

## Hard to combat the upside pressures on the loonie The greenback is in troubled water, but in no danger of sinking

### HIGHLIGHTS

- With financial risks easing and the economic recovery shaping up, the U.S. dollar, which had acted as a safe-haven currency thus far, went back on a down trend. Given that the trade-weighted U.S. dollar index is still above its pre-crisis point, everything suggests that, in the short term, the pressure on the currency will remain to the downside.
- The greenback's struggles could let the euro keep rising moderately, over US\$1.50, over the next few months.
- With the Bank of England's November meeting over, the pound should be a little less volatile and could hold near US\$1.65.
- The emerging signs of economic recovery, negative sentiment about the greenback, and consolidating raw material prices are favourable to the Canadian dollar. Oil prices will have to be higher for USD/CAD parity to be achieved sustainably.

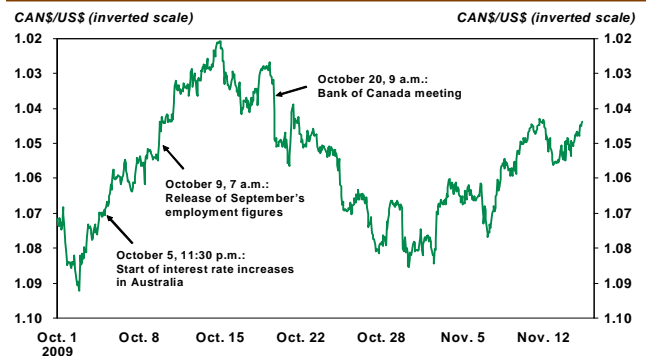
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### Editorial

The message from the Bank of Canada (BoC) has been clear in October: "Heightened volatility and persistent strength in the Canadian dollar are working to slow growth and subdue inflation pressures. The current strength in the dollar is expected, over time, to more than fully offset the favourable developments since July". It gave the loonie a sharp blow, which deteriorated by 6.5% in just a few days, with the USD/CAD pair coming back from a low of 1.0207 on the day after better-than-forecast results for employment here, to go to almost C\$1.0870 in early November. However, the effect was temporary, as Canada's dollar capitalized on the comeback by oil and gold prices to get back on track for growth (graph 1).

**Graph 1 – The Bank of Canada seems to be short on means for keeping the loonie from appreciating**



Sources: Bloomberg and Desjardins, Economic Studies

Despite its concerns about the volatile loonie, the BoC is still showing some optimism in terms of the Canadian economy's growth outlook. As it is not showing any conviction about the need to resort to quantitative policies at this stage of the recovery, we are wondering about the BoC's ability to actually contain the upside pressures on the loonie, which stem from the greenback's generalized weakness, the resulting rise by commodity prices, and expectations of interest rate hikes.

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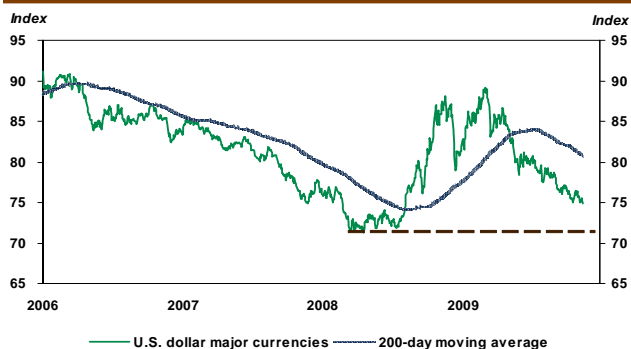
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Under these circumstances, it seems inevitable that, with global demand firming steadily, sooner or later, the Canadian dollar will be back at parity. To make sure, we are reviewing the major Canadian exchange rate determinants.

