COMMENTARY COVERSHEET

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Canadian Currency Appreciates as GDP Rises Most in a Decade

By Chris Fournier

May 31 (Bloomberg) -- Canada's dollar rose after a report showed the economy expanded at the fastest pace in a decade in the first quarter, increasing pressure on the country's central bank to raise interest rates tomorrow.

The currency, known as the loonie for the waterfowl on the C$1 coin, **rose to its strongest level in more than a week after Statistics Canada said gross domestic product rose 6.1 percent in the January-March period, more than the median forecast in a Bloomberg News survey for a 5.9 percent gain. The loonie was the best performer among the U.S. dollar's 16 most-traded counterparts.**

"Very good GDP, strong numbers," said John Curran, a Toronto-based senior vice president at CanadianForex Ltd., an online foreign-exchange dealer. "It certainly looks by all calculations like the bank should be raising rates tomorrow. Dealer sentiment has swung strongly in favor of a rate hike."

The Canadian currency advanced as much as 1.3 percent to C$1.0414 per U.S. dollar, the strongest level since May 20, before trading at C$1.0478 at 11:07 a.m. in Toronto, compared with C$1.0546 on May 28. One Canadian dollar buys 95.45 U.S. cents.

Twenty-five of 27 economists in a Bloomberg survey say Carney will tomorrow increase the record low target lending rate by a quarter-percentage point to 0.5 percent, the first Group of Seven central banker to do so since last year's global recession.

Crude for July delivery gained as much as 71 cents, or 1 percent, to $74.68 a barrel in electronic trading on the New York Mercantile Exchange. Crude is Canada's largest export. The loonie tends to follow movements in crude oil and stocks.

Canada's dollar has depreciated 2.1 percent this month versus the greenback along with other higher-yielding currencies and the euro amid concern the sovereign-debt crisis in Europe may hamper the global economic recovery.

The yield on Canada's 10-year bond dropped as much as 40 basis points last month, from 3.65 percent on April 30 to 3.25 percent on May 25. It traded today at 3.32 percent.

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Commentary

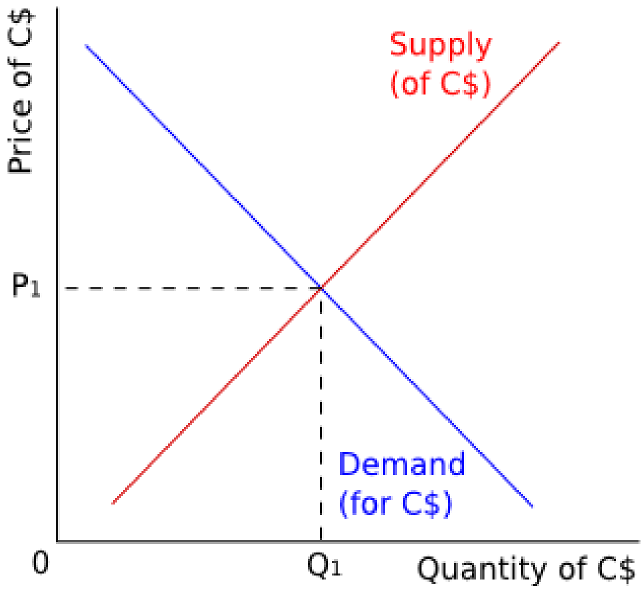

Figure 1: An exchange market for floating currency

The article "Canadian Currency Appreciates as GDP Rises Most in a Decade" describes a situation on foreign exchange market when a price of one particular currency increases. It deals with the phenomenon of **exchange rates**.

An exchange rate is the value of one currency expressed in terms of another currency.[1] Currencies are exchanged on foreign markets according to several exchange rate systems, known as **exchange rate regimes**. There are three main ones: *fixed exchange rates* – a regime when the value of the currency is fixed to another currency or to the another commodity (typically a gold). The second regime is *floating exchange rates* – when the value of the currency is determined only by the demand and supply for the particular currency at the particular exchange market. The last one is *managed exchange rates* – the currency is allowed to float, but there is a certain level of interference from the side of government.

