

Good morning,

This Monday, we attended a conference of The Economic Club of Canada, which had Mr. Paul Jenkins, Senior Deputy Governor of the Bank of Canada, as speaker. From the brief presentation titled “Beyond Recovery: Sustaining Economic Growth” we conclude the following:

-The Bank of Canada is most likely not going to explicitly intervene, if the Canadian dollar reaches parity and beyond. The speech itself was a message to Canada’s export sector to increase productivity to confront this appreciation. The operative word here is “explicitly” because as we have written many times here, the Bank of Canada does actually intervene in the market via its repurchase agreement transactions.

-During the question period, we asked Mr. Jenkins about the Bank’s view on sovereign credit default swaps. We posed this question in a very open way, to test the reaction. Our impression was that Mr. Jenkins was not familiar with this asset class, as he referred us to upcoming G-20 meetings that will address regulatory matters related to the issue. We cannot blame him, since Canada has so far never been quoted in the sovereign credit default swaps market, given its relatively solid financial position.

-We are concerned about the view the Bank of Canada has, relative to the environment the country is in these days. We do not want to get too theoretical here, but we think the Bank of Canada still holds the nineteenth century view that value is based on the productivity of production factors. The Bank is lately making comments on the productivity of Canada, on the belief that if productivity increases to match the appreciation of the Canadian dollar, the country will remain “competitive” and avoid inflation.

Why are we concerned? Well, what is productivity anyway, and why do you think the Canadian dollar has appreciated?

I am sure most will agree with the opinion that the latest appreciation of the Canadian dollar, in light of the increasing sovereign risk concerns coming both from Europe and the US, was driven not only by the “commodity bid” that accompanied the recovery of 2009, but also by the “safe-haven bid”, which has left this currency almost neutral vs. gold. We first proposed this thesis back in June 2009 and refreshed it on March 4th (refer: “Meanwhile in Canada”, in: www.sibleau.com/martin/2009/06/02 and “The stars favor Canada”, in: www.sibleau.com/martin/2010/03/04).

If we are correct, Canada is not only competitive supplying the world with commodities, but with financial, fiduciary services too. The main fiduciary service is ironically supplied by the Bank of Canada (which means its staff is grossly underpaid) that seems to be very competitive providing a reserve asset to the world. In fact, perhaps this country is way more productive exporting a reserve asset than oil or gas or mining products or engineering services. But would this productivity be included in the Bank of Canada’s calculations? Why not? Why should we worry if we are not more competitive than Brazil destroying our forests to win the forest products market? Why should we be concerned if we are not effective contaminating our boreal landscape with oil sands projects so that we may compete with the Saudis in the energy sector? What is wrong with being competitive with fiduciary services? The Bank of Canada of course doesn’t share our perspective and will never clarify that they implicitly make a subjective judgment on productivity.

Lastly, for those interested in the formal aspect of this discussion, we refer to the concept of a “Social welfare function”, under the Theory of Public Choice. In our opinion, for the Bank of Canada, this function is:

$$W = y_1 + y_2 + \dots + y_n ,$$

where W is social welfare and Y_i is the income of a sector i among n in the Canadian society. To maximize the social welfare function we may seek to maximize for instance the income of sector 1 *at the expense* of sector 2, if we deem sector 1 is “more productive” than sector 2. Does it make sense to you? In our view, the function (and by the way, we don’t think there is such a thing as a social welfare function) should be: $W = y_1 = y_2 = \dots = y_n$. But this is a discussion for another time!