

Economic Spotlight

Canadian Dollar Meets the Mighty U.S.

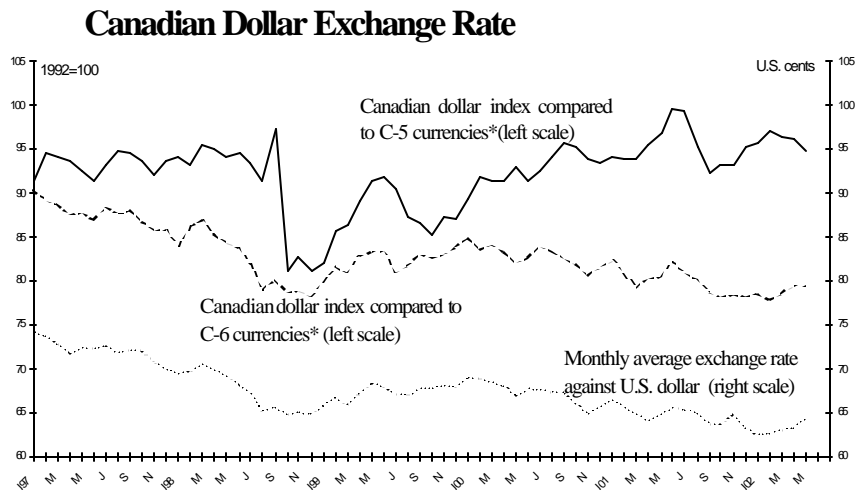
Overview

The Canadian dollar is currently trading around US\$0.65, a sharp reversal from the beating it took earlier in the year. The dollar declined to a record low of US\$.62 on January 18, 2002. Since then, the dollar has recovered all of its losses and looks poised to edge higher over the coming months. The Canadian dollar has benefited from the general weakness of the U.S. dollar against major currencies and from Canada's stronger economic performance.

Movements in world's major currencies affect Canadian dollar

A key feature of the major currency markets in recent years has been the pronounced weakness of most currencies against the U.S. dollar. The Canadian dollar fell from around US\$0.74 in early 1997 to US\$.62 in January 2002.

The C-6 trade-weighted index of the Canadian dollar has fallen entirely due to depreciation against the U.S. dollar. In fact, the C-5 currency index, which excludes the U.S. dollar, has appreciated in recent years as other major currencies have fared worse against the U.S. dollar. Shortly after its launch in January 1999, the euro rose as high as US\$1.19 amid predictions that the currency's importance would rival the U.S. dollar. Two years later, euro was a mere US\$0.83. The U.S. dollar reached a 15-year high against most major currencies in 2001.



Source: Bank of Canada

*C-6 currencies: U.S. dollar, euro, yen, U.K. pound, Swedish Krona and Swiss Franc

*C-5 currencies: excludes U.S. dollar

Why is the U.S. dollar so strong?

The appreciation of the U.S. dollar has defied traditional explanations of exchange rate determination, which focus on interest rate differentials and external current account imbalances.

Movements in interest rates had little affect on the value of the U.S. dollar. In fact, interest rates are at historically low levels in the United States.

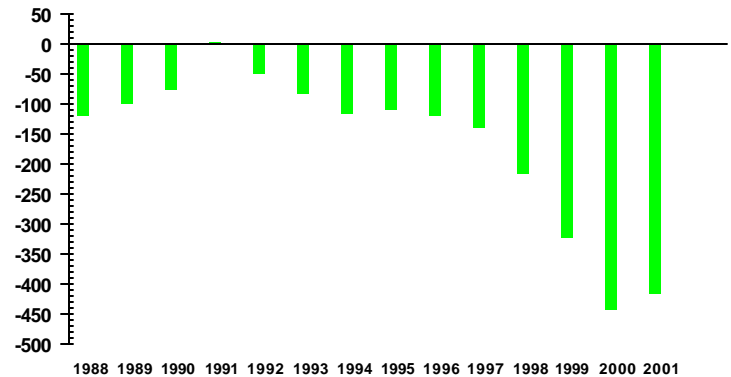
U.S. current account deficits have risen sharply in the past three years, from an average of about 1% of GDP in the 1975 to 1995 period to over 4% of GDP in 2001.

