

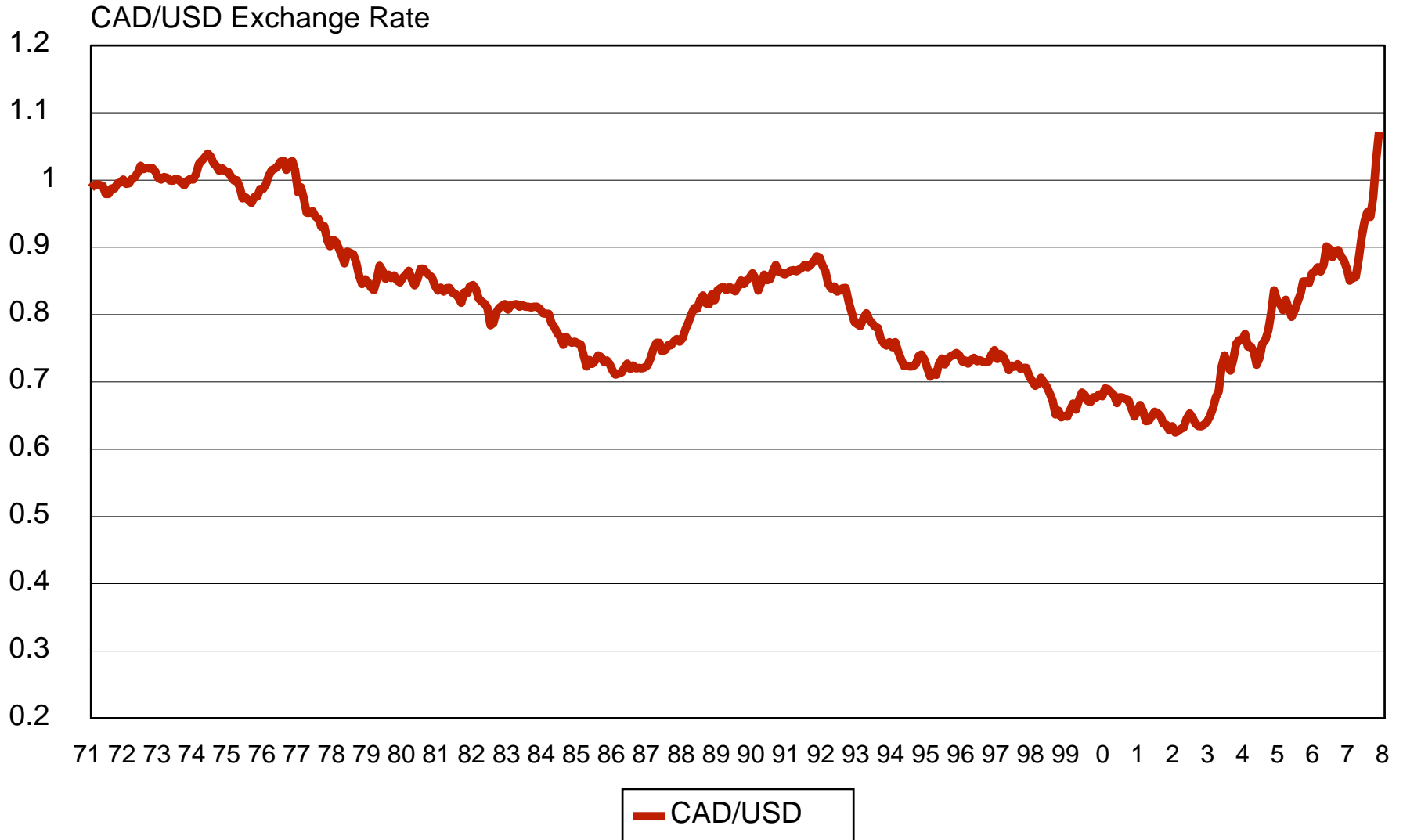
THE SURGE IN THE LOONIE:

Canadian Dollar Strength or U.S. Dollar Weakness?

Dr. Kenneth Matziorinis
Department of History, Economics & Political Science

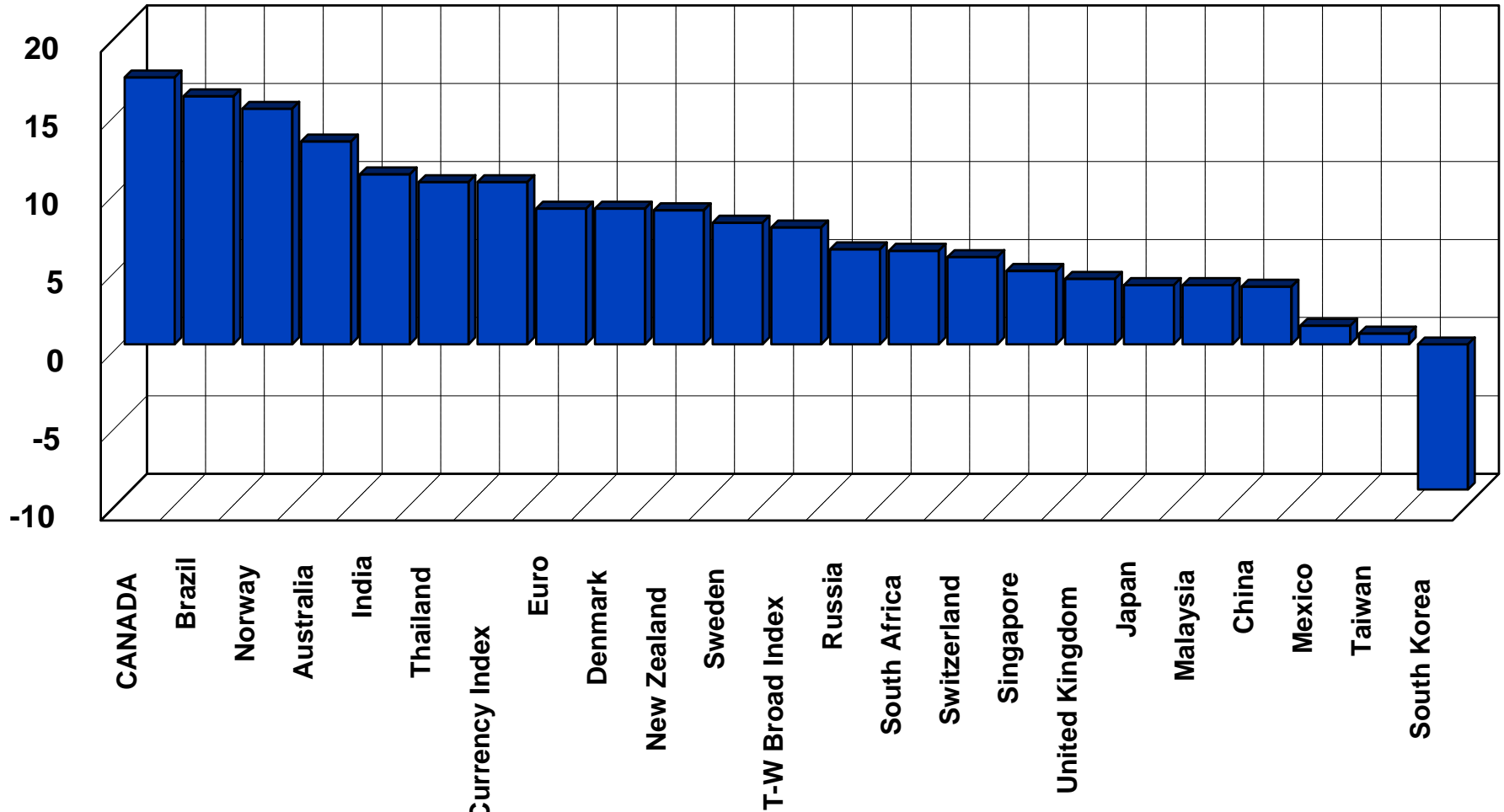
THE VALUE OF THE CANADIAN LOONIE AGAINST THE GREENBACK: 1971 - 2007

Canadian Dollar Floats in May 1970 (May 1962 - May 1970 = Parity)



CURRENCIES THAT HAVE GAINED THE MOST THIS YEAR: Year-To-Date: 2007

Appreciation Against the U.S. Dollar



Why Has the Loonie Appreciated?

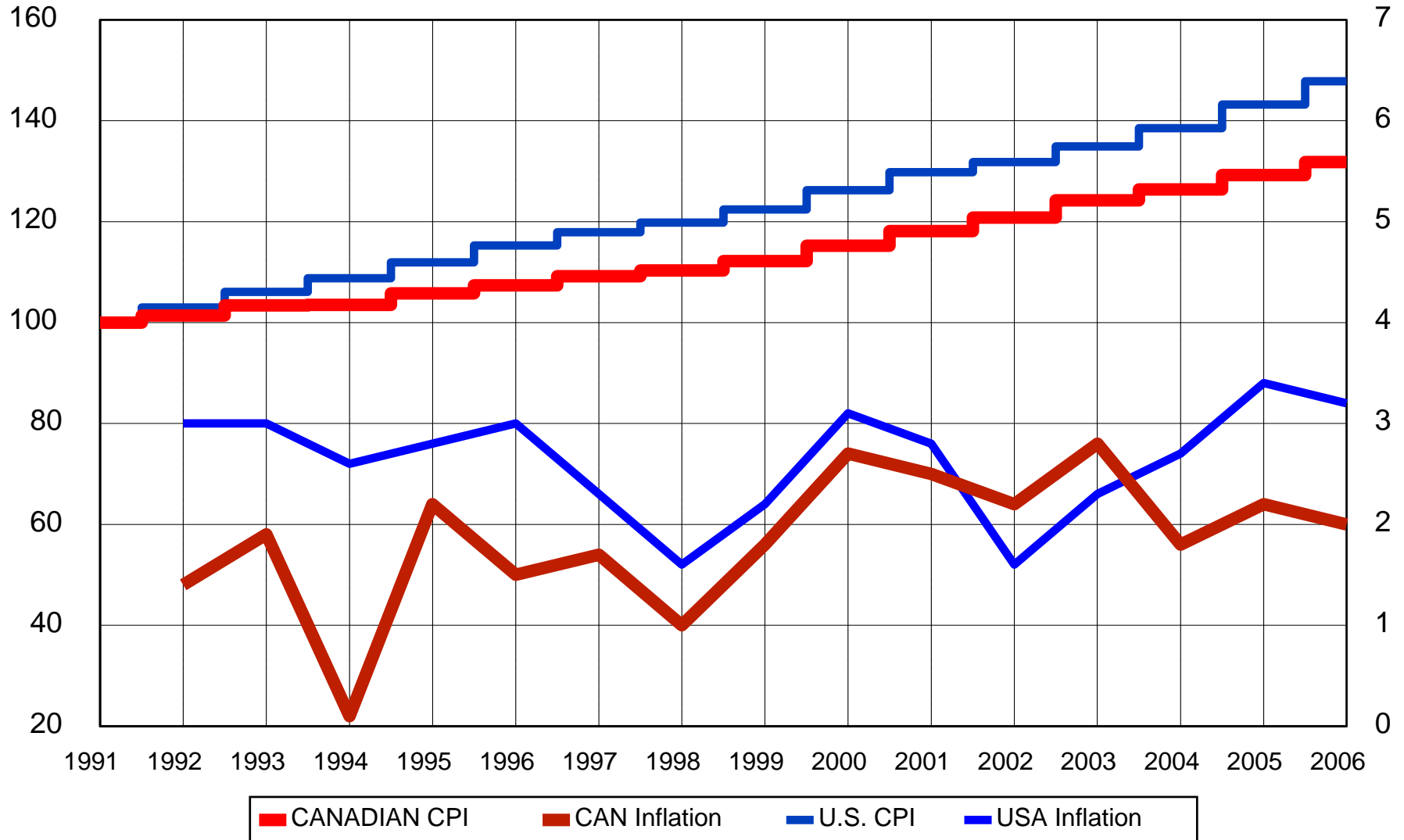
Improvements in Underlying Fundamentals

- **The introduction of inflation control targeting framework in Canada since 1991:
The target for inflation: 2%**
- **Elimination of public sector deficits and their transformation to sustainable surpluses: from a deficit of 9% of GDP in 1992 to surpluses of 1% of GDP**
- **Increase in the national saving rate: from 13% of GDP in 1992 to 24% in 2006**
- **Decrease in the country's external debt: from 44.5% of GDP in 1993 to under 7%**
- **Decrease in interest rates and the cost of capital: from 9% in 1992 to 4.2%**
- **Increase in the rate of gross fixed capital formation: from 18% in 1993 to 22%**
- **Up-turn in commodity cycle: rising commodity and energy prices including oil**
- **Improvement in Canada's terms of trade: higher export prices; lower import prices**
- **Gains from free-trade with the United States and Mexico: NAFTA**
- **Reduction in political uncertainty over Quebec separation**

