The Seductive Myth of Canada's "Overvalued" Dollar

The Globe and Mail
June 25, 2013

Christopher Ragan

Three Canadian economic facts may come together in a disturbing way in the near future.

First, the Canadian dollar is close to par with the U.S. dollar, and many pundits claim it is substantially overvalued. Second, Canadian exports have performed quite poorly since 2008, and there is little chance of a revival without a pick-up in U.S. and global growth. Third, the new Governor of the Bank of Canada, Stephen Poloz, was previously the head of Canada's export-promotion agency, Export Development Canada, and many see him as a natural cheerleader for Canadian exporters.

What do these facts suggest? Mr. Poloz will be pressured to delay raising interest rates, or even to begin reducing them, thus weakening the Canadian dollar. Such a depreciation would spur Canadian exports and provide a much-needed stimulus to medium-term economic growth.

But Mr. Poloz knows to resist this pressure. His explanation for doing so will rest on two central arguments.

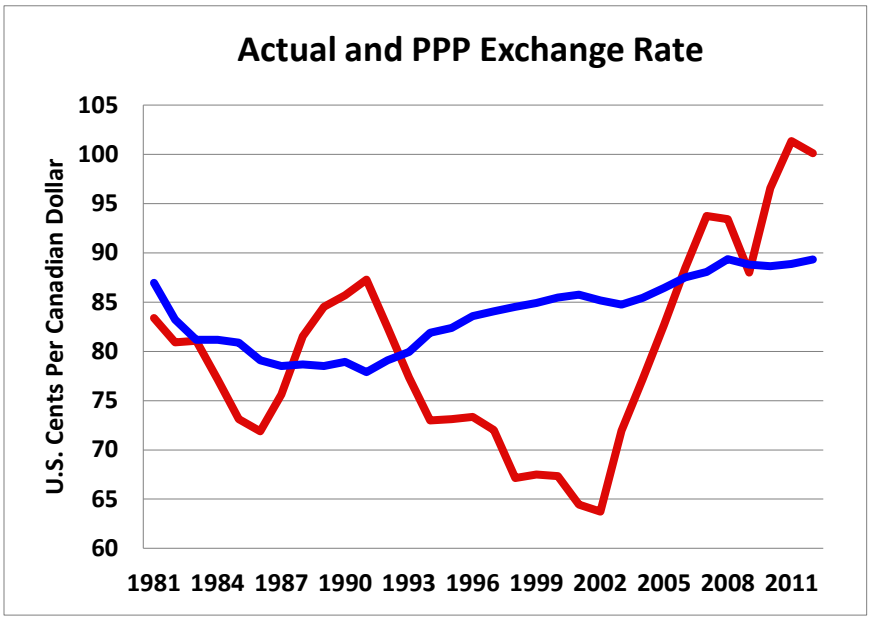
First, central banks have but one policy instrument – the setting of a short-run interest rate. And with only a single instrument, monetary policy needs to be directed at a single target. Central banks choosing to target the rate of inflation (as, by legislated mandate, the Bank of Canada does) must accept a freely fluctuating exchange rate, and any bank choosing to focus its monetary policy on the exchange rate cannot expect to achieve its inflation target. Faced with this unavoidable choice, most of the world's central banks have determined that targeting inflation is the better.

Second, there is a fundamental problem with the view that Canada's currency is overvalued. When the buying and selling decisions of millions of people or institutions interact to determine the value of a currency on any given day, it's not even clear what "overvalued" means.

Economic pundits arguing that the Canadian dollar is overvalued often base their view on the theory of purchasing power parity (PPP), which predicts that international trade eventually leads exchange rates to adjust until a typical basket of consumer goods and services in Canada costs the same as in other countries. If products are more expensive in Canada, buyers will switch their purchases away from Canada and toward cheaper countries, and this switching will cause 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 U.S. cents – roughly 7 cents below its current level.

