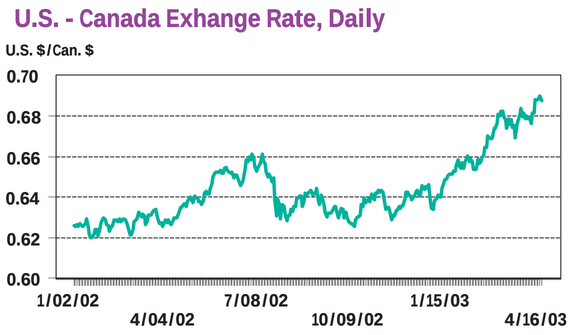
Weekly economic Briefing

VOLUME 9 . NUMBER 15 . APRIL 17, 2003

Canadian dollar hits three-year high

A widening interest rate spread between Canada and the U.S. continues to boost the value of the Canadian dollar, and has put the Canada-U.S. exchange rate at a three-year high of 69 cents. The recent Quebec election result may have also lifted the dollar, but the interest rate spread is the main catalyst, since short-term capital or money flows are attracted by higher returns. A rising exchange rate has a negative impact on Canadian and B.C. exports, and it lowers the cost of imported U.S. goods and services. On balance, it is negative for B.C.'s economic growth.

Canadian dollar appreciating



Source: Bank of Canada.

There is every indication that the Canadian dollar will make further gains and break the 70-cent mark in the near future. Canadian short-term interest rates will be rising while comparable U.S. rates are expected to remain fairly flat, thus further widening the rate spread. The U.S. current account deficit will remain large and depress that currency's value.

Once U.S. interest rates begin to rise, later this year at the earliest and most likely in 2004, the rate spread with Canada will narrow and that will reduce the attractiveness of the Canadian dollar, causing some depreciation. In the meantime, though, the Canadian dollar is headed higher.

The rising dollar slows demand for Canadian exports by making goods and services imported by Americans more costly, and this works its way through the domestic economy. Also, since the U.S. dollar functions as the world's currency, most internationally traded commodities are priced in U.S. dollars. Thus, when B.C. lumber, pulp, and energy exporters convert those sales back into Canadian dollars, they will receive fewer dollars and that hurts their bottom line.

Weekly Economic Briefing is written and produced for B.C. Credit Unions by the Economics Department, Credit Union Central of British Columbia.

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A rough estimate of the impact of the rising exchange rate on B.C.'s economic growth is that a 10% rise against the U.S. dollar will cause a 1% drop B.C.'s real GDP growth rate. It results in less employment, a higher unemployment rate, and a larger trade deficit (fewer exports and more imports) in B.C., as well as hurting most domestic economic sectors. The Canadian dollar so far this year has averaged 66.6 cents U.S., compared with last year's 63.7 cents average. It appears that an average near 69 cents is likely for all of 2003, which is about an 8% increase and could reduce real GDP growth by 0.8%.

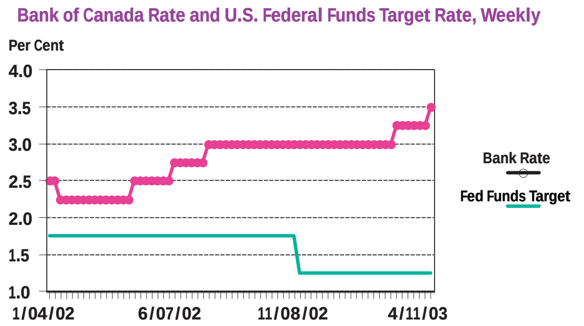
One benefit of the rising exchange rate is that domestic interest rates do not have to rise as much. Since a rising exchange rate slows export and overall economic growth, the Bank of Canada will not need to raise interest rates by as much to achieve its inflation target.

The Bank has created a Monetary Conditions Index, which combines the effect of interest rates and the exchange rate, to gauge the overall degree of monetary ease or tightness that's required. A 3% change in the exchange rate is equivalent to a one-percentage-point change in short-term interest rates. Since the beginning of the year, the exchange rate index used by the Bank has risen nearly 8%, or the equivalent of 2.5% in the short-term interest rate. The full impact of the higher exchange rate is felt over time and this factor should loom larger in the Bank's decision-making at future rate-setting meetings.

