Loonie Tunes: Living With a Strong C$

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So what's with the loonie these days. Even after giving up some ground, the currency is up 14% against the greenback since March, a climb that outpaced the ramp-up in commodities. But a strong C$ is not what the doctor ordered, at least not Dr. Carney, with the central bank expressing its clear displeasure at the currency's strength. While we see it giving back some ground over the next few months, our forecast of an average 1.17C$/US$ over the balance of the year will have implications, some negative, for the macro and sectoral outlook for Canada.

C$ Looks Overdone

The Canadian dollar's gains have in part been a reflection of brighter prospects for some elements of the country's export basket, most notably oil. Crude prices have more than doubled from their lows in the wake of OPEC success in restraining supply. But natural gas is languishing, and most resource prices are still well below where they stood back in early October, when dollar-Canada was last at $1.13 (Chart 1). That suggests that the loonie is overvalued relative to its longer term fundamentals, and its gains have instead rested on a global disenchantment with America's greenback.

Several alternative approaches to assessing those fundamentals back that conclusion. Purchasing power parity, the level of the exchange rate consistent with equilibrating the cost of a basket of consumer expenditures in each country, puts the "fair" value for dollar-Canada at 1.22, according to OECD estimates. The shortfall of that approach is that many consumer services are untraded, and hence there's nothing that forces an exchange rate back to PPP. The Bank of Canada has in the past made use of another approach, an error correction model that allows the currency to adjust over time to changes in real commodity prices, relative inflation rates, and Canada-US interest differentials. We updated that model for data to Q1 2009, and rolled it forward under the assumption of constant real commodity prices and unchanged interest differentials, and found that dollar-Canada "should" settle near 1.27 C$/US$ (Chart 2). In a sense, then, the firmer current level represents an overvaluation relative to those underlying fundamentals, even after our forecast of a modest retreat.

Recent trade flows seem to confirm that hypothesis. Canada ran a current account deficit of C$9.1 billion in the first quarter, including a C$5.3 billion deficit in goods and services trade. Even adjusting that balance to where it would have been had oil averaged $70/bbl, would leave a deficit of roughly C$6 billion (Chart 3). A much broader improvement in export prices or volumes would be needed to correct that imbalance.

None of this suggests that Canada won't see a firmer C$ come 2010, when a return to global economic growth gives a push to resource prices. Indeed, such a move is in our own forecast. But in the here and now, the loonie looks overdone

