Foreign Exchange and the Canadian Dollar: A Primer

Jim Stanford

The Canadian dollar has experienced dramatic fluctuations in recent years, rising from a low value of 62 cents U.S. in 2002, to levels that now meet or exceed parity with the U.S. dollar. These fluctuations have had tremendous impacts on exports, investment, and employment in many Canadian industries and regions. More recently, currency issues have become highly controversial in global economic diplomacy, too. For example, conflicts over currencies (especially between the U.S. and China) dominated the recent G20 summit in South Korea. Those conflicts were not resolved, and hence uncertainty and conflict over exchange rates will continue to mark much international interchange.

What determines exchange rates, and why do they matter? This primer introduces some of the key issues and concepts, to help make sense of the volatility.

What is foreign exchange?

If you live in one country, but want to make a purchase in another country, you need to obtain some of that nation's currency in order to facilitate the purchase. Therefore you arrange through a bank or some other financial intermediary to purchase some of that foreign currency, using some of your home currency. That transaction – converting one national currency into another – is called foreign exchange, and the system that arranges for those transactions is the foreign exchange market or system.

Why buy and sell foreign exchange?

There are many purposes for which foreign exchange is required. The most concrete reasons are to pay for imports from another country, or to visit that country and pay for things while you travel there. Businesses might also need to convert currency in order to pay for an investment in another country. In less concrete motivations, financial investors could convert currency in order to purchase financial assets (like bonds or corporate shares) in another country. In some cases, financiers purchase another nation's currency purely for the purpose of holding that currency – hoping that its value (relative to other currencies) will increase, thus generating a speculative profit.

What is the price of foreign exchange?

The price of one unit of a currency (say, a dollar) is the amount you must pay in another currency in order to buy it. If this "price" of a currency rises, it becomes more expensive relative to other currencies, and it is said to "appreciate." If a currency's price falls, then it "depreciates." A strong currency allows its owner to purchase more from other countries (goods, services, assets), since the currency is more valuable internationally.

What determines foreign exchange rates (I)?

Today, most countries allow their currencies to trade freely on commercial markets. For these currencies, foreign exchange rates fluctuate each day on the basis of supply and demand –

that is, how much of it people want to buy, versus how much people want to sell. Like other financial markets, foreign exchange markets experience rapid fluctuations in prices to “clear” markets very quickly. This system is called flexible exchange rates.

Governments in some countries manage or control the rate at which their currency converts into other countries. They could do this by fixing a certain exchange rate, and requiring all banks to make conversion at that rate. This is called a fixed exchange rate system; it was used in past eras (such as during the Bretton Woods currency system in the initial decades after World War II), but is rare today. A middle ground is called “managed floating rates,” where governments indirectly control the exchange rate by intervening in or regulating the financial flows and currency purchases that in turn determine the rate. This system is used today by China and some other countries.

How big is the Canadian foreign exchange market?

