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The Seductive Myth of Canada's "Overvalued" Dollar

by
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- A confluence of factors promises to put pressure on the new Bank of Canada governor to direct monetary policy at fixing Canada's so-called "overvalued" currency.
- However, central banks have but one policy instrument under their control: the setting of a short-term interest rate. And with only a single instrument, monetary policy can have only a single target – inflation. Further, the view that the dollar is overvalued is on shaky ground.
- The governor needs to reject the seductive simplicity of the argument that monetary policy should be used to weaken the Canadian dollar and encourage exports. His focus instead should be on keeping inflation close to the Bank's 2 percent target.

Three Canadian economic facts may come together in a disturbing way in the near future. They concern Canada's currency, its trade, and its new central banker.

First, the Canadian dollar has been close to par with the US dollar for the past few years, and many observers claim that at this level it is substantially "overvalued." Second, Canadian exports have performed quite poorly since 2008, and there appears to be little chance of a revival without a

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significant pick-up in US and global growth. Third, the new governor of the Bank of Canada, Stephen Poloz, was previously the head of Export Development Canada, a federal-government-owned export-promotion agency, and many see him as a natural cheerleader for Canadian exporters.

These facts can easily be woven together to produce a seductively simple scenario in which Governor Poloz delays raising interest rates, or even begins reducing them, in an effort to weaken the Canadian dollar. Any such depreciation would obviously reduce the extent of the currency's "overvaluation" and could play a leading role in encouraging Canadian exports. This would provide a much-needed stimulus to Canada's medium-term economic growth.

Mr. Poloz knows that such a policy approach would be misguided. But he also knows that he will face plenty of pressure to follow it even before he begins raising interest rates. Consequently, he will need to clearly communicate why designing the Bank of Canada's monetary policy to weaken the currency is a bad idea. He will need to make two central arguments.

First, many people will need to be reminded that central banks have but one policy instrument under their control: the setting of a short-term interest rate.[1] And with only a single instrument, monetary policy can have only a single target. Central banks choosing to target the rate of inflation must therefore accept a freely fluctuating exchange rate. A central bank that chooses instead to focus on control of the exchange rate cannot expect to achieve its inflation target. Faced with this unavoidable choice, most of the world's governments have determined that targeting inflation is the better option for their central banks – and the dramatic events of the past five years have not changed this assessment. As Mr. Poloz said in his maiden speech last week, the inflation target is "sacrosanct" to the Bank of Canada, and a flexible exchange rate is "key to achieving our inflation targets over time" (Poloz 2013).

An Overvalued Loonie?

The second argument is conceptual, but even more fundamental, and relates to the view that Canada's currency is "overvalued." It is not clear what "overvalued" means, when the buying and selling decisions of millions of people or institutions around the world interact to determine the value of a currency on any given day. Doesn't an increase in demand for a currency, from whatever source, justify its appreciation? And doesn't any reduction in demand naturally lead to a depreciation?

Economic pundits arguing that the Canadian dollar is "overvalued" often base their view on the theory of purchasing power parity (PPP). The theory predicts that international trade in products eventually leads exchange rates to adjust until a typical basket of consumer goods and services in Canada costs the same as similar baskets in other countries.[2] The basic idea is that if goods are more expensive in Canada, buyers will switch their purchases away from Canada and toward countries with cheaper goods. This switching will cause

1 The central bank's single instrument can be viewed as changes in the size of its balance sheet or as the interest-rate adjustments associated with these changes. But the movements in interest rates and measures of "money" are not independent of each other – they are best viewed as opposite sides of the same coin.

2 Other commentators argue less precisely that speculative forces often cause the exchange rate to deviate from its "fundamental" value, without specifying the meaning of the latter. In these settings, the theory of PPP is usually used, implicitly or explicitly, to determine the exchange rate's "fundamental" value.

the Canadian currency to depreciate (or Canadian prices to fall relative to foreign ones) until the prices of the baskets are equal. This comparison suggests that the "right" value for the Canadian dollar is about 88 US cents – so today's Canadian dollar is overvalued by approximately 10 cents (Macdonald 2012).

The fact that this argument draws on hard numbers makes it appear much stronger than it is. To be sure, it holds up to a point. International trade does indeed tend to equalize prices of individual goods such as barrels of oil or diamonds or ounces of gold – this is the famous "law of one price" at work. But the same logic does not apply straightforwardly to the wide spectrum of products that make up a modern economy.

