SOCIETY OF ACTUARIES

Article from:

Risks and Rewards Newsletter

October 1998 – Issue No. 31

What One Can Learn from the Bank of Canada

by Nino Boezio

Canada, like many countries, was considered to be a dramatically rising star in early 1997. Even though it, like most of the Western world, was a debt-laden country, it took major steps to cut spending and bring its fiscal house in order. And as with most, falling interest rates helped alleviate its debt problem as less of its fiscal budget was required for debt financing. Canada, like Europe, was being seen as a late bloomer from the severe recession of the early 1990s and, hence, it had a lot of fast catching up to do to the United States and the United Kingdom. Even though taxes were still high, this was not seen as a major impediment in a world where Canadian industry and exports would soon be in full gear. High unemployment and weak consumer demand in preceding years meant that wage pressures and inflation would not materialize for a very long time. This combination of fundamentals overall suggested that Canada would have economic growth possibly higher than any of the other G-7 nations in the coming years. It was also increasingly being suggested that the Canadian dollar ($Can) could eventually rise above 80¢ U.S. by 1998 or 1999.

The Asian crisis helped to change all that, as it has for most of the world. Even though still in trade surplus, the Canadian surplus fell greatly because of falling commodity demand. The fundamentals for Canadian companies no longer looked as good, particularly when approximately 40% of Canadian exports are commodity-related.

Because fundamentals were no longer as attractive (as can also be said for the Asian and South American economies, Australia and Eastern Europe) less foreign investment took place, leading to a falling currency. And even though the falling currency was mainly tied to weakening fundamentals (and strong fundamentals underlying the U.S. dollar driving up that currency) the Bank of Canada tried to fix the problem through monetary mechanisms.

Short-term interest rates in Canada were much lower than that of the United States in early 1997. Call money was at 3% p.a. whereas the equivalent U.S. Fed funds rate was at 5.5% p.a.. This rate was lower because the Canadian economy was still perceived to be in a much weaker state of growth than its U.S. counterpart, and hence required more monetary stimulus.

When the Asian crisis took center stage in the fall of 1997, the Canadian dollar began to sag and approached the psychologically important level of 70¢ U.S. Even though all other commodity-based currencies were suffering much more (the Australian currency that was initially higher in value to the U.S. dollar than $Can but was now already trading in the 65¢ range) the Bank of Canada refused to accept this worldwide phenomena and "drew a line in the sand."

It first approached the problem by selling its foreign currency reserves to buy Canadian dollars which only provided temporary relief. Then by ill-advised advice from various economists who claimed that short-term money rates were too low relative to that of the U.S. and should be increased, the Bank raised its call money rate to 5%. It is difficult to say whether this rate rise slowed the Canadian economy down significantly, but it can be noted that major gains in economic growth and declines in unemployment halted soon after. This is also somewhat puzzling considering that the Canadian and U.S. economies have historically been closely-linked and tend to prosper and suffer together at a similar magnitude.

The currency eventually broke below 70¢ U.S. and the Bank was reluctant to raise rates further without endangering the economy. It spent billions of dollars in foreign reserves and used borrowing and the selling of securities to buy $Can, to little ultimate avail. Each successive intervention was also increasingly unsuccessful and currency speculators became no longer afraid of the Bank. Currency traders began to realize that economic fundamentals "rule" (one can read my article "Does Raising Domestic Interest Rates Strengthen A Currency?" in the Sept. 1994 issue of *Risks and Rewards*) and that any attempt to prop up the dollar by the Bank would be met by renewed selling and even lower currency values, unless economic prospects were improved. Also, the wisdom behind Bank intervention was increasingly coming under attack as outdated and inappropriate and thus the Bank was losing credibility very quickly.

It was also difficult for the Bank to change its image. It would claim that it no longer cared or would let the currency float more freely, but everyone knew that the Bank would try to strike periodic blows to short-sellers. It was also rather confusing when the Canadian Prime Minister would claim that the falling dollar was good for the economy in that it would stimulate exports and thus no further Bank intervention was necessary, only to find the Bank intervening a few days later.

When it was finally acknowledged that the fundamentals of the Canadian economy had to be changed and that currency free-fall was just a symptom, there were some offers to the Canadian public of all-round tax cuts to stimulate consumer demand. High taxes were an issue of contention for years but it was suspected that the Federal government was partially unwilling to cut taxes (even though it could afford to do so) because it wanted to give such "goodies" away in a future election year. As

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a result, the government lost the initiative and was finding itself becoming reactive rather than proactive to the currency crisis. Unfortunately, economic confidence had been so badly shaken that such an approach would not likely produce too much in the way of positive results in the near-term. The tax-cut announcement was met with a further decline in the $Can, which was a combination of scepticism, too-little-too-late, or just worries about the prospects for further debt reduction if the tax cuts were made. It would not be a quick fix. It also still has to be realized that Canadian fundamentals, like those of most countries today, are largely affected by what is occurring in the global village and any attempt to divorce an economy from such impacts is difficult, if not impossible.

Summary

Hopefully the Bank of Canada, and any other foreign central banks that have responded to currency declines by intervention or interest rates, is learning that these are only short-term solutions and are probably much more short-term than was the case in the past. The currency markets today are much larger and therefore market forces will reward and punish its players more swiftly. A financial body cannot force a certain price or currency level to be accepted without adverse consequences elsewhere. Unfortunately, these should have been lessons learned from bygone eras. As pointed out in *Grant's Interest Rate Observer* (August 14, 1998, pg. 3) "raising interest rates and tightening monetary growth in the face of an economic downturn are the very policies that the modern age was presumed to have outgrown (How many of today's policy makers read the history of the Great Depression in graduate school and shook their heads at the sheer blockheadedness of the central bankers who had put up a discount rate to defend a gold-exchange parity?) Yet such policies are the very ones being widely implemented today."

A currency is only as strong as its economy even though there may be swings in the short term. If investors want to go there, businesses want to invest and sell there, people are buying there, and the tax and politic climate is accommodating, then a strong currency will follow. That is why everyone at the time of this writing wants $US. Only when the mood changes can the currency experience a major shift in value against other currencies. The only sign of strength in $Can (after it fell to 63 cents) was apparently when commodity prices stabilized or moved up.

Nino Boezio, FSA, is a Principal at Matheis Associates Benefits Consultants, Inc., in Pickering, Ontario.