

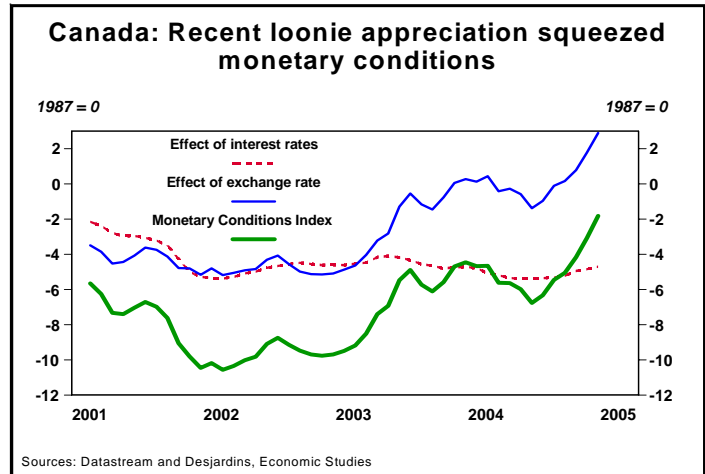
December 2, 2004

## Canada: Monetary conditions looser than they initially appear

### A modified index allows for more accurate historical comparisons

First of all, bear in mind that Canada is a relatively open economy that operates in a context of floating exchange rates, which means that fluctuations in the value of the Canadian dollar strongly influence the local demand for goods and services. The Bank of Canada therefore must take the Canadian dollar's evolution into account in managing its monetary policy. The Monetary Conditions Index (MCI) is very useful in this context since it combines the effect of short-term interest rates on domestic demand with the effect of our exchange rate on Canadian foreign trade.

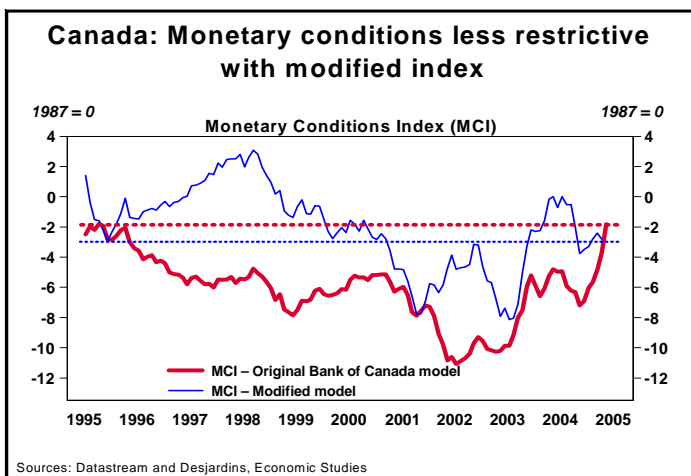
Many have recently noted that monetary conditions in Canada are tighter than in previous years. This obviously stems somewhat from two increases in key interest rates since September, but the loonie's considerable appreciation (nearly 18% since May and a bit more than 32% since early 2003) has a lot more to do with it. According to the Bank of Canada's original model, the MCI currently stands at -1.82, which is very high from a historical standpoint. In fact, current monetary conditions are, in a sense, the most restrictive seen since 1995.



### Creation of a new index

This type of historical analysis can be unreliable, however. Many structural changes have been made over the years, and it is difficult to make historic comparisons of the MCI in its original version. On one hand, short-term interest rates were much higher a bit more than ten years ago because inflation was at an unusually high level. Short-term interest rates are likely much less neutral today than they were at the time. To correct this situation, we propose a modified MCI that uses short-term interest rates expressed in real terms.

On the other hand, the equilibrium level of the Canadian dollar changes with time based on the progression of underlying factors (Canadian and U.S. interest rate differentials; raw materials prices, with and without petroleum; and the budget balance) that influence the value of our currency. So a US\$0.85 loonie would have been much more restrictive in 1997 since its equilibrium value was as low as US\$0.66. Therefore, we propose also changing the exchange rate portion of the MCI and replacing it with the difference between the Canadian



**François Dupuis**

Deputy Chief Economist and Strategist

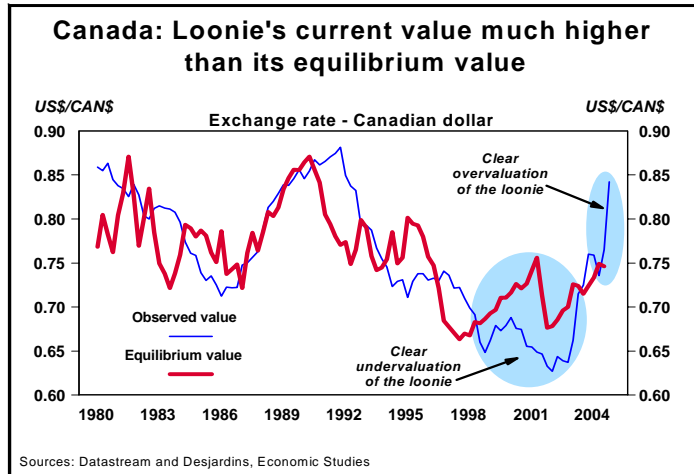
Phone: 514-281-2336 or 1 866 866-7000 ext. 2336

**Benoit P. Durocher**

Economist

E-mail: desjardins.economics@desjardins.com

dollar's observed value and its short-term theoretical equilibrium value. It would also be better to use the real exchange rate for the Canadian dollar, which takes into account the differences between national inflation rates, rather than the nominal exchange rate. A new version of our modified MCI might enable us to develop this aspect in the future.



Our modified MCI differs significantly from the original version. The major undervaluation of our currency from 1998 to 2002 skewed the progression of the original MCI, which fell to unusually low depths during that

period. A study of the modified MCI indicates that monetary conditions were not actually as tight as we initially believed. At -2.8, the modified MCI shows less restrictive monetary conditions than those observed in early 2004, when the Bank of Canada had just increased its leading interest rates three times and the Canadian dollar had gained about 22% in 2003.

### Consequences for the Bank of Canada

We must not assume, however, that the Bank of Canada will take advantage of this additional leeway to increase its key interest rates quickly. The Bank of Canada principle, which is that exchange rate variations should compensate for exchange terms (prices of exports in relation with prices of imports), is not feasible in the short term. The recent rise in the Canadian dollar was much too rapid and sudden. Even if the latest increase in prices of raw materials enables certain sectors to offset the negative effects of the loonie's appreciation on other sectors, it seems that, overall, the adjustment asked of companies is too violent in the short term. In the coming weeks, the Bank of Canada's policy should be more moderate and the next rate increases more discreet. David Dodge's speech from last week is a first step in that direction, but it remains to be seen if this new message isn't too late.