

Economic Commentary

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FED DECISION AND IMPLICATIONS FOR NORTH AMERICAN AND GLOBAL ECONOMY

The Fed met yesterday and decided to leave the benchmark fed funds rate unchanged at 1.25%, as expected. What was not so clear was what the Fed would do with its rate bias statement. It stated that its rate bias is that the risks of deflation exceed the risks of inflation in the months ahead, which means that it is predisposed to cutting rates further. Its next meeting is on June 25th. Unless the US economy shows firm signs of recovery and economic rebound, it can be expected that the Fed will cut rates at its next meeting.

At the same time the US dollar depreciated against all major currencies yesterday and continued its recent downward trend. It has lost the most against the Euro which now stands at 1.14, it lost against the Australian and New Zealand dollars, the Mexican peso, the Swiss franc, the British pound, the Japanese yen and of course, the Canadian dollar, which made a new high yesterday rising above \$0.72 in intra-day trading and closing at 0.7182, gaining a full cent so far this week. Obviously, it is not only the rising Canada-US rate differential which is at work here, it is also US dollar weakness, which will continue into the foreseeable future.

From a big picture standpoint, one should not be surprised by what is going on. What is happening is that the US dollar is returning to a more normal valuation and un-winding the 30% gain it staged in the late 1990s against all of the world's currencies, when the greatest bull market of the 20th century was raging on Wall Street. I expect that the US dollar will continue to correct itself coming down from the unreasonable highs that it reached in the late 1990s. At last, currency valuations are going back to more reasonable levels.

Looking ahead one must ask, what does this mean for the euro, the yen and the Chinese yuan? Dollar weakness will undermine Japanese exports to the USA and will put downward pressure on the yen, which remains increasingly vulnerable to depreciation. It will put up-ward pressure on the Chinese yuan, the effects of SARS notwithstanding. As far as the euro is concerned, it will continue to trend up-wards, making the Euro-zone less and less competitive. The European Central Bank (ECB) should cut rates in Europe A.S.A.P. to stimulate domestic expansion. As the US dollar continues to fall, US goods in Euro markets will become mighty competitive and bring about an "invasion" of US goods, which following events in Iraq will force a "regime change" in the structure of Europe's corporatist-socialist system, especially in its inflexible labour markets. Europe cannot continue to have it both ways, be capitalist and socialist at the same time.

As far as Canada is concerned, the good news in all this is that it will set in motion the "virtuous circle" of high currency and low interest rates that made for the great economic expansion of the late 1990s in the USA. The Bank of Canada now has the higher dollar doing all its dis-inflationary dirty work and does not need to raise interest rates any more. I do not see much more than a 1/4 point rise in rates in Canada for the rest of the year, if any. By being pro-active, David Dodge in raising rates in Canada early on this year, he has facilitated the resurgence of the Canadian dollar, which is now putting downward pressure on Canadian prices. How far can the loonie go? To 75 cents and beyond over the next year and a half. Will this undermine the competitiveness of the Canadian economy? Yes, of course it will, but at the same time it will force Canadian manufacturers to restructure by investing more on productivity-enhancing equipment which will boost demand for capital goods, it will enhance productivity growth, and make our economy more productive and raise our living standards - at last. Falling inflation, cheaper US-made capital goods in combination with low interest rates and an expansionary fiscal policy should produce a boom in Canada over the medium term. Am I worried about an economic slowdown from a weak US economy and a stronger Canadian dollar? No, because the above-mentioned factors will off-set the effects of the more expensive dollar and the Canadian economy will become more propelled by domestic demand. I see higher output growth, slower employment growth, higher productivity, yet falling unemployment rates and lower inflation. It will become great again to live in Canada!

For Canadian manufacturers who complain about the negative effects of a rising dollar, I have this to say. What did you expect? That the Canadian dollar would stay so low forever and give you an easy ride on world markets? You should have used the chance you had over the last few years to invest in productivity enhancing equipment. If you did not, now you only have yourself to blame. But, then again, it is never too late, you just have to do it the hard way now.

All this also bodes well for Canadian asset prices. I think that international capital will continue to flow into Canada pushing up equity and fixed-income prices, putting downward pressure on the long end of the yield curve, which would make it a good time to increase exposure to Canadian government and selective corporate bonds.

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