

September 20, 2007

CANADIAN DOLLAR: A WEAK GREENBACK AND HIGH OIL PRICES MEAN PARITY IS A SURE THING

The U.S. slowdown's potential impacts on our economy were quickly dismissed, allowing the loonie to continue the momentum gained in recent months. For the first time since the early 70s, the Canadian dollar is trading at par with the greenback. As the determinants are positive on all fronts, from the greenback's generalized weakness to shrinking short-term interest rate spreads and high oil prices, parity was almost unavoidable in the near term.

Greenback's generalized weakness

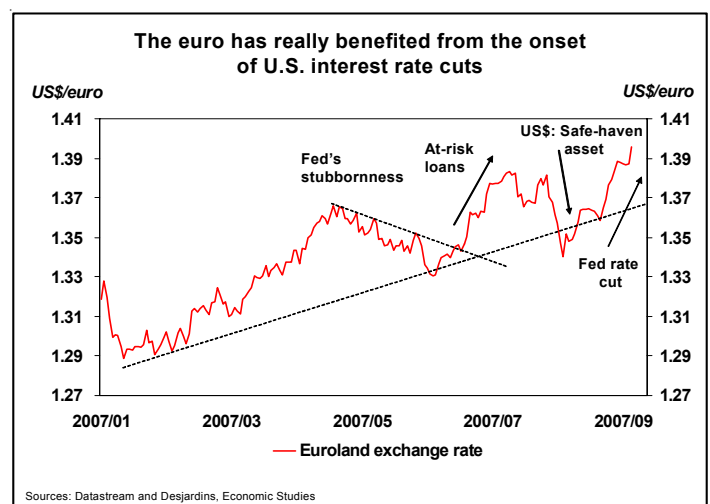
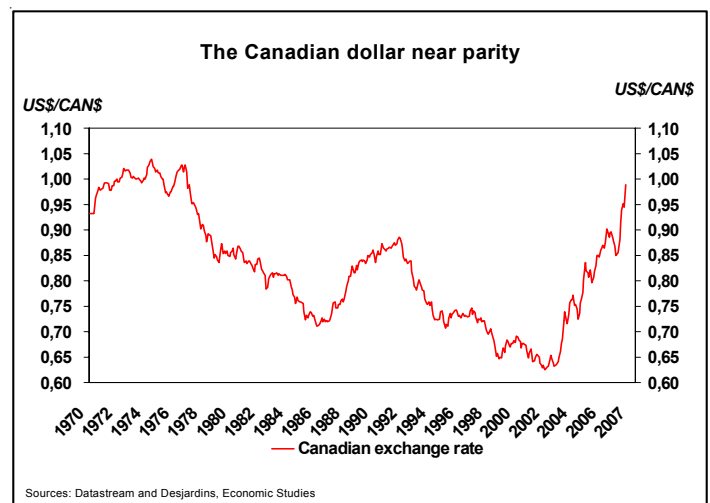
The recent evolution of the major currencies is primarily a reflection of the volatility that took hold of the financial markets at the end of July. While the subprime mortgage credit derailment allowed the euro to regain ground on the American dollar over the first three weeks of July, the resurgence of risk and the evaporation of the demand for asset-backed commercial paper have prompted investors to favour American safe haven assets such as U.S. government securities, temporarily pushing up the greenback against the other major currencies. However, successive signs that the housing correction will be deeper and will last longer than expected have shifted the perceptions of the money market players, and it is now accepted that the U.S. Federal Reserve (Fed) is in easing mode. Based on our interest rate scenario, we foresee a reduction totaling 100 basis points by the end of the year—an eventuality that would certainly return the greenback to its long-term downward trend.

Canadian economy's relative strength

Despite our geographic proximity and the American market's importance to our export sector, it is now clear that the oil windfall out west and the economy's shift toward services will allow Canada's economy to limit the damage.

Shrinking interest rate spreads

While the Bank of Canada put monetary tightening aside in September, this does not mean it will cut its



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rates any time soon. The Canadian economy is still evolving above capacity, and the jobless rate has not been this low since 1974. As a result, given the cuts to U.S. federal funds already initiated, the short-term interest rate spread will continue to shrink and provide the loonie with solid support in the months to come.