Most of the products purchased by consumers are services that cannot be traded across international boundaries. Examples include haircuts, restaurant meals, grass-cutting, home renovations, dry cleaning, movie tickets, hotel stays, car repair – the list goes on and on. In Canada, as in most developed economies, non-traded services represent well over two-thirds of consumer spending.[3] The market forces that might make their prices converge internationally are weak compared to the sustained national differences in labour costs, land values, industry-specific market power, and indirect taxes and subsidies. Realistically speaking, no market force will bring the prices of non-traded services into equality across countries, thus greatly weakening the theory of purchasing power parity.[4]

Consider a comparison of the actual Canada-US exchange rate over the past 30 years and the "PPP exchange rate," which reflects theoretical parity in the prices of consumer baskets in the two countries (Figure 1). Two observations are immediately apparent. First, the PPP exchange rate is fairly stable over time, although since the early 1990s there has been a gradual appreciation due to the slightly lower inflation in Canada. Second, the actual exchange rate is quite volatile, with periods of substantial appreciation in the late 1980s and throughout the 2000s, and a decade of depreciation during the 1990s. In other words, movements in the PPP exchange rate are a poor indication of those in the actual exchange rate – that is, the PPP theory has little explanatory power. The actual exchange rate deviates significantly and for periods of several years from the PPP exchange rate.

Of course, a booster of the PPP theory might look at Figure 1, see the actual exchange rate buffeted by shocks but nonetheless "eventually" returning to the PPP rate, and retain PPP as an adequate long-run theory of exchange-rate determination. A more sober assessment of Figure 1, however, is that PPP provides little or no practical guidance to movements in the actual exchange rate for intervals of several years. And if PPP cannot provide practical guidance as to the appropriate value of the exchange rate, the foundation for the claim of the Canadian dollar's "overvaluation" loses its strength.

Instead, it is more sensible to view the forces of demand and supply in the foreign-exchange markets as determining the "right" value of any freely floating currency. It makes little sense to think of such currencies as ever being "overvalued" or "undervalued."