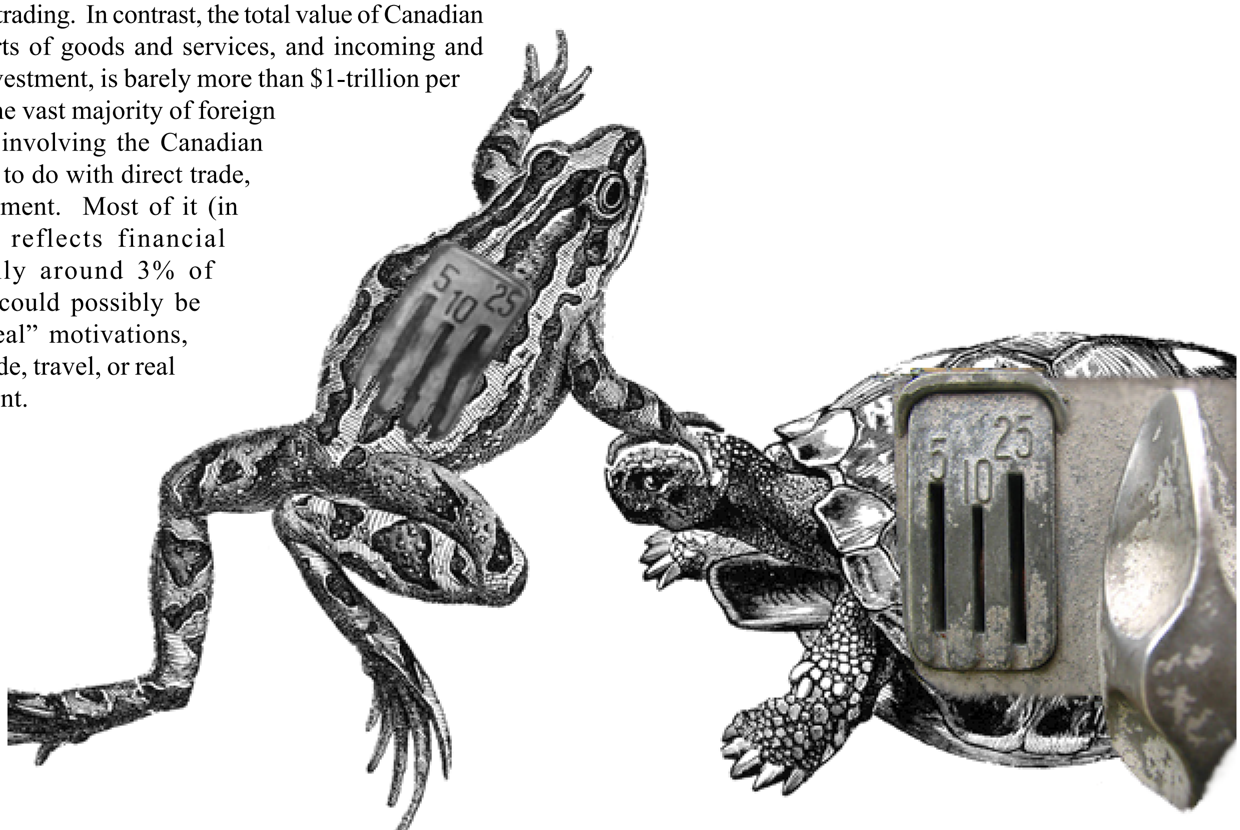
The latest reliable international survey of foreign exchange markets was conducted in 2007 by the Bank of International Settlements (BIS), an international banking regulator based in Switzerland. At that time, the total global currency market was estimated to trade $3.2-trillion per business day (or $800-trillion per year). That is about 40 times as much as the value of global GDP. The BIS estimated that 4% of those trades involved the Canadian dollar (either buying it or selling it). That implies a daily foreign exchange market for the Canadian dollar of about $135-billion (or $32-trillion per year). That figure has surely grown substantially since 2007, in light of the continued expansion of pointless financial trading. In contrast, the total value of Canadian imports and exports of goods and services, and incoming and outgoing direct investment, is barely more than $1-trillion per year. Therefore, the vast majority of foreign exchange trading involving the Canadian dollar has nothing to do with direct trade, tourism, or investment. Most of it (in excess of 95%) reflects financial motivations. Only around 3% of currency trading could possibly be said to reflect “real” motivations, such as foreign trade, travel, or real business investment.

What determines foreign exchange rates (II)?

Under flexible exchange rates, rates reflect the supply and demand for a currency. But what are the deeper factors behind those supply and demand pressures? To a small degree, real economic factors like trade and foreign investment flows might influence exchange rates. A country with a trade surplus (exporting more than it imports), or experiencing a strong inflow of foreign investment, might experience appreciation – since foreigners need more of the home currency to buy its products and/or purchase business assets.

However, these “real” determinants of financial inflows and outflows are dwarfed by financial flows – whereby money converts from one currency into another as a result of decisions by financial investors to purchase different financial assets. This could include purchases of stocks, corporate bonds, term deposits, derivatives, or government bonds. It could also include the currency itself: an investor might wish to hold a country’s currency solely in hopes that its value will increase.

