Economic Spotlight

Exchange Rate

October 10, 2013

Why has the loonie dipped below parity?

Overview

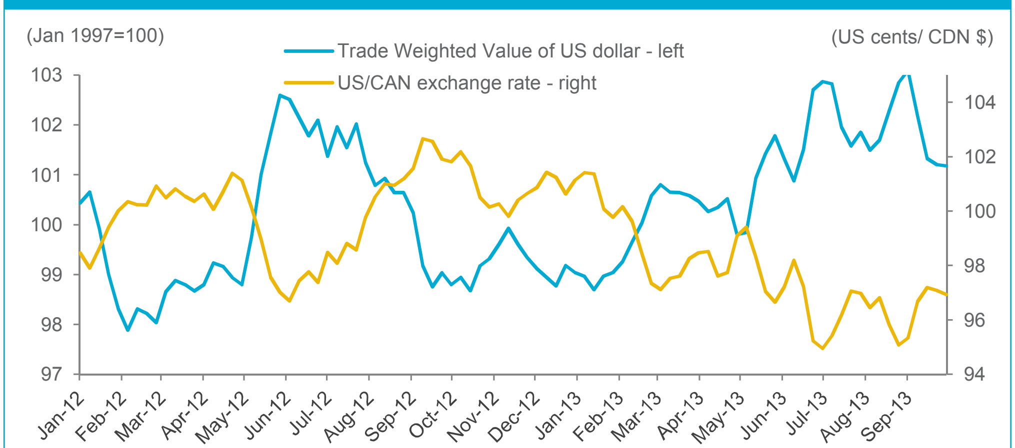
The Canadian dollar has fallen below parity against the US dollar since the beginning of 2013. After averaging 100.7 US cents/ C$ in the second half of 2012, the loonie has dropped to 97.6 in the first nine months of this year. In early July, the dollar closed at almost a three year low of 94.5. More recently, the Canadian dollar has recovered some of its losses, hovering around 97 cents in recent days.

What accounts these recent swings? Explaining the source of exchange rate movements is complicated due to a confluence of factors. This note discusses some factors that have contributed to the depreciation of the Canadian dollar in 2013, particularly since June. These include changes in monetary policy, economic growth prospects, commodity prices, fiscal policy, and emerging market developments.

A stronger US dollar

The Canadian dollar is not the only currency to have fallen against the US dollar in recent months. With the exception of the Euro and the Chinese yuan, which have strengthened slightly, nearly all global currencies have fallen against the dollar since the beginning of the year. The trade weighted US dollar index appreciated by over 4% since the beginning of this year and is maintaining its strength despite some retrenchment since late July (chart 1). The Japanese yen and Indian rupee have fared poorly. The US dollar has appreciated by close to 12% against the yen since the start 2013.

Chart 1: US/Can exchange rate vs. US dollar Index



Source: US Federal Reserve Board

* Weighted average of the foreign exchange values of the U.S. dollar against the currencies of major U.S. trading partners.

Weekly data, last observation October 4, 2013

The Indian rupee fell by about 25% from the start of 2013 to the end of August before recovering somewhat in the last month. The Australian dollar, which depreciated by about 15% between January to August, has recovered somewhat in the past month, but is still down more than 10% from the beginning of this year.

Divergence in monetary policy

Speculation on when the US Federal Reserve (the 'Fed') will unwind its extraordinary monetary stimulus has contributed to large swings in the US dollar. With its policy interest rate at its effective lower bound of 0.25%, the Fed has been buying US treasuries and mortgage -backed securities at a rate of US$85 billion per month since December. The bond purchases, known as quantitative easing (QE), have been used to push US long terms interest rates lower, and have increased the availability of credit. At its June policy meeting, the Fed signaled that it may begin to taper its QE program as early as September, pushing bond yields and the US dollar higher. Yields on US 10-year bonds moved from 1.6% at the beginning of May to an average of 2.7% in August and 2.9% in early September.

On September 18th, the Fed surprised markets by not tapering its asset purchases, and announcing it will continue its current QE program. The announcement led to a decline in long term yields and the US dollar.

However, both interest rates and the value of the US dollar (relative to the Canadian dollar and on a trade weighted basis) continue to remain above levels prior to the June announcement.

