The Fortnighter

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I have a subscription to the Globe & Mail (print edition!) and a recent "Letter to the Editor" caught my eye. A reader was wondering how the Bank of Canada's aggressive interest rate increases (to combat inflation) were of any benefit to him. Seems he had recently purchased a small, necessary item and it had increased in price. If he had to buy another in 6 months, how were higher interest rates going to be of benefit – he had to buy the item.

On the surface it's a valid point. Food and energy prices, in particular, have risen dramatically over the past year. Is having a more expensive home-equity line-of-credit going to make these things cheaper? No.

The letter-writer misses a couple of key points, however – one somewhat obvious and one less so. The first is the difference between discretionary and non-discretionary spending.

I've commented on this before, but on the surface the economy still seems to be firing on all cylinders. Restaurants and bars are packed, airports are overflowing and businesses are desperate for workers. This is (largely) discretionary spending at work.

We are an absurdly indebted nation. By making borrowing more expensive, the Bank of Canada's policies ***should*** take a bite out of discretionary spending. HELOC now at 6%? Perhaps you'll do a stay-cation or defer that bathroom reno. It ain't happening much yet, but at some point higher rates will bite and lessen demand.

The second, and more rarely discussed, issue has to do with foreign exchange.

As you know, we have a very large economy to the south of us which also has an inflation problem. The Fed is raising rates aggressively and that attracts capital – money flows (in general) to the place with the highest rates. In addition, money gravitates to the U.S. in times of uncertainty (like now) as it is still the largest and most stable of the world's economies. The U.S. dollar is going UP against just about every other currency – including ours.

Up to a point, having a "cheap" Canadian dollar benefits us because we are an export-driven economy. But too much of a decline in our dollar is INFLATIONARY. Last fall, the Cdn dollar touched 81 cents US – now it's under 76 cents. Right there, that's a 6% increase in pretty much anything sourced in the US. Wonder why your food costs have gone up so much?

Without the Bank of Canada raising rates in lock-step with the Fed, our currency would likely plummet. So, the BOC's inflation-fighting policies are as much about defending the currency as they are about tempering demand.

As consumers, there are things we can do to help lessen some of the inflationary impacts we're seeing ("buy less" and "buy local" to start!). And as investors, we have additional options. I've developed a few strategies/ideas along these lines over the years - let me know if you'd like to discuss.