The crucial determinant of exchange rates, therefore, are the shifting judgments, hopes, and fears of financial investors regarding the returns that can be earned by holding assets denominated in a particular nation’s currency – or even holding the currency itself. (By “financial investors,” of course, we refer primarily to banks, investment banks, hedge funds, and other financial institutions, not to individuals.) If investors decide that Canadian-denominated assets are likely to be more profitable in the future – for example, because the Canadian stock market is rising, or Canadian interest rates are going up, or profits of



Canadian businesses are expanding – then they will buy those assets, and that creates new demand for Canadian dollars. In this regard, exchange rates are financial variables. Their daily ups and downs resemble the ups and downs of the stock market, reflecting the herd mentality and fleeting emotions of financiers.

Monetary policy will also affect exchange rates, for similar reasons. If the central bank reduces interest rates (relative to those paid in other countries), it will become less profitable to own bonds and other assets in that country, and financial investors will tend to move their money into assets in other countries. When the U.S. Federal Reserve (its central bank) recently adopted a policy of "quantitative easing" (in essence, printing U.S. money to purchase bonds and other U.S. financial assets), the U.S. dollar declined against other currencies, since U.S. interest rates were pushed down (and some investors feared a rise in future U.S. inflation). Indeed, that depreciation (which will help to spur U.S. exports and limit U.S. imports) was likely a partial motivation for the Fed's actions.

What is currency speculation?

A financial investor who purchases an asset solely in hopes of re-selling it later for profit, is a speculator. Most currency trading reflects speculative motives directly or indirectly: with investors hoping to make speculative gains from either changes in the prices of assets denominated in a particular currency, or from changes in the value of the currency itself. Speculation can cause exchange rates to gyrate wildly. When a currency (like any other financial asset) begins to move notably in a certain direction, for whatever reason, speculators act immediately to try to profit from that movement. If a currency is rising, speculators purchase it, and that act in and of itself causes the currency to rise further (the expectation of speculators is thus self-fulfilling). This can carry on only for a while, however; once a currency goes too far in one direction, it will become clear that its value bears no relation to its "real" or "fundamental" determinants, and it will reverse direction. Because of these speculative motives, and the vast flows of finance which speculators are now able to wield on any day of the week, exchange rates move dramatically and quickly, and typically "overshoot" (that is, adjust too far in one direction, requiring an eventual bounceback in the other direction).

What is the Canadian dollar's "fair value"?

There is no generally accepted theory of what should determine exchange rates in the long-run (or in "equilibrium"). One traditional model is called purchasing power parity (PPP). According to this theory, a currency should ultimately settle at a level which would equalize the common-currency costs of a basket of standard goods and services across different countries. One way that this outcome might be attained, is through "arbitrage": that is, if a currency deviates too far from its PPP value, it becomes profitable for middlemen to buy goods in a country with an undervalued currency, transport them, and re-sell them in a country with an over-valued currency. An example of this is cross-border shopping, which is common along the Canada-U.S. border. When the Canadian dollar is too high, Canadians cross the border to buy stuff for cheaper in the U.S.; when the Canadian dollar is too low, Americans come this way to do the same. At PPP, there is no motive for arbitrage to occur in either direction. Based on the absolute level of average consumer prices in Canada and the U.S., the PPP value for the Canadian dollar is currently about 82 cents (U.S.).

Another possible benchmark for the Canadian dollar is the unit cost of producing goods for world markets. In the long-run, Canada must be able to produce and sell enough production in international markets, to pay for the imports which come into the country. Resource-based exports can assist the country's trade balance, but are not nearly enough to pay for everything we need. Other exports, produced by more mobile industries (and in particular by manufacturing), must also be viably sold into international markets. Canadian workers are paid more than U.S. workers. Yet average productivity in Canadian industries is about 15% lower than in the U.S. (mostly because of a lack of capital investment by Canadian businesses). Given these realities, Canadian manufacturers need an exchange rate in the mid-70s (U.S. cents) in order to compete on unit cost grounds with companies in the U.S. and elsewhere. This is lower than the PPP benchmark for the Canadian dollar.

