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Two Economies, One Exchange Rate: How the Bank of Canada Should React to the High Canadian Dollar

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Canada's unemployment is at a 30-year low, demand is growing faster than the economy's capacity to produce, inflation is above the 2 percent target, and surveys show that people expect it to remain above the target. The case for further increases in the Bank of Canada's overnight rate — as urged recently by the C.D. Howe Institute's Monetary Policy Council, and signaled in the Bank of Canada's latest interest-rate announcement — seems clear.

Yet economy-wide statistics mask major regional disparities. Newfoundland and the energy- and resource-rich West are riding a worldwide commodity boom, while Central Canada's manufacturers are already facing increasing competition from Asia. Since these manufacturers are also seen as suffering from an exchange rate that has been buoyed by interest-rate increases, the Canadian dollar's flirtation with levels around US$0.87 might suggest that the Bank should temper the rise in its target for the overnight rate.

Changing Terms of Trade and Monetary Policy

Should the Canadian economy's split character influence the Bank's interest-rate decisions?

Recall first that we have seen developments like these before. Japanese growth in the 1970s and 1980s, and the emergence of the Asian tigers a decade later, drove up world prices of energy and other commodities relative to those of manufactured goods. Those events induced major adjustments in Canada, as in all countries heavily involved in both commodity production and manufacturing. The current Asian boom is doing the same on a colossal scale, and arguably on a more permanent basis.

In the long run, more Canadians will work in commodity and energy production, and fewer in manufacturing — particularly in industries that rely heavily on less-skilled labour and are more vulnerable to foreign competition — and capital will also move. Jobs and investment are flowing between sectors, and from Central Canada to the western provinces and Newfoundland. These changes

will continue regardless of the level of the policy interest rate and the exchange rate. An increase in the price of oil relative to that of cars is a real change. It sends the same message in any currency, at any exchange rate. Monetary policy cannot affect it.

When fundamental forces require resources to move, monetary policy can change the channels through which the signals travel, but it cannot change their content. The message that comes through the exchange rate when it moves will come through domestic wages and prices if it does not. If the Bank of Canada tried to hold the dollar down, manufacturers now under pressure from the exchange rate would instead find themselves priced out of their markets by rising wages and other domestic costs.

This does not mean that the Bank of Canada should ignore structural adjustments in the economy. Those adjustments might temporarily reduce the economy's productive potential as resources are redeployed. They might also temporarily undermine consumer and producer confidence, depressing demand. The relative strength of these competing influences should certainly influence monetary policy — but so should all the other signals the Bank is receiving. When so many other indicators point to economic over-heating, it is hard to make a case for easier money to hold the exchange rate down.

The Effects of Exchange-Rate Volatility on the Economy

There are two main objections to this conclusion.

The first is that the recent strength of the Canadian dollar has been greater than changes in Canada's fundamentals can justify. On this view, only some of the exchange rate's rise reflects increases in world demand for Canadian energy and commodities. The rest reflects some extraneous force affecting financial markets — for example, a turn in sentiment against the US dollar — which will depress Canada's net trade balance, and hence domestic demand. The Bank, it is argued, should offset these effects with easier money lest inflation fall below target.

This objection is hard to sustain. The exchange rate must respond not just to current changes in the demand for Canadian goods and services, but also to expectations of future demand — as when an inflow of foreign investment precedes the drilling of a new oil well. Hence, the already well-established influence of energy and commodity prices on the C$/US$ exchange rate is probably enough to explain the dollar's recent movements.

The second objection is that some purely temporary factors may be at work in energy markets — for example, the effect of hurricanes on oil production in the Gulf of Mexico, political difficulties in US-Venezuelan relations, or continued unrest in Iraq. Furthermore, it is argued, the exchange-rate swings they are causing are so damaging to the Canadian economy that the Bank of Canada should tolerate more movement of inflation around its target than it normally would while it tries to iron them out.

This argument is harder to dismiss outright. It is certainly true that when the exchange rate moves for any reason, prices determined in Canadian markets and set in Canadian dollars — most notably wages — move less readily than those determined in world markets that trade in other currencies. The local prices of physical capital relative to labour, of machinery relative to structures, of imported

goods at the dock relative to imported goods on the supermarket shelf — these and many others are indeed more volatile the more the Canadian dollar fluctuates against other currencies.

But while short-run and essentially gratuitous movements in relative prices might create problems, it is unclear how monetary policy should respond. To argue that the Bank of Canada should smooth volatility of the Canadian dollar around a trend that reflects fundamentals is to attribute unwarranted precision to the Bank's estimate of that trend. An exchange-rate smoothing policy based on this dubious assumption could easily end up preventing the exchange rate from responding to fundamentals that should move it, with the consequences for domestic costs and prices already described.

Inflation, Not the Exchange Rate, Is the Target that Matters

We conclude, therefore, that the Bank of Canada should continue to steer policy with its eyes firmly on domestic indicators of inflationary pressure. Large divergences between the fortunes of different sectors of the economy, and regions of the country, in the face of world economic shocks make it harder for the Bank to hit its inflation target. They do not, however, make it any less desirable that it try to do so. The value of an inflation target is that it tells Canadians, as consumers and investors, what the purchasing power of their money will be in the future. When, as now, international forces are straining the Canadian economy, that value is all the greater.

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