- **The ONLY NEGATIVE: Canada's lagging productivity growth**

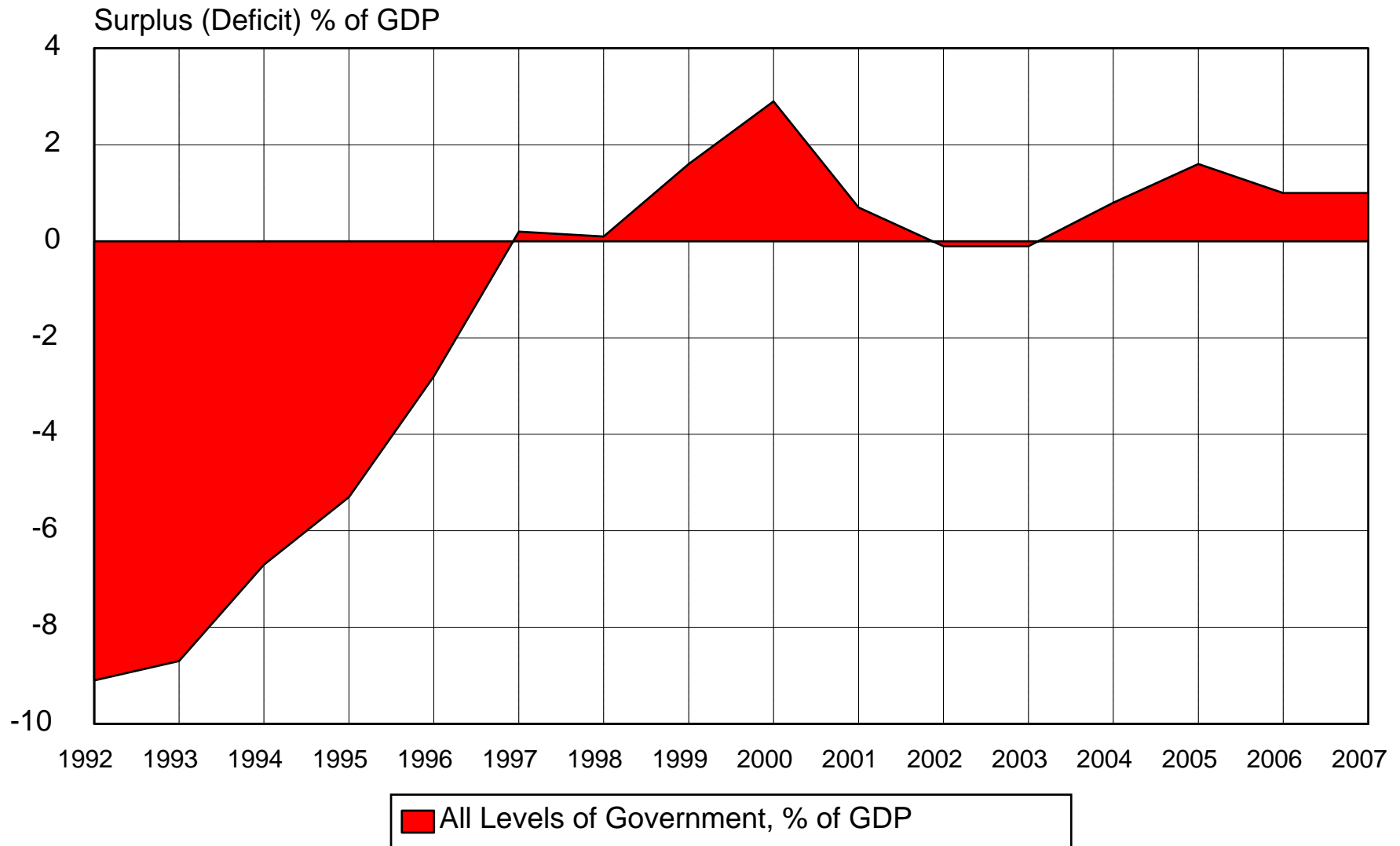
CANADA - U.S. CONSUMER PRICE DIVERGENCE

Since 1991, Canadian prices have risen by 10.8% less than U.S. prices on a cumulative basis. This adds 10.8% to the value of the loonie relative to the greenback. Average Inflation: Canada 1.9% vs. U.S.A. 2.6%



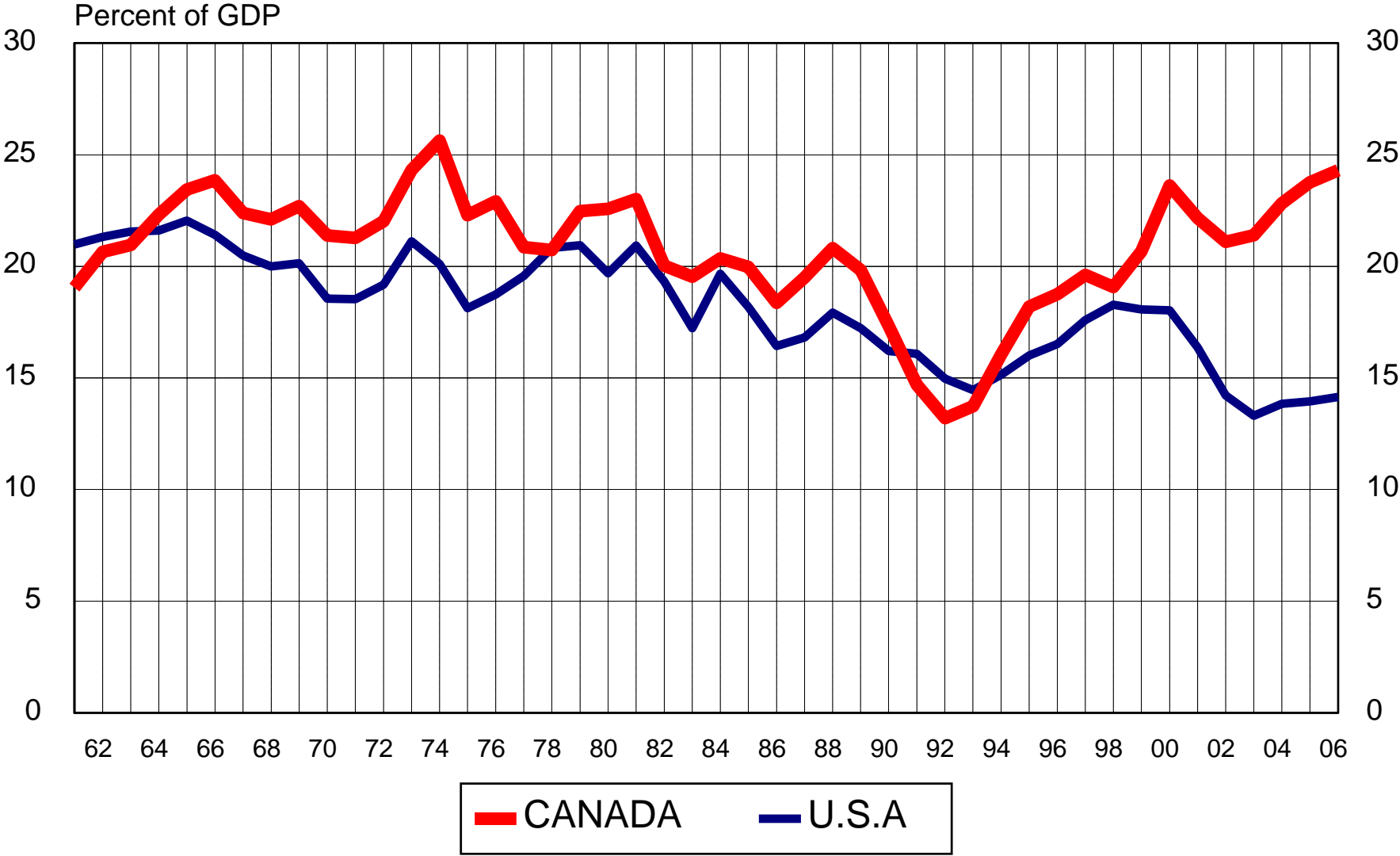
CANADA'S GOVERNMENT BUDGET BALANCE, 1992 - 2007

Canada's public sector has shifted away from the largest deficits to the largest budget surplus in G-7



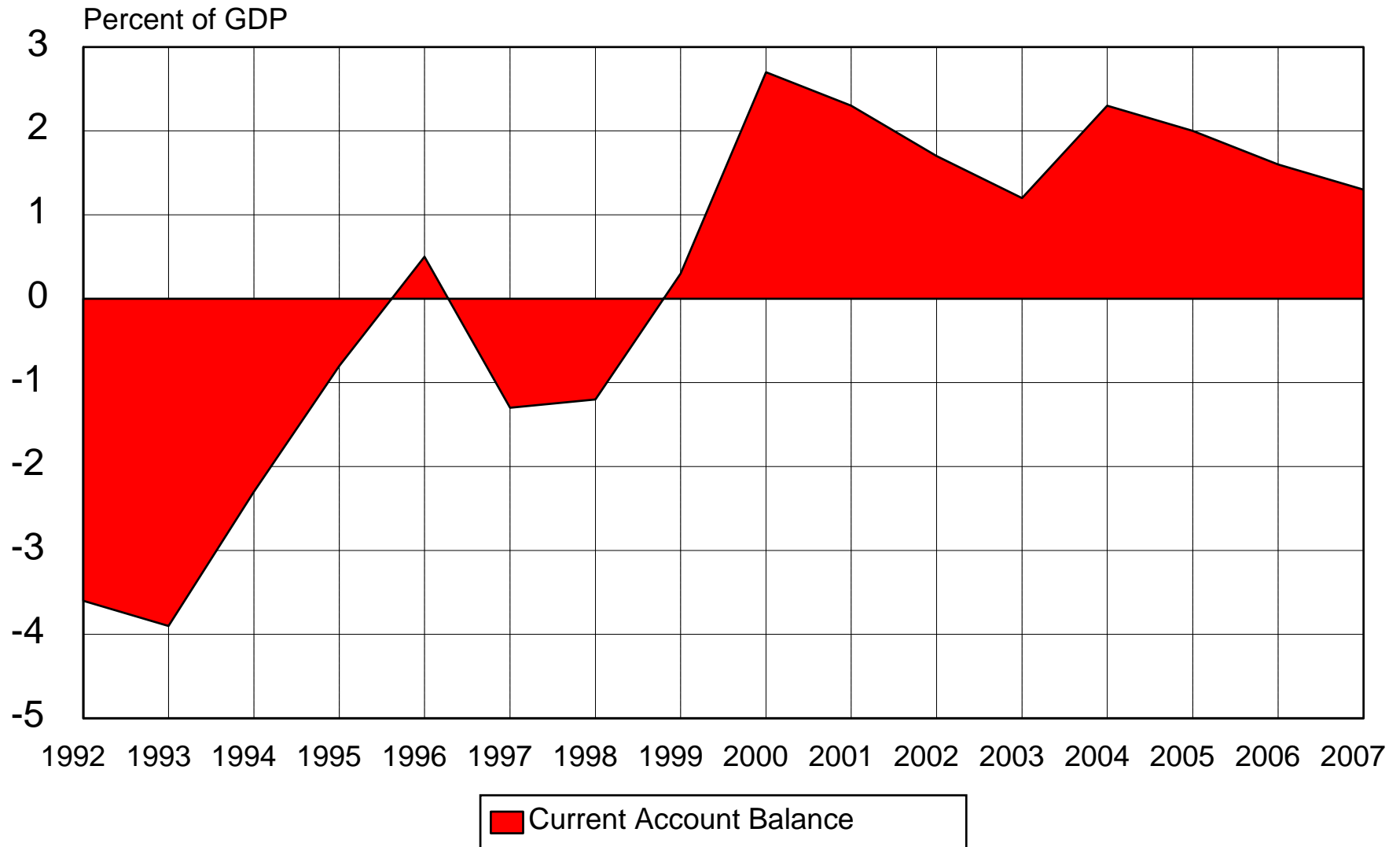
NATIONAL SAVINGS RATES, CANADA AND THE U.S.A: 1961-2006

The saving gap widens between the two NAFTA neighbors



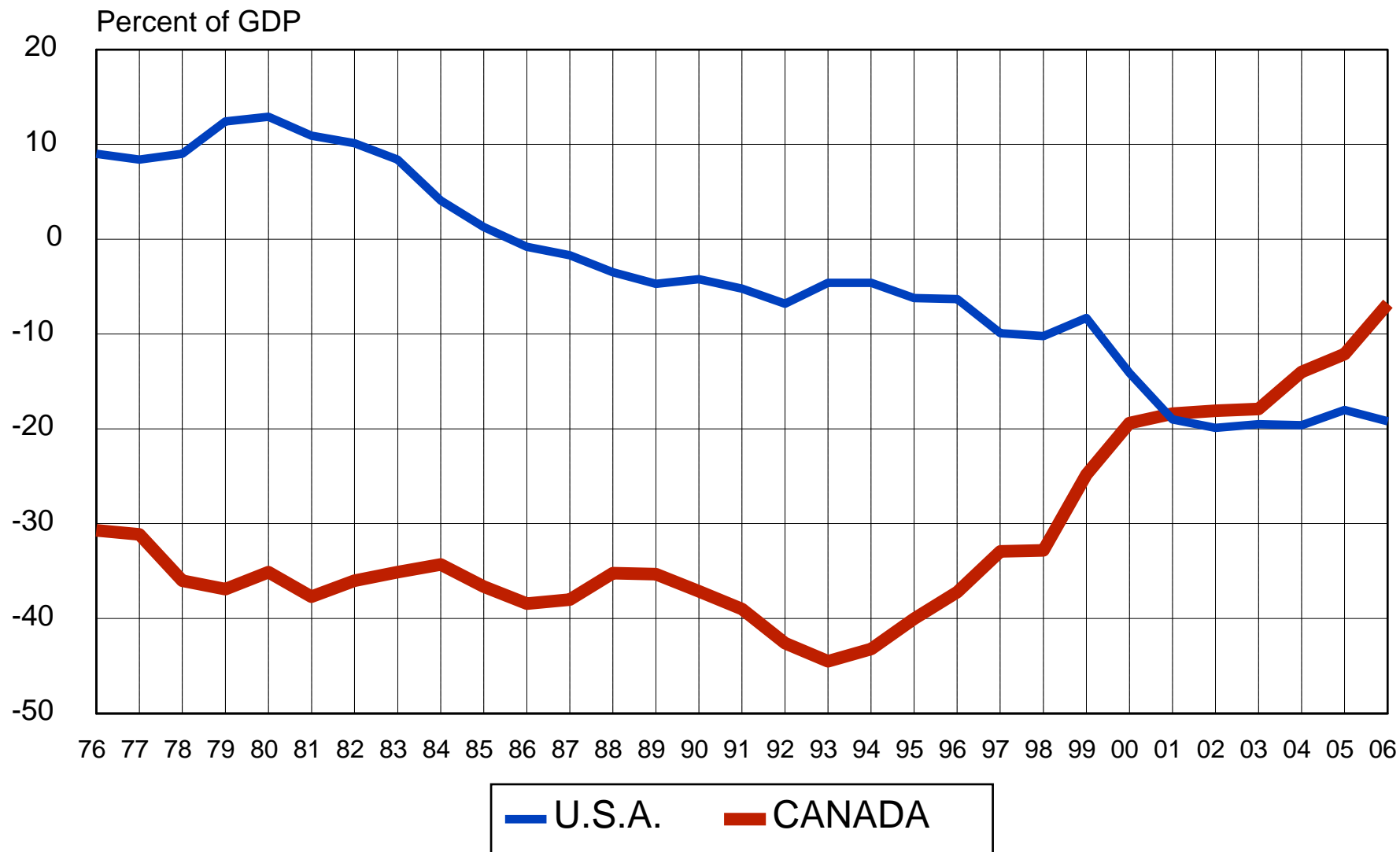
CANADA'S CURRENT ACCOUNT BALANCE, 1992 - 2007

