Bank of Canada's inflation targeting has evolved a commodity currency

By Paul Beaudry and Amartya Lahiri

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Canadians recently reopened the debate about the previously taboo subject of fiscal deficits. Is it also time to reopen the debate about the Bank of Canada's narrow focus on inflation and its general hands-off approach to exchange-rate movements?

Over the past year, the value of the Canadian dollar has depreciated precipitously. How does the Bank of Canada react to such a change? Given that it is an inflation-targeting central bank, its response is to generally disregard such exchange-rate movements and instead focus on setting policy in a manner that is most likely to help inflation attain its target of 2 per cent. Is this the best policy for Canada? We believe not.

Inflation targeting was implemented by the Bank of Canada in the early 1990s, after a period of substantial variation in the rate of inflation. It has been highly successful at stabilizing the inflation rate and, for this reason, it should be applauded. However, one key implication of adopting inflation targeting is that the bank does not directly target the exchange rate. Instead, it lets it be determined by market forces.

By taking this hands-off approach, the bank has left the market considerable leeway on deciding how to determine the exchange rate, at least in the short run. Over time, the market has coalesced around the notion that the dollar should fluctuate closely with commodity prices. This wasn't always the case. Before the inflation targeting period, commodity prices had very little predictive power for the Canadian dollar. In this sense, the inflation-targeting regime has allowed and supported its evolution into a commodity currency.

This trend raises two related questions. First, does the dollar now fluctuate excessively with commodity prices? Second, should the Bank of Canada do anything about it?

Canada produces and exports many products, commodities being simply an important component. Commodity prices are typically determined in international markets, denominated in U.S. dollars and tend to be very volatile. Given a choice, how should we want the Canadian economy to adjust to these price movements? There are two extreme possibilities.

On the one hand, we could want stable prices of commodities in Canadian dollars, which would have the benefit of stabilizing the oil and commodity sectors. This requires the Canadian dollar to fluctuate substantially with international commodity prices, which means that the prices of other imports and exports in Canadian dollars must fluctuate strongly. Alternatively, we could want the demand for our other exports – such as manufactured goods – to be more stable. This would require the dollar to be relatively stable against our trading partners.

Which of these choices would be better for the Canadian economy? That depends on which sector is better able to adjust to large price fluctuations. The commodity sector appears better suited to handle large price fluctuations, the main reason being that, after a period of shutdowns, it is relatively easy to restart production anew when the price is high again. In contrast, our other export sectors may not have such flexibility. When the dollar rises with the price of commodities, manufacturing exports tend to lose competitiveness and firms close up shop.

One might think that when the dollar falls back, this should induce non-commodity firms that

had left Canada to start up again. However, starting up again in most of these sectors is very difficult, much more so than starting up oil production. This is one of the reasons fluctuations in the Canadian dollar are becoming greater. Producers of non-commodities recognize that the dollar has become a commodity currency and accordingly require a weaker and weaker dollar to return to produce in Canada as they know that such a situation is likely to be temporary, lasting only until the next commodity boom. In short, there is a strong case to be made that the Canadian economy would be better off in the medium and long run if the commodity sector absorbed more of the fluctuation in commodity prices, thereby allowing demand in non-commodity sectors to be more stable.

The desirability of exchange-rate targeting is a highly debated issue. Research on the topic has mostly found that strict exchange-rate targeting is hazardous and often fails. However, the current inflation targeting framework that governs monetary policy in Canada, with its hands-off view regarding the exchange rate, may not be the best option. The emergence of the Canadian dollar as a commodity currency was not one of the objectives of the inflation-targeting regime, but it has become one of its unintended consequences. For this reason, it would be a good time for the Bank of Canada to reconsider its inflation-targeting framework.

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