

INDEPTH: THE CANADIAN DOLLAR

What's behind the soaring Canadian dollar?

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Less than three years after hitting an all-time low, the Canadian dollar is on quite a ride. Since January 2003, the once-lowly loonie is up more than 25 per cent against the currency it's most concerned with – the American dollar.

On Oct. 20, 2004, the dollar did something it hadn't done in almost 11 years – it closed over 80 cents US. Many economists are saying there's only one direction for the dollar over the short term – up.

So what's behind the buck's run-up? Well, there are several reasons, but most of it "had nothing to do with Canada," said Avery Shenfeld, senior economist at CIBC World Markets. Washington holds the key to the value of the Canadian dollar.



By Oct. 22, 2004, the Canadian dollar had appreciated by seven per cent on the American dollar for the year – but only three per cent on the euro. The loonie's been flying mainly because the U.S. economy has been struggling to get off the ground. Washington is facing record budget and trade deficits.

While the Canadian dollar is constantly being measured against its U.S. counterpart because Canada and the U.S. are neighbours and the world's largest trading partnership, the loonie is just one of the national currencies that are valued in U.S. dollars, the closest thing to world money.

That's where the U.S. trade deficit comes in. In 2003, the U.S. bought \$490 billion US more in foreign goods and services than it sold. By October of 2004, the U.S. was heading towards a record annual trade deficit of \$590 billion US.

To pay for those imports – including huge amounts of oil, gas, cars and car parts, lumber and numerous other products from Canada – U.S. consumers have to buy foreign currencies. To do that, they have to sell U.S. dollars in international money markets. As in any market, the unending supply has pushed the price of the greenback down, as measured in other currencies.

For several years, Americans' sales of U.S. dollars didn't have much effect on the price of the Canadian dollar, but that changed in 2003. The greenback fell 22 per cent against the loonie during the year – and fell almost exactly

the same amount against the euro.

"It's about time," said Frank Atkins, an economics professor at the University of Calgary. In early 2002, the Canadian dollar was trading at record lows, but given Canada's better economic performance in terms of cutting government debt and deficits, and the growth and inflation figures, it should have been no surprise when the loonie took off, he said.

Atkins' observations point to a second set of factors that influence the dollar: while the story in 2003 and part of 2004 was the international flight from the U.S. dollar to other currencies, Canada's economic performance also plays a big role.

Canada continues to run large trade surpluses, which means other countries had to buy Canadian dollars to purchase our exports. The increase in commodity prices, a key factor in trade, also boosted the value of exports and helped push the dollar up, Shenfeld said.

The Bank of Canada has been another contributor to the higher dollar. By keeping interest rates above U.S. levels, the bank made Canada a relatively more attractive destination for foreign capital, which boosted demand for the loonie.

Bank of Canada governor David Dodge is not shying away from further interest rate hikes. The bank's October 2004 monetary policy report said the economy has been running at or near full capacity since mid-2004 and would probably continue to do so until 2006. The report noted that further interest rate hikes would be needed to keep the rate of inflation within the bank's target.

Pretty tame language for lay people – not so for a central banker. While there's acknowledgement in the report that a rising Canadian dollar could hurt exporters, there's no suggestion that the bank would shy away from increasing rates to keep the dollar from rising.

South of the border, Federal Reserve Chairman Alan Greenspan has hinted that rates may not have to rise as quickly to keep the U.S. economy from overheating.

Another factor that has helped push up the Canadian dollar is rising commodity prices – especially a run-up in the price of oil. As a net exporter of oil, Canada is seen as better able than the U.S. to absorb record oil prices.

Winners and losers

When the loonie has a big move in either direction, some of the effects are instantly obvious. In 2003, for example, exporters lost ground because Canadian products became more expensive for U.S. buyers. With a rising

dollar, "the biggest impact is that exporters find it harder to compete," Shenfeld said.

That could mean lost jobs if the weakest companies are forced out of business. But Atkins said the loss of the price advantage arising from the cheap dollar will force exporters to be more efficient. "This will be good for them in the long run," he said.

Cheaper U.S. dollars also provide Canadian companies with an opportunity to invest in the tools that make them more competitive. Much of the software and machinery Canadian companies buy to run their operations are bought from the U.S. A more favourable exchange rate means those companies can invest more in those tools of efficiency.

For some companies, including those that have been reporting weaker American sales because of the loonie's gains, there can be yet another silver lining. As the Canadian dollar rises, the cost of repaying U.S. dollar debt falls, so forest products companies Abitibi-Price and Cascades, and Allstream (formerly AT&T Canada) all reported quarterly gains in 2003 based on the loonie's increase.

Snowbirds and other Canadian visitors to the U.S. are finding that their money goes much further – although not far enough to resurrect those days of cross-border shopping sprees from the early 1990s. (Conversely, U.S. visitors to Canada are finding that their money is buying less than it used to, to the dismay of the Canadian tourist industry.)

As the dollar jumped, companies that buy in U.S. dollars but sell in loonies, like petroleum refiners (which buy oil in U.S. dollars but sell gasoline in loonies) or telecommunication providers (which buy telecom equipment in U.S.-dollar markets, but bill Canadian subscribers in Canadian dollars) should be ahead.

But it's not clear that the gains have all been passed on, Atkins said. "That's the math," but it may be that all along the line, companies have taken a bit more profit.