In practice, currencies do deviate from PPP for long periods of time, and so there are clearly other structural factors which influence exchange rates. More deeply, I tend to think that exchange rates fundamentally reflect the structural appeal (to financial investors, and capitalists in general) of doing business in a particular place. If profits are high (whether due to productivity, pro-employer social and legal conditions, unique technology or resource wealth), global capital will want in on the action, and a country's currency will tend to rise. If a country's economy is growing relatively more quickly, with high capacity utilization, lower unemployment, and higher profits, then the currency may appreciate as well (to a point: unless unemployment becomes too low, in which case profits are threatened by uppity workers and rising wages). If a country's products are relatively more competitive in international markets, its currency may tend to rise: partly via an actual trade surplus (with the country exporting more than it imports), but more importantly via financial flows behind the scenes (including stock market trends and currency speculation). Finally, if government finances are strong and secure, then there will be little fear of default on government bonds (which constitute a financial market at least as large as the stock market), and that can push up the exchange rate, too. (The reverse happened in Canada in the mid-1990s, when Canada's economy was uniquely weak, deficits were high, and investors were additionally spooked by the threat – since receded – of Quebec separatism.)

What explains the Canadian dollar's dramatic rise since 2002?

According to the preceding "structural" analysis, the take-off of Canada's currency since 2002 is tied up with the record-breaking improvement in the profits of Canadian business during that same period. During those years, the share of corporate profits in Canada's GDP reached all-time record levels – exceeding even the levels in the USA. This in turn reflected the global commodities boom (high prices for oil and other commodities, some of which Canada exports). Profits in Canada's resource sector (especially oil and gas) have been phenomenal over the past decade – far out of step with any historical precedent. This has produced many side-effects, including stock market performance that exceeded U.S. benchmarks, and a shift in the composition of Canada's exports (away from manufactured goods, especially automotive products, and toward resources, especially energy). It's important to note that the chain of causation between commodity prices, the resource boom and the high-flying loonie was not experienced through a strong trade surplus. It is often glibly stated by financial commentators that the loonie is strong because "the world wants what Canada is selling"; if that were true, why has Canada's trade performance been so poor??? In fact, Canada's trade balance has tipped into record-breaking deficits: Canada is running a current account deficit (including trade, tourism, and investment income) that will exceed $60-billion, or 4% of GDP, in 2010. It is more through profits, and profit-related indicators (like the stock market), that the strong demand for the Canadian dollar is manifested.

In this regard, a strong dollar can in no way be interpreted as proof of a "strong economy" (as politicians often imply). Rather, it is a sign of very well-off capitalists – which is quite a different thing altogether.

What are the impacts of a high (or overvalued) dollar?

Canadian-made products are more expensive in international markets, and hence foreign customers buy less of them. Imports seem cheaper, and hence Canadians buy more of them. In mobile industries (including manufacturing and tradeable services), Canada looks too "expensive," and hence direct investment leaves the country. In resource-based industries (which must locate here by virtue of the location of the resource deposit), export sales translate into smaller flows of Canadian-dollar incomes (since most commodities are sold in world markets in U.S.-dollar prices, and if the Canadian dollar is higher then those prices translate into lower revenues in Canadian dollars). Tourism flows adjust, since Canada becomes an "expensive" jurisdiction. Indeed, incoming tourism to Canada has been affected more dramatically in recent years even than manufacturing. The trade balance falls into deficit, and the country begins to accumulate international debt to cover those deficits.

There's been tremendous attention from right-wing populists to the accumulating deficit of Canadian governments. Few commentators mention the accumulating Canadian debt to the rest of the world, which is embodied in Canada's massive current account deficit. That deficit sums to almost $100-billion in the last two years – just as large as the deficits of all levels of government combined.

What is international "currency competition"?

Because of these negative real side-effects of an overvalued currency, many countries try to reduce the value of their currency on international markets (in order to promote exports, reduce imports, and attract foreign investment). In essence, this becomes just like so-called "protectionism," which was widely (and somewhat wrongly) denounced for worsening the depression in the 1930s. Reducing your exchange rate can be just as effective as increasing tariffs, in an effort to stimulate domestic output and employment during tough economic times. The WTO and the ideology of free trade prevent (in theory) countries from using formal trade barriers to support domestic jobs. But competing efforts to devalue currencies have similar motivations, and similar effects.