As Canada's national saving rate recovered, Canada's international trade balance has risen in recent years



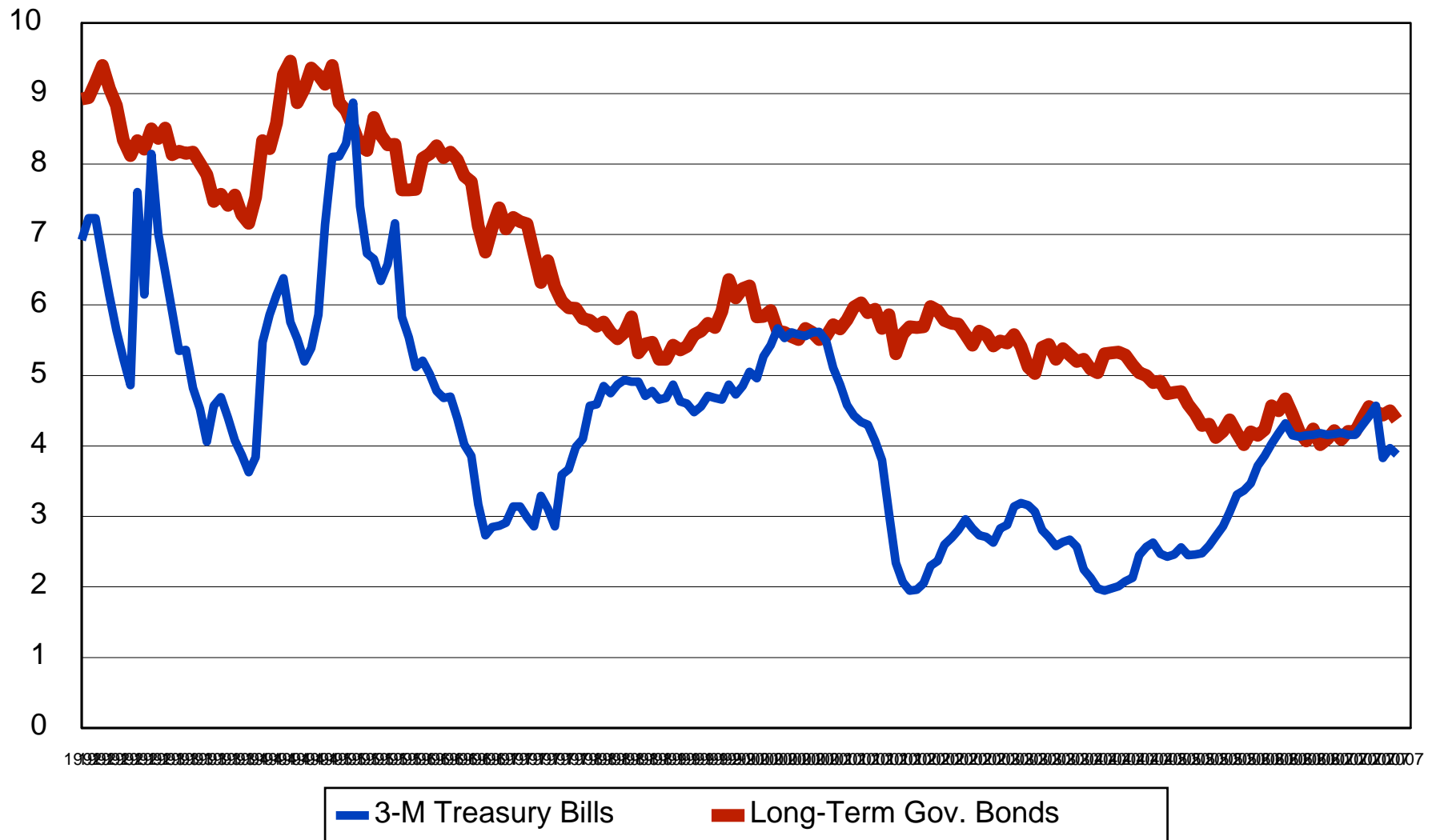
NET INTERNATIONAL INVESTMENT POSITIONS OF CANADA AND THE U.S.A.: 1976 - 2006

A Tale of Two Countries: Canada's foreign debt is falling while America's is rising



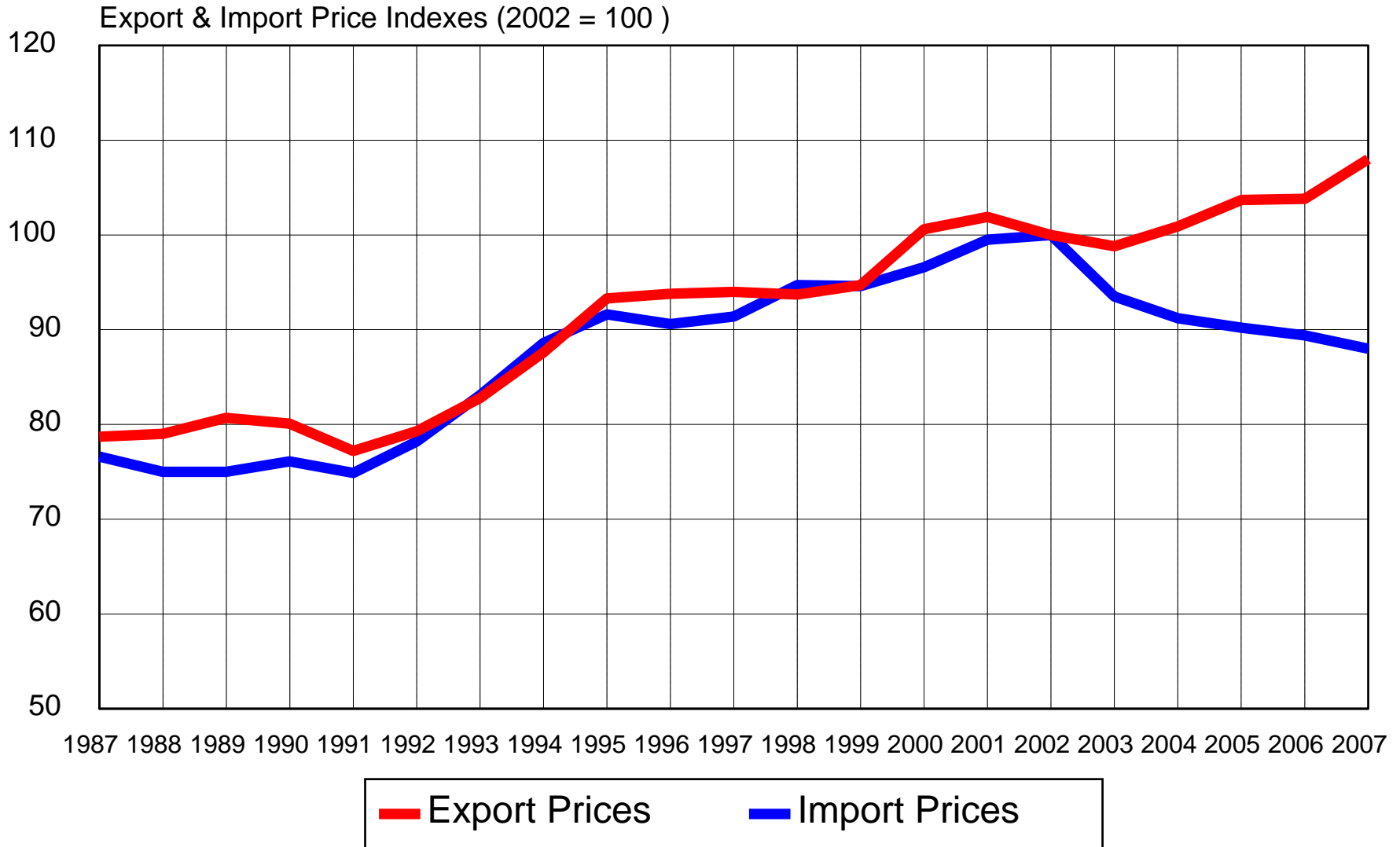
LONG AND SHORT-TERM INTEREST RATES IN CANADA: 1992-2007

The cost of capital in Canada has declined benefiting producers and consumers



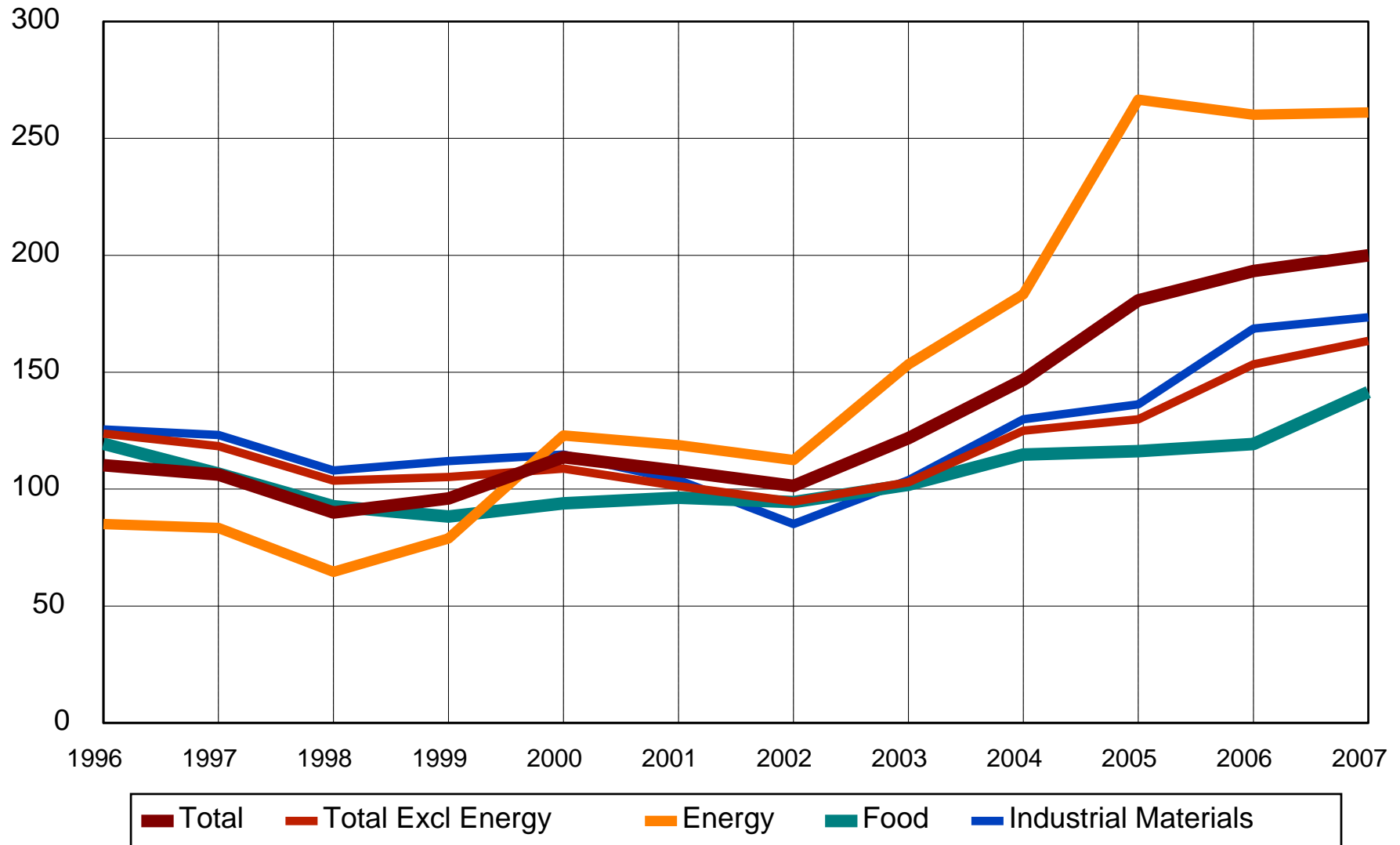
CANADA'S TERMS OF TRADE, 1987 - 2007

Since 2002 our export prices have risen faster than our import prices, improving our terms of trade