High oil prices

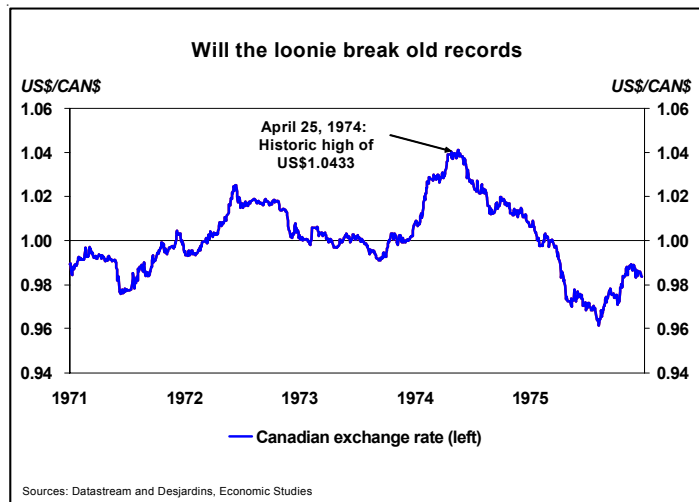
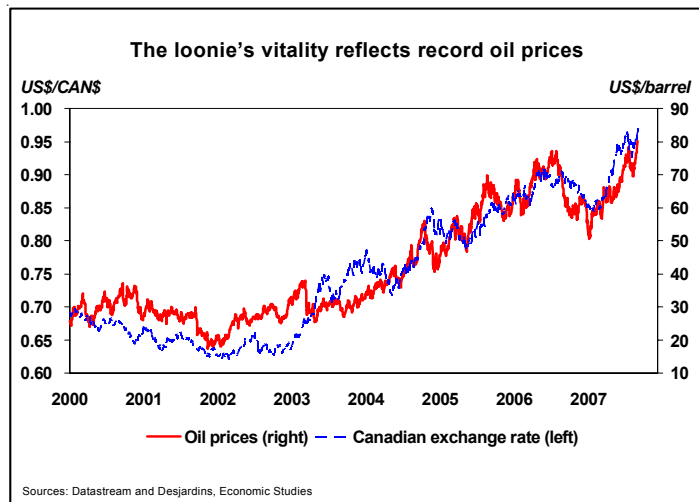
The price of oil has increased significantly since the beginning of the summer. The financial crisis caused the price of oil to pull back temporarily in August, but the barrel jumped to over US\$80 in September. Oil's appreciation is in large part due to the fact that the world's consumption of black gold is greater than its production and should remain so for the next few quarters, causing inventories to shrink. The situation is causing fears of a shortage, as the uncertainties surrounding production are substantial (hurricanes, Iran, etc.), and the Fed's vigorous action is limiting the outlook for a drop in U.S. demand. Fears should gradually moderate over the next several months, although oil prices will remain relatively high with the onset of winter.

Looking at new highs

Although we are maintaining our stance that oil prices must stay over US\$82 for a long period to ensure sustainable Canadian dollar parity, it seems increasingly clear that the loonie could go even higher in the short term, given the current enthusiasm for the currency.

The situation has its points in common with the situation in the early 70s. Back then, the strong Canadian dollar had a lot to do with high commodities prices as a result of strong worldwide demand. Parallel to that, Canada, a small net oil importer, was less affected by the oil crisis. Added to this was the generalized weakness shown by the greenback against all the other major currencies following the collapse of the Bretton Woods fixed exchange rate system. The Canadian dollar reached a peak of US\$1.0443 on April 25, 1974.

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¹ See the May 31, 2007 Economic Viewpoint "Will the Canadian dollar keep surprising us?".

Currency markets: History and forecasts

End of period	2006		2007				2008				
	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	
American dollar											
Canadian dollar (USD/CAD)	1,1179	1,1654	1,1535	1,0638	1,0000	0,9804	1,0204	1,0638	1,0000	0,9756	
Euro (EUR/USD)	1,2667	1,3186	1,3311	1,3500	1,4000	1,4200	1,3800	1,3500	1,3200	1,3100	
British pound (GBP/USD)	1,8723	1,9589	1,9673	2,0080	2,0200	2,0000	1,9800	1,9600	1,9500	1,9300	
Yen (USD/JPY)	118,03	119,03	117,67	123,20	116,00	114,00	112,00	110,00	108,00	106,00	
Australian dollar (AUD/USD)	0,7461	0,7889	0,8090	0,8503	0,8200	0,8200	0,8300	0,8500	0,8600	0,8600	
Mexican peso (USD/MXN)	10,99	10,80	11,04	10,81	11,00	11,35	11,40	11,35	11,30	11,25	
Effective dollar* (1973 = 100)	81,83	81,41	80,53	78,72	78,65	78,30	78,89	78,55	77,76	78,08	
Canadian dollar											
American dollar (CAD/USD)	0,8945	0,8581	0,8669	0,9400	1,0000	1,0200	0,9800	0,9400	1,0000	1,0250	
Euro (EUR/CAD)	1,4161	1,5367	1,5355	1,4362	1,4000	1,3922	1,4082	1,4362	1,3200	1,2780	
British pound (GBP/CAD)	2,0931	2,2828	2,2694	2,1362	2,0200	1,9608	2,0204	2,0851	1,9500	1,8829	
Yen (CAD/JPY)	105,58	102,14	102,01	115,81	116,00	116,28	109,76	103,40	108,00	108,65	
Australian dollar (AUD/CAD)	0,8341	0,9194	0,9332	0,9046	0,8200	0,8039	0,8469	0,9043	0,8600	0,8390	
Mexican peso (CAD/MXN)	9,83	9,27	9,57	10,16	11,00	11,58	11,17	10,67	11,30	11,53	

f: forecasts

* Trade-weighted against major U.S. partners.

Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies