

PERSPECTIVES

A REPORT FOR CLIENTS OF TD PRIVATE CLIENT GROUP - PRIVATE INVESTMENT COUNSEL

Policy Prescriptions for the Loonie

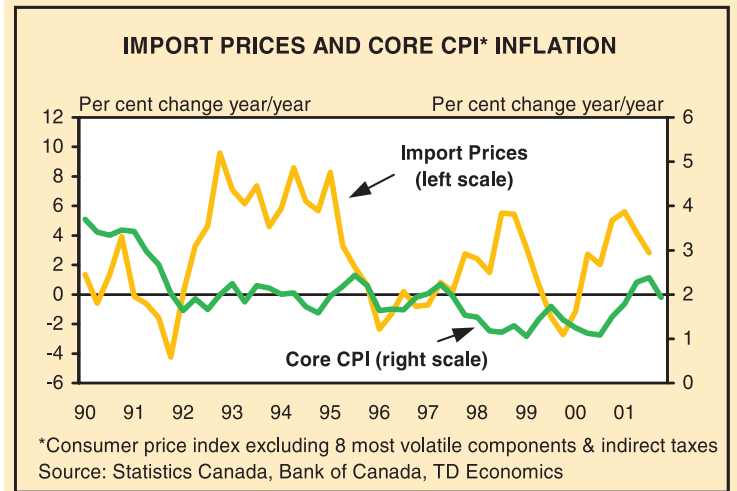
With the Canadian dollar dropping below 62 U.S. cents, there have been widespread calls for the Bank of Canada and the government to bolster the loonie. Although the cry for action has been loud, the demands have rarely included policy recommendations, illustrating that there are no simple and immediate solutions to what ails the Canadian dollar. This begs the question, what should and can be done?

The Bank of Canada's dilemma

The problem for the Bank of Canada is that its primary mandate is to ensure price stability and the weakness in the Canadian dollar is not feeding through to create significantly higher consumer prices. *Although the currency depreciation does increase prices for imported goods, many Canadian importers are not passing the additional costs on to the consumer, with the result that inflation remains under wraps.* Of course, the Bank does not focus on current inflation rates, but sets policy in terms of where inflation will be in roughly twelve months time. According to the communiqué accompanying the last rate cut on January 15th, core inflation is expected to average just under 1.5 per cent in the second half of 2002. Given the Bank's two per cent inflation target – the mid-point of its 1-3 per cent target band, there are clearly no inflation risks from the currency to prompt a policy reaction.

Higher rates could weaken currency

Even if there were greater import price pressures, it is not clear what the monetary policy remedy for the currency would be. The primary policy tool available is changes in the Bank's target overnight rate. *In the past, positive interest rate spreads were considered supportive for a currency, as higher relative returns on fixed-income instruments attract foreign money into the assets denominated in the local currency. But times have changed.* The recent performance of the euro is a perfect example. The European Central Bank (ECB) was slow to cut rates last year, with the result that the spread between overnight rates in the Eurozone shifted from 175 basis points below that in the U.S. to 175 basis points above. However, the widening interest rate differential failed to boost the euro, for as the Fed slashed rates, global investors concluded that the U.S. economy would recover sooner and would provide better profit opportunities than the Eurozone.



A similar explanation was used to explain the most recent dip in the Canadian dollar. Prior to the Bank of Canada's January 15th policy announcement, markets began pricing in a 50 basis point cut. However, the Bank disappointed those expectations with only a 25 basis point rate reduction and released an optimistically worded communiqué that hinted the easing cycle was drawing to a close. This seemed at odds with comments from Fed Chairman Greenspan on January 11th, which suggested that significant risks remain to the U.S. economic outlook. It also looked complacent at a time when Canadian job losses were mounting. *Accordingly, it has been suggested the Bank's less aggressive easing contributed to the weakness in the loonie. The implication is that higher interest rates would do nothing to support the Canadian dollar and the negative impact on the economy would likely add to the currency's woes.*

Meanwhile, it is not clear that further rate cuts will boost the Canadian dollar. The Bank has already delivered 375 basis points of easing, taking the overnight rate down to a mere two per cent. Recent robust housing and consumer spending data already show the positive impact of the Bank's prior actions. Although the Bank was slightly slower in cutting rates than the Fed, it is utterly unfair to characterize policy makers as being complacent. Certainly, the decision to cut rates by only a quarter point in January will have a negligible impact on the economy, as none would argue that 400 basis points of easing will fuel a recovery, but 375 will leave the economy in recession.