**U.S. DOLLAR TREND**

Overall, investor sentiment about the greenback is negative. The magnitude of the American government deficit and Federal Reserve’s quantitative measures, the allied long-range inflation risks, rumours about the creation of a super currency and diversification of central banks’ portfolios, and use of the greenback as a currency for financing carry-trade positions, are all valid sources of market concern. With financial risks easing and the economic recovery shaping up, the U.S. dollar, which had acted as a safe-haven currency thus far, went back on a down trend. Given that the trade-weighted U.S. dollar index is still above its pre-crisis point, everything suggests that, in the short term, the pressure on the currency will remain to the downside (graph 2).

**Graph 2 – The American dollar is gradually getting back to its pre-crisis levels**



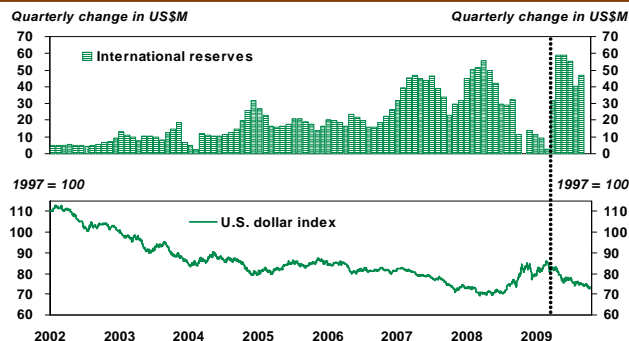
Sources: Bloomberg and Desjardins, Economic Studies

The risks of a chaotic correction (often put forward in the markets as the predominant risk), seem to be limited, however. Relatively speaking, although activity in the United States did plunge substantially, its decline was still about half as big as what occurred in Japan and in some of Europe’s major economies. Growth potential appears to have been impacted by the destruction of production capacity in some industries, including the auto industry, and the pressures the credit crisis put on financial innovation; however, a number of factors, including demographics, signal that the output gap will close more quickly in the United States than in most of the other major industrialized economies.

Moreover, it is in no one’s interest to allow the currency of the world’s biggest economy to collapse. In particular, developing Asia’s growth model is still mercantile. It is thus not surprising to note that China has restarted to amass

reserves at lightning speed since the greenback started to slide again (graph 3).

**Graph 3 – The U.S. dollar’s decline is prodding China to start stockpiling foreign currency reserves again**



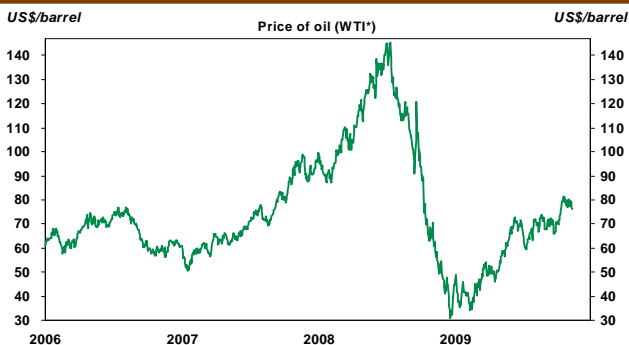
Sources: Datastream and Desjardins, Economic Studies

**COMMODITIES**

There are still many uncertainties, such as whether the private sector will be able to take over the reins from the government in supporting the ongoing economic recovery. The fact remains that easing market volatility has prompted investors to gradually take on riskier positions. Commodities were the first to benefit. The hopes of a faster recovery in Asia than in the industrialized economies resulted in a surge by energy and metal prices.

After crumbling to US\$30 a barrel at the end of last year, when the possibility of a depression was on everyone’s lips, oil rebounded by almost 160% to cross the US\$80/barrel mark in October (graph 4). If the greenback stays on its down trend and the ongoing economic recovery consolidates, in the context of a limited supply, the dynamic for oil prices will continue to favour appreciation by crude prices until the end of next year.