COMMODITY PRICE INDEX, 1982-90 = 100, U.S. DOLLAR TERMS

Commodity prices have surged led by the price of energy



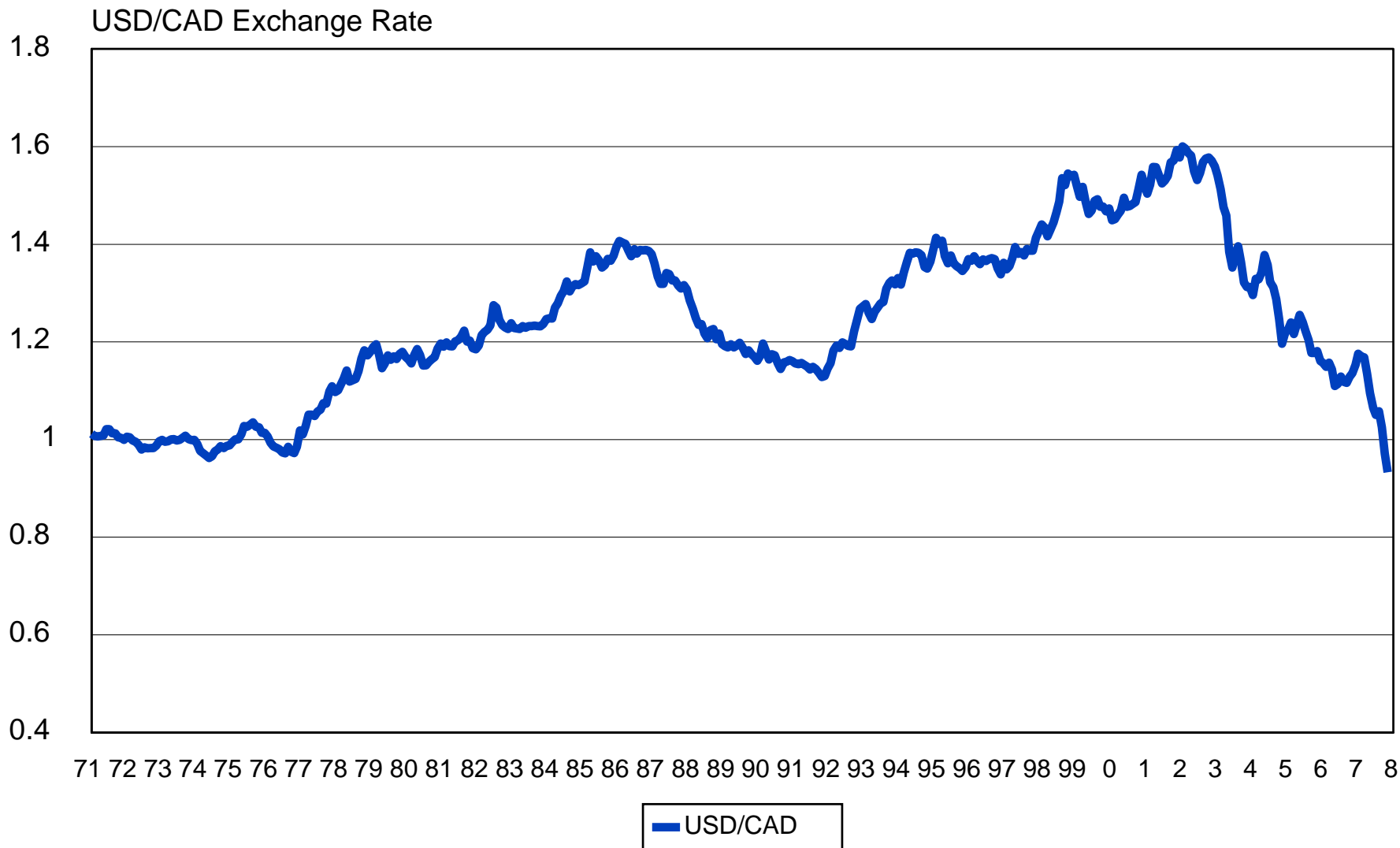
U.S.DOLLAR PERCENT DEPRECIATION AGAINST MAJOR BENCHMARKS

The Loonie is not the only currency being lifted

	Year-to-Date	January 2002 - November 2007
Trade-Weighted Broad Index	-7.5%	-23.0%
Trade-Weighted Major Currency	-10.4%	-35.4%
Gold	-21.1%	-64.8%
Canadian Dollar	-17.1%	-38.9%
E.U. Euro	-8.7%	-38.8%

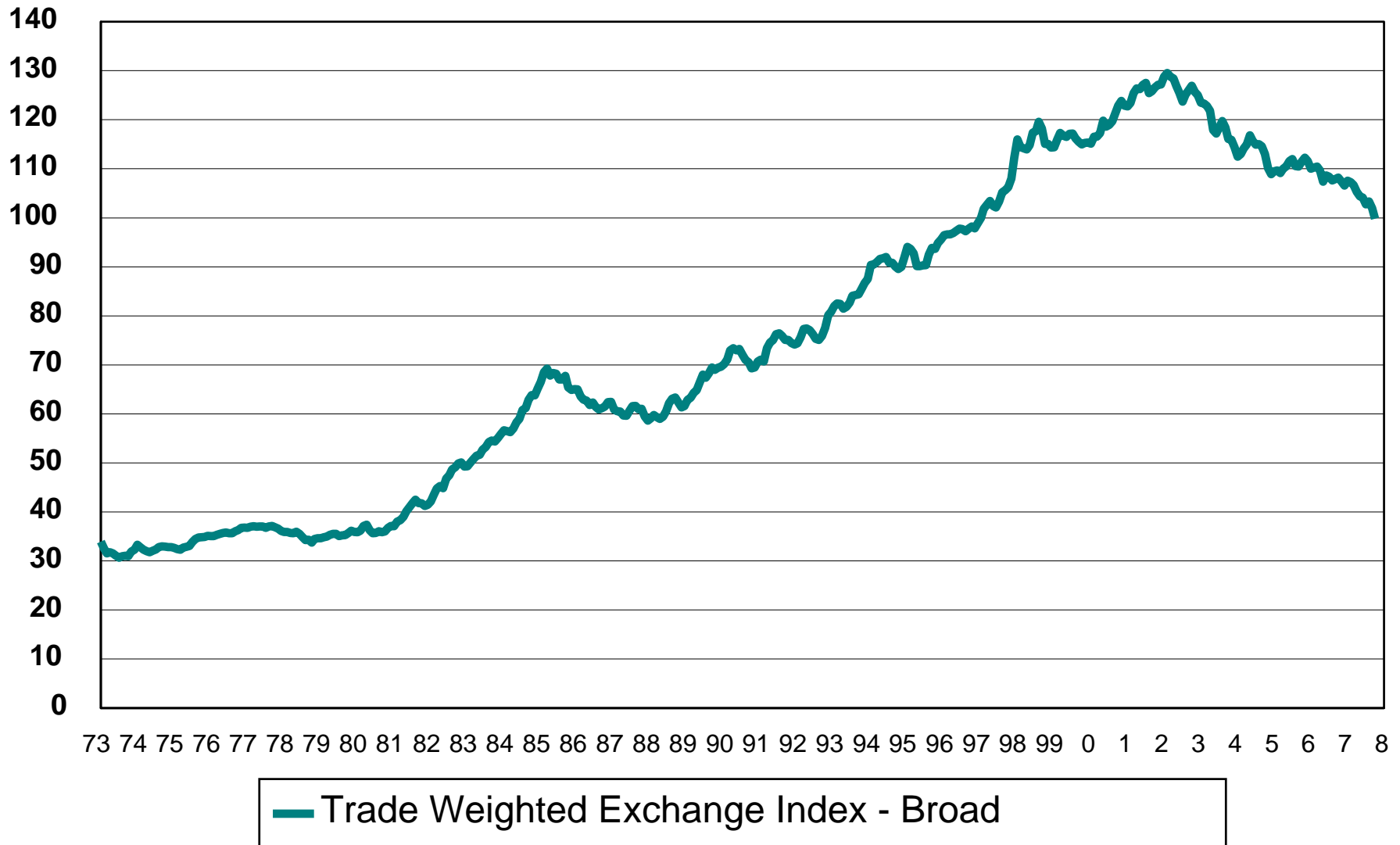
THE VALUE OF THE U.S. GREENBACK AGAINST THE LOONIE: 1971 - 2007

In August 1971 President Nixon Suspends Convertibility of Gold to the U.S. Dollar, Beginning of the End for Gold Exchange Standard Set Up at Bretton Woods



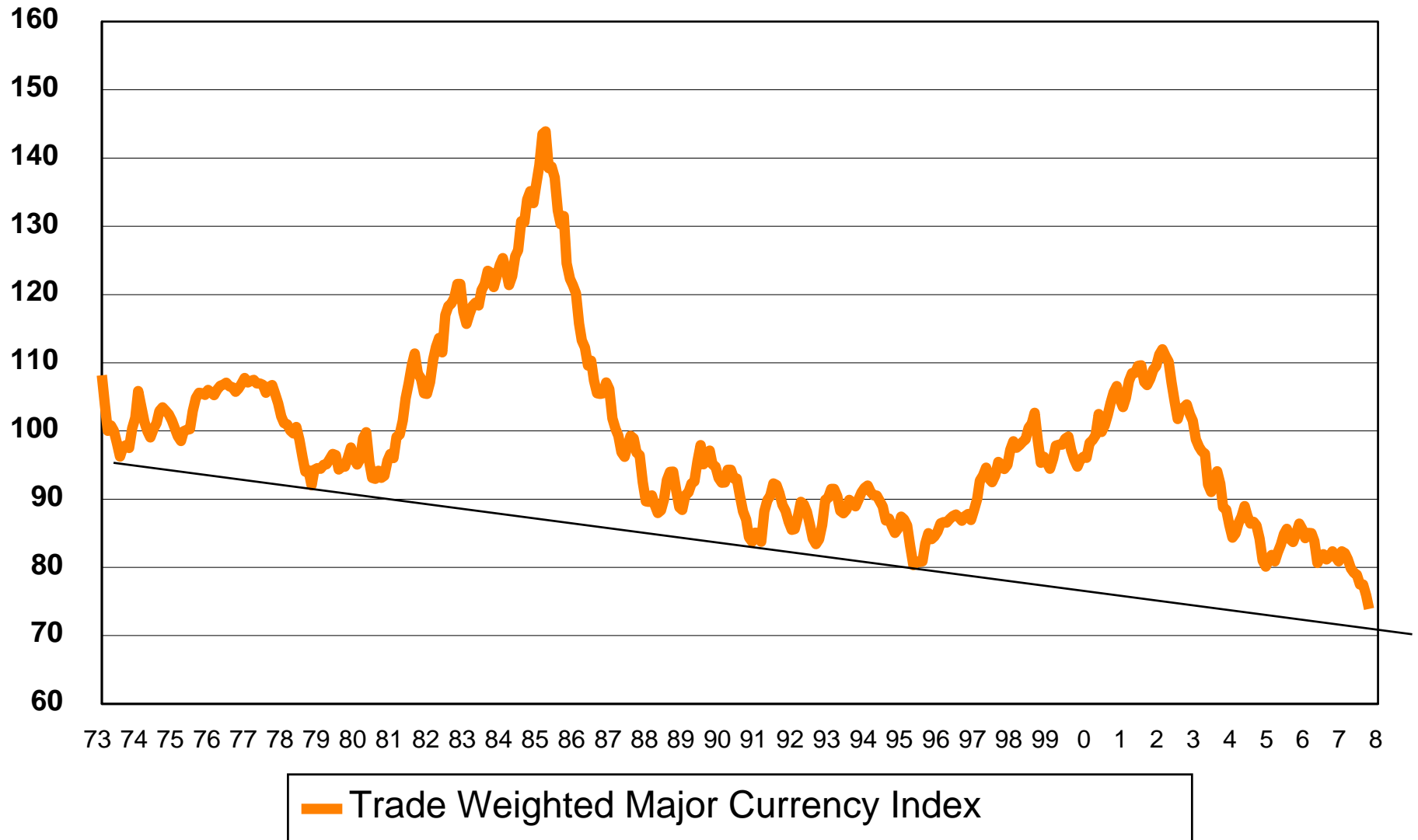
U.S. TRADE WEIGHTED EXCHANGE INDEX: Broad Basket of Currencies

Source: Board of Governors of the Federal Reserve System (1973 = 100.0)



