Leave Interest Rates Alone!

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Many economists have been urging the Bank of Canada to reduce interest rates in response to the soaring Canadian dollar. They argue that the appreciation of the loonie from 65 to 77 U.S. cents is killing Canada's exports, and that the Bank must reduce interest rates to offset this effect and stimulate the economy. In the past few weeks it appears that the markets expect the Bank to finally take this advice: bond markets have priced in a 25-basis-point reduction in anticipation of the Bank's next rate decision tomorrow.

But the effect of exchange-rate changes on the economy is not so simple, and there's a good argument for the Bank to hold its present course and leave interest rates at their current level. Before knowing how the Bank of Canada should respond to changes in the exchange rate, we must know why the exchange rate is changing. Different causes of exchange-rate changes should lead the Bank to different decisions. Over the past year, the changes in the Canadian dollar have been pushing the economy in opposite directions, making it tough for the Bank to plot the right policy course.

First, we have all been hearing about the growing U.S. current account deficit— the amount by which the United States is buying more goods and services from the rest of the world than it is selling to them, and thus financing the excess expenditure by borrowing. Though there is nothing fundamentally bad about current account deficits, there is growing concern about the magnitude and sustainability of the present imbalance. With typically low U.S. private saving rates, together with large and growing public borrowing under the Bush administration, it is not clear how the situation will change. Over the past year, financial markets have taken notice of these numbers, and the collective market view appears to be that a turn-around in the U.S. current account deficit will happen only with a significant depreciation of the greenback. The growing expectation of U.S. depreciation leads holders of U.S. financial assets to sell their holdings and re-position their portfolios, switching toward British, German, Canadian, or even

Japanese assets. Of course, this capital flight out of the United States contributes to the depreciation that the asset holders are trying to avoid.

Over the past year, this capital flight has pushed the U.S. dollar down against all major currencies — by 10 percent against the pound sterling, by 11 percent against the yen, and by 21 percent against the euro. And, of course, the greenback has depreciated by 18 percent against the Canadian dollar.

Suppose for a moment that this shock — this movement of financial capital — is the only major shock hitting the Canadian economy. How should the Bank of Canada respond to the accompanying appreciation of the Canadian dollar? The Bank's goal is to keep inflation between one and three percent, and it does this by trying to offset major shocks to the economy in order to keep GDP close to the economy's productive potential. The financial flow toward Canada drives up the value of the loonie and hurts Canadian exporters. The decline in exports is a negative demand shock and will eventually help to push inflation below the Bank's target range. If we suppose that the Bank was more-or-less content with its policy stance before this shock occurred, then its appropriate response is to loosen its monetary policy by reducing interest rates, thus stimulating the overall level of demand in the economy and offsetting the effects of the negative shock.

This is essentially the story being told by those who are urging the Bank of Canada to cut interest rates, and it is a good one. But it is only one half of the overall story; the second half is just as important, and works in the opposite way.

Over the past year the U.S. and world economies have begun to recover. One sure sign of a strengthening U.S. and world economy is the dramatic increase in non-energy commodity prices. As the world economy ebbs and flows, so too does the demand for all kinds of raw materials, and the cycle in commodity prices closely follows the cycle in world economic activity. During 2001, as the world economy slowed sharply, non-energy commodity prices fell by 10 percent. In 2002, a year of retrenchment and very sluggish growth, commodity prices were flat. But in 2003, as the world economy picked up speed, commodity prices increased by 20 percent.

The Canadian dollar is a commodity currency, meaning that it tends to rise and fall along with commodity prices. Given our large role in producing and exporting raw materials, this can hardly be surprising: when the world demands more raw materials, it is typically demanding

more from Canada, and thus the demand for Canadian dollars increases. The effect on the dollar is usually quick and strong, as suggested by the 18 percent appreciation of the loonie over the past year.

Again, suppose that this rise in commodity prices is the only major shock hitting the Canadian economy. How should the Bank of Canada respond to the accompanying appreciation of the loonie? Since Canada is a net exporter of raw materials, the increase in commodity prices is a positive demand shock for Canada and it will eventually help to push inflation above the Bank's target range. If the Bank was more-or-less content with its policy stance before this shock occurred, then the appropriate response is to tighten its monetary policy by raising interest rates and dampening the overall level of demand in the economy. Of course, this policy response is exactly opposite to the one required by the first shock, and therein lies an important problem for the Bank.

The Bank of Canada's job is a difficult one. It must base its policy decisions on incomplete information and questionable forecasts about a very uncertain future. It must consider data for output, employment, wages, productivity, and many other important variables, and do its best to figure out what is happening and how best to respond. To make matters worse, the messages from the data almost never point in the same direction, and this is surely one of those times, as even a cursory glance through the business press will tell you, with conflicting signs and reports from various parts of the Canadian and U.S. economies.

Given the conflicting economic data, many people argue that the soaring loonie should tip the balance and make an interest-rate cut the obvious choice for the Bank. But there is nothing obvious about it. The flight away from the U.S. dollar has been strengthening the loonie and putting pressure on some Canadian exporters. This shock calls for an interest-rate cut. On the other hand, the recovering world economy has been raising commodity prices and stimulating the Canadian economy by helping resource-based exporters. This shock calls for a rise in interest rates. Given that both shocks have been happening simultaneously and are likely to continue, this is one of those times that the Bank may do the most good by staying exactly where it is: leave interest rates unchanged.

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