**Graph 4 – Oil prices have been highly volatile over the last two years**



\* West Texas Intermediate. Sources: Datastream and Desjardins, Economic Studies

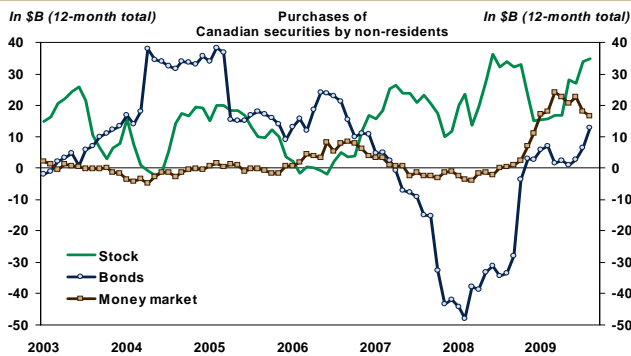
The same is true for base metal prices. Unlike the ends of previous cycles, in which a combination of mining overproduction and sagging demand had always put downside pressures on base metal prices, production capacity did not expand substantially in this decade, to the point that prices did not collapse as we could have thought, judging from the extent of the drop in activity noted in the last recession. As a result, the upswing by global demand is expected to keep upside pressures on metal prices in the near future.

**INTEREST RATES**

The global monetary firming cycle is underway. The Reserve Bank of Australia has already raised its key rate twice since the beginning of October, and the Bank of Norway fell into step at the end of October. Many think that New Zealand and Canada, two economies that are also tied into commodity movements, will be the next to proceed with interest rate increases.

In Canada, the solid performance by domestic demand, less extensive deterioration in the job market and net recovery by the housing market all attest to some vitality in Canada's domestic economy following the crisis. However, the BoC will have to be highly cautious in conducting its monetary policy to avoid driving the loonie to new heights. Already, the spread between Canadian and U.S. interest rates has triggered a portfolio movement that favours Canada's economy (graph 5). In the context of subdued inflation, we think that the BoC has the leeway it needs to maintain its commitment to keeping the key rate at a low of 0.25% until mid-2010, but, in the meantime, the markets won't fail to test the monetary authorities' resolution. With a substantial spread between Canadian and U.S. monetary policy, especially if we factor in the scope of the Fed's quantitative easing, expectations regarding interest rate increases will continue to give the loonie some support until the end of next year.

**Graph 5 – Canadian stock and bonds gaining popularity abroad**



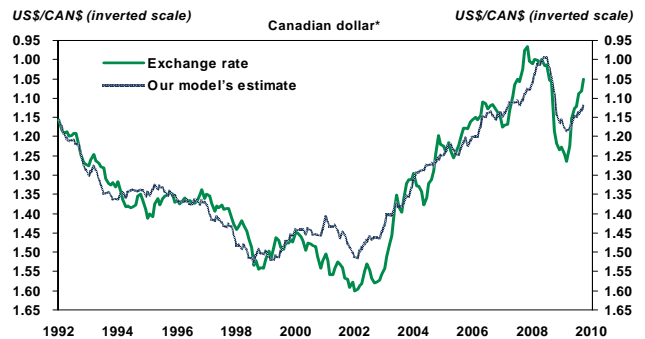
Sources: Statistics Canada and Desjardins, Economic Studies

**THE THEORETICAL MODEL**

Unless there is another negative shock that would be likely to temporarily reverse the greenback's down trend, everything suggests that the winds favour slow appreciation by the Canadian dollar over the coming quarters.

Our forecast model, which is based on the trade-weighted USD index (excluding the Canadian dollar), the price of energy and non-energy commodities and the interest rate spread, signals that, at its current level, the loonie is slightly overvalued (graph 6). However, note that the currency has a tendency to frequently go above its equilibrium value when it is on the upswing. Under these circumstances, it would not be surprising to see the USD/CAD pair reach parity at any time. However, our position is clear: oil prices will have to be higher for a longer period before parity becomes sustainable.

