More Angst Than Mystery In the Loonie's Decline

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The ongoing decline of the Canadian dollar is generating many headlines and lots of angst. Of all the questions I receive from journalists and students, the cause of our currency's fluctuations is surely the most common. But there really isn't much of a mystery here – or at least there shouldn't be.

Let's start with the facts. Our dollar was worth 73 U.S. cents in 1995 and dropped to 63 cents by 2002. It then rose steadily to 93 cents by 2008 and kept rising to be above par in 2011. Over the past four years, the Canadian dollar has fallen again; it is now just above 70 cents.

Economists have long been studying the causes of exchange-rate fluctuations, especially after the collapse of the Bretton Woods agreement in the early 1970s. The Bank of Canada has undertaken lots of empirical research on this topic, and it repeatedly finds that the lion's share of swings in the Canadian-U.S. exchange rate can be explained by two factors.

The most important driver is changes in the global prices of commodities, from oil and potash and wheat, to copper and uranium and timber. The total production of these goods makes up only a small fraction of our national economy, but they represent over a third of our merchandise exports, and this is where the exchange rate fits in.

Increases in global commodity prices indicate that the world is prepared to pay more for our natural resource exports, and this raises the demand for our currency and causes it to appreciate. This is exactly what happened between 2002 and 2008. Conversely, declines in these prices cause the Canadian dollar to depreciate, as happened between 1997 and 2000 and also over the past four years.

And what causes these global prices to rise and fall? Mostly, it's the ebb and flow of global demand, as reflected by the world's business cycle. When the world's economies were growing quickly during the 2000s, especially the resource-hungry countries such as China and India, these commodity prices were rising quickly.

With today's slowing growth in these same countries, combined with a European economy that remains in the doldrums, there simply isn't as much demand for commodities, and so their prices fall. China's latest stock market "issues," which may lead to an even sharper growth slowdown there, just add to the downward pressure – both on global commodity prices and the Canadian dollar.

The second most important cause of swings in the Canadian dollar is the differential between Canadian and U.S. interest rates, which in turn depends largely on monetary policies. The U.S. economy has been recovering more quickly than ours (partly because of the different way the two countries respond to the decline in global commodity prices) and the U.S. Federal Reserve now appears to be on a rising-rate path. In contrast, our continued sluggish recovery is keeping the Bank of Canada in a holding pattern for interest rates.

As U.S. interest rates rise relative to ours, highly mobile financial capital naturally moves to capture the higher returns; the outflow of financial capital causes the Canadian dollar to depreciate. If the U.S. economic recovery continues to be more solid than ours, and the interest rate differential increases, we can expect more of the same.

So, is the depreciation of the Canadian dollar good or bad for Canada over all? As I would say to my students, this is actually the wrong question. Movements in the exchange rate are not the underlying shock to be analyzed; rather, they are a symptom of that shock – mostly, the change in global commodity prices.

The better question is whether the decline in global commodity prices is good or bad for Canada. And the answer is simple. As long as we remain a large net exporter of resource-based products, lower commodity prices are bad for the overall Canadian economy. They help some of us and hurt others, but the generally negative effect is unambiguous.

The other question I always get from journalists is about my prediction for the future of the Canadian dollar. My answer is always very straightforward. As soon as they can tell me where global commodity prices are going over the next five years, I can make a sensible prediction about our exchange rate. Otherwise, I haven't got a clue.

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