Bank of Canada raising rates

Further monetary tightening by the Bank of Canada is expected this year, with another increase likely at the next rate-setting meeting on June 3. Above-target inflation against a back-drop of a near full-capacity Canadian economy, coupled with expectations of renewed economic growth both here and abroad later this year and in 2004, will be enough to move the Bank. Similar reasons were put forward by the Bank for its recent rate-setting announcement on April 15.

Central banks on different paths



Source: Bank of Canada. Latest: Week ending April 18

Another change would put the prime lending rate at 5.25% in June, up from its current 5.00%. That would be the third increase this year and the sixth since the tightening phase began in April 2002. And, it will probably not be the last increase this year. We look for another two hikes of one-quarter percentage point each after June's hike, putting the prime rate at 5.75% at year-end.

In 2004, the Bank will not be raising rates as frequently, since rates are approaching normal levels in relation to economic growth and inflation and the higher exchange rate will help restrain inflation pressures. Rates fell to abnormally low levels following the 9/11 shock.

The situation is much different in the U.S., with the Federal Reserve Board holding rates low and unchanged. While the Bank of Canada was raising rates last year, the Fed was cutting rates to stimulate the economy and to ward off deflation. These divergent central bank actions have resulted in the widest spread between the Bank rate and the Fed Funds target rate since the mid-1990s. It is now 2.00%, in contrast to the roughly 1.00% average spread since 1990. A wide interest rate spread with the U.S. causes the Canadian dollar to appreciate, and a further currency appreciation is expected in the coming months.

U.S. housing starts rebound in March

Residential construction in the U.S. rebounded in March from a cold weather and war-related lull in February. Housing starts totalled 1.78 million units on a seasonally adjusted annualized basis. U.S. starts are on a rising trend, with March's figure up 8% from February and up 6% from a year earlier. Both single-detached and multi-family starts rose in March.

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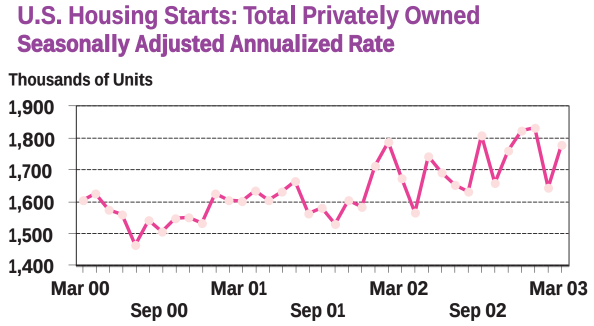

Source: U.S. Bureau of Census.

Low inventories of existing and new houses for sale, together with continuing low interest rates, are driving the upward trend in residential construction. The on-going bear market in business investment is also raising investment demand for residential property. As expected, residential property prices are rising faster than the overall inflation rate.

The strong pace of residential construction is expected to continue for several months, before waning somewhat as the year progresses. Mortgage rates are expected to rise, leading to a slowdown in property sales. Building permits issued in March dropped 7% from February.

Little upside in lumber prices

Despite strong housing construction and renovation markets in both Canada and the U.S., lumber prices remain low. The problem is supply, as excess sawmill capacity and production in North America as well as competition from offshore imports continue to put downward pressure on lumber prices.

The Canadian dollar price of standard western spruce, pine and fir lumber averaged about $335 per thousand board feet in the first two months of 2003. That's down $57 (-15%) from the same period last year. Standard lumber prices are expected to remain soft, with little upside, through 2003.

Meanwhile, the quantity of lumber produced in B.C. continues to rise, following an 11% increase in 2002. B.C. sawmills have, in general, produced more lumber since U.S.-imposed quotas on Canadian softwood exports were replaced with duties in 2001. Timber prices in B.C. have dropped to reflect low lumber prices and the impact of export duties.

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