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It's the Economy, Stupid

Is a falling dollar a problem? Depends on why it's falling.

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As we all know, the Canadian dollar has taken a pounding over the past two years. Though it has regained some of its value recently, the Loonie is still worth 5 percent less in U.S. dollars than it was two years ago. This decline may be small potatoes when compared with the 1997 collapses of the Southeast Asian currencies, but it is large by Canadian standards. And, naturally, Canadians care about it.

Unfortunately, many Canadians would be hard pressed to explain clearly *why* they care about the value of the dollar. There is more confusion and bad reasoning surrounding the movement of exchange rates than for any other economic variable. Let me make three simple points.

First, changes in the value of the dollar are usually good for some people and bad for others. Remarkably, this point usually gets ignored in public debate because people forget that the exchange rate is nothing more than the price of foreign currency. And as for any other price, a change affects buyers and sellers differently. If the Canadian dollar appreciates, many Canadian exporters are made worse off as their foreign customers switch toward lower-price substitutes. But many Canadian importers are made better off because foreign goods are less expensive. With these competing perspectives, it is hardly surprising that there is such a heated discussion whenever the dollar surges or plunges.

But can't we say that a fall in the dollar is bad for Canada *overall*? And an increase is good for Canada *overall*? Unfortunately, it's not that simple. This brings us to the second point.

A strong Canadian dollar is not necessarily a good thing, and a weak dollar is not necessarily bad. The exchange rate can rise or fall for several reasons, and the desirability of any particular change depends crucially on its cause. For example, the Canadian dollar rose in value from 83 U.S. cents in 1988 to over 90 U.S. cents in 1991. Was this a good thing for Canada? Surely not, as the main reason for the dollar's rise was that the Bank of Canada slammed on the monetary brakes to reduce inflation, and in the process drove up interest rates and helped to create a protracted Canadian recession. In contrast, the dollar has increased in value by a couple of U.S. cents over the past few months, due mainly to an upturn in world commodity prices, including a dramatic increase in the price of gold. Is this good for Canada? Yes, because Canada is an exporter of commodities and we are enriched whenever the world is prepared to pay more for the goods that we export.

So, we should not focus on the dollar itself as a measure of the strength of our economy. Instead, we should focus on the underlying economic variables whose changes end up being reflected in the dollar's movements. There are simply too many things going on in the world economy that affect the Canadian exchange rate to make simple inferences based only on the exchange rate itself.

The third point is the most difficult. It is that economists don't know much about the Loonie's future. There are three important determinants of the Canadian exchange rate, and the combined forecasts of these three variables leave us quite unsure about what the future holds.

The first is world commodity prices. These have made a partial comeback in the past few months and most economists see them rising further as the Asian economies continue their recovery. A Japanese recovery, when it does occur, will add even more upward pressure on commodity prices. On this front, then, there is good reason to expect the Canadian dollar to appreciate in the coming months.

The second factor is the path of Canadian versus U.S. inflation. The Bank of Canada has credibly established its anti-inflation stance. Similarly, though the U.S. Federal Reserve does not have a formal inflation target like Canada's, there is a clear commitment to low inflation. Since we can expect Canadian inflation to remain equal to or slightly below U.S. inflation, on this front we can expect a small appreciation of the Canadian dollar, but nothing to get excited about.

The third factor is productivity growth. If Canada experiences greater productivity growth than its trading partners, the decline in the prices of Canadian exports made possible with the greater productivity tilts the export markets toward Canadian goods, thus strengthening the value of the Canadian dollar. Conversely, weaker productivity growth in Canada leads to a decline in the dollar.

Adding up the three separate effects, we get the overall predicted path for the Canadian dollar. If Canada's future productivity growth is very weak, the negative effect on the dollar will offset to some extent the positive effect from rising commodity prices. In this case, the dollar may stay roughly where it is today. But if Canada's productivity growth is strong relative to that in other countries, then the Loonie will surely strengthen.

So there you have it—one complex problem all wrapped up in a nice neat package! But there's a catch that perhaps you missed. Notice that I didn't offer a view of where Canada's productivity is likely to go. That's because I don't have a clue, for two reasons. One is that data on productivity, especially in the growing service sector, are notoriously bad, and thus the results of the many conflicting studies are difficult to interpret. The second reason, much more important, is that economists don't fully understand where rising productivity comes from. Despite much that we have learned over the years, the source of productivity growth remains one of the great mysteries in macroeconomics.

So the next time you're listening to a debate about the gyrations in the Canadian dollar, keep in mind that what's important is not the dollar itself, but the things behind the scenes that make the dollar fluctuate. And there are lots of those things changing at once, making simple, one-dimensional explanations implausible. As for economists' ignorance about the causes of productivity growth, maybe now is a good time to send a generous donation to the economics department at your Alma Mater!