**Graph 6 – The Canadian dollar's value currently exceeds the value estimated by our model**



\* Monthly averages. Sources: Datastream and Desjardins, Economic Studies

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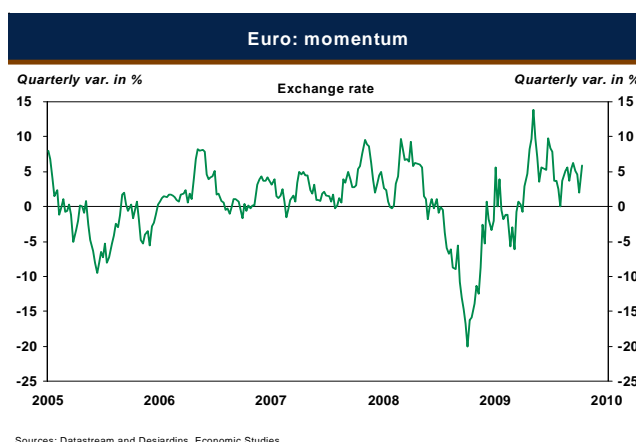
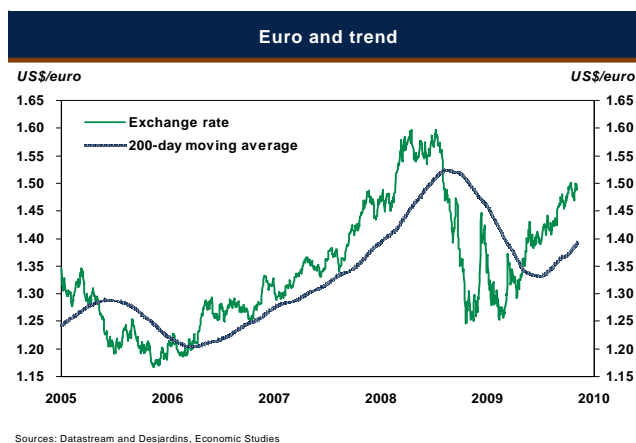
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# EURO (EUR)

## The euro could rise further in the near term, but 2010 promises to be tougher

- After hitting US\$1.5018 on October 23, an over 14-month peak, the euro fell abruptly, descending to around US\$1.45 in early November. The euro's sudden downturn can be explained by a surge in investor anxiety, which favoured safe-haven securities like the U.S. dollar. However, the American economy's stronger-than-forecast growth in the third quarter reassured investors. The G20 commitment to keeping stimulus policies in place allowed Euroland's currency to climb back to around US\$1.50.
- Despite the temporary dip recorded at the end of October, the euro's trend is still upward. The euro's price is still well above its 200-day moving average, while the currency's momentum is slightly positive. Net speculative positions have edged down, but remain very high. Overall, the market indicators are not pointing to any looming upward or downward technical movement.
- In the near term, movements by the EUR/USD pair could primarily reflect the American dollar's fluctuations. This means that any upswing by investors' fear that would favour safe-haven securities should prompt euro depreciation, while renewed risk appetite would benefit Euroland's currency. Recently released euro zone economic statistics remain mixed. On one hand, the jobless rate continues to rise and retail sales pulled back in September. On the other, the confidence indexes and purchasing manager indexes point to a substantial improvement in the situation, while industrial output posted its fifth straight month of growth in August. The scenario of modest growth for the second half of 2009 seems to be shaping up, as the zone's GDP would have grown by an annualized 1.5% in the third quarter, according to the flash estimate.
- At its November meeting, the European Central Bank was slightly more optimistic. It is still calling for a slow recovery, but it dropped the sentence that indicated it was expecting an uneven recovery. President Jean-Claude Trichet also clearly opened the door to gradually reducing the extraordinary liquidity measures, saying he did not want to alter the market's perception that 12-month refinancing operations would no longer be offered next year.

**Forecasts:** The greenback's struggles could let the euro keep rising moderately over the next few months. However, a relatively sluggish economic recovery and the zone's structural issues, including the major deterioration in public finances, should play against the euro next year, possibly taking it below US\$1.40.



