TD Economics

Special Report

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COMPARING PARITY – 1976 VS 2007

Summary

The Canadian dollar's long awaited return to parity yesterday has sparked a great deal of interest in the subject. In this piece, we compare the conditions that existed in 1976 (when the exchange rate was last at parity) with those of today. There are both profound similarities and differences.

HIGHLIGHTS

- **The Canadian dollar was last at parity in 1976.**
- **There are substantial similarities between the two eras, but also several differences.**
- **One difference is that parity was achieved from opposing trends. In 1976, the Canadian dollar was already depreciating when it touched parity and it did not stay at parity for long.**
- **This time, parity was the culmination of a trend appreciation in the C$.**
- **Rate spreads were more favourable during the first parity occurrence.**
- **Both eras saw major commodity appreciation that supported the Canadian dollar.**
- **Canada's twin surpluses are a relatively recent phenomenon that add strength to C$ but did not exist to the same extent in 1976.**
- **Canadian productivity levels were much more comparable to the U.S. in 1976 and have since deteriorated – this argues against C$ strength today.**

The Leadup to Parity

Addressing the time frame of the currency's ascent is important to provide context.

Prior to 1976, the C$ had actually flirted with parity a number of times and had even rallied well above par with the greenback at one point.

By contrast, the current rally in the C$ has taken five years of substantial upward movement. Since the C$ touched an all time low against the USD in Jan. 2002, the move has amounted to a 60% appreciation.

Who Came to the Party?

Today, the Canadian dollar is but one of many currencies experiencing incredible strength relative to the U.S. dollar. In turn, one must characterize U.S. dollar weakness as a key aspect of the latest Canadian dollar run through parity. By contrast, the Canadian dollar was much more unique in its strength in 1976.

	Parity Comparisons	
	1976	2007
Official Interest rates: US	5%	4.75%
Official Interest rates: Canada	9%	4.50%
CPI, % y/y	6%	2%*
PPP for C$	0.80¢ US	0.81¢ US
Oil Price, % chg in prior five years	297%	187%
Gold Price, % chg in prior five years	203%	125%
Canada C/A as a % of GDP	- 3.8%	2%
US C/A as a % of GDP	flat	- 5.5%
Canada Fiscal Position	Deficit	Surplus
US Fiscal Position	Deficit	Deficit
Relative Productivity	87%	74%
* 3 month average		

Commodity Prices

The 1970's were notorious for wild movements in commodities, especially in oil and gold. Indeed, there were some special circumstances like the first oil price shock in 1973 which was an important driver of prices during that time.

Gold prices were $130.25 per troy ounce in 1976, whereas today they are $734.60 per troy ounce. But this direct comparison is somewhat deceptive insofar as inflation has steadily eroded the value of money over the past thirty years. Perhaps more relevant is the movement in gold prices over the prior few years. Gold prices tripled between 1971 and 1976, and they have more than doubled between 2002 and 2007.

Oil prices also contributed to C$ strength in the 1970s and today. WTI prices quadrupled from prior to the oil shock to $13.90/bbl by 1976. At $83/bbl today, crude oil prices have roughly tripled from 2002.

Given Canada's strong commodity orientation, commodity prices were likely a key driver in the ascent of the Canadian dollar in both eras.

Inflation

The level of inflation was certainly much higher in both Canada and the U.S. in 1976 compared to 2007. Indeed, Canada, like many other countries, was struggling with high inflation in the 1970s. Growth in the consumer price index peaked at 12.5% in December 1974 and by the end of 1976 was nearly half that at 6%. The worry over inflation led the Trudeau government to introduce the Anti-inflation Board (AIB) in 1975 which introduced wage and price controls, in an effort to combat inflation.

But the relevant issue about inflation from a currency perspective is the long-term average rate of inflation between the two countries. We find that inflation has grown a touch more persistently in the U.S. since 1976 – by a cumulative 257% versus 250% in Canada. In turn, this supports a slightly stronger nominal C$ today than in 1976, though the difference is hardly profound.

