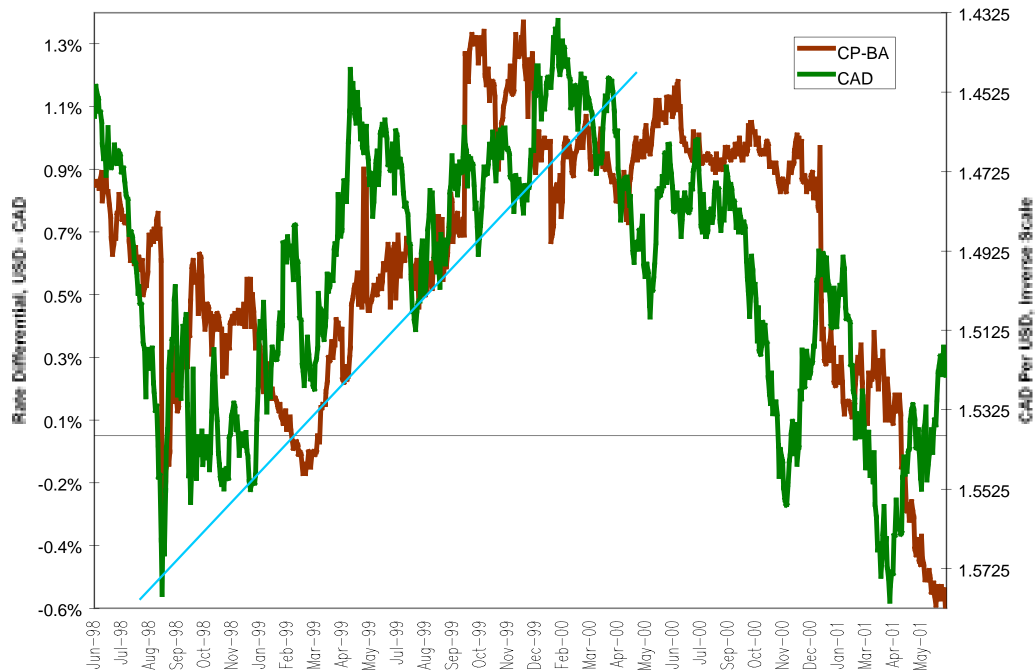
Canada: A Warning From The North

Can some exploding technology and telecommunications firms knock down an entire economy? The question is far from academic for Canada. The recent bad news for Nortel and JDS Uniphase has negative implications for both the Canadian dollar (CAD) and the Toronto 300 index, hence for the economy as a whole. The severe losses – Nortel and JDS Uniphase are down 69% and 70%, respectively, so far in 2001 – are amplified by Canadian policies steering retirement accounts into domestic issues. It's a virtual certainty all Canadian investors have been impoverished somewhat by these companies misfortunes. Needless to say, this is a rather unhealthy situation for an otherwise prosperous nation.

Breaking The Pattern

Normally, the CAD/USD exchange rate is a fairly close function of interest rate spreads between the two countries. This relationship has broken during the past year, much in the same way the previously tight interest rate relationship between the USD and the European currencies has weakened. In the case of the European currencies, many have scrambled to explain how the euro weakened persistently in the face of a narrowing and eventually negative interest rates differential between the U.S. and Europe. Far less attention has been paid to the same problem with the CAD, even though the U.S. and Canada are each other's largest trading partner.

