Trend for the Canadian dollar
Gains at first, followed by more difficult times

The Canadian dollar’s rise over the last ten years has been unequivocal. In just a few years, the loonie climbed from a low of around US$0.60 to reach parity with the U.S. dollar; it has held around this level for about six years (graph 1). Several factors contributed to this appreciation in Canada’s currency, including the stellar rise in commodity prices, and oil prices in particular. However, we may wonder whether the context will remain favourable for the Canadian dollar, or if the pullback observed over recent weeks is the beginning of a long downtrend. This Economic Viewpoint shows that the loonie could still appreciate between now and 2015. Thereafter, it will become more difficult, and its value could be more in line with a level associated with the purchasing power parity theory.

HOW DID THE LOONIE REACH PARITY?

In a floating exchange rate regime like Canada’s, it is supply and demand in the exchanges that sets a currency’s value. Generally, the better a country’s economy is doing compared with others, the higher the demand for and value of that country’s money will be.

Many things have influenced Canada’s economy and demand for the loonie over the last ten years, but the rise in commodity prices, and oil prices in particular, was the most decisive factor. The resources sector is a large part of the Canadian economy. Rising commodity prices improve the terms of trade and boost incomes for Canadians. High prices also stimulate exploration and investments in this sector. The health of Canada’s economy is therefore positively influenced by these changes to commodity prices, and Canada’s exchange rate reacted strongly (graph 2).
A healthy economy often goes hand in hand with less accommodating monetary policy. Compared with the United States, Europe and Japan, far less monetary easing has been needed in Canada in response to the crisis periods that have been shaking the planet since 2008. Slightly higher interest rates in Canada also raised demand for Canadian securities and contributed to the loonie’s appreciation. This effect has been especially visible over the last two years (graph 3). That being said, monetary policies do not just differ in terms of interest rates, but also in terms of the amount of money that central banks inject into the economy. The Federal Reserve (Fed) injects a lot of liquidity, which puts downside pressure on the U.S. dollar (graph 4). The inflation expectations that underlie monetary policy can also influence exchange rates. However, other components of Canada’s economy may grow less quickly for some time. Despite some signs to the contrary, the most likely hypothesis includes a continued downtrend by the residential real estate market. Households are also increasingly cautious with regard to taking on debt, which limits some consumer spending, while the fight against budget deficits is hindering government spending.

In spite of everything, the Canadian economy should grow faster than its potential as of this autumn, supported by exports and business investments. Excess production capacities should therefore decrease slowly, which will trigger some monetary firming around fall 2014 (graph 6). The Bank

Finally, the solidity of Canada’s financial system, smaller public deficits and its ongoing AAA rating on its sovereign debt are other factors that have buoyed demand for the Canadian dollar. The question we have to ask now is this: will these factors persist for much longer?
of Canada will be one of the few central banks in industrial nations to raise its interest rates that early. The Fed should wait several more quarters after that before removing liquidity from the financial system and raising key rates. The gap between Canadian and U.S. monetary policy should benefit the Canadian dollar.

The loonie will also continue to benefit from the Canada’s solid financial system, the country’s improved budget situation and the AAA rating on its sovereign debt. The Canadian dollar’s recent weakness should therefore be fleeting, given all of these favourable elements. The most likely scenario over a 12-month horizon is a loonie that is back above parity.

MORE DIFFICULT IN THE LONG TERM

The game will change when the Fed initiates monetary firming, either by withdrawing liquidity that it had previously injected, or by raising its key interest rates1. This should occur around the second half of 2015, but the effects on exchange rates could be felt a bit earlier as expectations adjust. What’s more, monetary firming should be more substantial in the United States than in Canada. The Fed will have to work twice as hard to normalize its monetary policy, given the scope of the measures taken over the last five years.

Increased support from commodities could help the loonie cope with U.S. monetary firming. However, potential help from this quarter will be limited in the longer term. While demand should be sustained, a larger supply could rein in future price increases. For oil, for example, the International Energy Agency expects that increased global demand will be almost entirely met by increased production capacity outside of the members of the Organization of the Petroleum Exporting Countries (graph 7). In this context, oil prices will have a hard time rising much above US$100/barrel.

All the same, Canada’s economy will benefit from returns on investments in the resources sector and a larger volume of exports. Furthermore, the budget deficit battle should be less pronounced in a few years, as will the adjustments in the residential real estate sector. Outlooks for the Canadian economy remain good, but that will not be enough to stop the loonie’s depreciation. Relatively speaking, the other major economies will be doing just as well, which will cancel out the Canadian currency’s advantage.

The current account deficit could also put downside pressure on the loonie (graph 8). In the short term, the global economy’s forecast rebound and the development of the natural resources sector will help increase Canada’s exports. After that, some depreciation of the Canadian dollar could become necessary to support export growth and shrink the current account deficit. However, other factors could favourably influence the current account balance, such as decreased public deficits. Finally, the current account deficit is less problematic when it is being used to finance business investments, because these investments help support economic growth in the long term.

WILL WE RETURN TO PURCHASING POWER PARITY?
The expected softening of the Canadian dollar as of 2015 could gradually near the equilibrium value of the exchange rate suggested by the purchasing power parity theory (PPP). According to this theory, a basket of goods and services should cost the same, regardless of the country it is purchased in, and the exchange rate should adjust to maintain this equality.

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1 Note that the reduction to the Fed’s securities purchases, expected to start in fall 2013 and be staggered over several months, cannot be considered the start of monetary firming. The size of the Fed’s balance sheet, and the amount of liquidity injected into the financial system, will continue to grow, though at a slower and slower pace.
Consumer price indexes (CPI) are currently used to estimate PPP. According to our estimates, Canada’s exchange rate has been moving above this mark for the past few years (graph 9). The loonie’s value could thus head toward US$0.90 over the long term. This equilibrium value could rise slightly if prices in Canada grow a bit slower than in the United States.

However, the PPP is not a reliable measurement. While exchange rates tend to fluctuate around this value, they rarely stay there for long. That is because many other factors influence exchange rates. What’s more, use of the CPI entails some measurement bias. Firstly, the basket for Canada’s CPI is different from the one for the United States: we are therefore not comparing the same goods and services. Next, we have to exclude the effects of consumption taxes, which add to differences between the CPIs. Finally, not all goods and services can be imported or exported, which means that there can be lingering price differences from one country to another.

Producer price indexes (PPI) are sometimes used to work around some CPI shortcomings. However, the baskets for the United States and Canada are still made up of different things. What’s more, because the selling prices of some Canadian businesses are established in U.S. dollars, this distorts the causal relationship between exchange rates and PPI ratios.

**A SCENARIO WITH MANY RISKS**

In sum, the Canadian dollar could first return above parity, but a lasting downtrend should begin around 2015. This trend should bring the Canadian currency to PPP, around US$0.90. At that level, the loonie will remain strong historically speaking, but it will at the same time offer some respite for exporters.

However, several risk factors could modify this scenario. The three main issues will be the health of the Canadian economy, demand for commodities and changes to monetary policies. The loonie’s depreciation could occur sooner and be more pronounced if Canada’s economy grows less than expected, if demand from emerging nations for commodities is smaller, or if the Fed pushes its monetary firming sooner. There is a sizeable risk that the loonie could return to a range between US$0.80 and US$0.90. On the other hand, we cannot completely rule out the possibility that the loonie will remain above US$1.00 for longer. Canada’s economy could contain some upside surprises, as could demand for commodities from emerging nations. The Fed might also have to postpone monetary firming or spread it over a longer period of time. Forecasting exchange rates remains a difficult exercise, one that often comes with a large margin of error.

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