# RISK AND THE MACRO PICTURE

*For Canada, inflation, interest rates and the loonie are heading up.*

WARREN JESTIN *Senior vice-president and chief economist, Scotiabank Group, for Scotia Capital.*

The Canadian economy has picked up momentum, with growth in the second quarter exceeding the pace south of the border as exports regained traction after nearly three years of slippage. While the U.S. has enough built-in gains to beat the 3% to 3.25% output advance expected here in 2004 by a full percentage point, look for a much closer race in 2005 as U.S. growth falls below 3.5%. However, neither country will match Mexico, which is on track to win the NAFTA growth sweepstakes in both years after a prolonged period of weakness.

Overseas economic momentum will soften in 2005, with Japan's growth spurt sputtering and U.K. domestic demand cooling. Eurozone activity will hopefully strengthen, but any improvement will be modest. There also may be a loss in altitude among high-flying growth leaders such as China and India, though gains should still be more than double the average of the G7 nations.

## "THE BEST OF THE LOW INFLATION NEWS IS OVER."

External trade has been a big swing factor in Canada's economic performance this decade. The 7% drop in merchandise exports from 2000 to 2003 was a key reason why Canada lost G7 growth leadership to the U.S. in 2003 for the first time in five years. Conversely, the jump in foreign sales this spring accounted for two-thirds of the 4.3% annualized real GDP gain in the second quarter. Looking ahead, exports will be supported by strong commodity markets, although earnings may be constrained as oil prices recede from recent lofty peaks. Manufacturing exports—dominated by the auto sector—will be buoyant but show little growth as U.S. domestic demand cools.

Even with a rekindling of job gains, U.S. consumer spending will be tempered by a gradual rise in borrowing costs and the exhaustion of pent-up demand after a decade-long shopping spree. While there is more pent-up demand in Canada, reduced job creation and higher interest rates will also reinforce a more cautious spending attitude. The auto and housing sectors have already lost momentum in both countries.

Strong profit gains have revived U.S. business confidence and investment; however, widespread excess capacity will limit the bounce in construction spending. The sharp rise in the Canadian dollar has kept companies cautious on this side of the border, but firms will be investing to upgrade technology and boost competitiveness. Energy-related investment will also be supported by the sector's extraordinarily strong profitability.

The best of the low inflation news is over, with the U.S. consumer price trend moving up to 2.5% or higher as cost-push pressures percolate through the production chain. While slower growth and a higher exchange rate will keep domestic inflation below U.S. levels, the Bank of Canada's 2% central target will be surpassed in the first half of 2005. In this environment, monetary policy in both countries will be gradually tightened. By late 2005, policy rates will be at least 2.25 percentage points above cycle lows in the U.S. and 1.5 percentage points higher in Canada.

Currency markets will remain volatile as economic and geopolitical uncertainties interact with the enormous liquidity overhanging global markets. U.S. dollar weakness, punctuated by brief rallies, will be the dominant trend through 2005 as hefty U.S. trade and fiscal deficits encourage global investors to diversify their portfolios. Canadian dollar strength will be reinforced by solid trade surpluses, buoyant commodity markets and G7 fiscal leadership. Against a background of large and sudden exchange rate swings, the Canadian dollar is likely to break through the 80-cent threshold in 2005. ■