LOONIE'S UNPRECEDENTED RISE WILL CONTINUE TO SHAPE THE ECONOMIC LANDSCAPE IN 2004, SAY TD ECONOMISTS

TORONTO -- The unprecedented rise in the value of the Canadian dollar was *the* economic event of 2003, and the loonie's flight will remain instrumental in shaping the economic landscape in 2004, say TD economists in a Special Report entitled *Loonie Tunes – Understanding the Rally in the Canadian Dollar and its Consequences* available online at www.td.com/economics.

"The loonie's massive appreciation has really put Canadian businesses and investors on the spot," said Don Drummond, Senior Vice President and Chief Economist, TD Bank Financial Group. "Not only are the dollar's gains here to stay, but there is further upside potential for this year – which means that businesses and investors will need to put the loonie left, right and centre in their financial plans."

The report points out that Canadian businesses can still be competitive at the current level of the exchange rate – and that over the long haul, the economy can reap important benefits from the currency's gains. Over the near term, however, significant adjustments will be required. "The real problem is not the level of the currency," noted Drummond. "It is the speed at which it has taken flight, which has caught just about everyone off guard."

The TD Economists note that the currency spent the better part of the 1980s and a good part of the 1990s close to or above its current level -- but never has it gained this much ground, this quickly.

“Adjusting to the reality of a stronger dollar will require a new mindset on the part of Canada’s business community, one that will require a much tighter focus on competitiveness,” remarked Drummond. “Investors will have to put more weight on exchange-rate considerations in their decision tool kits as well,” he added.

The report covers a broad array of issues, including the long-term fair value for the dollar, its short-term prospects, the economic fallout from the currency’s rise, the corporate response, the implications of the loonie’s flight for Canadian investors, and the impact on monetary and fiscal policy.

Loonie is likely to continue to gain ground

The loonie is likely to continue to dominate the headlines in 2004, say the TD economists. “We have yet to see the full impact from last year’s appreciation, and the high degree of volatility in the Canadian dollar will be with us for some time,” noted Drummond.

While TD expects the loonie to continue to gain ground in 2004, ending the year at 79 U.S. cents, it is likely to swing around within a wide range, from 74 to 82 U.S. cents. In addition, they note that the outlook for the Canadian dollar remains highly uncertain.

“When the Canadian dollar was at 63 U.S. cents, there was a clear consensus that the prevailing exchange rate did not reflect the currency’s underlying positive fundamentals, and not surprisingly, virtually all forecasts predicted that the currency would eventually strengthen," said Drummond. Now, the outlook is much less clear-cut, with forecasts covering a much wider range.

A number of competing forces will buffet the currency in the coming months – rising commodity prices, shrinking Canada-U.S. interest-rate spreads, and a weaker U.S. dollar among others. While the TD Economists believe that the loonie will gain some ground in the coming months, they also recognize that the range of possible scenarios covers an unusually broad gamut. Moreover, the currency is now within the range of estimates of its long-term "fair" or "equilibrium value" which, notwithstanding their limited usefulness, range from 72 to 84 U.S. cents.

"All of this drives home the fact that businesses should be looking at a wide range of scenarios and considering active strategies to manage their foreign exchange risk," noted Drummond. The report finds that about two-thirds of Canadian companies with more than 20 per cent of their revenues in U.S. dollars have been hedging their foreign exchange exposure to some extent, limiting the near-term fallout from the currency's rise. Hedging is more prevalent for large companies than small and medium-size enterprises.

Investors will also need to put more emphasis on alternative exchange-rate scenarios. "While Canadians have been encouraged to hold foreign assets in a well-diversified portfolio – which still makes perfect sense – they must also recognize that large exchange-rate movements can have an important bearing on their investment returns, and therefore, should be an important part of their asset allocation decision," said Drummond.

Stronger loonie will weigh on growth and inflation

The rise in the dollar took a big bite out of the Canadian economy in 2003, and TD economists expect the loonie's gains to continue to weigh both on economic growth and inflation over the next few quarters. "The currency's appreciation is likely to shave about two full percentage points off GDP growth in 2004. Had the loonie remained at 63 U.S. cents, the combination of strong U.S. growth, mega-low interest rates, and rising commodity prices would have amounted to GDP growth of close to five per cent. Instead, Canadian economic growth will come in below the three per cent bar this year," remarked Drummond. The report also spells out the relative impact by region and industry sector, relative to net export exposure.

The combination of weaker growth and some pass-through of the movement in the exchange rate to consumer prices will keep the Bank of Canada's measure of core inflation below the two per cent target all the way to late 2005. "Because of the currency's fallout on the economy and inflation, the Bank of Canada is poised to cut interest rates on March 2nd – and should economic growth come in even weaker than we are expecting, further rate cuts will be in store," said Drummond.

Finally, slower economic growth spells bad news for Canadian governments, which are seeing their fiscal positions squeezed. "For Canada's federal and provincial governments, the loonie's strength hardly comes at an opportune time, given the fact that all – with the sole exception of Alberta – are either struggling to remain out of deficit or are already facing structural shortfalls," noted Drummond.

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The report *Loonie Tunes – Understanding the Rally in the Canadian Dollar and its Consequences* (including charts and detailed tables), is available in PDF format on TD Economics' Home Page at: www.td.com/economics.