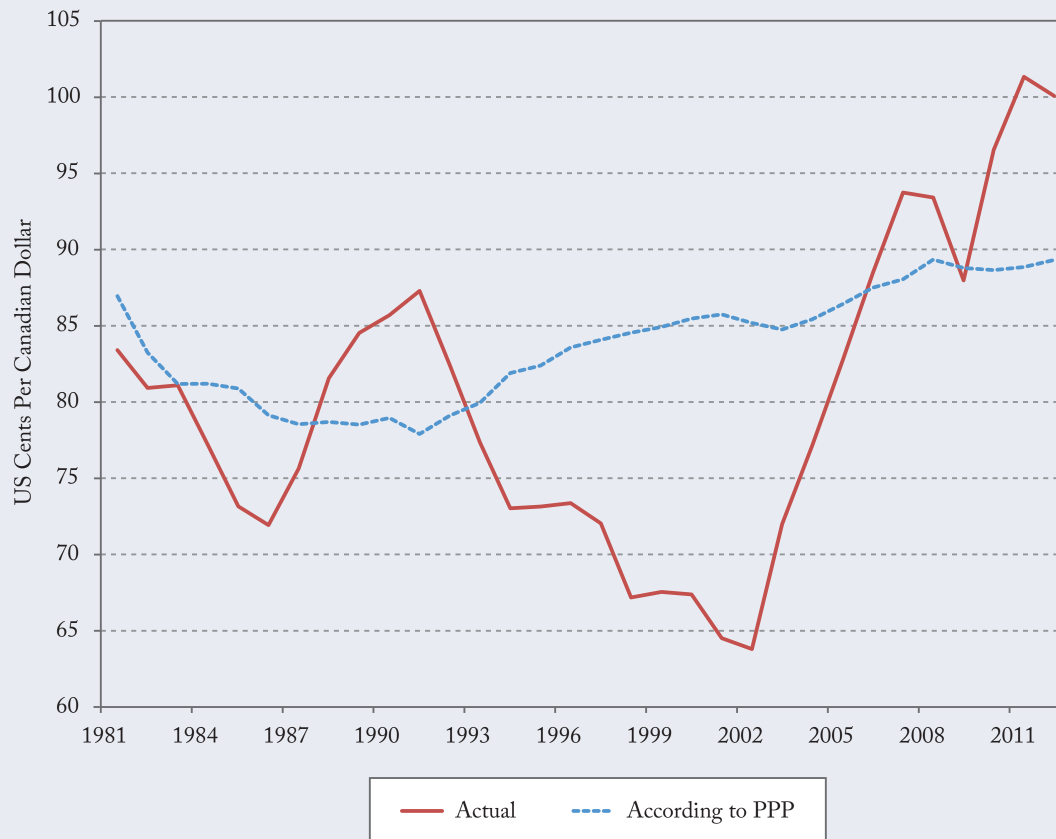
Commodities and Confidence

What are these market forces that drive exchange rates? There are many that matter, but in Canada's case, one towers above all others. As research at the Bank of Canada has shown for over 20 years, the dominant

3 Based on the weights in the Canadian 2011 CPI basket (evaluated at January 2013 prices), the share of consumer expenditures accounted for by services is just over 70 percent.

4 See Lafrance and Shembri (2002) for a more detailed discussion of PPP and other reasons for its failure to explain movements in actual exchange rates.

Figure 1: Canada-US Exchange Rate: Actual and According to Purchasing Power Parity (PPP)

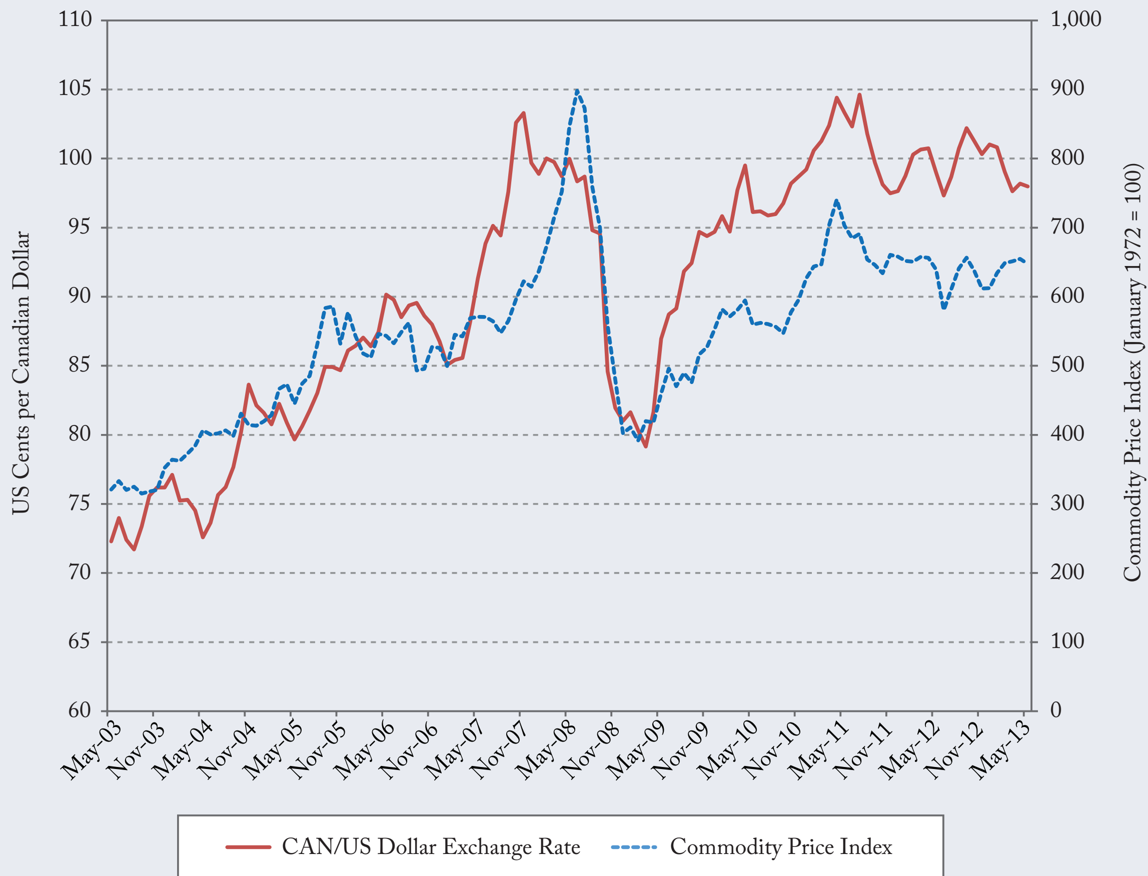


Sources: Author's calculations based on data from Statistics Canada and the US Bureau of Labor Statistics. The PPP (purchasing power parity) exchange rate is set to equal the actual exchange rate in 1987-88, as shown in the recent study by Statistics Canada (Macdonald 2012).

