**ALBERTA FINANCE**
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# Economic Spotlight

## CANADIAN DOLLAR

**KEY MESSAGES**

- The Canadian dollar has fallen by more than 3 cents against its U.S. counterpart since the beginning of April, recently touching a 7-month low of 78.6 US cents.
- Although domestic political uncertainties have played a role in the Canadian dollar's decline, the recent global strength of the U.S. dollar has also been a major factor. Negative Canada-U.S. interest rate spreads and downward pressure on commodity prices (especially oil) have also weighed on the Canadian dollar of late.
- Economic fundamentals should support a renewed rise of the Canadian dollar in the medium term, as Canada's economic growth picks up and interest rates rise, and as the U.S. dollar faces renewed downward pressure due to the large U.S. trade and budget deficits. However, further reversals in the Canadian dollar are possible in the near term.

**BACKGROUND**

- The Canadian dollar appreciated significantly in the latter half of 2004, rising from 72 cents US in mid-May to a high of 85 cents in November, supported by high commodity prices and a general decline of the U.S. dollar against most major world currencies.
- From December 2004 to March 2005, the dollar traded within the range of 79.9 to 84.3 cents, averaging 81.7 cents while exhibiting considerable volatility on a day-to-day basis. Weakening Canadian economic growth and exports weighed on the dollar during this period.
- Since the beginning of April, the Canadian dollar has faced significant selling pressures, due to both federal political uncertainties and a resurgence of the U.S. dollar on global markets. The U.S. dollar increased to its highest level against the euro in nearly seven months.
- A number of factors have been supportive of the U.S. dollar recently:
    1. The U.S. trade deficit moderated to $55 billion in March, from a record high of $60.6 billion in February.
    2. Employment increased 274,000 in April, substantially exceeding expectations.
    3. Retail sales jumped 1.4% in April, twice the consensus forecast increase.
    4. Personal income increased 0.7% in April, the highest growth in 2005.
- In contrast, several factors have been negative for the Canadian dollar in recent weeks:
    1. Canada's trade surplus was $4.2 billion in March, below the consensus forecast of $5 billion.
    2. Manufacturing shipments fell 2.4% in March, following a 0.7% decline in February.
    3. Oil prices have declined substantially in recent weeks, from a record high of over US$57 in early April to less than $50 recently.

4. Political uncertainties regarding the future of the minority federal government.

- The U.S. Federal Reserve has increased interest rates eight times since June 2004. The spread between Canadian and short-term interest rates fell from +175 basis points (1.75 percentage points) at the beginning of 2004 to –50 basis points at present.
- Interest rate differentials are likely to continue to favour the U.S. dollar in the near term. The U.S. economy is continuing to experience solid economic growth (at a 3.5% annual rate in the first quarter of this year, compared to an expected growth of around 2.5% in Canada), and there are concerns regarding U.S. inflation as well. As a result, the Federal Reserve is expected to continue to raise interest rates throughout 2005. In Canada, interest rate increases appear to be on hold until the latter half of 2005, at the earliest.
- With reports of slowing global economic growth, commodity prices (including, but not limited to energy) have weakened in the past month. This factor may continue to be a negative for the Canadian dollar in the coming months.
- However, the upturn in the U.S. dollar may be short lived. Currently, foreign exchange markets are focusing on interest rates and economic growth, but once the Federal Reserve Board is done with raising rates, the underlying issues of 'twin deficits' (current account and budget) are likely to place downward pressure on the U.S. dollar.
- The United States has become the world's largest net debtor country, with Japan and China alone holding over $900 billion (about 46% of total) in U.S. Treasuries. There have been some indications recently that these governments wish to reduce their U.S. dollar holdings to lower their exposure to foreign exchange risk.
- Over the medium term, economic and fiscal fundamentals favour the Canadian dollar against its U.S. counterpart. Canada is running large trade and fiscal surpluses, and, with an expected resumption in strong economic growth within next year, the Canadian dollar is in a very good position to maintain a value in the range of 81 to 85 cents U.S.

**RISKS**

- The Canadian dollar could weaken further in the short term, despite positive longer-term fundamentals. On the other hand, if commodity prices strengthen once again, the Canadian dollar may experience a further substantial appreciation.
- Canadian political uncertainties regarding the status of the minority federal government will remain a notable risk to the forecast in the near term.