

Whither Goes the Canadian Dollar?

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The Bank of Canada has begun raising rates after a one-year “conditional commitment” to hold rates at record lows. Have the markets fully priced the predictable but delayed rate hikes now emerging?

Canada has recovered from its recession faster than many expected, but the pace of growth may slow. One sector that is doing particularly well is auto manufacturing. Because so much of production is driven by US demand, this sector was hard hit by the sudden collapse in US consumer spending when the US housing bubble burst. Recently, however, with help from substantial fiscal incentives, car sales in the US have revived. Canadian production has risen to meet demand, even as local sales remain relatively stable. Further gains are likely to be slower in the period ahead.

Another sector that has done well in Canada is housing. Permits are almost back to their 2008 peak, in sharp contrast to the US, which has been left with a huge oversupply of homes for sale that may take some time for the market to absorb. One reason for Canada’s early residential real estate recovery and limited home-price declines is that the country’s conservative, bank-dominated mortgage market generally shunned the risky and inventive forms of financing that have dominated housing markets elsewhere in the past

decade. (The one exception was Canada’s energy-producing provinces, where home prices soared and then collapsed.) Overall, the housing market in Canada has emerged in much healthier shape than in the US, and prices have fully recovered to their precrisis highs.

In addition, Canada’s home-mortgage financing market didn’t reach the levels of excess seen in the US. From 2005 to 2007, bank mortgage credit remained relatively subdued, at less than 50% of GDP, versus nearly 80% in the US (**Display 1**). More recently, however, in the aftermath of the crisis, demand for mortgages in Canada has risen sharply, spurred by historically low rates, averaging 1.75% on the 40% of the market priced on a variable basis, while official rates have been at 0.25% for most of this year. Higher policy rates are likely to dampen housing demand.

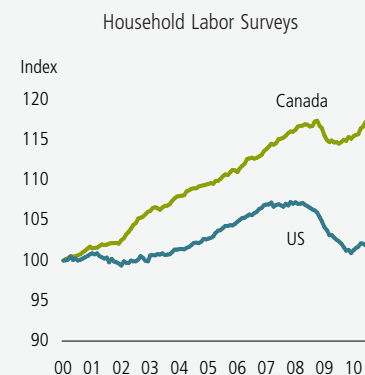
With boosts from car assemblies, an early recovery in home construction, continued energy investment in the western provinces, and very accommodative fiscal and monetary policy, Canada’s employ-

Display 1
 Mortgage Demand in Canada Is Catching Up to the US



Through March 31, 2010
 Source: Bureau of Economic Analysis, Haver Analytics and US Federal Reserve Board

Display 2
 Employment Is Back to Precrisis Levels



Through June 30, 2010
 Source: Haver Analytics, Statistics Canada and US Bureau of Labor Statistics

ment market has bounced back (**Display 2, previous page**). Employment recently reached prerecession levels, in sharp contrast to the situation in the US. Unfortunately, official estimates show modest productivity gains for Canadian labor, which could restrain GDP growth. Indeed, policymakers are concerned that this low productivity growth may soon lead to capacity constraints.

Given this view of the economy, the Bank of Canada has begun to raise policy interest rates ahead of the US Federal Reserve. It has already reversed aspects of quantitative easing and, on June 1, it raised the overnight rate by 0.25 percentage points, the first in what is expected to be a series of rate hikes, with the next increment due later this month.

Canadian rates have historically hovered somewhere between 1% and 2% above inflation during times of low inflation risk. Thus, with prices projected to increase

around 2%, we estimate that the policy rate could climb to between 3% and 4% by the time this rate-hike cycle is over, although the central bank is likely to adopt a gradual approach as long as the US Fed remains on hold.

Many of the factors propelling Canadian growth will be less positive going ahead. A substantial increase in the country's fiscal deficit in 2009 will begin to be reversed in early 2011, as infrastructure projects are completed. Monetary policy is tightening, which could have a potentially significant impact on the housing market. Meanwhile, the recoveries in both housing and auto-assembly operations seem to have run their course. The timing of this rate-hike cycle, largely priced into market expectations, could prove questionable if for any of the above reasons the path of growth slows.

With the widely anticipated beginning of the Canadian rate-hike cycle, at a time

when the US housing market is still sluggish, the Canadian dollar has been soaring in recent quarters. This rise puts it at the higher end of the real exchange-rate band versus other major currencies, which we believe makes further gains unlikely. The strong Canadian dollar clearly raises doubts about the country's future economic expansion, and it has already eroded its trade and current account balances.

In conclusion, the strength of the Canadian dollar is different from the rallies in the currencies of high-productivity emerging-market countries. After the recent surge in the value of the Canadian dollar, and given Canada's low productivity growth, we don't see much room for additional appreciation. We favor buying high-productivity currencies in emerging markets, including those with important commodity exports, while selling or remaining neutral the Canadian dollar.

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