CHART 1

CANADIAN DOLLAR: RAPID RECOVERY

(US$/C$)

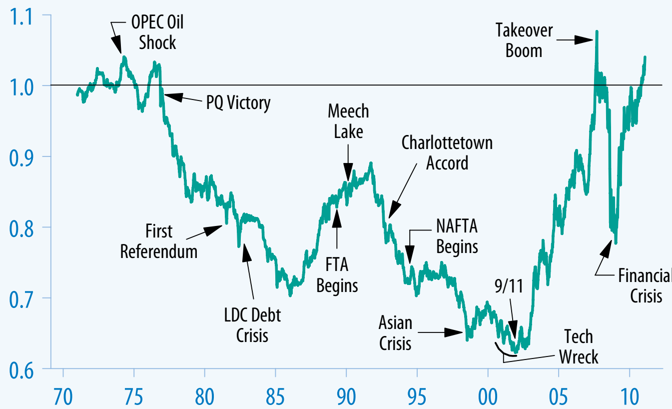
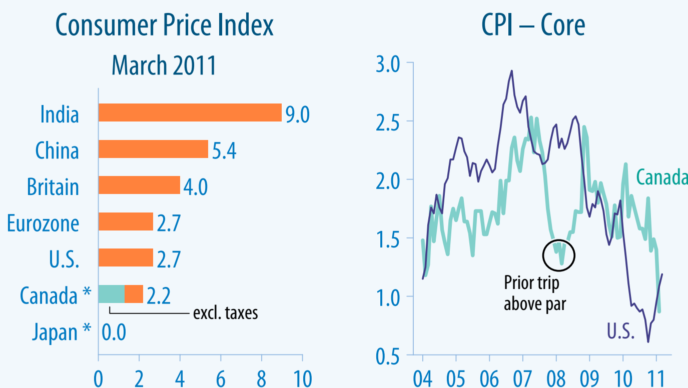


CHART 2

UNDERLYING INFLATION LOW... IN CANADA

(y/y % chng)



* February data; Canada March estimate is 2.7%

TABLE 1

PRICE GAP: IT'S BACK

2011 Item	Cdn. Price (C$)	U.S. Price (US$)	U.S. Price* (C$-terms)	Gap (%)
Magazines (sample 3)	6.64	5.66	5.54	20
Book "Moonwalking with Einstein"	16.75	14.82	14.52	15
Blu-ray movie "The King's Speech"	24.99	19.99	19.59	28
W-S Double Mezzaluna Chopper	50.00	38.00	37.24	34
Crate & Barrel Appetizer Plates (12)	24.95	22.95	22.49	11
Gap Cargo Shorts	44.50	39.50	38.71	15
Running Shoes (sample 5)	147.99	101.99	99.95	48
Titleist ProV1 Golf Balls	49.99	45.99	45.07	11
Canon Rebel T1i Camera	749.99	749.99	734.99	2
iPod Touch 8GB	249.99	204.99	200.89	24
Cars (sample 5)	37,349	32,988	32,328	16
AVERAGE				**20.4**

* using C$0.98/US$ exchange rate, the average of the past three months

Raging Loonie: What It Can and Can Not Do

Douglas Porter, CFA, Deputy Chief Economist

The Canadian dollar is again within striking distance of modern day highs, casting off the losses of the financial crisis in the market equivalent of a heartbeat. The currency has now risen more than 30% from levels prevailing two years ago, one of its fastest climbs on record. There is little mystery behind the loonie's breakneck ascent—the U.S. dollar is in broad-based retreat, commodity prices have surged, and investors globally are seeking the safety that Canada's relatively healthy fiscal backdrop provides. From our perspective, this strength is not a flash in the pan, as the gains look more sustainable than the spike in 2007 *(Chart 1)*. No less of an authority than Bank of Canada Governor Mark Carney recently opined that the world is in the *"midst of a* (commodity) *supercycle"*, a view we have long subscribed to, notwithstanding this week's correction. In other words, it appears that Canadians should get accustomed to a lofty loonie, and we continue to look for the currency to remain above par through 2012, if not beyond. Below we consider some adjustments we expect from a sustained bout of a super-sized loonie, and some we don't expect.

