Ignoring the Noise

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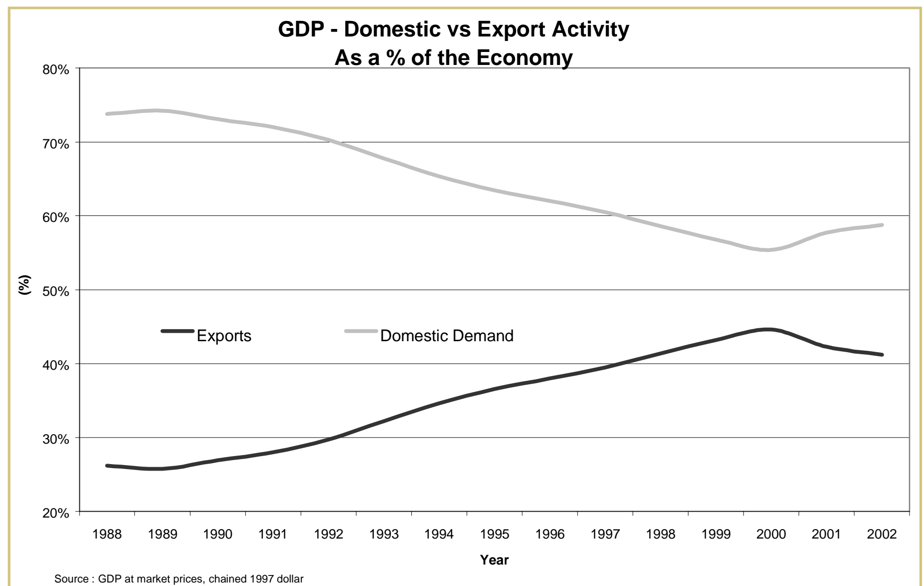
As the world goes through war, viruses and pestilence, and while economists and traders try to figure out whether the economy is cooling off or inflating, Canada's domestic economy keeps chugging along. The consumer and small business owner still likes what they see. Vibrant job growth, increasing purchase power and lower taxes seem to have driven the consumer housing boom and Canada's small business expansion. But most importantly, the interest rate picture is becoming clearer to these two groups. During the past 10 years, the small business sector has witnessed the trials and tribulations of the Canadian economy, as well as the rise and fall of interest rates. Unfortunately, they always had a problem committing to expensive capital expenditures because of the erratic nature of interest rates. Until recently, interest rates have been neither stable nor low. But the landscape has changed.

Back in 1995, when former Finance Minister Paul Martin was drastically cutting the deficit due to the excesses of the past, the economy was teetering on the brink of recession. To attract the capital needed to fund the deficit, interest rates were raised. But it didn't stop there. Government lowered its spending and raised taxes. The rest is now in the history books. The Canadian economy underperformed vis-à-vis the U.S. considerably. From 1993 to 1997, the average Canadian GDP was 2.4% vs. a robust average U.S. GDP of 3.4%. Until 1998 – since Canada had to prove to the international community that it was serious about the chronic deficit—the economy paid a heavy price.

After 1997, a curious event happened: we started paying down our debt, and at the same time started to "take back" our bond market. We decided not to rely upon foreign investors to bail us out. This had huge implications. Real rates started to fall and our interest rate market started trading on fundamentals and not on supply/demand issues. The final proof was post-September 11, 2001.

Prior to 9/11—whether it was the Bank of England devaluation crisis in 1992, the Mexican Peso crisis in 1994, or the Asian meltdown in 1998—there was always an international "run" on the Canadian dollar and a large spike in interest rates. The uncertainty caused by this inevitable scenario stalled the economy and delayed decisions on long-term capital expenditures. After 9/11 we did see that same run on the currency, but strangely enough, interest rates went down, and stayed down. The Canadian economy, along with the help of a depreciated Canadian dollar and low interest rates, kept us on a smooth course, despite the fact that the U.S. economy slowed; our domestic economy was doing just fine. It seemed as if we had won the battle. But this was just the first of two battles. The main issue left was the Canadian dollar.

Back in 1996, while the economy was performing erratically, Gordon G. Thiessen, Governor of the Bank of Canada (BOC), said he wanted the economy to be more



balanced. The BOC wanted the domestic economy to take some weight off the exporter's shoulders when it came to growing the economy. The trouble was that the economy was still restructuring and the Canadian dollar was being beaten down in the financial arena every day. Although it appeared as if we now "owned" our interest rate market, we still did not own our currency.

Today, we have the chance for a truly independent monetary policy. Canada is now in the process of "owning" its own currency. With all the positive economic news that Canada has presented, the international markets are starting to pay attention. Canada is now reaping the rewards of a stronger currency. Usually, the process of getting there takes several years. The decisions that were made in the '90s are starting to pay off now.

Thiessen was a bit early, but today the domestic economy is in a very healthy state and consumers are confident about making long-term decisions. Whether it is regarding housing, car purchases, or other large discretionary items, the consumer is willing to take some risks. Nowhere is that seen as clearly as the housing market, which has been healthy and hearty for the past four years. This should continue during the next few years, barring any unforeseen shocks to the economic system.

The Bank of Canada is now tightening monetary policy through interest rate hikes and through a stronger Canadian dollar. The exporters will complain about this stronger dollar as a competitive disadvantage. Exporters have been dependant upon our weakened currency just like an addictive drug for more than 10 years. It was needed during the restructuring of the economy. Now, it must be addressed. The Bank of Canada can see that with a stronger currency real rates can drop further. This will stimulate the domestic economy more. Canada can never abandon its heavy dependence on exporting, but a vibrant domestic economy sure helps. In the long run, a stronger currency allows for productivity gains and wealth creation for the country. When this occurs, we will be truly independent when it comes to our monetary policy.

So, as the financial pundits argue about the economy going hot or cold, Canada's small business owners are ignoring the noise. They keep purchasing equipment to become more productive and grow their bottom line. In essence, they understand what the Bank of Canada is trying to achieve—and they're doing what they can to take full advantage of it.

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