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Let the loonie be; There is little that the government or the Bank of Canada should do to suppress the loonie's movements

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In the aftermath of the loonie's meteoric rise in 2007, many Canadians now worry over its recent and sudden fall amid global financial market turmoil. During past declines in the exchange rate, there have often been calls for Bank of Canada intervention, or even for fixing the exchange rate to the U. S. dollar.

In fact, the exchange rate's recent behaviour demonstrates the continuing link between the Canadian dollar and global commodity prices. This link suggests there is little that the government or the Bank of Canada could or should do to suppress the loonie's movements.

The Canadian dollar's weakening is the consequence of two forces: declining commodity prices, as people anticipate a global economic slowdown, and the strengthening of the U. S. dollar as investors move to the perceived safety of U. S. Treasury securities. Although the flight-to-quality nature of the U. S. dollar's rise is a big part of the story of the loonie's recent decline, commodity prices, and especially energy prices, continue to exert a powerful influence on the dollar. While in the past year Canadians got used to hearing about the strong upward force of commodity prices on the dollar, we now see the flip-side, and the impact is as strong on the way down as up.

To be more precise about the effects of commodity prices, I have adapted an equation based on work by the Bank of Canada, separating the effect of energy and non-energy commodities and interest-rate differences on the Canada-U. S. exchange rate. The model implies that while the run-up of the dollar over the past few years was predicted by fundamental forces, its value clearly over-shot before falling back toward a level arguably explained by fundamentals.

There is a natural tendency for markets to over or undershoot a value consistent with fundamentals, and this volatility is a necessary part of price discovery. Indeed, the current decline to 77¢ as of Oct. 27 puts the loonie below my current predicted value, implying that the market has overcorrected, considering that energy prices are not so low compared to a couple of years ago and the difference in yields between Canadian and U. S. treasuries has widened dramatically. Although my predicted value may soon come down somewhat with oil prices, it will remain much higher than the exchange rate's bottom in the early part of this decade.

Looking at the fundamental values back to 1972, the most recent overshoot has been larger, and lasted longer than in any previous episode. This is likely in part related to the asset price bubble in the U. S., which had spillover effects on global commodity and foreign exchange markets. Because monetary policy played a part in inflating this bubble, this is a timely reminder of the powerful and far-reaching effects that loose money can have, and the need for a long-term outlook on the part of policymakers.

So should the government react now? The Bank of Canada's guiding policy target is an inflation rate of 2%, with a one percentage point range. And an integral part of the inflation-targeting regime is a floating exchange rate. To react to exchange rate movements driven by changes to our terms of trade, the price of Canada's exports relative to imports would require abandoning the inflation-targeting program, likely with more costs than benefits.

The diverse nature of the Canadian economy means that the lower dollar offers advantages to some. Exporters, especially in central Canada, were hard hit last year by the explosive growth in the Canadian dollar's price. They are likely to find some relief now as their goods become more competitive abroad. A lower dollar is also likely to discourage consumption of imported goods, and encourage domestic consumption and savings, likely positive effects in a softening economy.

Although this recent decline in the oil price is linked to fears of short-term declines in growth rates in major developed and developing nations, it remains at historically high levels, and no one seriously predicts that demand for commodities from the fast developing nations of Asia will subside. Moreover, the U. S. dollar will eventually feel the effects of the burgeoning U. S. government debt. So before long, we will likely be faced with a resurgent loonie.

Canadians are right to closely follow the movements of the dollar. As a small economy that is heavily reliant on trade, sharp movements in the exchange rate can affect our prosperity. However, when those movements are driven by real factors, the only sustainable strategy is adaptation. To that end, government's best policy choices involve ensuring that markets for financial capital and labour in Canada work as well as possible. When responding to the current market crisis, policymakers should retain their long-run focus on the productivity agenda, which remains the determinant of future Canadian prosperity.

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