In Canada, the central bank does not see any immediate need to tighten due to weak economic growth and inflation below the mid-point of the Bank of Canada's target of 1% to 3%. Tapering talk in the US, combined with a more neutral stance by the Bank of Canada, has contributed to a depreciation of the loonie against the US dollar since June.

Outside North America, monetary policy developments have also driven exchange rate movements. Japan is pursuing an aggressive monetary expansion to support its growth and reinflate its economy and the yen has depreciated significantly. The European Central Bank (ECB) lowered its policy rate by 25 basis points in May and announced in July its commitment to keep rates low for an extended period. However, a lower perceived risk of the Euro region collapsing has kept the Euro currency relatively stable against the US dollar in recent months.

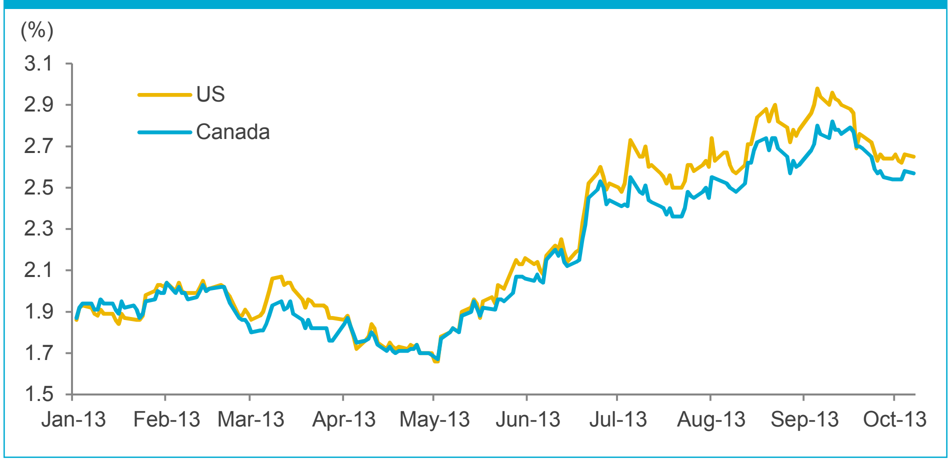
Improving US economic growth prospects

Brighter prospects for the US economy, combined with continued weakness elsewhere, has enhanced the appeal of the US dollar to foreign investors. Despite ongoing fiscal drag, the US economy is expected to advance by 1.6% in 2013 and by 2.6% in 2014 according to the International Monetary Fund (Chart 3). With impact of the financial crisis fading and a recovery in housing taking shape, the US dollar has regained its attractiveness. The US current account is also improving, led by a shrinking trade deficit. The US has seen a revival in manufacturing activity, leading to stronger growth in exports, while the resurgence in oil production has pulled down the country's oil imports.

Meanwhile the Eurozone continues to struggle, just barely nudging out of a prolonged recession in the second quarter of this year. While renewed growth in the Eurozone area is seen as positive for the euro, growth prospects remain dim. In 2014, Eurozone GDP is expected to increase by only 1%.

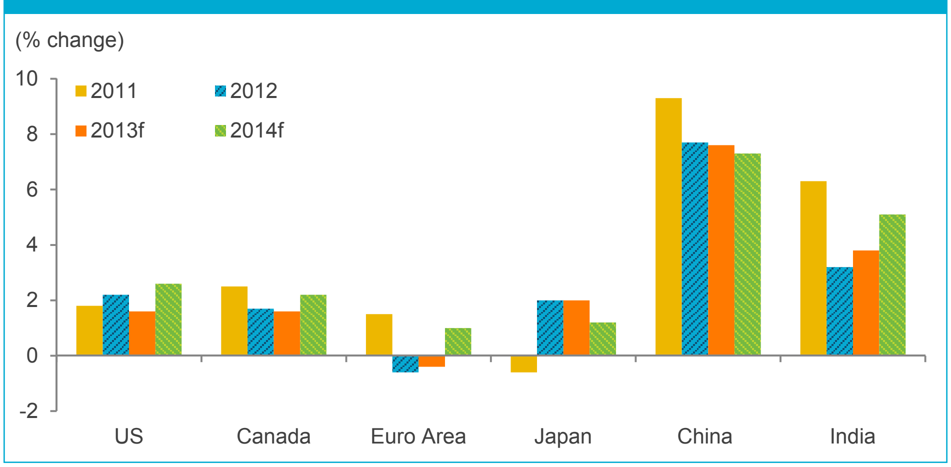
Emerging economies, including China, India and Brazil are posting weaker than expected growth. GDP in China is expected to increase just over 7.5% in 2013 compared to estimates of around 8% at the start of the year. In Canada, growth expectations are similar to the US in 2013, but prospects are weaker in 2014. Canada's export performance has remained sluggish, resulting in worsening trade and current account deficits. A soft landing in the Canadian housing sector along with relatively flat commodity prices have created some negative sentiments towards the loonie as well.