This has sparked the recent international tension in currency markets. China strictly (but indirectly) regulates its currency, keeping it low despite China's enormous trade surplus and inflood of foreign direct investment. The U.S. complains about this practice (even though it is largely U.S. corporations who produce the goods which are imported to the U.S. from China). Other countries (including Japan, Brazil, and others) also regulate exchange rates. Canadian officials have been content to "play by the rules," allowing the loonie to rise as high as speculators are willing to push it – with no countervailing interventions at all. This is a beggar-thy-neighbour battle that can some countries may "win," but not all. Current international tensions over exchange rate reflect the fundamental problems with a competitive, dog-eat-dog global trading system which encourages every country to generate trade surpluses, yet imposes no adjustment burden on surplus countries to resolve the resulting trade imbalances.

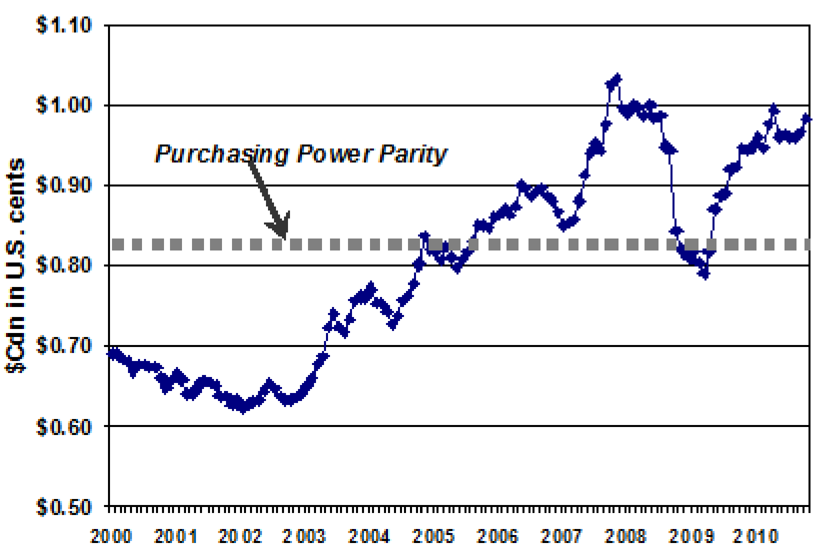
How high will the loonie go?

Rightly or wrongly, the Canadian dollar seems to have settled into a trading range at or slightly below par with the U.S. dollar. This is around 20 per cent overvalued relative to PPP criteria – and even more if we measure the benchmark in terms of the competitiveness of manufactured exports (in which case the dollar should settle in the mid-70s U.S.). Canada's trade and current account deficits are breaking records, and still growing. More direct investment is leaving Canada than entering (despite the huge resource takeovers which continue apace – the one exception being the blocked takeover of Potash Corp.). While Canada's recession was somewhat less severe than those experienced in some countries, and while the financial crisis resulted in less banking chaos here, Canada's economic "recovery" has stalled more dramatically than those in other OECD countries. Indeed, Canada's GDP growth in the 2nd and 3rd quarters of 2010 was barely above zero, and much slower than in most other OECD countries.

For all these reasons, the "fundamentals" suggest that the dollar should fall in coming years, not rise. The only feature which suggests a higher currency is the stronger fiscal position of Canadian governments (and hence the lower risk of long-run default on government bonds). This could encourage investors to buy Canadian assets rather than European or American ones. But a smaller deficit is not enough reason to hold an overvalued currency for long periods of time, however – especially when real economic conditions are deteriorating.

All that being said, there is no guarantee that financial forces won't push the Canadian dollar up even higher in the future. This could occur if investors begin to fear future U.S. devaluation or (worse yet) accelerating inflation or government defaults (which are quite possible among state and municipal governments in coming years), and/or if the continuing European debt crisis unfolds badly. Very high oil prices (unlikely, given the shaky state of global growth) could also push the dollar skyward, via their impact on oil industry super-profits.

Is the loonie strong because the American dollar is weak?



The value of the Canadian currency is usually measured versus the U.S. dollar, since most Canadian trade and investment flows involve our southern neighbour. It takes two to tango, and hence that specific bilateral relationship should reflect conditions in both countries (not just in Canada). Some Canadian officials have claimed the problem is weakness in the U.S. dollar, and hence there is nothing that can be done about it from Canada's side.

