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The Real Reasons for the Canadian Dollar's Power Trip — And What Not To Do About It

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The Canadian dollar's recent dramatic rise has taken many Canadians aback, and there are calls for the authorities to do something to hold it down, to fix the exchange rate, or even to abandon the dollar altogether for some kind of North American currency union.

Those reactions are misplaced. The immediate causes of the dollar's rise are buoyant world demand for Canadian exports, and the general depreciation of the U.S. dollar against all major floating currencies, likely caused by mounting concern over U.S. fiscal and current account deficits. Altering Canadian monetary policy, or even Canada's monetary regime, would not ease the stress this is causing. Worse, a focus on monetary responses to the strong currency could distract attention from reforms to Canadian tax, industrial and regional policies that would enhance the economy's capacity to withstand currency volatility.

There is nothing gratuitous about exchange rate movements under Canada's inflation-targeting regime, and there is no economic free lunch to be had from intervening in foreign-exchange markets or pegging the dollar at a fixed rate against its U.S. counterpart. If the currency were not free to rise and fall, the same fundamental forces that are now partly absorbed by the Canada-U.S. dollar exchange rate would create additional volatility in domestic output, employment and inflation instead.

To hold the dollar down in current conditions, the Bank of Canada would have to ease monetary policy. If it did so directly by lowering its target for the overnight rate and promoting faster money and credit growth, exporters and other producers of tradable goods would no doubt welcome the exchange rate relief that would initially follow. But they, along with everyone else, would soon be under pressure from rising domestic costs as inflation targets were overshot, and 12 years of hard-earned monetary-policy credibility began to erode.

Direct intervention by the central bank in the foreign-exchange market, buying the U.S. currency with newly issued Canadian currency, would not avoid these consequences. The domestic inflationary impact of such measures could at best be delayed by simultaneously buying up Canadian currency in exchange for government securities. Such a policy is unsustainable, however, because it amounts to taking from the market with one hand the same liquidity that the central bank is trying to provide with the other. When it broke down, domestic inflation would inevitably follow.

Medium-term swings in the Canada-U.S. exchange rate result from differences in the structures of the two economies. Canada is a major exporter of commodities, and the United States is an importer. Commodities, moreover, are usually priced in U.S. dollars in international markets over which Canadians have little influence. When commodity prices fall, Canada is effectively poorer and the U.S. simultaneously richer. When they rise, Canada gains and the U.S. loses. Such changes cause movements in the real exchange rate between the two countries — the price, measured in a common currency, of a representative bundle of Canadian output relative to a representative bundle of U.S. output.

Recently, Canada's real exchange rate rose in part because of higher commodity prices. Adjustment to those prices could have involved either a nominal exchange rate rise or a more rapid increase in Canadian than in U.S. domestic prices or some combination of the two, but it had to happen. Under current arrangements, the nominal exchange rate has absorbed the shock.

The link between commodity prices and the exchange rate is clear in a statistical relationship first discovered at the Bank of Canada by Robert Amano and Simon van Norden and further explored by other researchers at the central bank and by David Laidler and Shay Aba at the C.D. Howe Institute. These studies show that the Canada-U.S. exchange rate's major swings (though not every short-term movement) since the early 1970s have largely arisen from four factors: relative rates of inflation in the two countries; changes in the real U.S. dollar prices of Canada's non-energy commodity and energy commodity exports, and fluctuations in the short-term Canada-U.S. interest rate differential.

The significance of energy and non-energy commodity prices has varied from decade to decade. Until the early 1990s, Canada did little more than break even in energy trade, exporting coal, natural gas and oil from the West, while almost offsetting that outflow with oil imports in the East. As such, previous Bank-of-Canada-style equations revealed only a weak and negative correlation between energy commodity prices and the exchange rate. Since the mid-1990s, however, Canada's energy exports have grown considerably, and the country now runs a large energy trade surplus (Figure 1).

Although unable to account for as large a rise in the exchange rate as experienced over the last two years — indicating that other factors are at play — a more recent estimation of the Laidler-Aba equation captures the changing influence of energy exports in the form of a now positive and significant correlation with the exchange rate for the period after 1993 (Figure 2). While the influence of non-energy commodity prices has diminished, those prices retain a positive and significant influence on the exchange rate. (Further details and complete estimation results for the equation underlying the forecast shown in Figure 2 are available on this website at www.cdhowe.org/pdf/ebrief_8_appendix.pdf.)