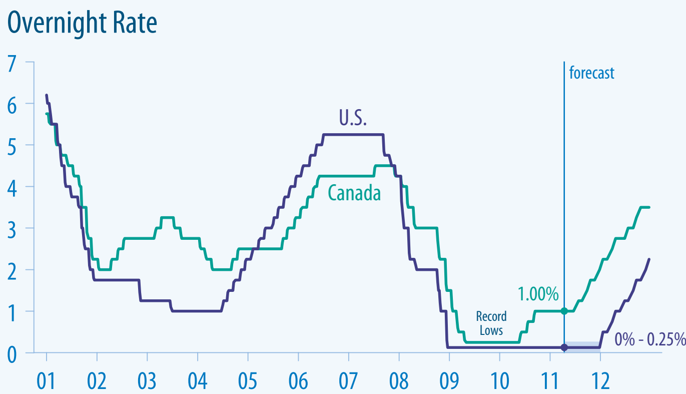
1. a) **It can restrain inflation:** The strong currency rewards consumers first and foremost, by helping hold prices lower than they would be otherwise. In recent months, underlying inflation trends in Canada have dipped below those of the U.S., despite a much healthier domestic economic backdrop north of the border. The Canadian dollar is helping dampen the price of goods, in particular. Aside from Japan, Canada now has one of the lowest headline inflation rates in the world, despite the impact of various sales tax increases across the country in the past year *(Chart 2)*. Excluding indirect taxes, Canada's CPI is up a mere 1.3% y/y.

b) **But it can't equalize prices between Canada and the U.S.:** That more moderate inflation performance versus other countries is overwhelmed by the surge in the currency. As a result, the cost of a basket of goods, adjusted for today's exchange rate, has bolted higher again in Canada relative to the U.S. We estimate that the gap has widened out to more than 20% on a selection of

typical goods (*Table 1*). When we last looked at this issue in the summer of 2009, the spread was just under 7%. Essentially, the price gap has widened one-for-one in line with the rebound in the currency. Put another way, there has been precious little movement in underlying relative prices in the past two years, despite the currency's record sprint.

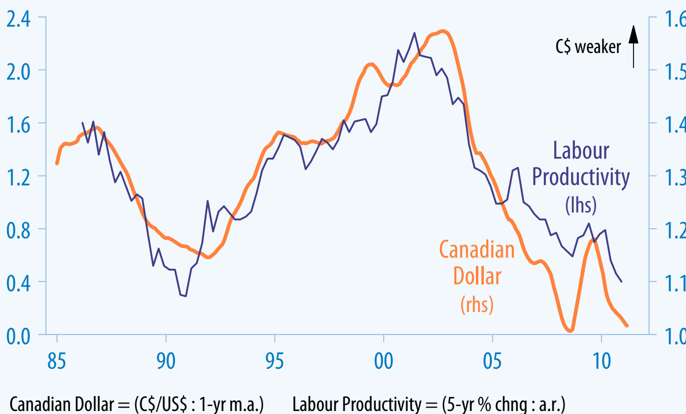
2. a) **It can keep interest rates low:** With the Fed unlikely to start lifting interest rates for some time yet (we believe they will start in early 2012), and the currency on a roll, the Bank of Canada is constrained from lifting rates as quickly as they would like. While there have been plenty of cases in the past decade where policy has diverged, for a time, Mr. Carney put it succinctly when he suggested that Canadian rates can only diverge "so far" from the U.S. lead *(Chart 3)*. And, the Bank this week elevated the strong loonie to rock star status in terms of risks to the growth and inflation outlooks; accordingly, markets now seriously doubt if the Bank will even begin hiking rates by July. In a nutshell, the Fed's expected slow boat to tightening will act as an anchor on Canadian rates.

