Economic News
Desjardins Economic Studies
www.desjardins.com/economics
January 27, 2014

CANADA

The exchange rate reaches purchasing power parity: is the correction over?

The Canadian dollar is in the throes of a substantial downside correction, a movement that is mainly due to worries about Canada's economy and the Bank of Canada (BoC), which seems increasingly concerned about how weak inflation is. Among other things, the situation is prompting investors to look for a cut to key interest rates, or at least a very long monetary policy status quo.

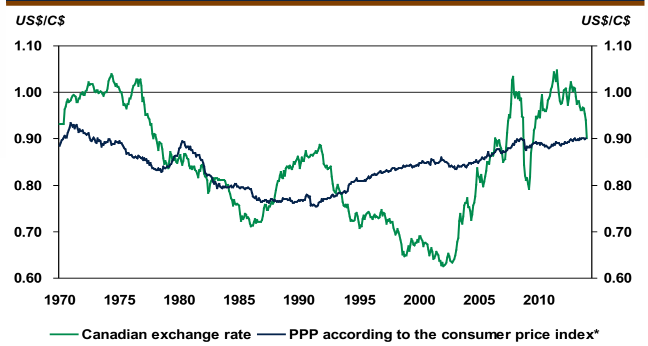
Given the substantial depreciation, there is reason to wonder about the loonie's equilibrium price. According to purchasing power parity (PPP) calculated since 1970, the dollar is now at equilibrium at US$0.90.

Based on the logic of PPP, the price of a basket of goods and services must be the same from country to country. In the event of a disparity, the exchange rate should theoretically adjust to return to the equality. However, PPP cannot be observed directly. Most often, the ratio between the consumer price indexes (CPI) is used to estimate it.

Nor is PPP a very precise metric. Graphically, it is clear that the exchange rate can move well away from the value of PPP, because numerous other factors also affect exchange rate movements. What's more, using CPI introduces some measurement biases. Firstly, the Canadian CPI basket differs from its U.S. counterpart: we are therefore not comparing prices for the same goods and services. Then, the effect of consumer taxes should be excluded, as they add divergences. Lastly, not all goods and services can be exported or imported, which means there could well be price differences from country to country, as there is no possibility for arbitrage.

Producer price indexes (PPI) are sometimes used instead of CPIs. There again, the baskets differ between Canada and the United States. Moreover, the fact that some Canadian businesses set their selling prices in U.S. dollars skews the causal relationship between the exchange rate and the PPI ratio.

Purchasing power parity (PPP) puts the Canadian dollar's equilibrium price at US$0.90



* Estimate according to a base period that began in 1970, when the Canadian dollar was first allowed to float.
Sources: Datastream and Desjardins, Economic Studies

Implications: PPP has just reached a psychological threshold, but its unreliability and the existence of many other variables affecting the exchange rate suggest that the downside correction could persist. The Canadian dollar should stabilize when sentiment about Canada's economy becomes less negative and, in particular, when investors sense the BoC is less worried about inflation's weakness. Recently, inflation moved back into the BoC's target range, a first step toward seeing the loonie stabilize. However, price growth will have to remain convincing in coming months, and this is not guaranteed. Futhermore, worries about some emerging nations also seem to be trying to materialize again. This could be a drag on commodity currencies, as it could affect demand for resources, with the result that the loonie could lose a few more cents in the short run.

Hendrix Vachon
Senior Economist

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Senior Director and Deputy Chief Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Mathieu D'Anjou — Senior Economist
Benoit P. Durocher — Senior Economist
Francis Généreux — Senior Economist
Jimmy Jean — Senior Economist
Hendrix Vachon — Senior Economist