Loonie Takes Flight

By Cameron Muir, BCREA Chief Economist

The meteoric rise of the Canadian dollar has many concerned that it's flying just a little too high. Five years ago, a loonie buried at centre ice during the Salt Lake Winter Olympics helped the Canadian team win gold. While our players faced off over the lucky dollar, worth just 64 US cents, more than one NHL team was in jeopardy of relocating south of the border. The greenback was king and everybody wanted to be paid in US dollars—my, how times have changed.

The subprime mortgage debacle was the icing on the cake for an already troubled US dollar. The spectre of multi-billion dollar writedowns in the US banking sector and severe belt-tightening by American consumers has taken the bloom off the rose. The value of the greenback has fallen compared to most major world currencies.

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But the velocity of the loonie's rise has more fuel than just a troubled US economy. Strong international demand for our minerals and Alberta's immense oil sands increase the pressure. Add to this a government flush with cash, a $60 billion tax cut, a strong domestic economy and you get the proverbial perfect storm.

While consumers line up at border stations along the 49th parallel, Canadian retailers scramble to cut prices on inventories purchased at pre-parity prices. BC lumber mills are struggling to keep the sawdust flying and Vancouver hoteliers are nervous. So, how will we survive?

Most economists agree that the Canadian dollar is now out of line with the fundamentals; however, don't count on the loonie to descend to the 95-cent range with the same rapidity. It could take many months or years to float down to a level suggested by the fundamentals. This will depend a great deal on the how quickly the US returns to economic form.

In the meantime, the Bank of Canada will be hard pressed to increase its trendsetting overnight rate in fear of completely derailing the manufacturing sector—not bad news for a housing market coping with eroding affordability. Cheaper imports from the US will lower consumer prices and stimulate retail sales. In the short term, BC households will benefit from a loonie that stretches further than ever before. However, the longer our dollar stays at its lofty height, the more negative the economic impact.

Industry is better able to cope with a slow, rather than quick, rise in the loonie's value. Over many years, investment in machinery, equipment and technology can offset an eroding exchange rate by increasing productivity and international competitiveness. A rapidly rising dollar can leave industry unable to respond quickly enough, leading to huge losses, layoffs, temporary closures and even business insolvency.

Therein lies the rub. There will be winners and losers: consumers and hockey teams have more purchasing power, while industries struggle to compete on a newly tilted international playing field. Unless you believe the mighty US economy has permanently lost its dominant position in the world, the long-term outlook remains positive. However, the longer the loonie remains in the stratosphere, the more the negative fallout will impact our economy and, by extension, BC households. Like the fabled Icarus whose wax wings came too near the sun, the loonie may also be soaring above its cruise altitude.

Canada–US Dollar Exchange Rate

SOURCE: BANK OF CANADA