Interest Rates

Canadian official interest rates were substantially above the U.S. in 1976, though making a direct comparison is difficult since Canada did not actively target any instrument until 1975.

By our calculations, the relevant Canadian interest rate was approximately 9% in 1976, versus about 5% in the U.S. Thus, Canada had a positive rate spread of 400bp in 1976.

Today, the story is somewhat different. The Fed funds rate is at 4.75%, the Bank of Canada's overnight rate is at 4.50%, which points to a -25bp spread. This is slightly deceptive insofar as expectations are that the two policy rates will converge and possibly even invert.

Nonetheless, it is clear that rate spreads were more of a positive driver in 1976 than today.

External Balances

Canada has made great strides in terms of its external liabilities. On the fiscal front, the government was running a small deficit in 1976, whereas today it has a surplus. Canadian trade patterns are also improved. In 1976, the current account as a % of GDP was a deficit of 3.8%, while today the current account surplus is 2% of GDP. Canada remains one of the only G7 countries with twin surpluses, which is a strong underlying long-term driver of the currency.

By contrast, the U.S. was running fiscal deficits in both eras, but even larger ones today. The U.S. current account position as a percent of GDP has gone from a relatively flat one to a deep deficit amounting to 5.5% of GDP. Of course, the U.S. economy has been able to shoulder such a large current account deficit, in part, because of its position as a locomotive for global growth, and the greenback's position as a global reserve currency. Nonetheless, this is hardly a positive for the U.S. dollar.

It appears that Canada's twin surpluses when contrasted with the U.S.' twin deficits provide substantial support for the Canadian dollar today – support that did not exist as profoundly in 1976.

Productivity

Canada has long been less productive than the U.S., though the situation has deteriorated over the years. In 1976, Canadian productivity was holding relatively steady at 87% of the U.S. level (Source: CSLS). By contrast, this has deteriorated to about 74% of the U.S. level today. Relative productivity levels can be viewed as a proxy for a "fair value" for the currency, and so the strength of the Canadian dollar in 2007 appears to be a more of a stretch than it was in 1976, at least according to this one measure.

Purchasing Power Parity

On purchasing power parity (PPP) basis, the value of the Canadian dollar appears overvalued both now and in 1976. The OECD estimated that PPP represented about 80 U.S. cents per Canadian dollar in 1976, and the estimate today is little different (about 81 cents). In turn, the currency had gone well through these support levels in both 1976 and 2007.

By this measure in isolation of all others, the Canadian dollar appears overvalued.

What Ended the Parity Party in 1976?

It is instructive to examine what brought an end to the parity party in 1976 in an effort to learn some lessons for today.

One profound driver for the currency after 1976 was the election of a separatist government in Quebec for the first time, which prompted sovereignty fears and thus a softer currency. Although we are far from prophets on this subject, there is unlikely to be a similar corollary today as the political landscape looks comparatively more stable.

In addition to this important factor, it was also death by a thousand blows for the Canadian dollar. Commodity prices eventually ceased their assent, Canadian productivity became less impressive on a relative basis, Canada's positive interest rate spread with the U.S. eventually reversed, and the influence of purchasing power parity acted as a subtle but burdensome anchor for the soaring currency.

Conclusions

There are clearly both similarities and differences between the Canadian dollar's strength in 1976 and today.

Similarities include the substantial run up in commodities that preceded both flights to parity. It is also useful to note that the currency appeared substantially overvalued according to PPP definitions in both instances.

But there are differences as well – the Canadian twin surpluses are much more impressive today than they were in 1976, and this is a non-trivial driver of Canadian dollar strength. In addition, interest rate differentials vis-à-vis the U.S., were more supportive of Canadian dollar strength in 1976 than today. Finally, the Canadian dollar is also being buffeted along by U.S. dollar weakness today that was not as prevalent in 1976.

By contrast, relative productivity levels were much more favourable to Canada in the 1970s when compared to today. This makes a case for a strong Canadian dollar in 1976 that no longer exists today.

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