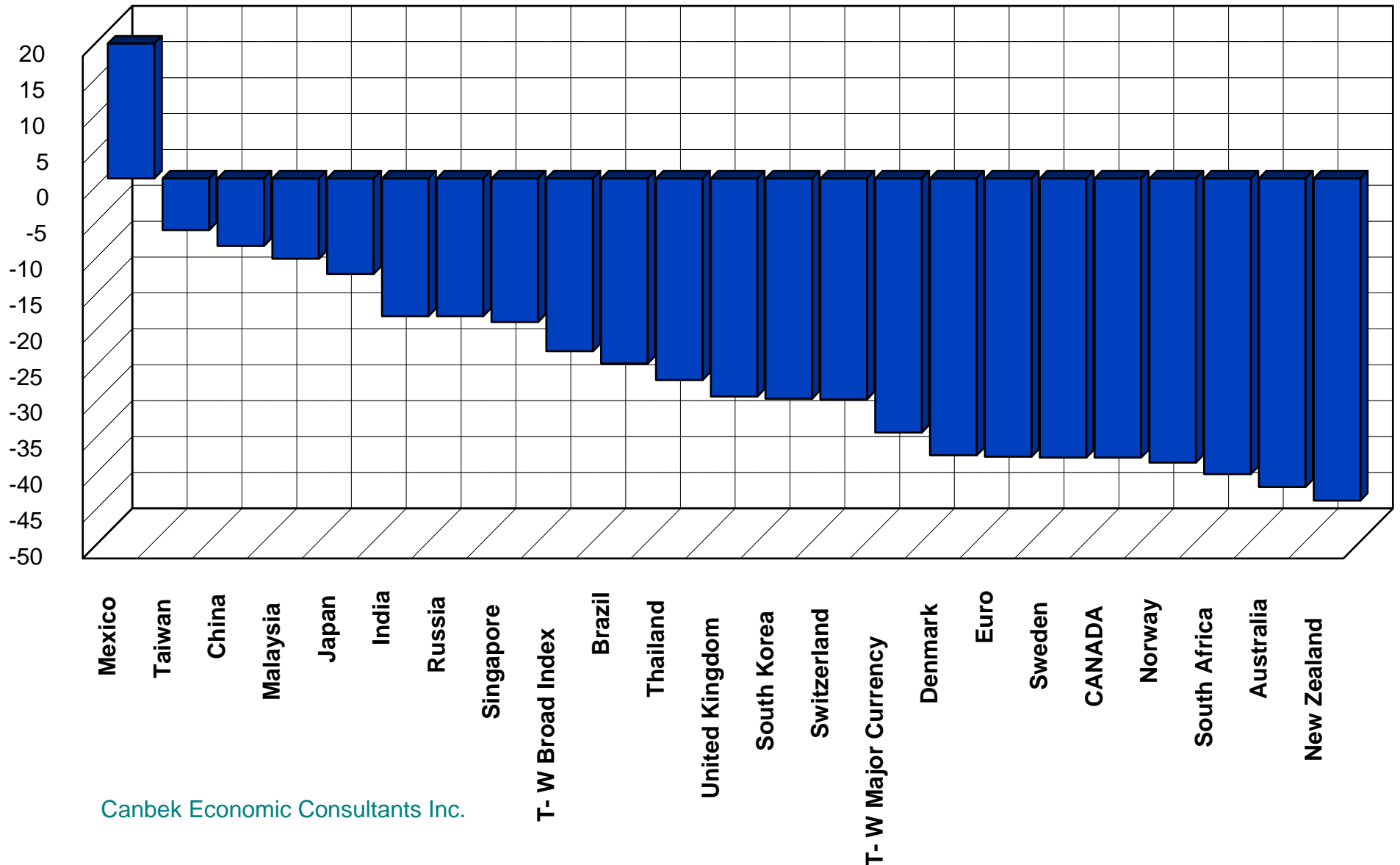
U.S. TRADE WEIGHTED EXCHANGE INDEX: Major Currencies

Source: Board of Governors of the Federal Reserve System (1973 = 100.0)



U.S DOLLAR DEPRECIATION SINCE FEBRUARY 2002

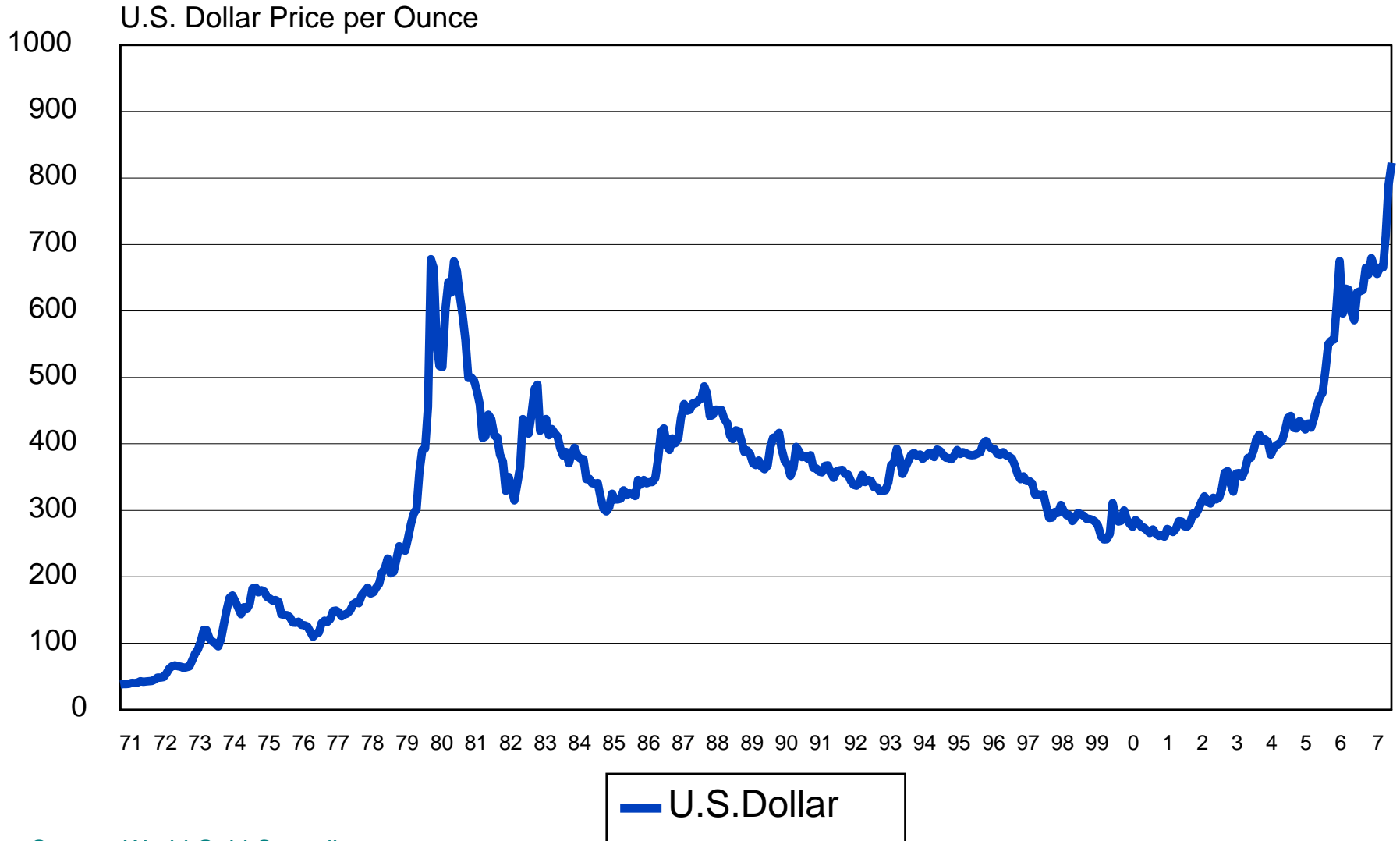
Percent (%) Decline in the Value of the US Dollar Since Recent Peak



GOLD PRICE, U.S. DOLLAR PER OUNCE

(LONDON PRN FIX)

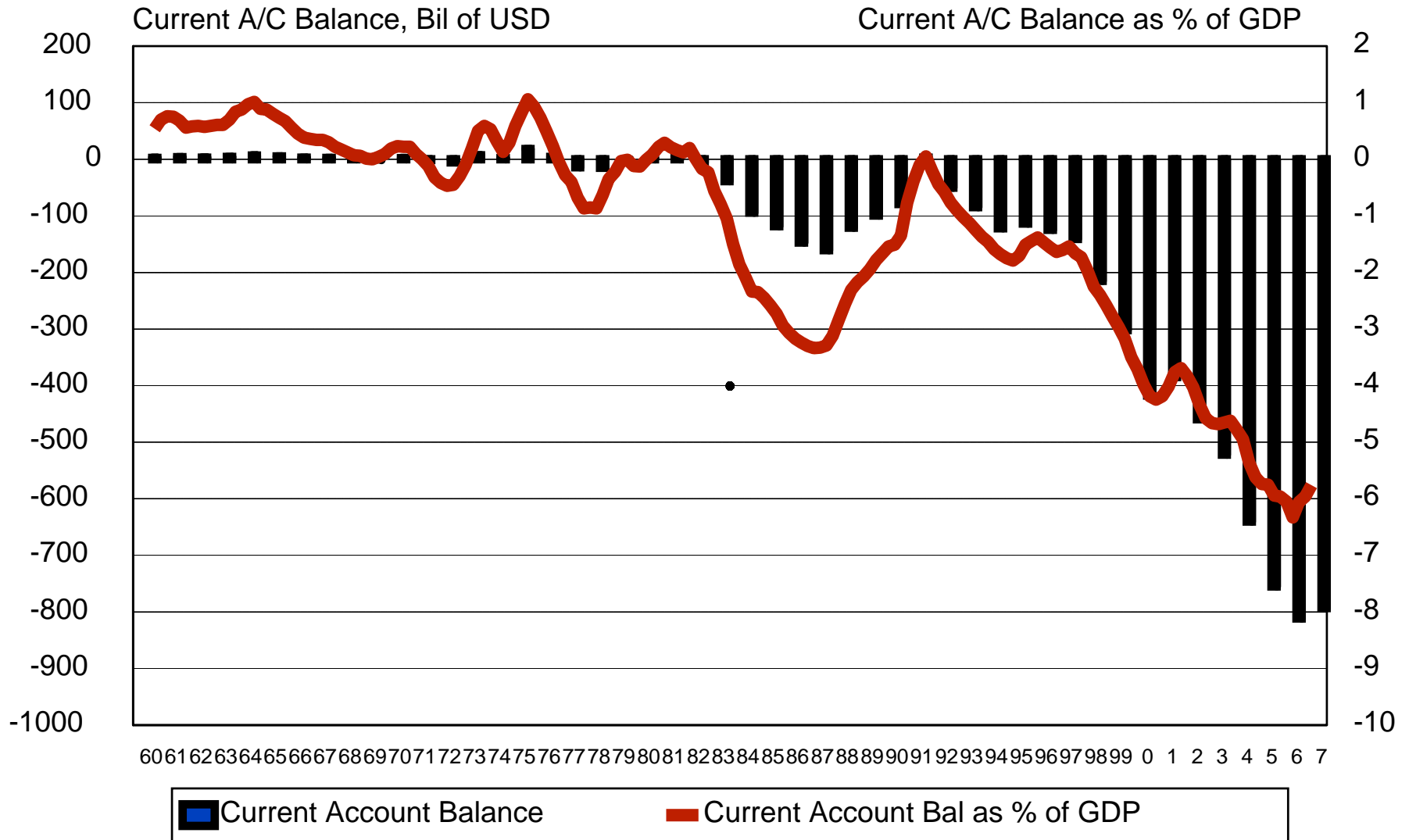
The U.S. Dollar price of gold has broken through its previous high of January, 1980, not a positive sign!



Source: World Gold Council
Canbek Economic Consultants Inc.

