



Bank of Canada not moved by dollar surge

The Bank of Canada opted for a wait-and-see approach to setting interest rates at its October 15 meeting, citing stronger economic growth and tame inflation ahead. The Bank acknowledged the potential negative impact of the higher exchange rate on exports but it was not moved to act.

Instead, it will monitor the situation. The Bank is counting on stronger external growth to offset some of the negative impact on exports from the higher currency, and on a stronger domestic economy. Some rebound from the depressed shocks-related economic activity is to be expected, but the Bank's forecast requires a stronger U.S. and global economy and a rather limited net negative impact on exports.

The Bank has one target in mind -- 2% core inflation. It does not have an economic growth target or an exchange rate target. This does not mean that growth or the exchange rate are unimportant; they are to the extent that they impact inflation. The Bank's current assessment is that growth is strengthening, so why cut rates and jeopardize the inflation target with a potential overshoot? The Bank can always cut rates in the future if needed.

One implication of not changing rates is a higher Canadian dollar -- at least until the Canada-U.S. rate spread narrows. The dollar will probably rise to 77 cents U.S. in the next four to six weeks and that will see the Bank facing another tough decision at its December 2 meeting. But judging by the October 15 decision, the Bank will not cut rates at that time either, unless there is growing evidence of slower economic growth. The Bank expects above-potential growth in Canada, strong domestic demand, and a U.S. recovery to offset some of the negative impact on exports.

The Bank's economic forecast calls for over 3% growth for the balance of 2003 and for 2004. This is above the Bank's estimate of potential growth and would close the output gap sometime in late 2004. By then, the economy's excess capacity accumulated in the first half of 2003 will have been used up and inflation pressures will potentially materialize, and that is what the Bank is looking at now, given the time lags involved.

The higher dollar tightens monetary conditions and the Bank is willing to let the currency do the tightening at this time. No one, including the Bank, knows the precise net impact of the higher currency on the economy, so it is taking a cautious approach, true to the nature of a central banker.

Dollar heading higher

The Canadian dollar broke through 76 cents U.S. for the first time in ten years and appears headed for 80 cents U.S. Several factors are pushing up the Loonie. First and foremost is the depreciating U.S. dollar in the context of a positive Canada-U.S. rate spread. That's followed by higher commodity prices and expectations of stronger Canadian economic growth. These forces are expected to remain in effect during the next few months, thereby driving up the currency.

The rising dollar will hurt exports over time. It may take two years to feel the full impact of the higher dollar, particularly its positive effects, but this year's rapid appreciation is akin to a currency shock and its negative short-term effects will appear fairly quickly.

The revenue impact is immediate for any export product priced in U.S. dollars when converted into local currency. These exporters will have to make some immediate adjustments, while honouring existing contracts. The larger adjustment will come when those contracts expire and some exporters, particularly commodity exporters, find themselves priced out of the market due to the higher currency. That's when the full impact will be felt.

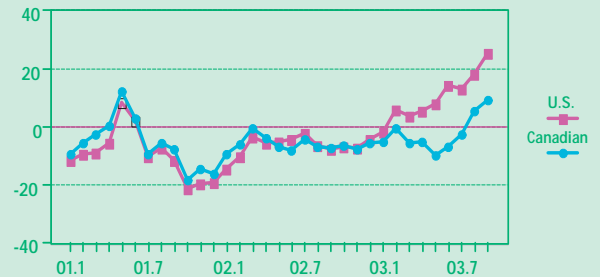
Fortunately, some offsetting effect is coming from higher commodity prices and growing demand in the U.S. and other countries. How the volume and price gains will stack up against the appreciated currency is debatable. Some rules of thumb that relate currency changes to changes in exports see this year's 15% gain (using the C-6 trade-weighted index) causing a 15% to 20% drop in exports over time, with all else remaining constant. Of course, other factors do not remain constant and we will not actually see that kind of drop, since global demand and commodity prices are expected to rise.

There are positive effects related to a higher currency, namely a lower price for imported U.S. goods and services, which helps some businesses and consumers in general. A lower rate of inflation is possible and, therefore, so are lower interest rates, which would benefit all borrowers. For manufacturers, the cost of machinery and equipment from the U.S. would be lower and help them to modernize and expand facilities, thus enhancing efficiency and productivity. Over time, this would boost investment spending and economic growth.

Commodity price gains lower in Canadian funds

Commodity Price Index in US and Canadian Dollars, Monthly

Per Cent Change



Note: Industrial materials index, excludes energy and foods.

Vehicle sales slip in August

Total new vehicle sales in B.C. during August fell back after robust sales in July. Sales incentives continued in August, so the drop was due to other factors. Most of the drop was in the passenger vehicle category, with commercial vehicle sales holding up. This has been a tougher year for new car dealers, with sales down across the board. Slower economic growth and higher unemployment are contributing factors.

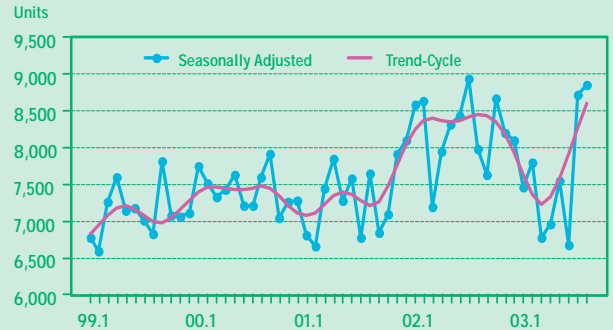
Passenger vehicle sales are down 7% so far this year versus the same period last year. Except for July's spike, the monthly sales trend has been negative. This year will see the first drop in sales since 1998. (Passenger vehicles are defined as those whose primary function is to carry passengers, excluding those classified as commercial vehicles. The definition includes cars used for commercial purposes, such as taxis, rental cars and other fleets.)

Commercial vehicle sales are faring about the same, with sales down 8.3% this year. The distinction between passenger and commercial vehicles is blurred by the inclusion of minivans and sport-utility vehicles in the commercial definition. According to Statistics Canada, commercial vehicles include light and heavy trucks, minivans, sport-utility vehicles, vans, coaches and buses, regardless of their intended use.



Commercial sales held up

BC Commercial Vehicle Sales, Monthly

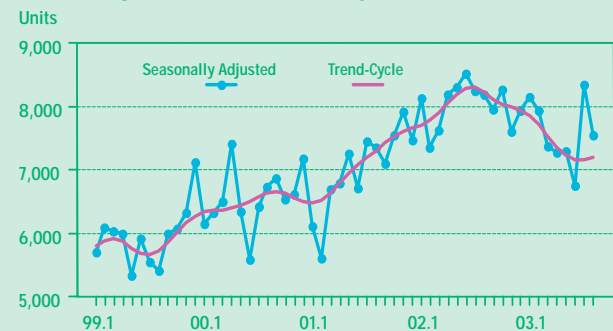


Source: Statistics Canada, CUCBC.

Latest: August

August sales down after July's spike

BC Passenger Vehicle Sales, Monthly



Source: Statistics Canada, CUCBC.

Latest: August