

Does the strengthening Canadian dollar mean a wider prosperity gap?

WITH THE VALUE of the Canadian dollar settling in at the mid to high 80 US cents range, after spending a long time in the 60 cent range, some are concerned that this will hurt our competitiveness and prosperity. The reasoning is that a stronger Canadian dollar makes Canada's manufacturing output more expensive in the important US export market, and that US imports are now a relative bargain.

But a review of the last twenty-five years' relationship between our dollar's strength and Canada's prosperity gap with the United States does not show a systematic relationship between the two. Between 1985 and 1989, the dollar was strengthening with little discernible impact on the prosperity gap (*Exhibit A*).

Between 1991 and 2001, our dollar weakened dramatically. At the same time, our prosperity gap experienced its most significant widening. But in

the current decade, as our dollar has been strengthening, our prosperity gap has grown moderately.

A casual observer may note that the last time the Canadian dollar was showing this kind of strength, our deep 1990-92 Canada recession followed – so maybe an even wider prosperity gap is around the corner.

However, there is a fundamental difference between now and the late 1980s. Then the strengthening of the Canadian dollar was mainly the result of high interest rates in Canada relative to those in the United States, as the Bank of Canada tightened its monetary policy to fight inflation. This tight monetary policy not only caused the dollar to strengthen, but also had a direct adverse impact on economic activity in Canada. The evidence indicates that tight monetary policy was a leading cause of the early 1990s recession.^a

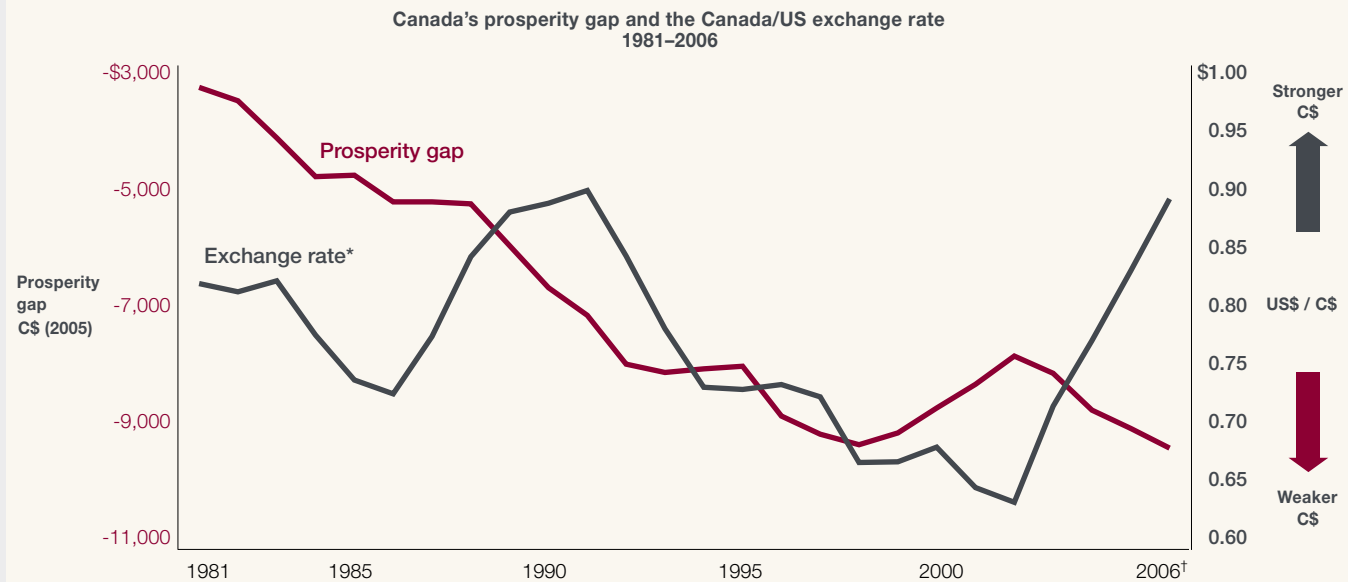
This time around, the cause of the dollar's strength is rising commodity and energy prices, not high interest rates, according to the Bank of Canada's analysis.^b Higher energy prices have led to a comfortable fiscal situation, which makes the macroeconomic picture today much more favourable than in the late 1980s.

In sum, our prosperity gap is the result of several factors – but it is difficult to include the rise and fall of the Canadian dollar in the list. While the dollar fluctuations may have some impact, it is important to consider the underlying reasons for them to assess their impact on our prosperity.

^a See our review of the research conducted by Dungan, Murphy, and Wilson in last year's Report on Canada, *Rebalancing priorities for Canada's prosperity*, p. 21.

^b See Ramzi Issa, Robert LaFrance, and John Murray (2006), "The turning black tide: Energy prices and the Canadian dollar," mimeo, Bank of Canada.

Exhibit A Performance of dollar and prosperity gap has varied



* Bank of Canada published rates adjusted for differences in GDP price deflators.

† Estimate based on first 9 months of 2006.

Source: Institute for Competitiveness & Prosperity analysis based on Statistics Canada; US Department of Commerce – Bureau of Economic Analysis; OECD.