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IN BRIEF

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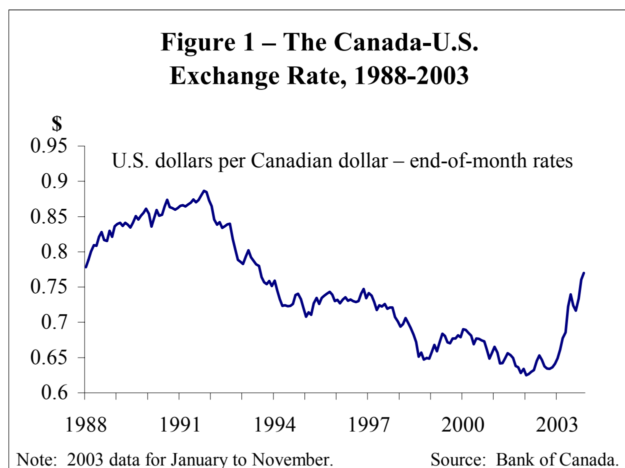
Why Has the Canadian Dollar Been Rising?

In 2003, the Canadian dollar ended a long period of decline versus the U.S. dollar. Although it has not made significant gains against other currencies, the Canadian dollar rose by 21.2% against the U.S. dollar through November, reaching the 77-cent U.S. level for the first time in just over 10 years.(1)

Figure 1 – The Canada-U.S. Exchange Rate, 1988-2003



Note: 2003 data for January to November. Source: Bank of Canada.

MAJOR FACTORS AFFECTING THE CANADIAN DOLLAR

Although the Canadian dollar's performance relative to the U.S. dollar is influenced by a wide range of factors, research at the Bank of Canada shows that most long-term movements in the exchange rate can be attributed to fluctuations in three variables: the difference between Canadian and U.S. inflation rates; interest rate differentials between the two countries; and the world price of commodities. Each is discussed below.

A. Inflation Differentials

If prices in Canada were to rise faster than in the United States, this situation would, over time, erode the purchasing power – and thus the value – of the Canadian dollar relative to the U.S. dollar. That erosion, in turn, would be reflected in a decline in exchange rates. Similarly, if inflation in Canada were low compared to inflation in the United States, there would be some upward pressure on the Canadian dollar as a result.

With the exception of a brief period in 2002, inflation in Canada has been consistently below U.S. levels for the past 10 years. Until recently, however, the positive effect on the exchange rate has been overridden by other factors.

B. Interest Rate Differentials

When Canadian interest rates are markedly higher than those in the United States, Canada becomes a more attractive destination for interest-sensitive capital flows. This situation results in higher demand for short-term assets in Canadian dollars and thus places upward pressure on the dollar itself. When Canadian interest rates are lower than, or comparable to, those in the United States, the opposite holds true and the Canadian dollar typically weakens.(2)

Through much of the late 1990s, the United States had higher interest rates than Canada, contributing to a weaker Canadian dollar. This situation was reversed in the current decade; and since early 2002, Canadian interest rates have not only been higher than U.S. rates, but the gap has been widening. This positive interest rate spread has contributed to the rising Canadian dollar.

C. Commodity Prices

The value of the Canadian dollar is correlated to the strength of world commodity prices. When world commodity prices are high, then resource-based industries in Canada are more profitable, making the Canadian economy stronger. This situation attracts investment and places upward pressure on the Canadian dollar. When commodity prices fall, they

undercut revenues for resource-based firms, eroding profits, dampening the domestic economy and pushing down the Canadian dollar.

Falling commodity prices were a major factor behind the weakness in the Canadian dollar through the 1990s. More recently, however, a strengthening global economy has triggered a modest recovery in commodity prices, contributing to the rise in the Canadian dollar.

While the improvements in commodity prices and interest rate differentials have certainly contributed to the current rise in the Canadian dollar versus the U.S. dollar, the magnitude of the rise is significantly larger than movements in those variables suggest. In other words, the rise in the Canadian dollar through 2003 is primarily due to some other influence.

THE FALLING U.S. DOLLAR

Specifically, most economists believe that the current strength in the Canadian dollar is in fact a reflection of weakness in the U.S. dollar. Indeed, most major world currencies have risen considerably against the U.S. dollar since 2002.

The explanation for the falling U.S. dollar is a two-part story. First, it is thought that the U.S. dollar had been overvalued in recent years, and the current decline represents a return to equilibrium levels. Second, weakening economic fundamentals in the United States are driving the exchange rate lower.

Beginning in the mid-1990s, the U.S. dollar began to appreciate significantly. A strong domestic economy and a booming equity market attracted investment, while a series of economic and political crises elsewhere – starting in 1997-1998 with the Asian Financial Crisis – shook confidence in world markets and led investors to flock to "safe" U.S.-dollar assets.

The resulting rise in the U.S. dollar through the late 1990s contributed to a deterioration in economic fundamentals in that country. Solid wage gains during those years created an upsurge in consumer spending that, in turn, increased demand for imported goods. This increased demand was magnified by the rising U.S. dollar, which lowered the price of those imports. As a result, the U.S. trade balance began to deteriorate.

The ballooning trade deficit caused the current account deficit to grow rapidly as well. From less than 2% of GDP in 1997, the current account deficit in the United States now sits at about 5% of GDP – one of the largest deficits in the OECD.[3]

A large current account deficit implies an outflow of capital from the United States, placing downward pressure on the U.S. dollar. In fact, the current decline in the U.S. dollar can be seen as a natural response to these conditions. A lower U.S. dollar will make that country's exports more competitive, raise the price of imports, and thus help alleviate its trade and current account deficits.

WHERE WILL THE CANADIAN DOLLAR GO FROM HERE?

Although normally such a rapid appreciation in the Canadian dollar might not be considered stable, economists are in general agreement that the current rise in the Canadian dollar will not be a short-lived phenomenon. Indeed, economic indicators have pointed towards a higher Canadian dollar for a number of years. It is only the rapidity, and perhaps the magnitude, of the appreciation that were unexpected.

Underpinning the belief that the Canadian dollar will remain higher in the near future is the conclusion that, while economic conditions in Canada are much improved today compared to the mid-1990s, the higher dollar results primarily from a depreciation in the U.S. dollar against most world currencies. Furthermore, a number of economists believe that this depreciation is taking place with the implicit approval of the U.S. administration. Given its ballooning current account deficit and an economy that until recently was sputtering, the United States is hopeful that a weaker dollar will increase export competitiveness, stem job losses in manufacturing, and stimulate economic growth in that country.

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(1) For a more detailed discussion of the factors driving the recent currency appreciation in Canada, see Michael Holden, *Explaining the Rise in the Canadian Dollar*, PRB 03-26E, Parliamentary Research Branch, Library of Parliament, Ottawa, 19 January 2004.

(2) Because the United States is considered a "safer" market, it will tend to attract capital flows even when interest rates in the two countries are comparable.

(3) According to the June 2003 OECD *Economic Outlook*, only Slovakia, Portugal and Greece have higher current account deficits than the United States.