Since 2002, the U.S. dollar has declined by an average of 25% against a weighted average of its major trading partners. (This measure of the U.S. "average" exchange rate is called the "Broad Index" and is calculated by the U.S. Federal Reserve.) This reflects the historic weakness of the U.S. economy against other regions. But over the same time, the Canadian dollar has appreciated by 55% against the U.S. dollar – more than twice as much. In other words, over half of the "problem" since 2002 (namely, the rapid rise of the Canadian dollar against its U.S. counterpart) reflects the unique strength of the Canadian dollar; less than half of the problem reflects the global weakness of the U.S. dollar.

This can be verified by considering the appreciation of the Canadian dollar against most other major currencies in recent years, including the euro, the Mexican peso, and the Chinese yuan. The Canadian dollar has risen strongly against all of these currencies (issued by countries which, incidentally, all maintain large trade surpluses – in contrast to Canada's large and growing trade deficit). Clearly, the Canadian story behind the appreciation of the loonie since 2002 is at least as important as the story of U.S. weakness.

What can be done to control the currency?

The government (and more likely its central bank, the Bank of Canada) can intervene in foreign exchange markets to influence flexible exchange rates. In essence, they would do the opposite of whatever private investors are doing, if they don't like the market-determined exchange rate. If the currency is too strong, the central bank would sell Canadian dollars (vice versa if the dollar is too weak). This is easier to do when the currency is too strong, than when it is weak. The Bank of Canada can conceivably supply infinite amounts of Canadian dollars to the market (since it can control the creation of Canadian currency, directly through printing and indirectly through its influence over bank credit), until enough is supplied that the exchange rate falls. When the Bank is trying to prop up the dollar, in contrast, it is limited by the amount of foreign exchange it has on hand to buy Canadian dollars; the Bank can also be defeated, in this scenario, by speculators who mobilize large financial sums to "attack" the currency in the expectation that it will eventually fall anyway. It is quite wrong to claim that the Bank of Canada could not have reduced or even arrested the recent appreciation of the Canadian dollar; other central banks (such as China's) have proven that it is quite possible to arrest an appreciating currency (much easier than trying to arrest a depreciating one).

Another way to control the currency is to simply re-establish fixed exchange rates – tying the dollar to another currency (most likely in our case the U.S. dollar), or even to the price of a real commodity (like gold). This approach has many pitfalls. Most importantly, it would effectively eliminate the ability of the Bank of Canada to set interest rates at levels which are best for Canada's economy; instead, interest rates would have to be set at whatever level was consistent with the fixed exchange rate. Fixed exchange rates are also subject to speculative attacks (especially for smaller countries). And the economy would lose some of the desirable flexibility in exchange rates: that which reflects genuine developments in the real economy (as opposed to speculative forces).

A left strategy for tackling the problem of Canada's overvalued currency would start from an understanding of the deeper underlying causes which have caused the problem in the first place. The loonie's rise reflects the interest of investors – foreign as well as domestic – in highly profitable business opportunities (especially in petroleum and other resources) in Canada. That chain of influence could be easily broken, by pro-active measures which targeted the resource super-profits and associated financial side-effects. Impose higher taxes or royalties on the extraction of non-renewable resources (for environmental reasons, as well as economic ones). Severely restrict foreign takeovers of Canadian resource companies and assets. That in turn would reduce share prices for resource companies on the Canadian stock market. All of this would quickly reduce the relative appeal of owning Canadian wealth, both financial and real. The dollar would depreciate immediately and rapidly. (Indeed, this is the same reason why exchange rates typically fall when left-wing governments are elected.)

More deeply, destructive exchange rate instability is another side-effect of the intense financialization which has characterized economic development under neoliberalism. The sheer sums of mobile financial capital which are available to speculate on assets, including across national borders, have grown dramatically due to the expansion of mutual funds and other financial vehicles, the unproductive allocation of new credit into financial rather than productive uses, and the concentration of financial wealth in the hands of an increasingly small elite. Reversing financialization – by socializing capital pools, by eliminating the reliance of pension funds and other social programs on stock markets, by taxing and redistributing financial wealth – would lessen the vulnerability of the economy to financial flows in general, including those which have wreaked such worldwide havoc through exchange rate instability. **R**