U.S. CURRENT ACCOUNT DEFICIT

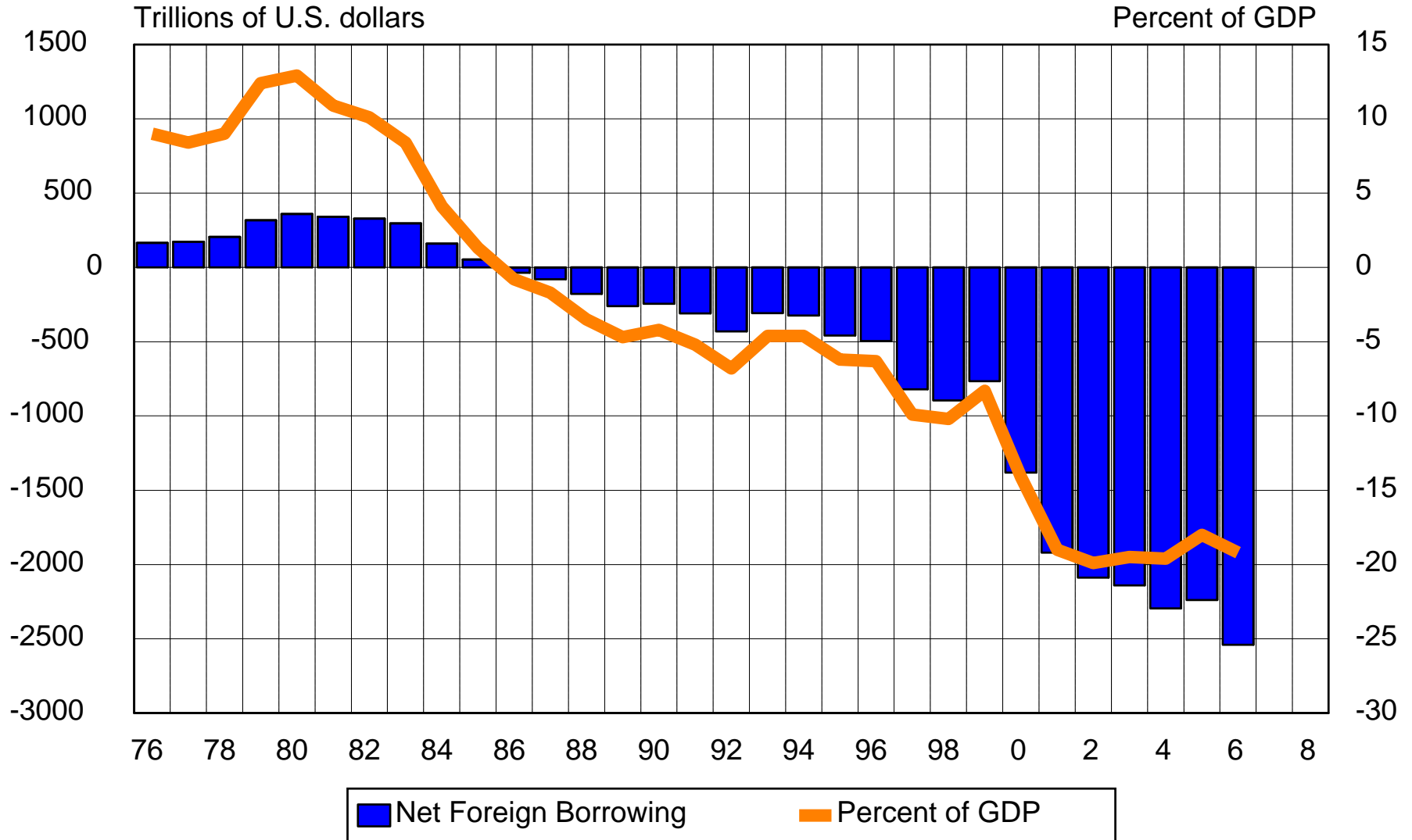
1960 - 2007



U.S NET INTERNATIONAL INVESTMENT POSITION

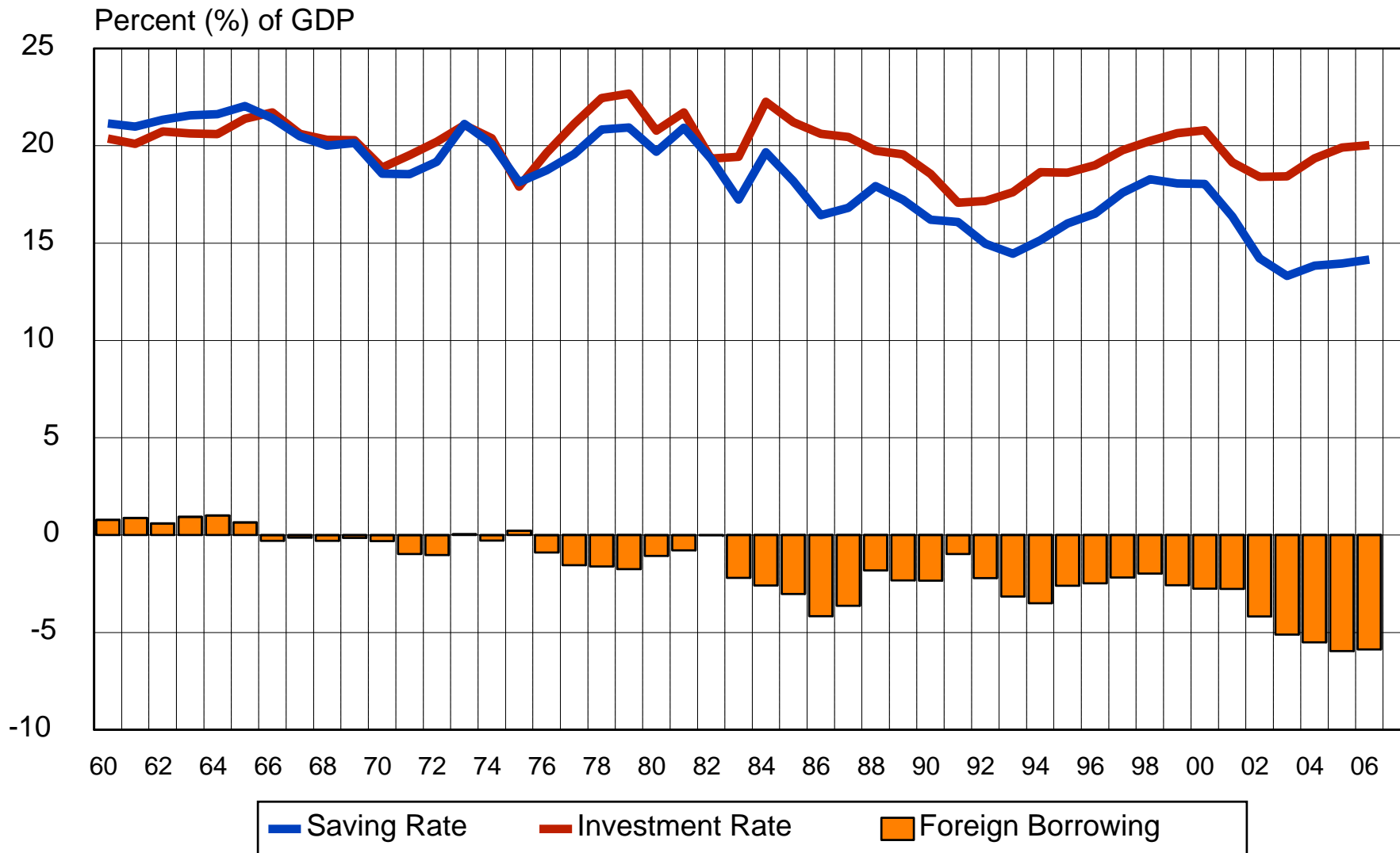
1976 - 2006

Source: BEA, US Department of Commerce



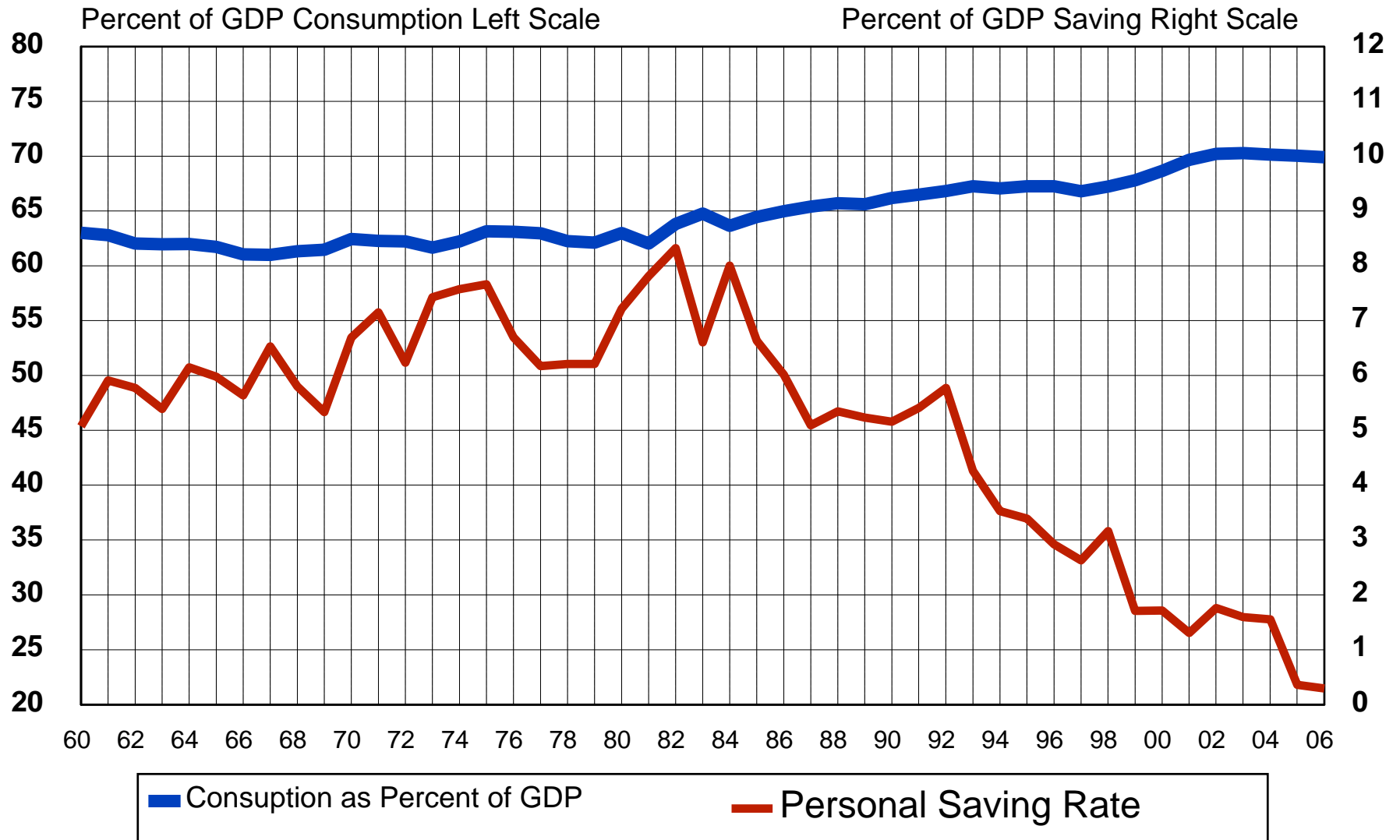
U.S NATIONAL SAVING - INVESTMENT IMBALANCE: 1960 - 2006

Investment Needs Exceed Available Savings: Must Rely on Foreign Savings



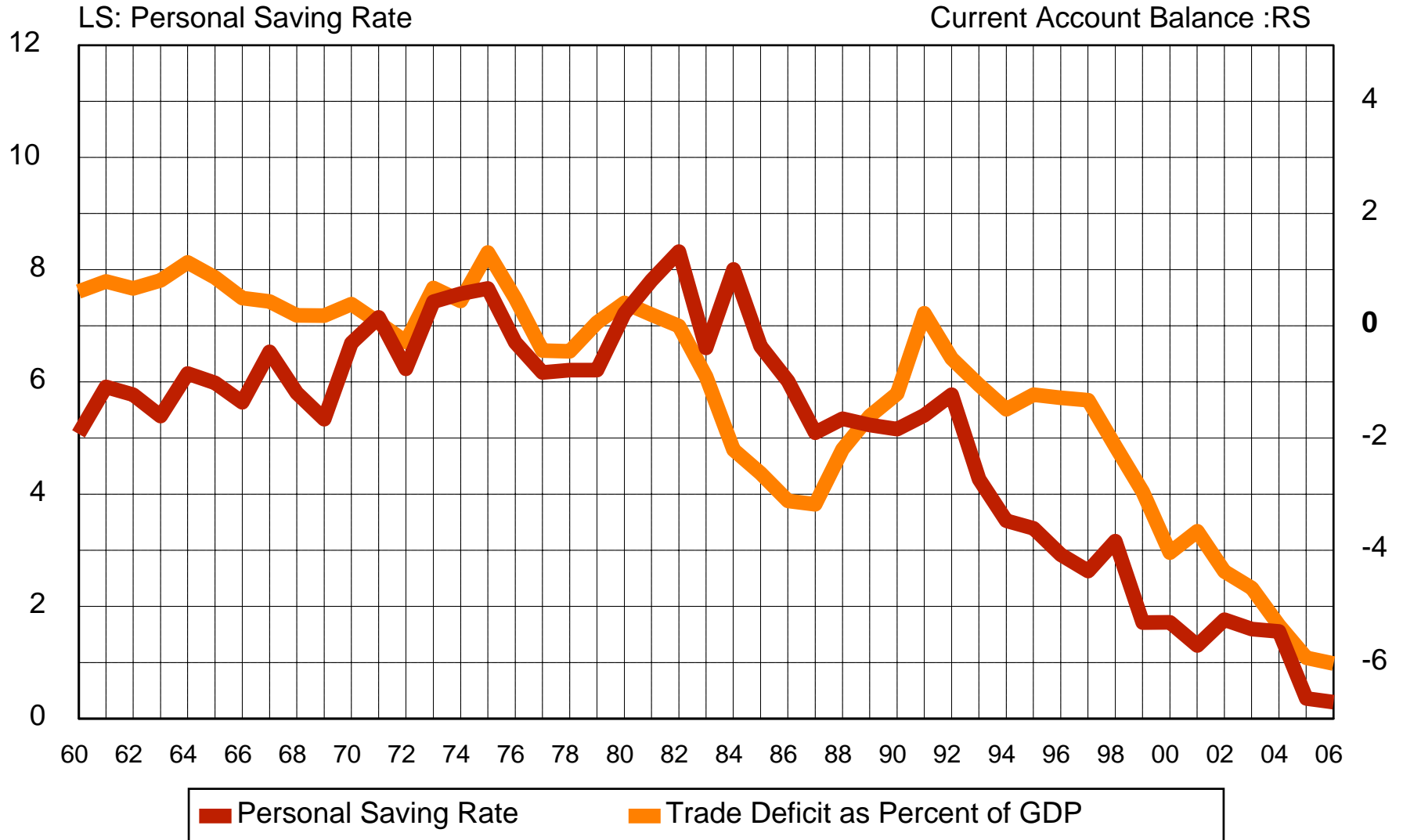
U.S CONSUMPTION AND PERSONAL SAVING RATES: 1960 - 2006

Spend More and Save Less: Hakuna Matata!



