to face international economic and financial crises. The high price of oil, given Canada’s position as a net energy exporter, has only added to the above strong picture. When the next global slowdown occurs, which is not a matter of if but when, Canada’s economy will be much better equipped to deal with the slowdown. Why? Because there is now lot of room for our currency to fall, mitigating the drop in exports, there is room for interest rates to fall, and there is room for the public sector to go into deficit by raising spending and cutting taxes.

In the meantime, as the Canadian economy strengthens further, the Bank of Canada can afford to start taking out gradually some of the monetary policy accommodation it put in place in concert with the Fed and other central banks in 2001, without unduly damaging economic growth. It now looks almost sure that the Bank of Canada will resume its drive to move interest rates to a more neutral setting at either one of the next two meetings, either the meeting of September 7th or that of October 18th. It is highly unlikely that it will wait for the December 6th meeting. By and large, economic analysts are seeing two quarter point hikes by the end of the year, which will bring the overnight rate up to 3.0% by December, compared to a 4.0% prediction for the fed funds rate south of our border.

As far as long-term interest rates are concerned, however, the picture is a lot less clear. At the end of last year virtually all analysts called for a rise in the 10-year bond yield towards the 5% level. Instead, after making an attempt to rise, bond yields fell back to the 4% level where they remain until now. The normal pattern would have been for the long-term rates to rise, as they usually do in the early stages of central bank tightening.

This “conundrum” or unexplained pattern has been the biggest surprise of the year as far as capital markets are concerned and it has led to much debate as to its causes. Either, the cause is structural, meaning the result of the imbalance in the structure of global currency values, largely the result of China’s currency peg to the US dollar which impedes the normal equilibrating trade adjustments and accentuates the build-up of US currency reserves by South-East Asian banks which are then re-invested in US government securities, thus keeping prices of US treasuries high and yields low. Or, the cause is functional, meaning that the fixed-income markets are anticipating an economic slowdown and a drop in inflation and are pricing it in the yields. If the first explanation is the cause, one should expect a jump in bond yields sooner or later, but the time path

of this adjustment is impossible to call at this time given the unpredictable nature of structural shifts. If the second explanation is right, then we should not expect an upward move in yields beyond the 4.5% level in the near-term. If anything, should this be the case, as I have argued in my previous Commentary, the drive by the Fed to return short-term rates to a more "neutral" 4% level may be unwarranted and potentially damaging to the US and global economy.

Turning to our dollar, one must express amazement as to it's ability to rally above the 82 cent level after having fallen below the 79 cent level this past May, and this despite the increasing negative differential between Canadian and US rates which is now a negative 75 basis points and about to rise to –100 points once the Fed tightens again on August 9th. One is left to imagine how much higher our dollar would have risen had our central bank not chosen to put on hold its rate tightening plans.

Looking forward, the up-ward march in short-term rates in the US coupled with a slowdown in the global economy and a resulting easing in oil prices, together, should take much of the wind off the Canadian dollar. But one must remember that if the US economy starts slowing down faster than anticipated, this too will take most of the wind off the US dollar as well. Given Canada's stronger fundamentals, this may mitigate downward pressure on the loonie and could push it even higher. In the long-run it is fundamentals that rule and one should think twice before betting against Canada's strong position.

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