The Exchange Rate

BACKGROUNDER

The exchange rate refers to the value of the Canadian dollar against the currencies of other countries. Among other things, it helps determine how much we pay for imported goods and services and how much we receive for what we export.

When the value of the Canadian dollar falls, imported goods become more expensive, and we tend to reduce the volume of our imports. At the same time, other countries will pay less for some of our products and that will tend to boost export sales.

The exchange rate plays a particularly important role in our economy because, compared to other countries, imports and exports are a relatively large part of Canada's economy. Most of our trade is with the United States, which is why the value of our dollar against the U.S. dollar is especially important.

Factors affecting the exchange rate

Canada has a floating exchange rate. That means there is no set value for our currency compared with any other currency. The exchange rate is affected by supply and demand for Canadian dollars in international exchange markets. If demand exceeds supply, the value of the dollar will go up. If the supply exceeds demand, its value will go down. On an average day, CAN$37 billion is bought and sold on the international exchange markets.

Several factors influence the supply of and demand for Canadian dollars. If *interest rates* are higher in Canada than in other countries, investors may choose to invest in Canada, increasing demand for the dollar, providing that the expected rate of *inflation* is not higher in Canada than among our trading partners. If our inflation rate is higher, investors are less likely to prefer Canada—even with higher interest rates—because of the expectation that the value of the dollar will be eroded by inflation.

Our trade balance also affects our dollar. If world prices for what we export rise in comparison with the cost of our imports, we will be earning more for our exports than we pay for our imports. The more favourable these "terms of trade," the more demand there will be for the Canadian dollar.

If investors are confident that the Canadian economy will be strong they will be more likely to buy Canadian assets, pushing up the dollar's value.

Monetary conditions

Together, interest rates and the exchange rate determine the *monetary conditions* in which the Canadian economy operates. Changes in the exchange rate affect spending and demand in the economy just as changes to interest rates can either increase or decrease the level of economic activity.

The Bank of Canada influences the exchange rate indirectly when it changes the *Bank Rate* and this affects short-term interest rates. The Bank will also *directly intervene in foreign exchange markets*, buying and selling Canadian dollars, when it considers this necessary to ensure an orderly market.