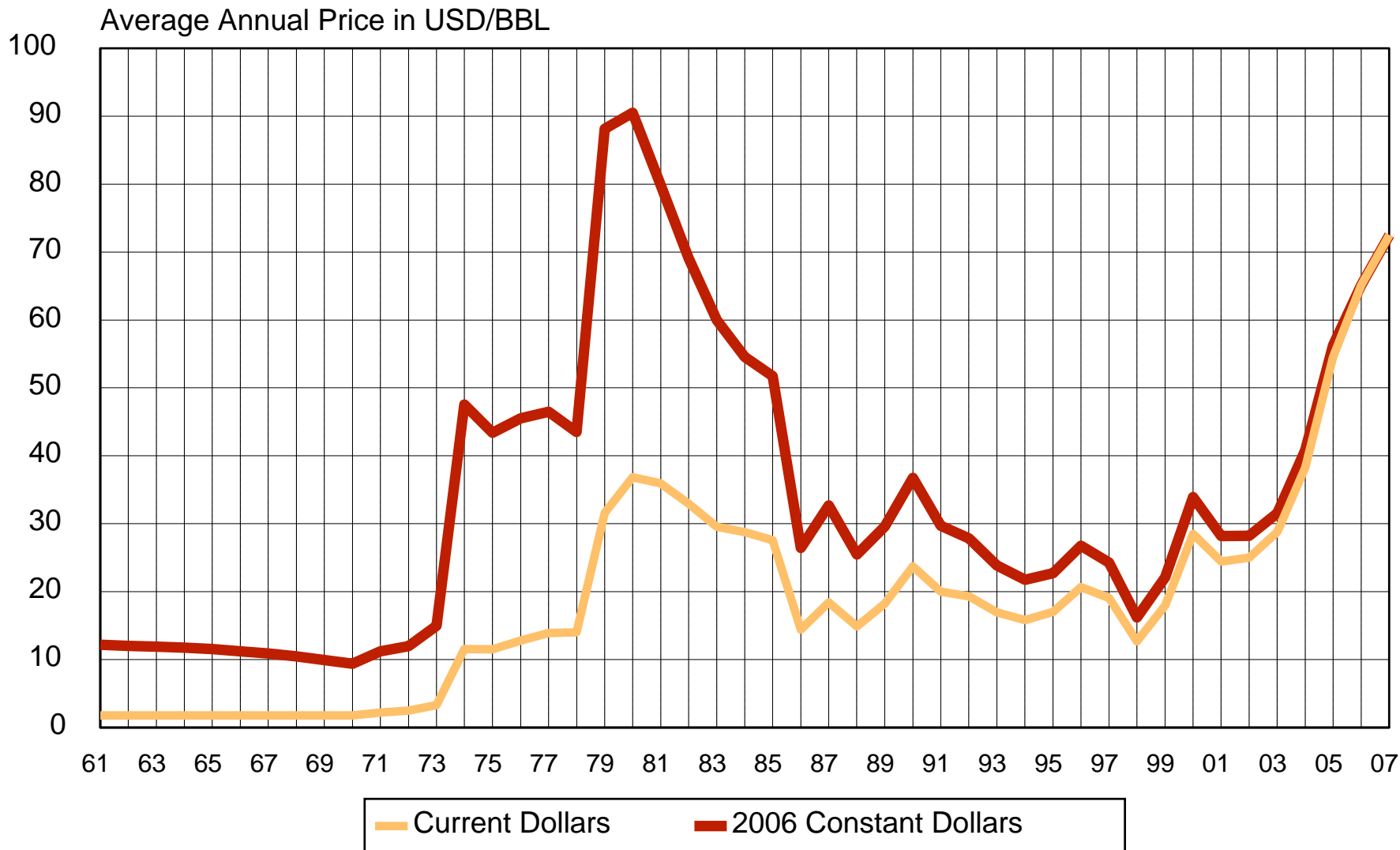
U.S TRADE BALANCE AND PERSONAL SAVING RATE: 1960 - 2006

Coincidence? Correlation? or Causation?



PRICE OF CRUDE OIL BRENT \$/BBL

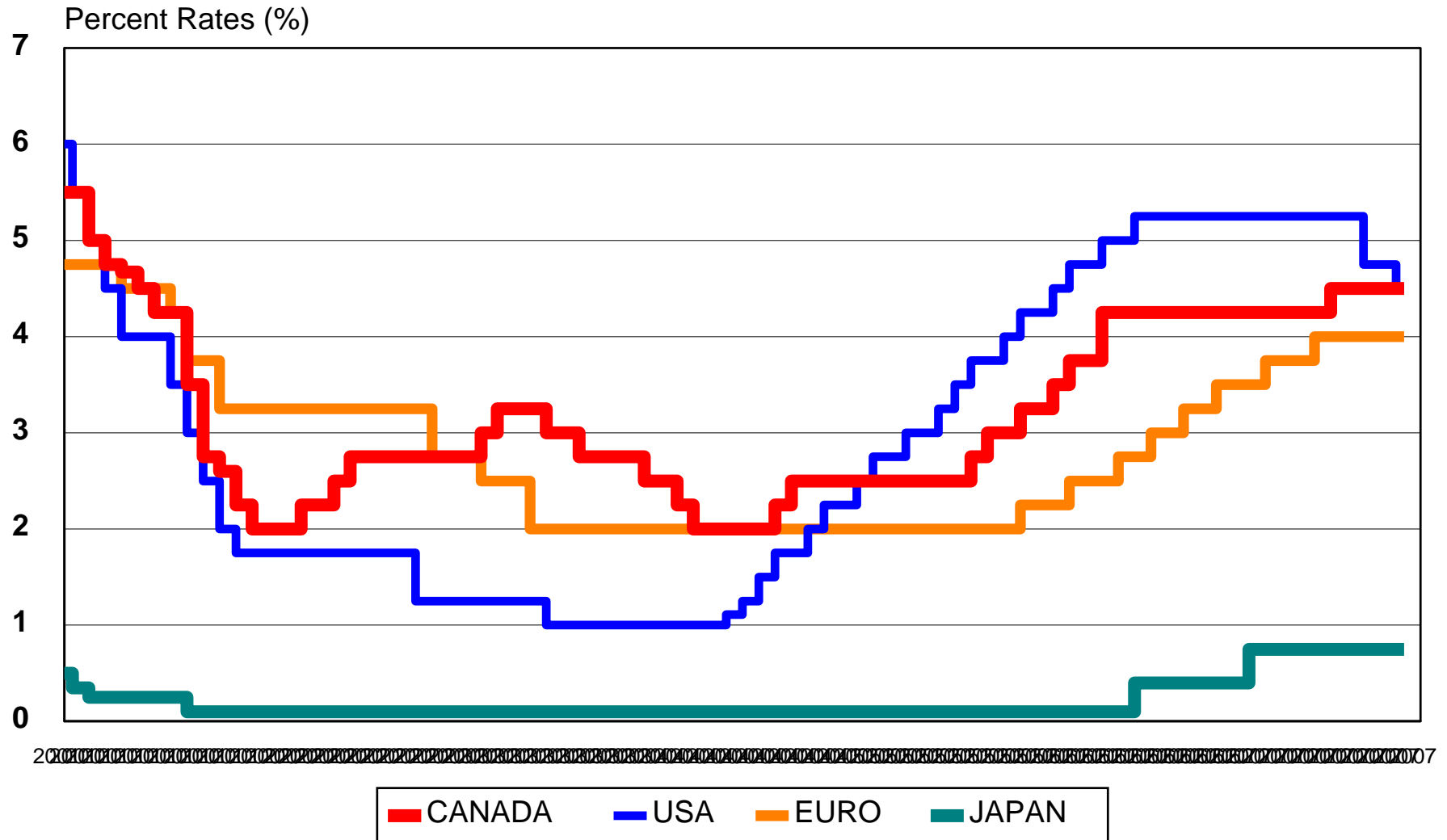
Oil prices have risen again and they are transferring wealth from oil consuming to oil producing nations. This time, however, the energy intensity of the world economy is about half what it was in the 1970s



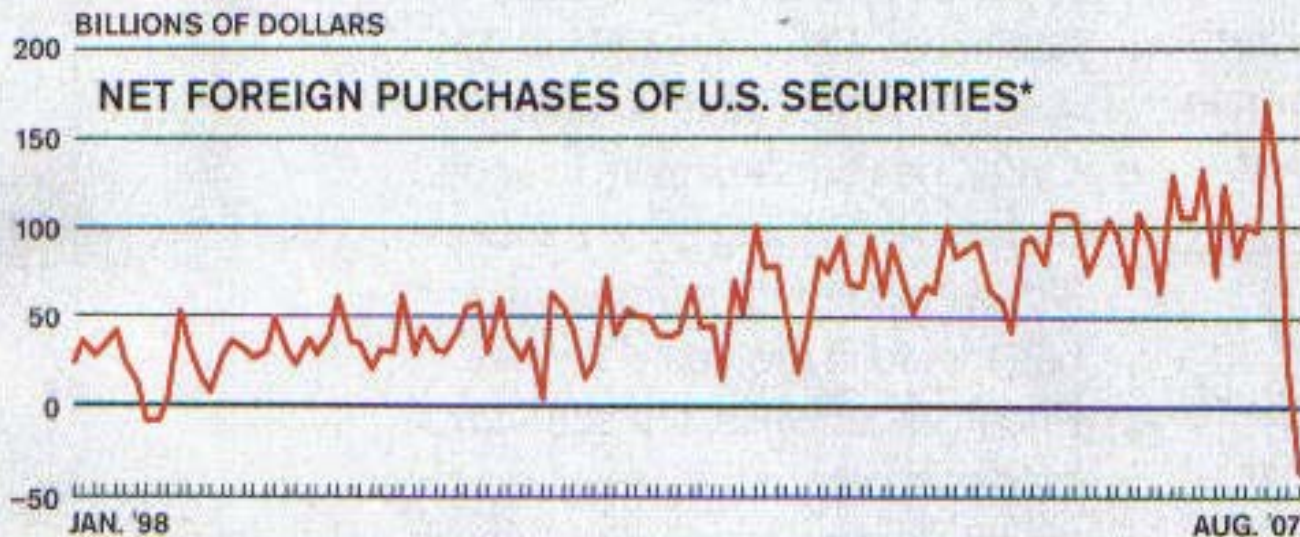
Source: BP, Historical Data
Canbek Economic Consultants Inc.

CENTRAL BANK KEY POLICY INTEREST RATES: 2001-2007

As the world's major central banks raise rates, US is forced to cut, narrowing spreads and reducing the attractiveness of USD-denominated assets



ARE AMERICAN MARKETS LOSING THEIR LUSTER?

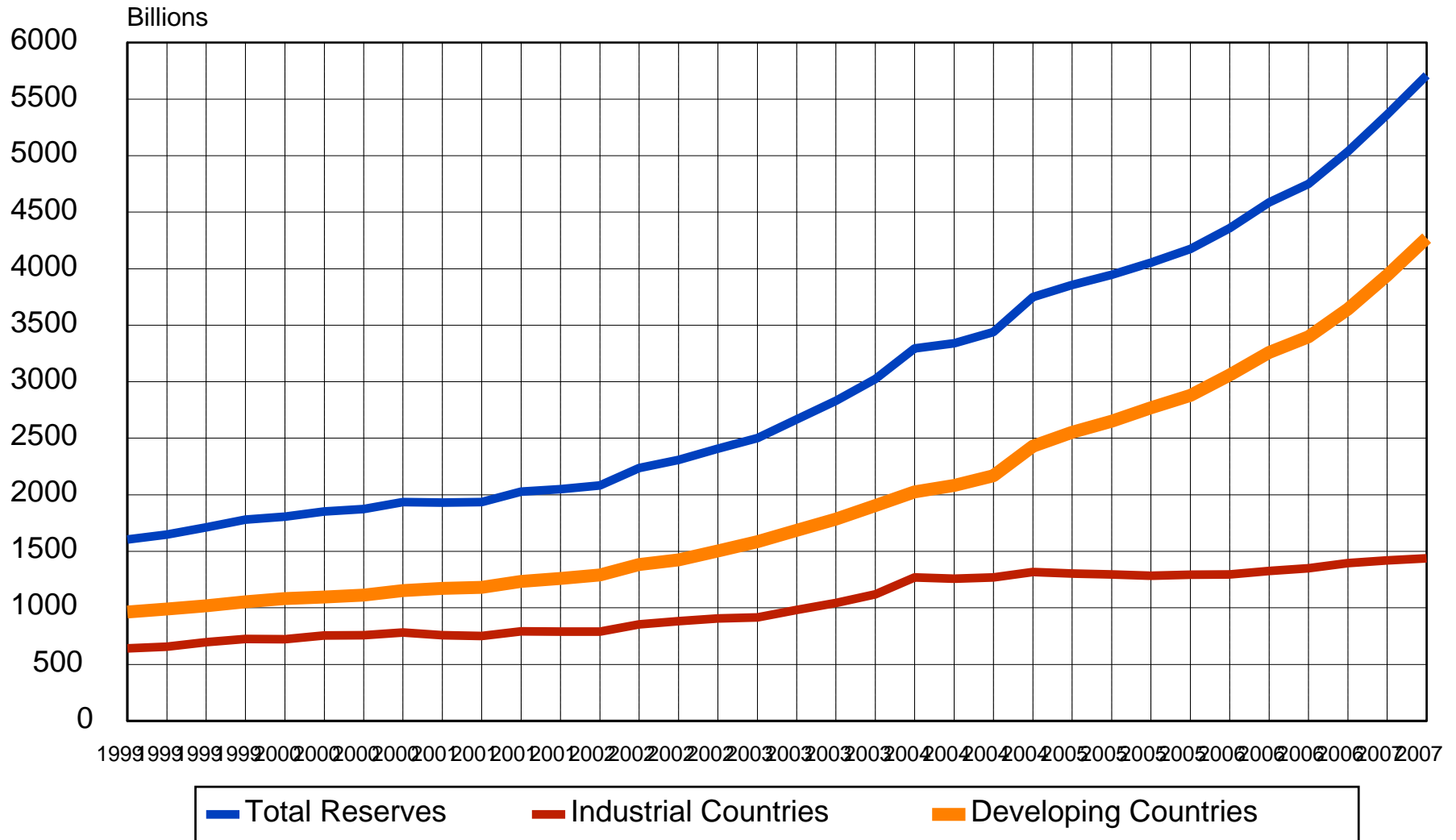


*INCLUDES U.S. TREASURIES, AGENCIES,
CORPORATE BONDS, AND STOCKS

Data: U.S. Treasury Dept.