Chart 1

C$ Rally Outpaced Commodities

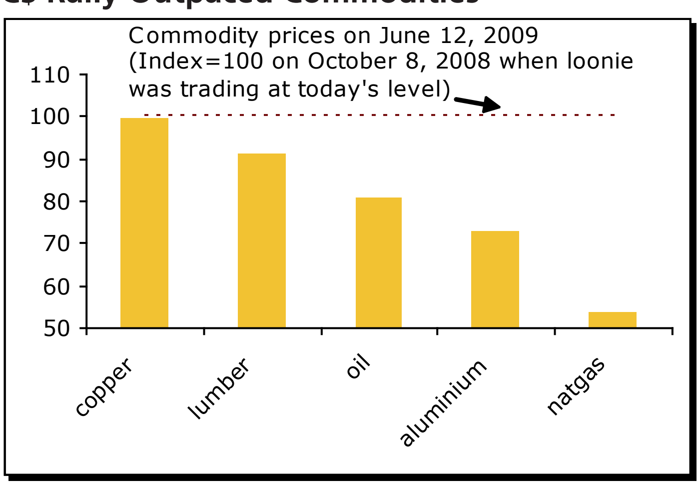


Chart 2

The C$: Actual Versus Model Predictions

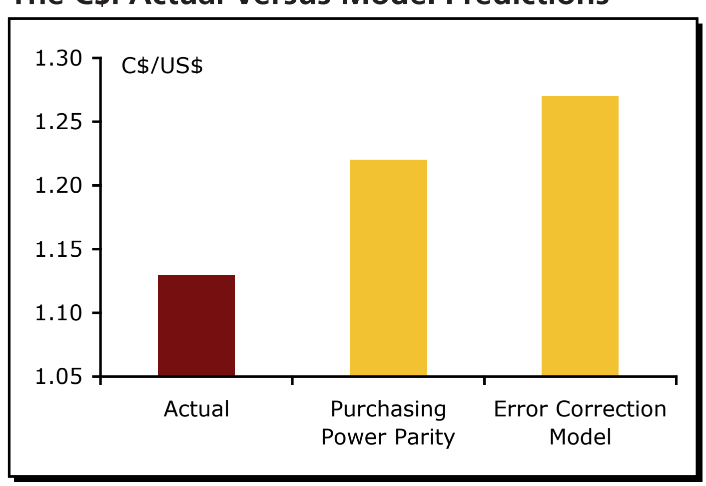


Chart 3

Canadian Current Account in Deficit Even With $70/bbl Oil

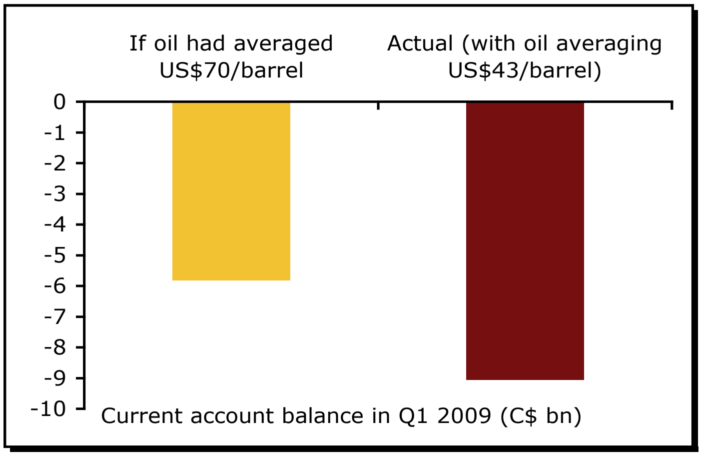
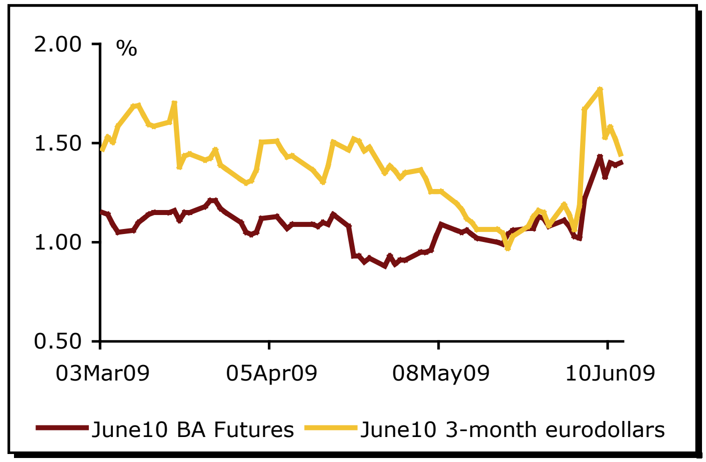


Chart 4

Market Expecting First-Half Rate Hikes



Who's Hurt?

An overvalued currency is not an unmitigated negative for the Canadian economy. Of course, it represents a punishing cost disadvantage for those manufacturers that rely heavily on exports, or that compete with imports in the domestic market. A partial offset comes in the form of lower materials/parts costs for those plants that have a heavy import share in their input mix. An index that nets these factors out, suggests that within manufacturing, the greatest negative impacts are seen in such sectors as machinery, paper and electrical equipment (Table 1). Some other materials sectors, including metals, might reap enough offset in 2010 from rising commodity prices, a factor not included in the analysis.

Outside manufacturing, a firmer C$ can be a plus. That's particularly the case for retailers, given the high import content in most stores' cost of goods sold, and the tendency for the retail sector to lag in passing on currency-related savings in their prices to consumers.

But overall, a firmer C$, one not fully a reflection of a boom in export prospects, is a negative for growth. Odd, then, that at the same time markets were pushing the loonie stronger, they were pricing in heightened odds that the Bank of Canada would raise rates sooner rather than later in 2010 (Chart 4). Instead, currency strength is just one more reason why we see the Bank on hold right through next year's anaemic recovery.

Table 1

Manufacturing Industry Vulnerability to a Strong C$

	Industry	TSX GICS Sector	Export Vulnerability (% of shpts. exported less imported inputs)	Import Vulnerability (% of shpts. to Can. Mkt.) **x** (import penetration of Can. Mkts.)	Combined Export-Import Vulnerability (col. 3 + col. 4)	Ranked by Total Vulnerability
H	Machinery	Industrials	54.6	18.0	72.6	1
I	Paper Manufacturing	Materials	53.1	12.5	65.6	2
G	Electrical Equipment	Industrials	38.9	25.9	64.8	3
H	Chemical Products	Materials	34.3	27.2	61.5	4
	Primary Metals	Materials	40.3	19.6	59.9	5
M	Clothing	Consumer Discretionary	16.2	42.9	59.2	6
E	Computer & Electronics	Info Tech	47.7	10.6	58.3	7
D	Furniture	Consumer Discretionary	33.2	22.3	55.5	8
I	Wood Products	Materials	45.6	8.2	53.8	9
U	Transportation Equipment	Cons Discret, Industrial	29.8	18.6	48.4	10
M	Fabricated Metals	Materials	8.8	27.4	36.2	11
	Food Manufacturing	Consumer Staples	13.4	15.9	29.2	12
L	Textiles	Consumer Discretionary	8.0	16.8	24.8	13
O	Beverages/Tobacco	Consumer Staples	2.2	21.3	23.5	14
W	Printing & Allied	Industrials	-1.1	10.7	9.6	15
	Petroleum Refining & Coal Prod.	Energy	-9.6	11.5	1.9	16