Chart 2: Ten Year Government Bond Yields



Source: US Federal Reserve Board, Bank of Canada. Last observation October 7, 2013

Chart 3: Real GDP Growth



Source: International Monetary Fund, October 2013

Flat commodity prices

The Canadian dollar is also linked to commodity price movements: an increase in the price of commodities produced in Canada puts upward pressure on the Canadian dollar. Lackluster global growth and a strong US dollar have pushed down prices of most major commodities this year (a rising US dollar tends to dampen commodity prices as most commodities are priced in the US dollars), with the notable exception of oil and gas prices. The net result is that the Canadian commodity price index has stayed relatively flat this year (Chart 4). Canadian oil prices have risen because of geopolitical tensions, some easing of transportation constraints and falling US oil inventories. Meanwhile, the metal and mineral index has declined about 12% since the start of the year. China is a major consumer of commodities and slower growth in that country have put downward pressure on commodity prices and commodity linked currencies.

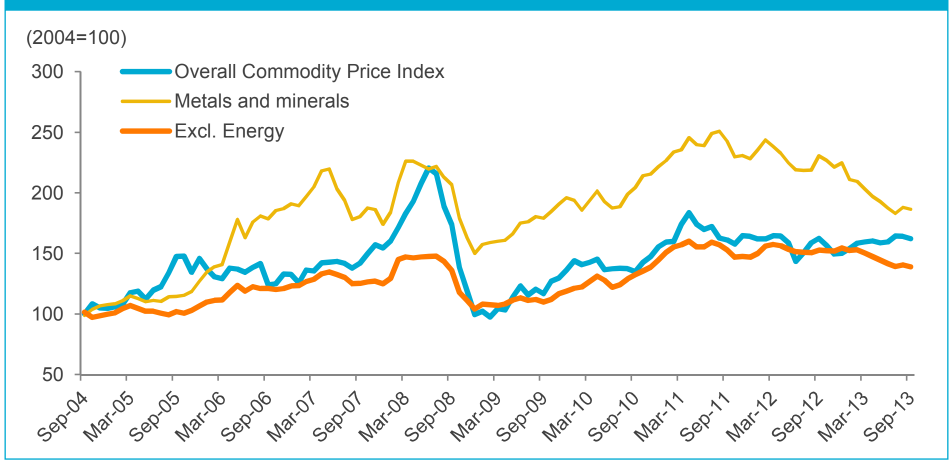
US fiscal balance has improved, but tensions and policy uncertainty escalates

Fiscal policy in the US has also had an impact on currency markets. Spending cuts and an improving economy have helped shrink the size of the US federal fiscal deficit, from a recessionary high of 11.4% of GDP to 1.4% as of the second quarter. Going forward, the Congressional Budget Office has recently lowered its forecast for the accumulated US federal deficit between 2013 and 2023 by over $800 billion.

In more recent weeks, market sentiments towards the US fiscal situation has turned sharply negative and uncertainty has escalated. The US Treasury estimates that it will reach the statutory debt ceiling on October 17. Currently, tax revenues only cover 84% of expenditures. Without the authority to borrow, the Treasury would have to either slash expenditures by 16% or default on its debt. Adding to the debt ceiling uncertainty, Congress could not agree on a budget for October 1. This shutdown non-essential federal government services, impacting around 800,000 federal employees. The longer the shutdown persists the greater the harm to the US economy. In 2011, debt ceiling tensions contributed to a decline in the US dollar against a number of currencies, and may have also contributed to some of the weakness in recent weeks.