CHART 3
NORTH AMERICAN RATES: THE TWAIN MAY MEET
(% : as of April 14, 2011)



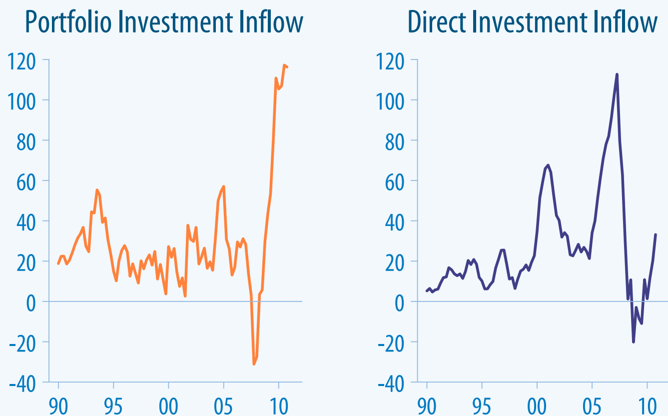
b) **But it can't keep them from rising altogether:** As we saw in 2010, the Bank is not completely beholden to U.S. policy. And, even with the Fed on hold through the second half of this year, we continue to look for the Bank to lift rates by as much as 100 bps in 2011 (assuming the currency doesn't flare higher from here), in response to a narrowing output gap and record household debt.

CHART 4
STRONG C$ ≠ STRONG PRODUCTIVITY
Canada



3. a) **It can help support business capital spending:** A common refrain amid the dollar's rapid rise is that it will help Canadian business invest in new machinery and equipment, by slashing the price of imported gear. While the long-term evidence is not exactly obvious on this score, we did find some modest impact on real capital spending on M&E of a rising dollar. Over the past 35 years, we find that a 10% rise in the Canadian dollar will boost real business investment by 4.5% after a year—a nice bump, but not a game-changer. The increase in volumes could simply reflect the fact that business can get more for its Canadian dollars spent, as we found no impact on nominal capital spending from a stronger currency.

b) **But it can't fix productivity:** The follow-on contention of the former point (higher loonie = higher real M&E spending) is that higher productivity will soon follow, and that has been the mantra among economists for years. But, the evidence clearly suggests that we are barking up the wrong tree if we are waiting for the lofty loonie to save



productivity. In fact, the opposite appears to be the case: since the mid-1980s, periods of a weak Canadian dollar have been associated with our strongest productivity growth, and vice versa *(Chart 4)*—precisely the opposite of the conventional wisdom! We don't believe that productivity is in fact helped by a weak currency, and that there are other common factors at play that drive both. For example, we suspect that booming commodity prices can boost the Canadian dollar, but also act as a drag on productivity, through a variety of channels—by squeezing manufacturing, by boosting incomes and employment in services and the public sector, and by encouraging development of less economically viable resource bodies. Note that Canada and Australia have had very similar productivity performances over the decades.

4. a) **It can put more pressure on the trade balance:** The real trade balance responds very quickly to changes in the exchange rate, as a rising currency puts abrupt upward pressure on imports. While this effect is partly countered by the improving terms of trade, the shift in volumes tends to dominate. As a result, the current account balance, which saw an average deficit of 3% of GDP over the past two years, is likely to remain uncomfortably wide, despite the run-up in commodity prices.

b) **But it can't dissuade foreign investment:** The deterioration in Canada's previously healthy trade backdrop is unlikely to make much of a dent on the currency's medium-term prospects. While our stock of net foreign liabilities is growing again, non-resident investors are only too happy to pour into the country. The driving force in the past few years has not been high-profile foreign direct investment (there have actually been larger outflows from Canada than into the country in the past year). Instead, there has been a wave of portfolio capital inflows from abroad, specifically foreign investment in Canada's bond market. In the past two years, inflows have averaged more than $90 billion, or almost 6% of GDP *(Chart 5)*, and they have been well-distributed between GoCs, provincial bonds, and corporate issues. To put the total buying in perspective, the prior annual record inflow to our bond market was $41 billion (in 2001). Simply put, investors are seeking close alternatives to the US$ or the euro, that offer some diversification and safety, and the Canadian dollar increasingly fits the bill. While there is debate over how long this trend can continue (and at what point global funds will be above their weights in Canadian dollars), our view is that there is still plenty of scope for further foreign buying.

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