Currency intervention won't help

Some have suggested that the Bank should sell some of its considerable stockpile of U.S. dollar reserves to strengthen the loonie. While such a policy could cause a momentary jump in the exchange rate, its effect would prove short-lived. At times when the Canadian dollar is weakening sharply, intervention can be effective by causing foreign exchange traders to pause for thought as to whether what is happening in markets is rational. **But when the currency is weakening gradually, as it has recently, traders have little reason to question the value of a currency as determined by millions of investors. Furthermore, intervention is risky, as it can lead to speculative attacks, as investors bet against the ability of the Bank to maintain a given level.** In the past, such attacks have often been quelled only by rate hikes, to the detriment on the economy.

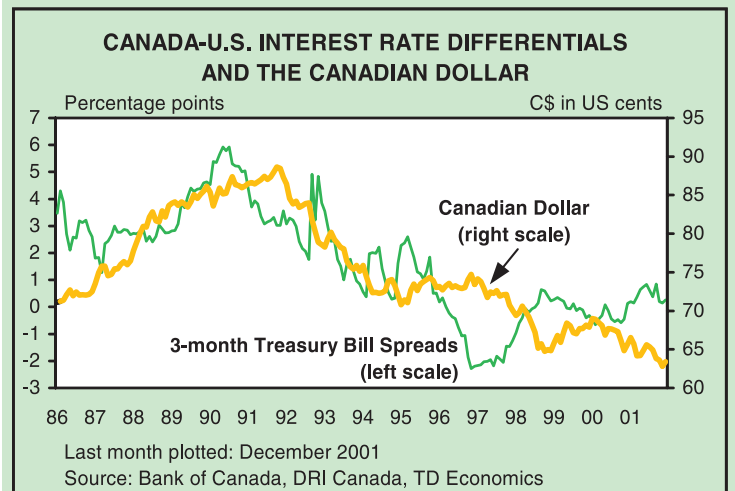
Verbal intervention

The government and the Bank have also been criticized for not pursuing a 'strong dollar policy' similar to the U.S. Treasury. However, such complaints never explain how statements desiring a stronger currency translate into a better exchange rate. The statement that the U.S. is in favour of a strong dollar simply indicates that it will not intervene in markets in response to signs of strength. Since the U.S. dollar has been remarkably strong, the policy has been extremely successful because it required no government action. History suggests that verbal intervention will do little to change an exchange rate unless backed up with some action, but as discussed above, it is not clear what immediate policy response would rally the loonie.

Course of action

Given the limited options, what action should be taken?

Finance Minister Martin has been providing verbal support to the currency by indicating that the government feels the currency is undervalued and that the current exchange rate does not reflect the country's economic fundamentals. This is a positive development, as it costs the government nothing and reverses the perception that officials in Ottawa believe that an ever-weaker currency is good for the country because it boosts exports.



However, the government's and the Bank's ability to bolster the loonie in the near-term are severely limited. Talking up the currency and signaling that policy makers will do everything in their power to fuel an economic recovery is the best short-term prescription – but the effect will likely be minimal. Over the long run, the government needs to go further in introducing policies aimed at bolstering Canada's productivity relative to the U.S., as such policies will increase Canada's standard of living and make the country more attractive to investment.

Implications for the Loonie:

- 1) Higher interest rates may hurt the economy.
- 2) Lower interest rates may help, but the Bank of Canada has already made appropriate decreases.
- 3) The best solution is for the government to implement long-term economic growth policies.

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