The loonie is overvalued – and the Bank of Canada has room to act

By Erin Weir
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On Tuesday, economist and fellow Economy Lab contributor Christopher Ragan characterized the notion of an overvalued Canadian dollar as a "seductive myth" that the Bank of Canada should not act to address. I have made the case in the past that we should broaden our central bank's mandate to include managing the exchange rate and welcome the opportunity to advance this important policy debate.

Significantly, Mr. Ragan agrees that currency "depreciation would spur Canadian exports and provide a much-needed stimulus to medium-term economic growth." Yet there are three main points of disagreement: Whether the Bank of Canada could manage both inflation and the exchange rate, whether the loonie is overvalued, and whether the benefits of a higher exchange rate offset its costs.

Mr. Ragan writes, "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," i.e. inflation.

Surely the global response to the financial crisis has demonstrated that central banks possess an array of policy instruments in addition to interest rates. Whether the Bank of Canada should deploy these instruments is debatable, but we should not deny their existence.

In particular, the Bank of Canada could sell (or credibly threaten to sell) Canadian dollars into foreign-exchange markets to moderate the exchange rate. Of course, this approach could boost inflation by expanding the global supply of Canadian dollars and/or by stoking inflationary expectations.

Some inflation helps the economy function smoothly. The Bank of Canada has concluded that 2 per cent is the optimal inflation rate. If inflation were already at that level, there would be a trade-off between keeping it on target and intervening to lower the exchange rate.

In reality, inflation has fallen below that target for 13 consecutive months and is now down to 0.7 per cent. If the Bank of Canada is serious about meeting its target, it should be trying to boost inflation.

In recent years, the Japanese and Swiss central banks successfully intervened to lower their national currencies, but no one would claim that they have allowed excessive inflation. Central bankers have proved capable of walking and chewing gum at the same time.

The Bank of Canada could manage both the inflation rate and the exchange rate. In certain circumstances, there would be trade-offs between the two. In current circumstances, efforts to lower the exchange rate would complement efforts to hit the inflation target.

Of course, we should endeavour to clip the loonie's wings only if it is flying too high. The exchange rate set by financial markets is currently far above purchasing power parity (PPP), the actual buying power of a loonie in Canada versus that of a U.S. dollar in the United States.

Mr. Ragan objects to this comparison because "movements in the PPP exchange rate are a poor indication of movements in the actual exchange rate." By this logic, our currency can never be overvalued (or undervalued). If the exchange rate equals purchasing power, then there is no case for overvaluation. If the exchange rate deviates from purchasing power, then Mr. Ragan deems purchasing

power to be invalid as a guideline for the exchange rate.

Indeed, in a C. D. Howe Institute e-brief also released Tuesday, he explicitly argues that our currency can never be mispriced: "It is more sensible to view the forces of demand and supply in the foreign-exchange markets as determining the 'right' value of any freely floating currency. It makes little sense to think of such currencies as ever being 'overvalued' or 'undervalued'."

That view is based on a theoretical faith in the market rather than on an empirical analysis of fundamentals. Recent years clearly demonstrate that financial markets make mistakes. While policymakers can also make mistakes, there is a role for central banks in moderating financial-market activity, including exchange-rate speculation.

Finally, Mr. Ragan argues that a higher loonie provides benefits as well as costs. His e-brief specifies, "If rising global commodity prices drive up the Canadian dollar, the clear winners are those firms and workers involved in the production and export of commodities."

Commodity producers clearly benefit from higher commodity prices. However, they do not benefit from the higher exchange rate associated with higher commodity prices. Like other exporters, commodity producers sell their output at prices denominated in U.S. dollars but buy many of their inputs using Canadian dollars. At any given level of commodity prices, a higher exchange rate shrinks U.S.-dollar revenues relative to Canadian-dollar costs.

In theory, Canadian consumers should be the beneficiaries of a higher loonie. But as Mr. Ragan himself points out, there has been little connection between the exchange rate and purchasing power in Canada. If the benefits of a stronger currency are not being passed through to Canadian consumers, then it is difficult to contend that they outweigh the very real costs of lost output and fewer jobs in export industries like manufacturing.

The Bank of Canada can and should act to moderate the exchange rate to a level consistent with purchasing power parity and conducive to exports, economic growth and employment.

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