The article deals with a foreign exchange market for Canadian dollar, which apparently according to the information included in the article works in the **managed exchange rate regime**. Therefore the price of the currency is apart from the interference from government determined by the **demand** for the currency and **supply** for the currency in the particular market. This can be illustrated graphically using the diagram – Figure 1.

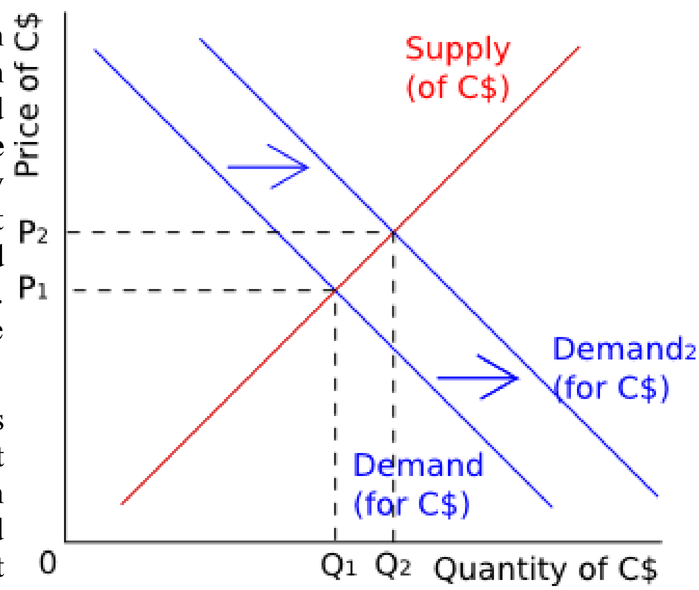

Figure 2: An increase in demand for the Canadian dollar

What happened in the market was that Statistics Canada had revealed that Canada's gross domestic product rose more than the median forecast had predicted in the period between January and March. This made that Canadian dollar a more attractive currency and the **demand** for the Canadian dollar **rose**. As we can see from the second diagram (Figure 2), when demand increases (shifts to Demand$_2$) the quantity demanded is higher ($Q_2 > Q_1$), however the **price is higher** as well ($P_2 > P_1$).

1 Jocelyn Blink & Ian Dorton, Economics Course Companion (1th Edition, Oxford University Press, Oxford 2007) p. 274

The changing value of the currency has various impacts on the economy itself. It directly influences *the inflation* and *the unemployment rate.*

When the exchanging rate is *low*, it is likely that greater employment in both export and domestic industries will follow – because with low exchange rate goods meant for export will be cheaper and low exchange rate will also make imports more expensive, which may encourage customers to buy domestically produced goods, instead of imports, thus employment would rise. However, as a disadvantage of a low exchange rate, inflation may rise because the price of imported raw materials would increase the production costs of producers, therefore prices of products themselves.

On the other hand, when the exchanging rate is *high*, there will be *downward pressure on inflation*, because prices of imported raw materials will be lower, which would lower production costs of producers and altogether with increased competitiveness of domestic products with foreign cheap goods would keep prices at lower level. But possible damage in export industries may follow, because export industries might find difficult selling their products abroad because of their relatively high prices. This is what may happen in Canada according to the article, since the price of crude, Canada's largest export, was raised as much as 1 percent.

As I have said, the Canadian dollar operates in the managed exchange rate regime, therefore some interferences from the side of the government are possible. Since government wants to maintain the Canadian dollar exchange rate between certain values (because of managing the level of inflation and the level of unemployment) and the rate has just gone up quickly it is likely that it will intervene in the market soon. Generally, government has two ways how it can intervene in to the market: it can *use their reserves of foreign currencies to buy or sell foreign currencies* or, and this is what the majority of economists surveyed in the article anticipate to happen, *change interest rates.*

More concretely, economists anticipate that the Canadian central bank will **increase** the **lending interest rate** for money. This action would decrease the demand for the Canadian dollar (so the exact opposite of the Figure 2), therefore the **price** would be **decreased** again.