Canadian Dollar As A Function of Rate Spreads

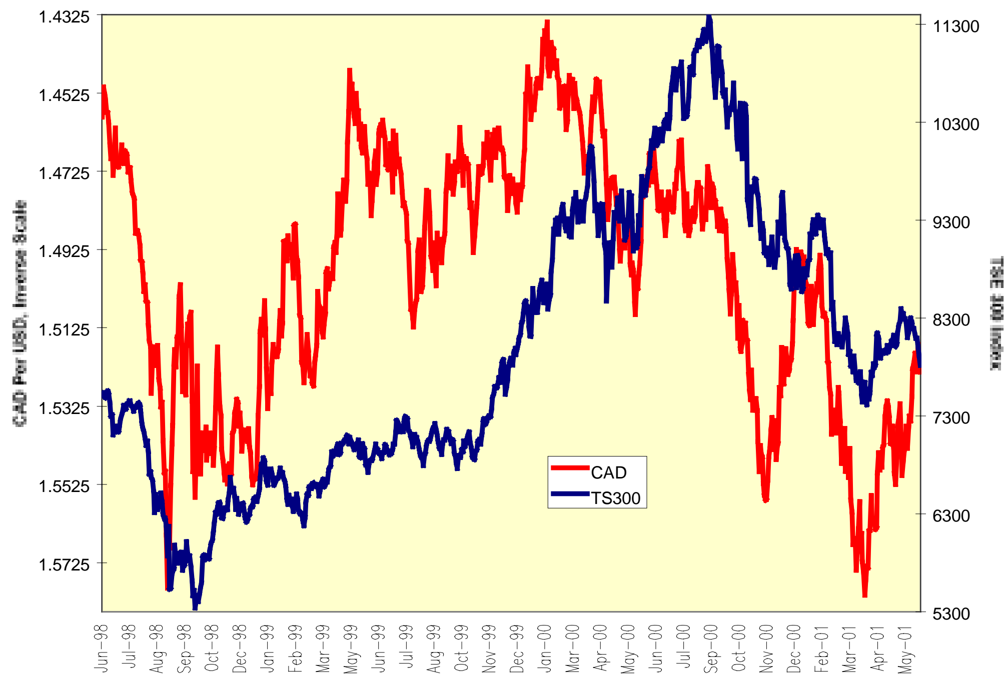


Well, what's sauce for the (Canadian) goose is sauce for the gander. Since the CAD hit its previous all-time low in August 1998, during the global financial crisis, it rebounded rather smartly through March 2000. This is highlighted with a trendline in the above chart. This CAD rally was unusual in the sense it occurred during a widening rate gap with the U.S. By the end of 1999, the final blastoff point for the NASDAQ en route to 5000, yields on 90-day commercial paper in the U.S. were 130 basis points higher than those available on 90-day Canadian bankers acceptances. Why the mad scramble to buy the CAD with such an interest rate penalty?

Irrational Exuberance, Eh?

At the time, some analysts, present company included, ascribed part of the CAD's strength to a rebound in commodity prices. Both the CAD and the Australian dollar have had a demonstrable link over time to the prices of metals and petroleum, and this is perfectly logical given the bases of the respective economies. However, both of these currencies dove throughout 2000. This was puzzling especially for the CAD since Canada is a huge exporter of natural gas and electricity to the U.S., and we all know how those prices rose in 2000.

In retrospect, a good deal of the CAD's rise and fall can be attributed to speculative investment flows into high-flying stocks such as Nortel and JDS Uniphase (who remembers their ticker being described as '**J**ust **D**on't **S**ell **U**s?'). The break in the CAD's trendline in 2000 corresponded not to any reversal in interest rate differentials, or even to expected policy differentials between the Bank of Canada and the Federal Reserve, but rather to the break in the NASDAQ. The CAD stabilized during the 2000 summer rally, and then broke again during the fourth quarter selloff. A modest rebound occurred once the Fed started cutting rates aggressively in January 2001, but look what happened during the spring selloff. Need we mention that the CAD rebounded sharply with the NASDAQ's April-May recovery? The same relationship between the CAD and the NASDAQ pertains to the CAD and the Toronto Stock Exchange 300.



Bad Policies Are Contagious

Both the European Central Bank and the Bank of Canada are constrained in their ability to cut rates aggressively for fear of further torpedoing their currencies. As a result, both central banks are importing both inflationary and recessionary pressures from the U.S. The weaker currency raises the price of imported goods, and the higher interest rates lower economic activity. Interestingly, the persistent strength of the USD both has prevented the Fed's rate cuts from stimulating manufacturing, and has forestalled a resurgence of inflation in the face of monetary largesse. A perfect storm of bad policy: All sides are losing here.

Many global recessions are longer and deeper than they would otherwise be due to these international transmission mechanisms; the most infamous example is the Smoot-Hawley tariff helping trigger a global wave of protectionism during the early stages of the Great Depression. Japan's never-ending trade surpluses and capital deficits have kept that country mired in recession for a decade, and helped contribute to the Asian financial crisis of 1997.

What is happening in Canada cannot be ignored in this context. If the country's currency, interest rates, and retirement savings are held hostage to the vagaries of the NASDAQ, which in turn reflects recent policy errors, then a return to a more stable growth path will be a long time coming. What may be needed, here and elsewhere, is a return to aggressive growth policies, fiscal as well as monetary, in order to raise the expected rates of return on investment capital. The alternative, a global cycle of transmitted policy errors, is too terrible to contemplate.