U.S. current account deficits have been supported by capital and financial inflows. Foreign investors have sharply increased their annual net purchases of US securities, surpassing US\$100 billion in 1993, rising to \$277 billion in 1998 and surging to \$530 billion by 2001. Net purchases of securities by U.S. investors declined from \$90 billion in 1997 to only \$20 billion in 2001.

Canadian investors also followed global capital flows and increased their net purchases of U.S. securities.

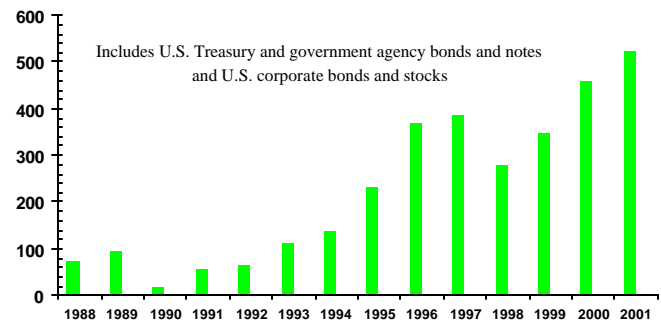
The rise in capital flows reflects higher returns to capital in the United States than in most other industrialized countries. In the last half of the 1990s, U.S. economic growth and productivity gains exceeded that of other industrialized countries. The stock market boom associated with the new economy provides an important explanation for the US dollar strength. Although the increase in equity prices was global, the demand for the US dollar

U.S. Current Account Balance (billions of US dollar)



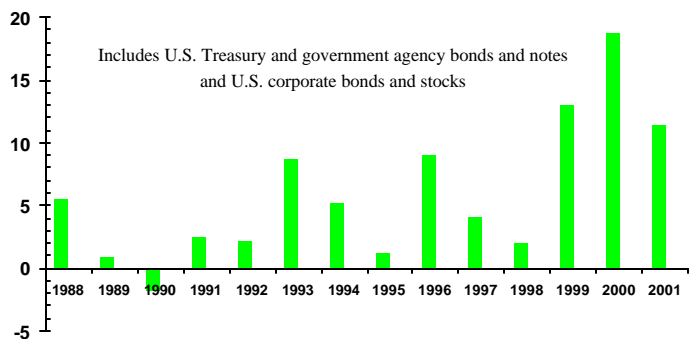
Source: U.S. Department of Commerce

Net Purchases of U.S. Securities by Foreigners (billions of US dollar)



Source: U.S. Treasury International Capital reporting system

Net Purchases of U.S. Securities by Canada (billions of US dollar)



Source: U.S. Treasury International Capital reporting system

was affected more as the “new economy” sectors are bigger in the United States than in Europe and Canada, overall market capitalization is higher and stock ownership is more pervasive. Safety was also considered a factor, as the United States was perceived more stable and less speculative.

The massive capital inflows have pushed the net indebtedness of the U.S. economy from around 5% of GDP in 1995 to close to 20% of GDP in 2000. It is unlikely that that these capital inflows can continue indefinitely.

Current Developments

The U.S. dollar has fallen against most major currencies in the past three months, March to May 2002. Equity markets have been weak in the United States this year and concerns about the strength of the U.S. economic recovery are putting downward pressure on the U.S dollar. Among the major currencies, the euro rose above 94 US cents in late May and even the yen managed to strengthen. The Canadian dollar has been trading around the US\$0.65 mark.

Summary and Outlook

Since much of the strength in the U.S. dollar was supported by above par growth in the United States and superior investment yield, any weakness in these factors will undermine the currency.

The recent weakness in the U.S. dollar takes back but a fraction of the currency’s gain in recent years. Most analysts expect the U.S. dollar to depreciate further. Even so, the Canadian dollar and other currencies may depreciate during times of uncertain geopolitical developments. The U.S. dollar remains a currency of choice in international markets and is seen as a safe haven during periods of global unrest.