explanation is fluctuations in global commodity prices (Maier and DePratto 2008, and Bergevin and Busby 2010). Since Canada is a major exporter of many commodities and the United States is a major importer, an increase in these prices means that the world is prepared to pay more for the Canadian dollars ultimately required to purchase the commodities. So an increase in commodity prices causes an appreciation in our currency relative to the US dollar. By the same logic, decreases in world commodity prices cause the Canadian dollar to depreciate against the US dollar.

Commodity prices and the Canada-US exchange rate have essentially moved in tandem over the past 10 years. This can be seen especially during the strong run-up in commodity prices in the early 2000s and the sharp drop during the global financial crisis (Figure 2). The period after 2009, however, shows that the strength of the Canadian dollar has been more than could be expected solely from rising commodity prices. This period reveals another important source of demand for the Canadian dollar: the confidence of financial investors. Since 2009, troubles in the European and US economies have led many investors to adjust their

Figure 2: Canada-US Exchange Rate and the Commodity Price Index



Source: Bank of Canada.

financial portfolios toward Canadian assets, both private and public. These financial decisions naturally involve greater demand for the Canadian dollar in foreign-exchange markets and thus explain some of the recent strength of the Canadian currency.

Some commentators might argue that while an appreciation of the Canadian dollar caused by rising world commodity prices is an understandable and even desirable outcome, appreciations caused by international portfolio reallocations are "artificial" and should be avoided. There is nothing artificial about such changes, however. If investors perceive that Canadian government or corporate debt is now less risky than similar debt elsewhere, or that Canadian equities are now more attractive investments owing to Canada's better business environment, there is naturally more demand for the Canadian dollar in foreign-exchange markets. The resulting appreciation of the currency is the predictable market response to such actions. Changes in global demand for Canadian assets are no less "genuine" causes of exchange-rate fluctuations than changes in global demand for Canadian exported goods and services.

Winners and Losers

It is important to recognize, however, that market forces and exchange rate movements create both winners and losers in the economy. If rising global commodity prices drive up the Canadian dollar, the clear winners are those firms and workers involved in the production and export of commodities; the clear losers are those firms and workers producing non-commodity goods for export whose prospects are harmed by the strong Canadian dollar. This is the "Dutch Disease" that has been so debated in Canada in recent months, and is a genuine phenomenon (Carney 2012).

In contrast, if the source of the Canadian dollar's strength is the greater attractiveness of government and corporate financial assets, there are clear winners – the governments (and their taxpayers) who can now finance their borrowing at lower interest rates and the firms and workers who can more easily borrow or raise capital. The clear losers are the firms and workers who do not benefit from the easier access to financial capital and whose exporting efforts are made more difficult by the stronger dollar.

The Canada-US dollar exchange rate is one of many relative prices in the economy, and like all relative prices it is usually changing in response to various economic forces, domestic and foreign. As occurs whenever relative prices change, some people are made better off and others worse off. But in a setting of freely floating currencies, it makes little sense to claim that today's exchange rate is either "too high" or "too low." Importers will always argue that the Canadian dollar is too weak, whereas exporters will always argue the opposite. Recently, and not surprisingly given the dollar's current level, it is the exporters who have been making the most noise.

Bank of Canada Governor Stephen Poloz needs to reject the seductive simplicity of the argument that monetary policy should be used to weaken the Canadian dollar and encourage exports. His focus instead should be on keeping inflation close to the Bank's 2 percent target. This means accepting the exchange-rate path that naturally results from existing market forces. By avoiding the distraction of Canada's familiar exchange-rate debate, Mr. Poloz can better prepare himself for the larger challenges ahead. They will not be in short supply.

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