

Rate-rise pressure

Canada, US, Europe resist for now

October 9, 2009 – Thanks to the central bank of the land down under, persistent grumbling about the weakness of the U.S. dollar over the past year took on a fresh urgency last week. Amid rumors of central bank currency market interventions in Asia, the Reserve Bank of Australia (RBA) hiked the target for its benchmark lending rate by 25 basis points, to 3.25%. It was the first of the G-20 nations to do so – and came sooner than expected. Could Australia’s move trigger a cascade of rate hikes? Could it include Canada?

Countries like Australia, Norway, Brazil, and Israel weathered the global financial storm of the past two years in relatively good condition. For a variety of reasons, including fundamentally sound banking systems, these countries dodged most of the shrapnel from the credit bomb and are now taking steps to head off resurging inflation.

Australia, whose economic size Canada’s most closely resembles, has benefitted from its unique position as a producer of key raw materials for Asia’s fastest-growing economy, China. Combined with a dose of fiscal stimulus and steady commodity demand from China, Australia is experiencing a strong rise in asset prices, particularly real estate. Even though overall inflation is about 1.5%, well below the RBA’s 2% to 3% target range, prices of homes have risen a startling 8% in the January-August period, catching the attention of inflation watchers at the central bank. And quicker than you could slap a shrimp on the barbie, interest rates jumped.

Norway, another member of the G-20, is also poised to raise rates. In the top five of the world’s biggest oil and gas exporters, Norway’s economy has surfed at the crest of the commodity wave, and like Australia, is seeing asset price increases that are giving central bankers itchy trigger fingers.

In the Asia-Pacific region, where the pace of economic recovery is rapidly gaining strength, South Korea, India, China, Taiwan, and Indonesia are all on track for rate hikes in the next two quarters. And this is what has stoked rumors of currency interventions to prevent excessive appreciation against the US greenback. A strong economic revival in the region is stimulating inflationary price increases.

Asian central banks must tighten monetary policy to nip inflation in the bud, but in doing so they risk upward pressure on their currencies, and the accumulation of ever larger US-

dollar reserves. It's a classic rock-and-hard-place scenario. And hence the grumbling about the weakness of the US dollar (dragged down by staggering deficits and a flood of easy money) and the reluctance of the Obama Administration and the Fed to do anything about it other than jawbone.

Of course, there's always the (very good and very likely) possibility that events are proceeding precisely as the US government wants, as a weaker currency lends support to both exports and manufacturing, thus shrinking the trade and current account deficits, which have been primarily responsible for the dollar's woes. These are politically desirable objectives for an Administration whose popularity is coming back to earth. Notwithstanding the surprise Nobel Peace Prize that Obama was awarded last week.

The longer-term impact on productivity and capital flows, however, could lead to dangerous structural problems. Currency weakness tends to lead to more weakness. At some momentum-created tipping point, that could lead to an out-and-out collapse, with hair-raising consequences for commodities, which are priced in US dollars. Think of gold's recent spike to record highs near US\$1,050 per ounce as a sort of barometer of what could happen. Although to be fair, gold's rise to prominence has as much to do with a weak US dollar than with any sustained change in view about gold. Just look at how it has performed in Canadian dollars.

Speaking of which, both Canada's dollar and the euro strengthened against the greenback last week, in the absence of any signals of monetary tightening by the Fed. The loonie jumped to more than US\$0.95, a 12-month high, while the euro advanced to over US\$1.47.

With the Canadian unemployment rate dipping unexpectedly in September, to 8.4% from 8.7% in August, and conditions generally improving in Canada's resource-based economy, many observers felt that the Bank of Canada would now have to follow Australia's lead and raise its target overnight rate from its near zero level.

But a number of important factors militate against that conclusion, most notably Canada's reliance on the US as the market for 80% of its exports. In addition, Canada's inflation rate is still near zero. In short, Canada's economy is not nearly as trade-diversified as Australia's, and is far more closely locked to its main trading partner. Which is to say that while a recovery is in progress, progress will be measured in inches. In addition, the Bank of Canada is loath to add even more upward pressure on the loonie by staging a rate increase before its self-imposed mid-2010 timeframe.

In the meantime, both the European Central Bank and the Bank of England kept their policy rates unchanged last week, at 1% and 0.5% respectively, even while readings from a key service sector purchasing managers index indicated a return to eurozone growth in the third quarter.

Against this backdrop, US Fed Chairman Ben Bernanke felt compelled to weigh in with more central bank mumblespeak last week: "Looking at the amount of excess capacity in

the economy, looking at the low rate of inflation, we believe that conditions will warrant policy accommodation for an extended period.” In other words, no change, no surprise.

Stock markets took it all in stride, too, and generally rose on the week’s trading.

Toronto’s S&P/TSX Composite Index advanced 4.4% from last week’s close, while New York’s Dow Jones Industrial Average gained 4%. The S&P 500 Composite rose 4.5% on the week, defying predictions of an imminent correction after closing with week-over-week losses for the previous two weeks. Global markets rose in tandem, as the MSCI Europe, Australasia & Far East Index also rose 4.5% on the week. And despite those rising currency and interest rate pressures, Asian markets also advanced, with the MSCI Emerging Markets Asia Index climbing 3.2% week-over-week. ■

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