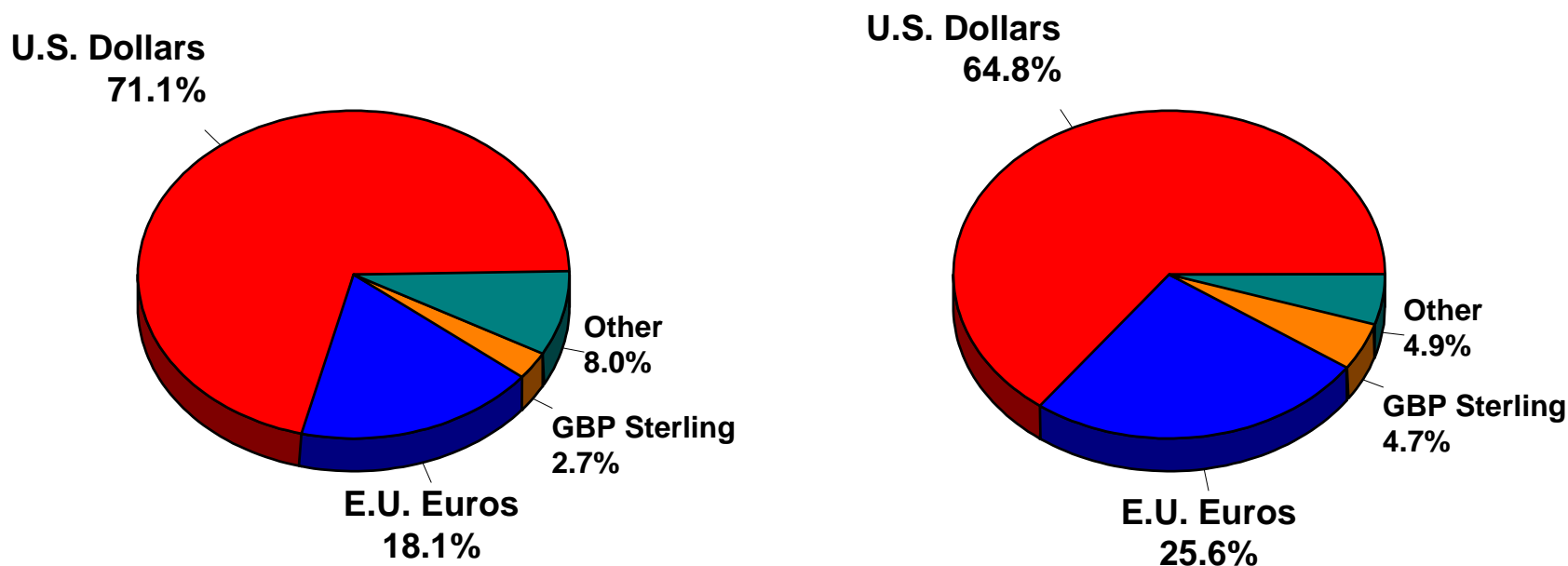
GROWTH IN CENTRAL BANK RESERVES: 1999 - 2007

Developing countries are accumulating unspent balances from export surpluses Source: IMF COFER



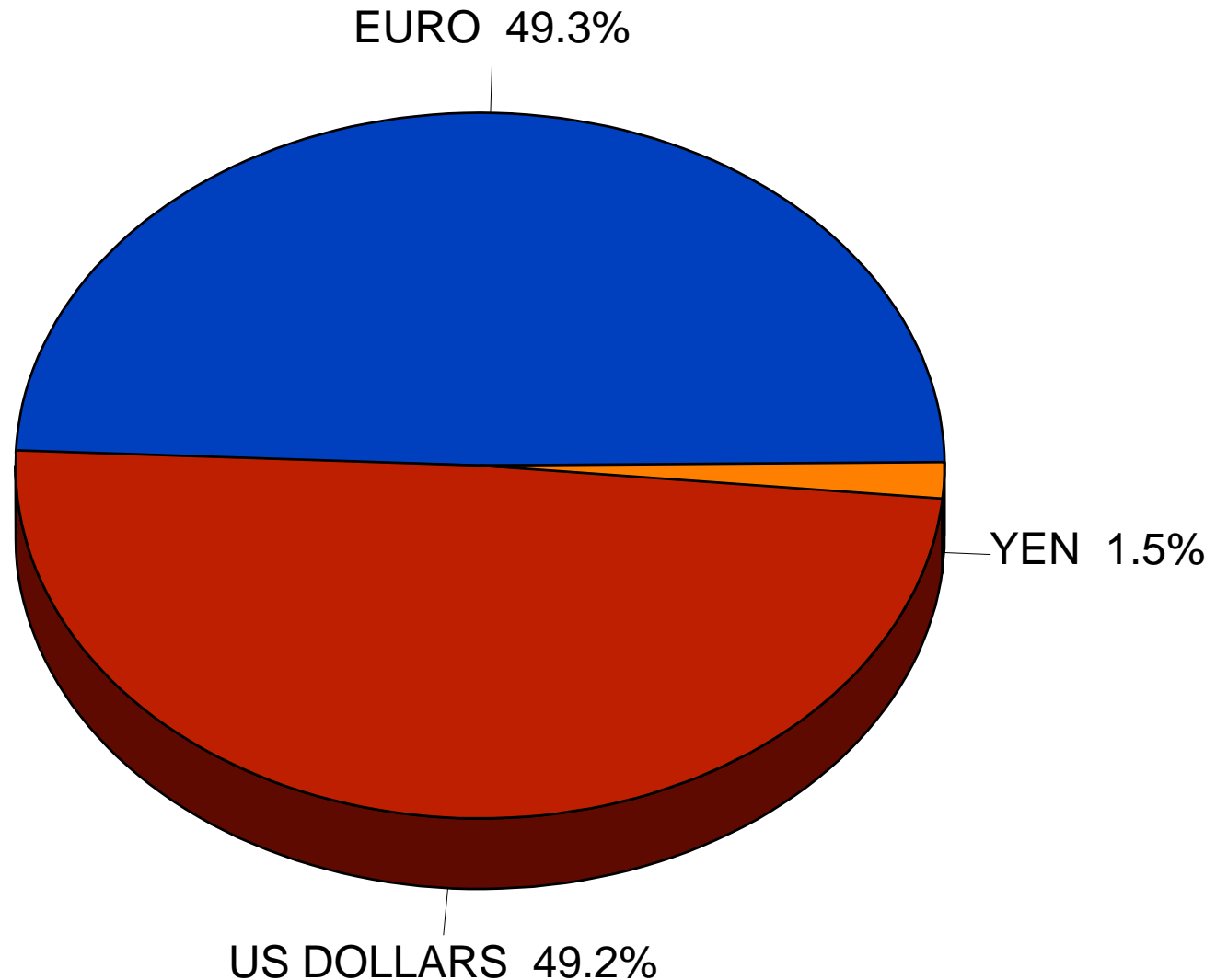
COMPOSITION OF GLOBAL ALLOCATED CENTRAL BANK RESERVES: 1999 & 2007

Not all central banks report the currency composition of their reserves: 64% are allocated
Although the share of U.S. Dollars is falling, the growth in developing country
central bank reserves is sufficient to finance U.S. trade deficit -for now Source: IMF
COFER



COMPOSITION OF CANADA'S FOREIGN EXCHANGE RESERVES: October, 2007

Does Canada's composition of F/X reserves indicative of the direction that other central banks in the world are going to follow?



Why is the U.S. Dollar Depreciating?

Too many negative factors and mounting loss of confidence

- **Huge and unsustainable trade deficit, near 6% of GDP**
- **Huge borrowing from the rest of the world amounting to \$2 Billion per day**
- **Deterioration in the U.S. net international investment position with the rest of the world: US net external indebtedness now over 20% of GDP**
- **Loss of confidence in U.S. financial markets: From Enron & WorldCom to the Fiasco in the sub-prime mortgage and asset-backed securities market involving securities totalling \$1 trillion dollars**
- **Distressed housing market, rising foreclosures, falling housing prices and recession in housing construction and automobile industries**
- **Cuts in policy interest rates: The fed funds rate cut by 75 basis points to 4.5%, while every other central bank in the world is raising policy rates**
- **Deteriorating inflation-adjusted interest differentials with the rest of the world**
- **The growing cost and burden on the U.S. A. of the war on terror and the Iraq War: estimated by CBO to exceed \$1.7 trillion by 2017**
- **Large dependence on increasingly unstable foreign oil: 66% of oil consumed in the U.S. is imported, most of it from the Middle East at a cost of over \$30 billion a year**
- **In August, foreigners sold more U.S. securities than they purchased, the sharpest drop in many years signaling a loss of appetite in U.S. securities by private foreign investors**

Implications for Current & Future Policy

It is not the end of the world, but the world will change

- Depreciating U.S. dollar will help restore international competitiveness of U.S exports and help reduce trade deficit, but it will take time
- Will intensify global competition and increase the strain on the rest of the world's economies, including Canada's
- Will undermine confidence in the U.S. dollar as an international reserve currency and accelerate the movement away from the U.S. dollar and toward the Euro
- Countries with their currencies pegged to the U.S. dollar will consider de-pegging and increase the probability that oil-exporting countries will start pricing their oil in non-U.S. currencies, further undermining the role of the U.S. dollar as the world's currency

Implications for Current & Future Policy

Tough choices: Between a Rock and a Hard Place!

U.S. policy makers will be forced to choose between:

A) a strong dollar which implies higher interest rates and weaker growth for the economy and

B) a weaker dollar which implies lower interest rates and avoidance of recession.

- Raising interest rates to shore the currency may push the U.S. economy to recession and place downward pressure on equity prices in the short-run, but will address the problem and set the U.S.

on a course of lower interest rates and faster growth in the long-run.

- Lowering interest rates to shore up the economy will lead to further currency depreciation, international monetary instability and erosion of U.S. economic hegemony in the world and by postponing the problem, reduce future growth and risk higher inflation and higher interest rates down the road

Implications for Current & Future Policy

Short-term Pain for Long-term Gain

- A tighter monetary stance to defend the integrity of the U.S. dollar will facilitate the necessary domestic adjustment the U.S. needs to undergo in order to restore the saving rate, reduce senseless consumption, clean up the financial excesses, reward thrift and industry and punish excess and speculation. In short restore value and integrity in the U.S. financial system and the U.S. dollar
- Recession is probably the better though not the most popular option for the U.S. now - The Federal Reserve has to make a stand: what is its main goal? price stability or economic growth?

Implications for Current & Future Policy

Solutions are Available, Is there a Political Will to Act?

- One credible and sound means to restore confidence to the U.S. dollar is to adopt an explicit inflation control target similar to the one adopted by Canada in 1991 and which the current Chairman of the Federal Reserve Ben Bernanke has already recommended that the U.S. central bank adopt
- A second measure is the introduction of a gasoline tax. Such a tax can increase domestic saving, reduce imported oil, reduce oil dependence and reduce carbon emissions thus achieving three desirable goals in one strike: reduce trade deficit, enhance national security and reduce carbon emissions

Implications for Canada

Payback Time !!!

- In the 1990s while going through its massive corporate and public finance restructuring Canada relied on a low dollar policy to keep its head above water
- Now our American neighbours to our South are counting on us to do the same for them!
- Currency re-alignments are exchange of favours. Now we are being called upon to repay.

Implications for Canada

Good for consumers, bad for manufacturers a test for East-West federal-provincial relations

- Stronger loonie will dampen exports and boost imports, reducing Canada's trade surplus
- Intense competition from U.S. imports will compress retail margins and the tourist industry
- Canadian consumers will benefit from lower prices of tradeable goods
- Consumer inflation will fall and will help keep interest rates lower than otherwise
- Stronger loonie will accentuate the divide between resource-rich Western Canada and manufacturing-intensive Central Canada
- Will complicate the application of national policies as two regions require different treatment
- Possibility that Central Canada will go into recession as Western Canada continues to grow

Implications for Canada

Moderating Factors: Strong Domestic Fundamentals

- Moderating the negative effects of a stronger loonie are:
- Strong fiscal balances at the federal and many provincial levels of government
- Strong trade balance and concentration in resources and energy
- Strong corporate balance sheets and high profit margins
- High saving and investment rates
- Favourable terms of trade

Implications for Canada

Will a U.S. Slowdown spread into the global economy or will Emerging economies (BRIC) pick up the slack?

- The extent of the negative impacts will depend on two factors:
 - 1. On whether the U.S. economy goes into recession, or not, and
 - 2. On how the rest of the world economy responds to a recession in the U.S.
- The U.S. accounts for 25% of GWP and in the past has always served as the world's growth engine
- This time it may be different: for the first time in almost 100 years the rest of the world economy may be resilient enough to weather a U.S. downturn without provoking a global recession
- In its October WEO forecast the IMF has said that China, India, Russia and Brazil (BRIC) account for more than 50% of growth in the planet's economy
- If the BRIC economies prove resilient enough to withstand a U.S. downturn, it will be the best-case scenario: it will help buttress the U.S. economy and help prevent Canada from going into recession

Implications for Canada and the World Economy

Global Recession or Global Re-ordering?

- Worst Case Scenario:
- The U.S. economy slides into recession and brings down the rest of the world's economy: resource prices fall, Canada's terms of trade tumble and expose Canada's two vulnerabilities: high concentration in resources and low productivity growth
- Best Case Scenario:
- Emerging economies take on the lead from the U.S. and maintain global growth albeit at slower rates, commodity and energy prices do not collapse, Canada's terms of trade do not deteriorate materially enough to expose our weaknesses and allow the U.S. and Canada's economy to make an orderly transition

The Surge in the Loonie!
U.S. Dollar Weakness
The U.S. Sneezes, the World Falls Sick
It May be Their Currency,
but it is Our Problem Now!

Portends Further Problems for the U.S. Ahead and Major
Challenges for Canada and the World Economy
We All Have a Stake in a Strong U.S. Economy

Thank You For Your Presence!

● The End