International trade does, indeed, tend to equalize prices of goods such as oil or diamonds or gold – this is the famous "law of one price" at work. But the same logic does not apply to the majority of

consumer spending that falls on services. Haircuts, restaurant meals, grass-cutting, dry cleaning, movie tickets, hotel stays, car repair – the list goes on, with services representing more than two-thirds of total spending. Since these products are non-traded, there is no realistic market force that will equalize their prices across countries. For this very simple reason, the claim of the Canadian dollar's overvaluation falls apart.

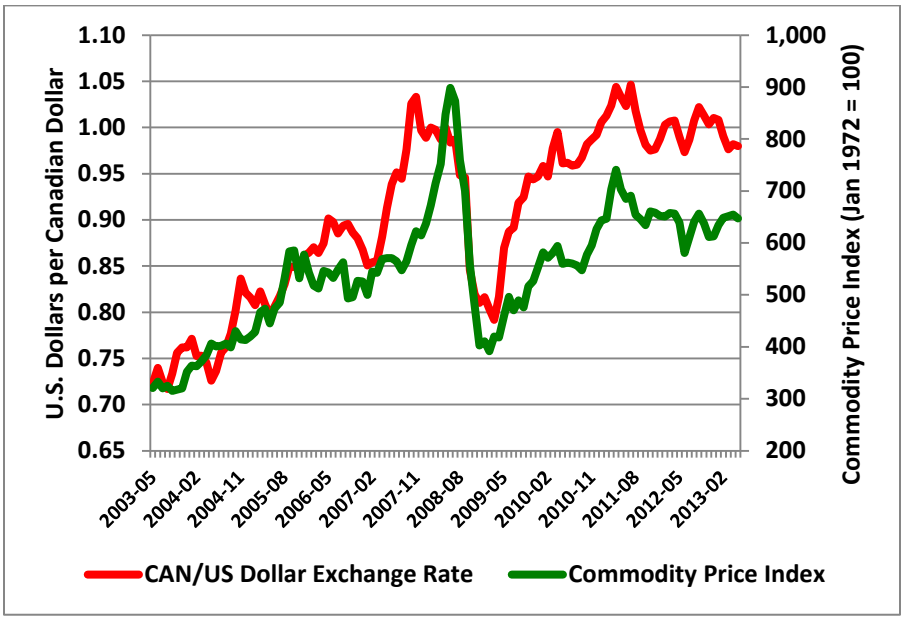


The chart above shows the actual Canadian-U.S. exchange rate over the past 30 years. It also shows the "PPP exchange rate," the exchange rate that would exist if PPP held exactly and the exchange rate equalized the prices of consumer baskets in the two countries. Two observations are immediate. First, the PPP exchange rate is not very volatile, 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 movements in the actual exchange rate.

So what market forces drive exchange rates? There are many that matter; but in Canada's case, as research at the Bank of Canada has shown for more than 20 years, the dominant explanation is global commodity prices. Since Canada is a major exporter of many commodities, an increase in prices means that the world is prepared to pay more for the Canadian dollars ultimately required to purchase them, thus creating an appreciation in our currency. By the same logic, decreases in world commodity prices cause the Canadian dollar to depreciate.

The chart below shows the path of commodity prices and the Canadian-U.S. exchange rate over the past 10 years. The very close correlation between the two variables is apparent, especially during the strong run-up in commodity prices in the early 2000s and the sharp drop during the global financial crisis. The period after 2009, however, shows that the strength of the Canadian dollar has been more than what would 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 U.S. economies have led many investors to adjust their financial portfolios toward Canadian assets, both private and public.



Some 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. 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.

As is true for all changes in relative prices, exchange-rate fluctuations help some people and hurt others. But 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, the exporters have been making the most noise.

Mr. Poloz needs to resist the exporters' pressure to stimulate growth by weakening the Canadian dollar. Instead, he needs to focus on the Bank of Canada's 2 per cent inflation target and accept whatever exchange rate results from the existing combination of market forces. It may make him unpopular in some quarters, but it is the right decision for Canada as a whole.

Christopher Ragan is an associate professor of economics at McGill University and holds the David Dodge Chair in Monetary Policy at the C.D. Howe Institute in Toronto.

*****