The Canadian dollar is, then, still largely a commodity currency, and it will likely remain one in the foreseeable future. Its depreciation in the 1990s was mainly the reflection of a slump in U.S.-dollar commodity prices, which was the combined result of weak world demand and a strong U.S. dollar. Its recent rise is

Figure 1: *Net Exports of Energy Commodities as a Share of GDP from 1973:Q1 to 2004:Q2*

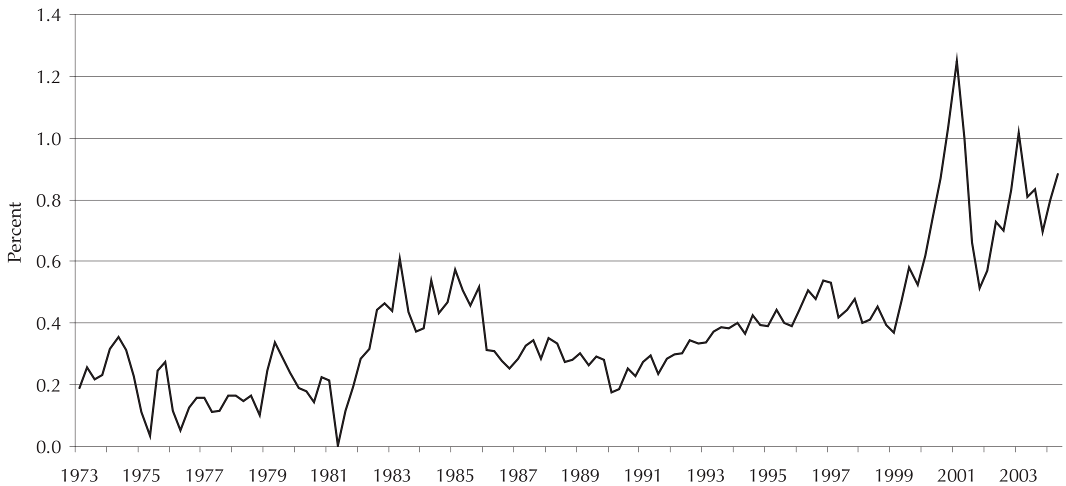
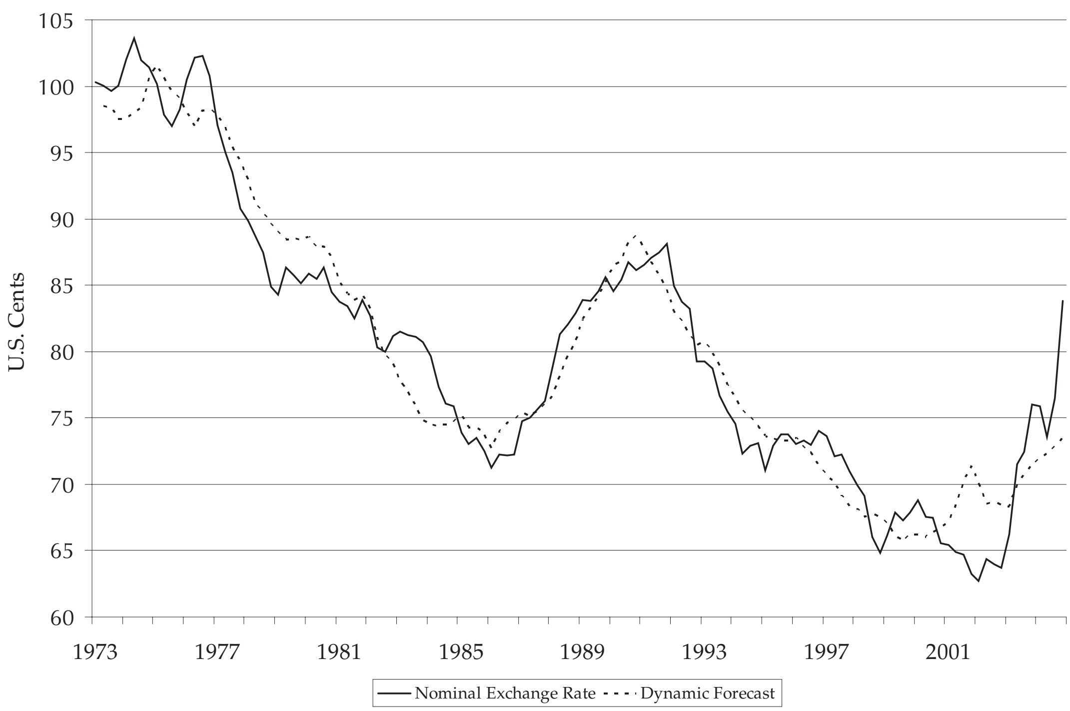


Figure 2: *Nominal Canada-U.S. Exchange Rate and Dynamic Forecast for the period 1973:Q1 to 2004:Q4*



in part the consequence of catching up to the fundamentals, shown in the equation in Figure 2, of a commodity boom and, in recent months, a weakening U.S. dollar against all major currencies.

Exchange rate volatility is inconvenient, even painful, particularly for those involved in foreign trade. For exporters, formal hedging contracts and other measures to insulate business from exchange-rate fluctuations, such as sourcing components from the United States and issuing debt in U.S. dollars, can help. But all Canadian businesses are hurt by government policies that raise their costs and hamper their ability to adjust to circumstances, including those created by exchange rate volatility.

Economic restructuring is a sustained process and Canada should make handling it easier. This does not require a different exchange rate policy; it calls for a set of tax and industrial policies that promote faster productivity growth throughout the economy. That would cushion the impact of a volatile dollar on the sectors most exposed to it and, more broadly, would help provide the faster output growth that makes all economic adjustments easier.