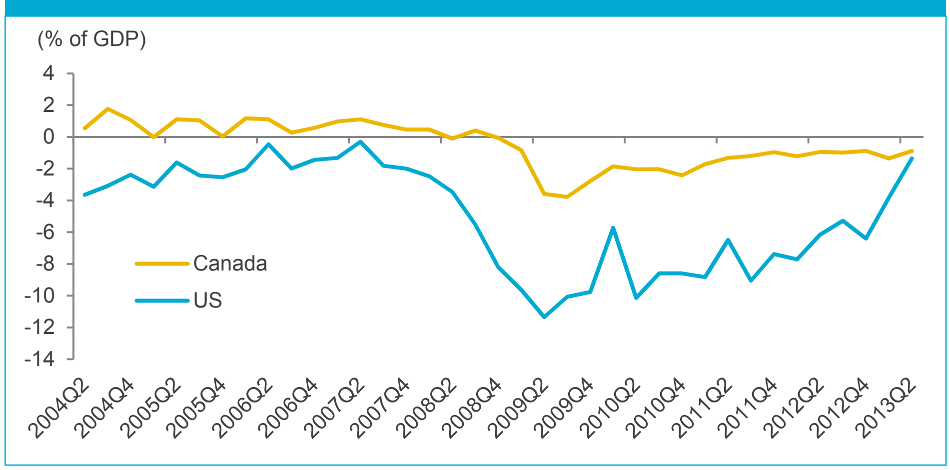
Canada is in a better fiscal situation, with a much lower debt to GDP ratio, though its fiscal deficit has shown a smaller improvement (Chart 5). As in the US, risks to the fiscal outlook remain elevated due to household debt and the potential for a larger-than-expected correction in the Canadian housing market.

Chart 4: Canadian Commodity Price Index



Source: Bank of Canada, monthly data

Chart 5: Federal Fiscal Balance



Source: Statitstics Canada, Department of Finance Canada, US Treasury, Haver

Deleveraging in emerging economies

International capital flows to the US have also been driven by developments in emerging markets. Until recently, relatively high interest rates and stronger emerging market growth attracted international capital to emerging markets. This additional credit fuelled growth in many emerging economies. Now these trends have reversed. Economic growth has weakened and credit conditions have tightened, leading to a deleveraging (i.e. reduced credit) in emerging markets. According to the Bank of Canada, emerging markets (Argentina, Brazil,Chile, China, India, Indonesia, Mexico, Russia, South Africa and Turkey) experienced broad based capital outflows in the second and third quarters of 2013. To stem capital outflows and support their currencies, these countries have adopted various measures including currency interventions, capital controls and higher policy interest rates.

The US has been the main beneficiary of this recent trend. The US has recorded an increase in capital inflows in treasuries, bonds and investments at US banks and securities brokers. Net capital flows in the US were about US$62 billion in the second quarter of 2013, up sharply from less than $10 billion a year prior. Canada has seen some reversal in its capital flows. In June, Canada recorded a net outflows of $15.4 billion in June, a sharp reversal from net inflows in the past few years. Overall, the US dollar is considered a "safe currency" and tends to benefit from increased negative sentiments and risk aversions among foreign investors.

Conclusion

This Spotlight explains the various factors that have likely contributed to a weakening of the Canadian dollar since early 2013. The evolution of the factors will play a key role moving forward, particularly the widely-watched actions of the US Federal Reserve towards its quantitative easing program. An announcement that the Fed will begin tapering this program would likely put further downward pressure on the Canadian dollar, due to its positive impact on US capital inflows and interest rates. In addition, the US government shutdown and debt ceiling discussions are likely to cause volatility in the US dollar over the short term.

What does a lower Canadian dollar mean for Alberta? Since energy products and other exports are priced in US dollars, a weaker loonie results in higher export revenue to producers and royalty revenues for the Alberta government. However, a weaker dollar also increases import costs. Prolonged weakness in the dollar could discourage investments in machinery and equipment and other imported capital goods that enhance productivity.

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