BANK OF CANADA
BANQUE DU CANADA

BACKGROUNDERS

The Exchange Rate

The exchange rate is the price of one national currency, such as the Canadian dollar, expressed in terms of another currency, for example, the U.S. dollar, or a basket of currencies.

For a very open, trade-dependent economy like ours, the external value of the currency is particularly relevant as it affects, among other things, the prices and the volume of goods and services we export and import. Specifically, a depreciation (fall) or appreciation (rise) in the external value of the Canadian dollar will make Canadian goods and services less or more expensive for foreign buyers, and this will tend to boost or restrain their demand for our products. Movements up or down in the Canadian dollar relative to other currencies will also make imported goods more or less affordable, thus increasing or reducing the volume of our imports.

What determines the exchange rate?

Canada has a flexible exchange rate system. Because we have a target for inflation that aims to preserve the domestic value of the Canadian dollar, we cannot also have a target for its external value. So, there is no set (fixed) value for our currency in terms of any other currency. The exchange rate for the Canadian dollar against the U.S. dollar, and indeed against any other currency, floats and is determined by the demand for and supply of Canadian dollars in the foreign exchange market.

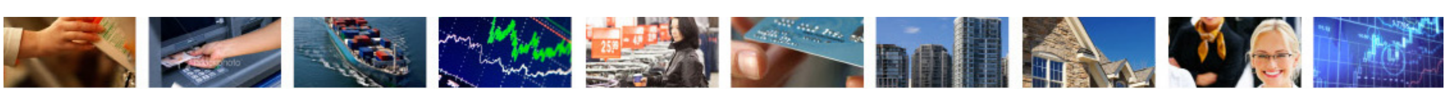
Because the bulk of our foreign trade (exports and imports) is still with the United States, the focus of attention is naturally the Canada-U.S. exchange rate. But when it comes to exports, it should be noted that Canada competes with many other countries for a share of the U.S. market. So the exchange rate of those currencies relative to ours also matters a great deal.

Movements in the Canadian dollar reflect the interaction of various domestic and external factors, any one of which may play a dominant role at different points in time. Among these are:

the world prices for commodities and Canada's status as a net exporter of raw materials compared with other countries, notably the United States which, although a commodity producer, is a net importer of commodities. This being the case, rising commodity prices tend to make our dollar appreciate against the U.S. dollar.

relative economic performance: stronger demand for Canadian products (from domestic and external sources) tends to support our currency.

relative inflation rates: if Canada's inflation rate were persistently higher than that of the United States, the expectation would be that our currency would tend to depreciate, everything else being equal, in order to maintain the competitiveness of our exports in U.S. markets.



relative interest rates: higher interest rates in Canada would attract investors to Canadian-dollar assets, boosting the value of our currency. But if inflation here is higher than elsewhere, investors might be less keen about such assets, fearing that inflation would erode their value.

Canada's productivity record relative to other countries, particularly the United States. Rising productivity supports steady, non-inflationary economic growth and higher living standards, while also preserving a country's competitiveness. Thus, a good relative productivity record is typically associated with a stronger currency; a poor one would take away from its value.

trade and current account balances: a surplus in Canada's balance of international payments means that foreigners are buying more goods and services from us than we are buying from them. To settle their purchases, they have to buy Canadian dollars, thus boosting the value of our currency.

The size of Canada's **public debt** relative to that of the United States, as well as Canadian tax policies and incentives to work, save, and invest compared to those of other countries can work in favour of, or against, our dollar. For example, a smaller public debt (as a share of GDP) in Canada compared with the United States would tend to support our currency.

short-term capital flows: international money flowing into Canada raises the value of the Canadian dollar; domestic money flowing out has the opposite effect. At times of global turbulence, international capital seeks safe haven, usually in the United States, leading to an appreciation of the U.S. dollar against major currencies, including ours.

domestic political turmoil can have a dampening effect on the external value of a currency.

Interest rates, short-term capital flows, and political developments tend to have more of a short-term effect on the exchange rate.

Longer-term currency movements reflect more fundamental forces at work. Thus, the Bank's research shows that the evolution of commodity prices is the main driver of the external value of the Canadian dollar over time. Commodity prices, however, are essentially shaped by global forces that are beyond Canada's control. (In this context, a floating Canadian dollar that rises and falls with sharp movements in commodity prices acts as a "shock absorber," helping our economy adjust with less overall loss in output and employment than if the exchange rate did not move.)

Other factors that influence the exchange rate over the longer term include Canada's relative performance in terms of economic growth, inflation, productivity, and fiscal position. Unlike commodity prices, these economic fundamentals are within our control.

The role of the exchange rate in monetary policy

Although there is no target for the Canadian dollar and the Bank no longer intervenes in foreign exchange markets except in very exceptional circumstances, the Bank is not indifferent to persistent currency movements, up or down, and takes into account their effect, together with that of other domestic and external factors, on total demand and inflation in Canada.

In reassessing the outlook for the economy and inflation before each of eight interest rate decisions a year, the Bank carefully examines the economic evidence accumulated since the last decision, including any currency movements. The lens through which this information is scrutinized is always the achievement of the inflation target.

By keeping domestic inflation low, stable, and predictable, the Bank contributes not only to the long-term soundness of the Canadian dollar, but to the overall health of the economy.

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