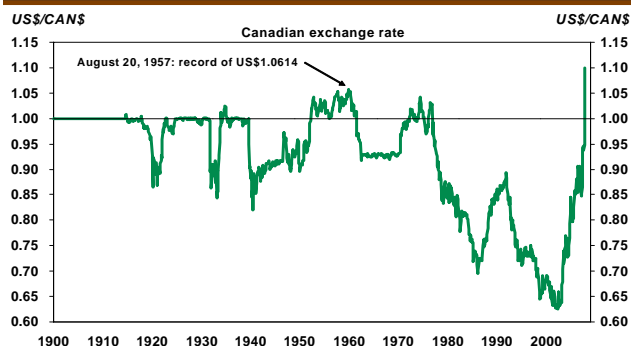


The loonie continues to soar, reaching US\$1.10 overnight

The Canadian dollar continues to amaze. In mid-October, with oil prices above US\$90, we could easily see it breaking US\$1.05 but there were no signs that it would keep reaching for the sky. Currently at US\$1.10, or almost four cents higher than the record set in 1957, our currency is now in uncharted territory... and it looks like there's no stopping it (Graph 1).

Graph 1 – With the 1957 record breached, the loonie is now in uncharted territory



Sources: Global Financial Data and Desjardins, Economic Studies

From a market perspective, the Canadian dollar is ripe for a correction. The currency has grown in a near linear fashion since the beginning of the year, rising an unprecedented 28% against the greenback. Demand is robust and speculation has reached new heights (Graph 2). However, the underlying fundamentals are sound and it doesn't look like the trend is about to reverse itself any time soon.

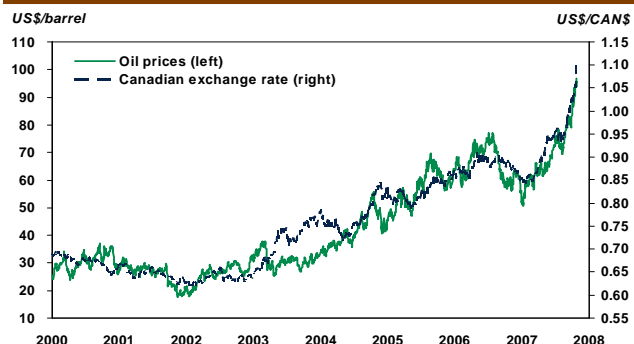
First, given that the dollar is affected by commodity prices, it has fully benefited from the risk premium that has recently driven oil prices to nearly US\$98 a barrel (Graph 3). At the same time, the strength of base metal prices continues to surprise, and precious metals, particularly gold, are setting new records. However, as the Bank of Canada's governor stated in a speech delivered in Washington on October 21:

Graph 2 – Speculation on the loonie is very high



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

Graph 3 – The rise in oil prices is offering good support to the loonie



Sources: Datastream and Desjardins, Economic Studies

“The recent round of appreciation has been abnormally quick and doesn't seem to be related to the domestic factors that would normally lead to that sort of rapid appreciation.”

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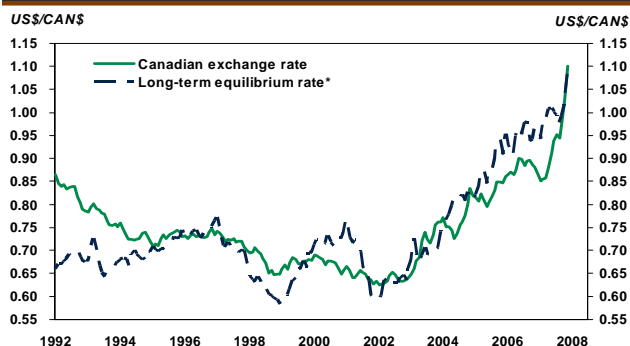
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NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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So the loonie is rising faster than the fundamentals would indicate. In fact, the Desjardins exchange rate econometric model¹ shows that if oil and metal prices stay at their current level over the long term, the loonie should reach an equilibrium value of about US\$1.09 (Graph 4). However, since the dollar has already broken this level, there are obviously other factors at play.

Graph 4 – The loonie’s value is already higher than its long-term equilibrium rate



* Based only on the price of energy and non-energy raw materials.
Sources: Datastream and Desjardins, Economic Studies

Beyond short-term variables, such as speculation and the capital flows associated with corporate buyouts and interest rate expectations, the broad based weakness of the greenback is the most worrisome factor. In fact, the U.S. dollar index, at an historic low, has fallen by more than 35% since 2002 (Graph 5). This, combined with unprecedented pessimism regarding the U.S. dollar, means its troubles are far from over.

Graph 5 – The U.S. dollar index at a historic low



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

¹ See the *Economic Viewpoint* at page 6, “Petrocurrency: Good or bad for Canada’s economy?” for more details on what drives movements in the Canadian exchange rate.

Comments by a member of the Chinese congress to the effect that “the U.S. dollar is losing its global currency status,” and that China should adjust its portfolio in order to “take advantage of the appreciation of strong currencies to offset the depreciation of weak currencies,” only added fuel to the fire. The euro and pound sterling benefited, reaching US\$1.46 and US\$2.10 respectively (Graph 6). Even the yen went up to 113 yen/US\$, thus returning to its trough of mid-August 2007.

Graph 6 – Major currencies have profited from portfolio diversification rumours

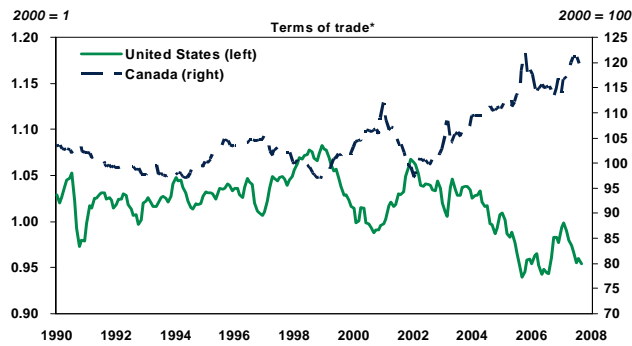


Sources: Datastream and Desjardins, Economic Studies

Implications: At this rate, the Bank of Canada’s worries about the pace of the loonie’s rise are just beginning. However, it is not likely to intervene to calm things down. Speaking before the Canadian Association of New York last night, Paul Jenkins, Senior Deputy Governor of the Bank of Canada, affirmed the importance of “allowing market-based adjustment mechanisms to work in an economy.” With another 25 basis point reduction in the federal funds rate widely expected on December 11, cutting the Canadian target rate on December 4 would have little effect. In fact, the vitality of the Canadian domestic economy does not allow the central bank to do more without compromising its objectives to contain inflation in the medium term. Consequently, the status quo will probably be maintained until 2008.

This is also not the time to revive the topic of a common currency. Setting up a common currency for North America is a massive undertaking fraught with obstacles such as restricted workforce mobility between Canada and the United States, a lack of genuine desire on the part of Americans to see such a project come to fruition, and most importantly, loss of sovereignty as regards Canadian monetary and economic policies. As a matter of fact, the current economic situation clearly shows the importance of having our own currency. While the United States and Canada are highly integrated, the two economies react differently to global shocks. In particular, the structure of the two economies is such that the Canadian terms of trade, through higher commodity prices and the reduction in import prices, have

Graph 7 – Terms of trade in Canada and in the United States are negatively correlated



* Ratio of export prices to import prices.
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

improved while the opposite is true for the United States (Graph 7). This situation will likely exert different pressures on prices, which is just one more reason for Canada to have its own currency.

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