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Backgrounder

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How Not to Get Hit by a Falling Dollar:
Why the Plunging Canadian Dollar Need Not Usher in a Slump

by

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Thanks to the fallout of Asia's financial crisis, the Canadian dollar is hitting new lows — headed for 68 US cents, or worse. On three past occasions when the dollar dropped like this, in early 1986, early 1990, and early 1995, its fall preceded an economic slump. Should the dollar's ultimate master, the Bank of Canada, not step in and stop the plunge?

If we want to avoid a repeat of the 1986, 1990, and 1995 downturns, the answer is a resounding no. The Canadian economy's weakness on those occasions actually owed less to the falling dollar than to the attempt to catch it. Our best hope of keeping the expansion on track lies in the Bank's new willingness to let the dollar go.

Catching a Falling Dollar Hurts

A sharp exchange rate decline not only wounds our national pride, it is unnerving. It makes imports more expensive, increases the burden of foreign-currency debt, and scares investors. But the Bank of Canada can only stave off heavy selling pressure in currency markets by hiking short-term interest rates and holding them up. And that would mean the Bank was giving the dollar's external value priority over its stewardship of domestic monetary conditions — a bad tradeoff.

The Bank's influence over the monetary climate in Canada stems from its influence over the cost of short-term borrowing. Through that, it influences the gap between the cost of funds and the price that households and businesses, depending on their optimism about the future, are willing to pay when they borrow for longer-term investments.

When the Bank thinks there is slack in the economy, it keeps the cost of funds relatively low. Credit and money growth pick up and, after a few months, so does the economy. If the Bank thinks that the economy is getting overheated and threatening inflation, it pushes the relative cost of funds up. Credit and money growth slow and, later on, the economy turns down too.

The hike in short-term rates the Bank would need to get the dollar back to where it was, say, even last week would squeeze — perhaps even eliminate — the recent gap between the cost of funds in Canada and the price at which Canadians will borrow. Reversing the dollar's slide in the face of continued currency market pressure would, therefore, mean choking off credit and money growth, and sending the economy back into a slump.

Where Is the Benefit?

With ample room for Canada's economy to expand, inflation below 1 percent, and government deficits all but eliminated, the possible arguments for going through the pain of defending the dollar look feeble.

One such argument has it that a low dollar boosts the economy, requiring an offsetting rise in short-term rates to keep noninflationary growth on track. But that is not true if the dollar is down because the economic or political outlook is worsening

In early 1986, commodity prices were collapsing. In early 1990, the economy was cooling off after the late-1980s' boom. In late 1994 and early 1995, the separatist threat in Quebec was growing, governments were borrowing around $60 billion a year, and the new federal government had recently let the Bank of Canada governor go. The dollar's decline on those occasions signaled coming weakness, not strength. With household and business optimism about the future dipping, the rise in short-term rates compounded the damage.

Now, Asia's problems and weak commodity prices are clouding the outlook for Canadian exports and resource industries. This deterioration in the outlook not only hurts the dollar, but is likely lowering the price that households and businesses are prepared to pay when they borrow. Higher short-term rates are the last thing we need.

Another argument is that if investors expect more dips in the dollar, interest rates will rise anyway. But this argument also looks weak.

It is true that lenders anticipating a falling currency will want an interest rate premium to compensate for their expected exchange-rate loss. But experience shows that central bank support for exchange rates typically just prolongs the agony. Once the currency is down, the need for an interest rate premium disappears. The longer the Bank resists a decline in the dollar by keeping short-term rates up, the higher interest rates of every type — short and long — will last, compounding the damage to the economy.

In any case, longer-term interest rates have barely budged since the Asian crisis began. For whatever reason — the improvement in governments' bottom lines; the growing evidence of Canada's commitment to low inflation; the relatively good outlook for Canada by comparison with Asia and Europe; perhaps all these things — investors now seem to regard Canada quite favorably. As the dollar's quite stable performance against other major currencies shows, the major theme in foreign exchange markets has been the strength of the US dollar, not the weakness of the Canadian. There is simply no sign of the kind of panic that could conceivably justify a show of economy-strangling strength by the Bank of Canada.

Let It Go!

At the end of the day, despite the blow that the dollar's decline deals to importers, to snowbirds, and to national pride, the Bank deserves praise for staying to one side. The monetary climate in Canada recently has been good. Credit and money are once more expanding at rates consistent with healthy noninflationary growth. Recent economic and inflation news has been highly encouraging.

In short, the Bank seems to have the gap between the cost of borrowing and the price Canadians will pay about where it should be, rightfully giving the domestic monetary climate priority over the exchange rate. This time, we seem to have learned the lessons of 1986, 1990, and 1995: the best way to avoid getting hit by a falling dollar is not to stand in its way.

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