



## One Dollar = One Loonie

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On September 21, 2007, the Canadian dollar—nicknamed the “loonie,” after the water fowl depicted on its reverse—reached parity with the U.S. dollar for the first time since 1976 (see chart). That is, one loonie could purchase one U.S. dollar. The Canadian financial press celebrated this milestone.

That the Canadian dollar equaled the value of one U.S. dollar is not intrinsically important; there is nothing special about a price (an exchange rate) equal to one. Nevertheless, the recent decline in the Canadian/U.S. dollar exchange rate will affect economic decisions. For example, consumers in both Canada and the United States now find U.S. goods to be relatively cheaper than Canadian goods. This benefits Canadian consumers but will make it more difficult for Canadian producers to compete with their American counterparts.

Before considering why the loonie has appreciated against the U.S. dollar, one should know that exchange rates appear to be only weakly connected to macroeconomic variables such as output, prices, and interest rates. Specifically, macro models have not had much success in predicting exchange rates. But we can reasonably identify some important qualitative factors, at least in hindsight.

Many analysts have ascribed the recent rise in the loonie mainly to U.S. economic problems. Very low domestic savings, for example, contributes to an enormous U.S. current account deficit, equal to almost 6 percent of gross domestic product (GDP). Some argue that a reduction in this deficit requires a fall in the dollar’s value. Perhaps as a result of concern about this scenario, China has allegedly reduced its demand for the U.S. dollar as a reserve asset. More recently, problems with subprime mortgages and the subsequent reduction in the federal funds target have reduced international demand for U.S. assets. All of these factors have probably contributed to recent weakness in the U.S. dollar. Indeed, the U.S. dollar has declined by about 30 percent against a basket of major currencies since early 2002.

A less-discussed factor in the appreciation of the loonie against the dollar, however, is the substantial improvement in Canadian economic policy that began about 16 years ago. In 1991 the Bank of Canada began “inflation targeting,” making a numerical range for inflation the primary or sole objective of monetary policy. The early 1990s also saw a turnaround in chronically large Canadian budget deficits;

since 1996 the Canadian budget has usually been in surplus and never in a substantial deficit. As a result, the net Canadian government debt fell from about 70 percent of GDP in 1995 to only about 25 percent of GDP in 2007. These policies have successfully reduced Canadian inflation. As a result, since 1996, Canadian long-term interest rates have almost always been lower than their U.S. counterparts. Prior to 1996, U.S. long-term rates were almost always lower. These measures have enabled the loonie to be viewed as a stable store of value.

Finally, global growth and fears about the international security situation have driven the recent rise in prices of Canadian export commodities such as oil and gold. Researchers at the Bank of Canada have noted that such strengthening in commodity demand has historically buoyed the price of the loonie.<sup>1</sup>

While U.S., Canadian, and global factors have all contributed to the rise in the loonie’s value, the case highlights the benefits of improved Canadian economic policies and the potential dangers of the low U.S. saving rate. ■

<sup>1</sup>Amano, R. and van Norden, S. “Terms of Trade and Real Exchange Rates: The Canadian Evidence.” *Journal of International Money and Finance*, 1995, 14(1), pp. 83-104.

