

Currencies - Difficult to Predict

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The Canadian dollar is back in the headlines. In a good way. It doesn't make much sense, but I still feel a tingling of pride when our dollar is doing well relative to the US dollar, also it makes our trips south a lot cheaper. The strength of our currency confirms our hunch that this giant, diverse, multilingual, open experiment that we live in is a success. And it is only going to keep getting better. That is something we need to remember during these Covid lockdown days.

A country should, almost needs, to have its own currency. It allows various political and economic stresses to be softened. Like a good boxer that can deflect a blow as opposed to stepping into a punch, the dollar can be a shock absorber. A recent example of a country unable to respond to external shocks by devaluation of its currency is Greece.

When the financial crisis occurred in 2008 Greece had the highest debt levels in Europe. Because the drachma had been exchanged for the Euro, they lost the ability to devalue the currency and were dependent on the rest of Europe to bail them out. This resulted in higher taxes, severe austerity, cuts in pensions, emigration of young people and unemployment of over 27%. The economy was still 20% smaller than before the financial crisis in 2019, before the pandemic.

If the drachma had still been in place Greece could have ramped up the printing presses and issued enough money to pay their debts. This would have caused the drachma to fall which would have helped tourism and exporters. Eventually they would have had to get their finances in order, but it would have given them more breathing room without the severe dislocation.

Sovereign debt crises happen when smaller countries or ones with a history of fiscal recklessness have to issue bonds in US dollars. This is necessary if international lenders know there is a possibility of severe currency devaluations. Argentina has gone bankrupt nine times since it became independent from Spain. Argentina had the same GDP as Canada in the 1930s. Now it is less than a quarter of ours. Never forget good governance is an essential element of prosperity. Canada has been uncommonly lucky in that regard, not withstanding our current batch of leaders.

Currency exchanges offer price discovery for us on an almost constant basis. Highly paid forex traders are employed by brokerages and banks to facilitate this continuous onslaught of information. Every bit of relevant data is instantaneously priced into rates.

This nearly unending availability and access leads to the assumption that exchange rates should be predictable. This is not true in any timely manner. There are a couple of base facts that underscore the Canadian and US exchange rate, but these are difficult to act on in such a way that money can be made for investors.

The first fact is that during times of international stress - such as the current pandemic - the US dollar goes up relative to ours and all other currencies. This is because the American dollar is still the safest place to ride out any major dislocations. The problem with taking advantage of this is judging how severe the disruption will be. Using the pandemic as an example, when Covid-19 first began to get attention it was dismissed by many people and so the US dollar rose a bit but not significantly. Then as it was realized that this was not going to be just another SARs, the US dollar jumped up almost immediately. By the end of March 2020, the exchange rate had gone from 1.30 to 1.45. At that point most currency watchers were predicting the trend to continue. But today, just over a year later, the Canadian dollar is at 1.21, even better than before the pandemic. How did this happen? Well, investors realized that the virus was beatable with vaccines and we began to enter a commodities bull market. Canada is a very urbanized country and we often forget that we are still very dependent on our resources. Our currency goes up against the US dollar when oil, lumber and copper go up in value. This is happening in all three of these assets, as well as most other agricultural and base metal products. Again, this was unforeseen, so unpredictable.

There was a time when Canada was seriously discussing merging our dollar with the American one. It was a difficult time for us. We were suffering a brain drain, with our brightest people moving south. Our country's debt levels were at the point where there was talk that the International Monetary Fund would need to intervene to save us from our reckless spending. Our dollar was consistently in the low 60s compared the US. But looking back that low dollar made our exports more affordable to the rest of the world. It allowed us to pay our debt levels down to the point, that until recently, we were the envy of the world. So, though we don't know where our loonie may trade day to day we do know that it is one of the reasons we are able to remain a sovereign nation; and will help us continue to be the favoured country where the world wants to emigrate to.

-Difficult to Predict