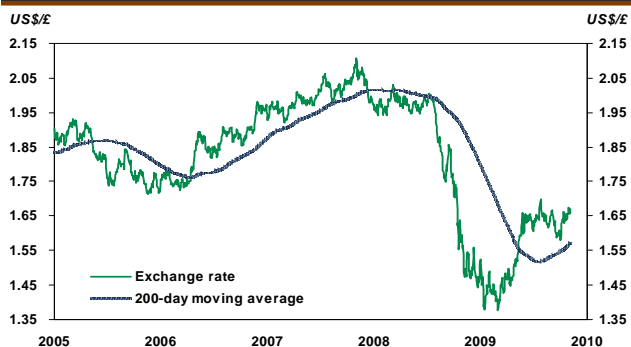
# BRITISH POUND (GBP)

## The measured increase in quantitative easing soothes the market

- The pound has been volatile in the last few weeks, responding to all the signals as to a potential increase in the UK's quantitative easing policy. In the end, the Bank of England (BoE) opted for a limited £25B (US\$41B) boost on November 5, although a slight majority of analysts had been calling for a £50B (US\$82B) increase. The financial markets received this decision well, helping the pound to cross above US\$1.65.
- Beyond fluctuations due to the BoE decision, the pound continued to consolidate the gains made in the first half of 2009, staying around US\$1.65. The currency's momentum remains very close to zero. Highly negative speculative positions prompted a swing back toward neutrality following November's BoE meeting.
- The recession has continued in the United Kingdom, with real GDP posting an annualized 1.6% contraction in Q3. However, the latest statistics on industrial output and the purchasing manager indexes suggest that economic growth will soon be back. The BoE has even substantially upgraded its growth outlook for 2010 and 2011.
- The current recession will have been one of the UK's worst. The output gap once again widened sharply in the third quarter, auguring subdued inflation pressure over the medium range. For technical reasons, the inflation rate, which fell to 1.1% in September, could rebound in the coming months but, for the BoE, the primary medium-term risk is inflation below the 2% target. By opting to expand its quantitative easing by £25B rather than £50B, the BoE seems to be saying that the need for extraordinary tools is starting to decline. The British government could also influence the pound in the months to come. If it increases its consumption tax by 2.5 percentage points in January 2010 as forecast, this could be a tough blow to consumer confidence. If it decides to prolong the temporary tax cut, its fiscal situation will deteriorate further and the risks that credit agencies will downgrade the U.K.'s debt rating will increase.

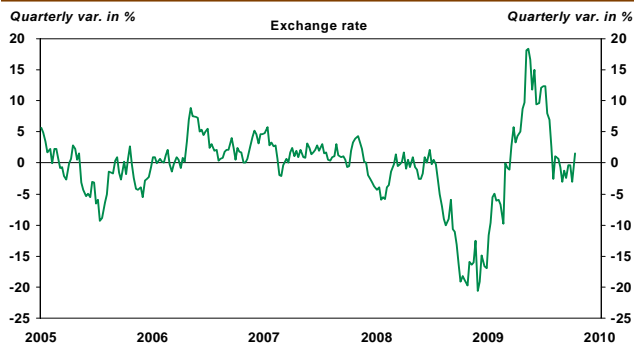
**Forecasts:** With the BoE's November meeting over, the pound should be a little less volatile and could hold near US\$1.65. The rapid rise by home prices could prompt the BoE to gradually tighten its monetary policy as of the fall of 2010, and take the pound to around US\$1.70.

### British pound and trend



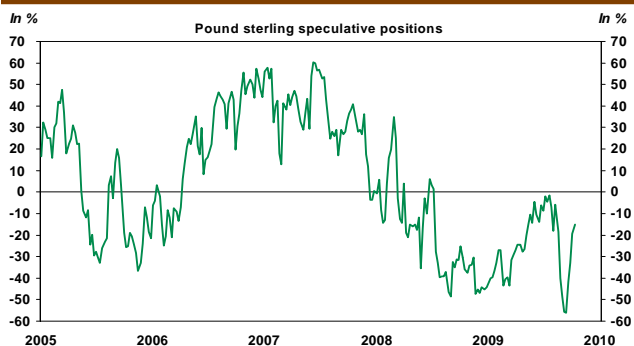
Sources: Datastream and Desjardins, Economic Studies

### British pound: momentum



Sources: Datastream and Desjardins, Economic Studies

### British pound: net speculative positions



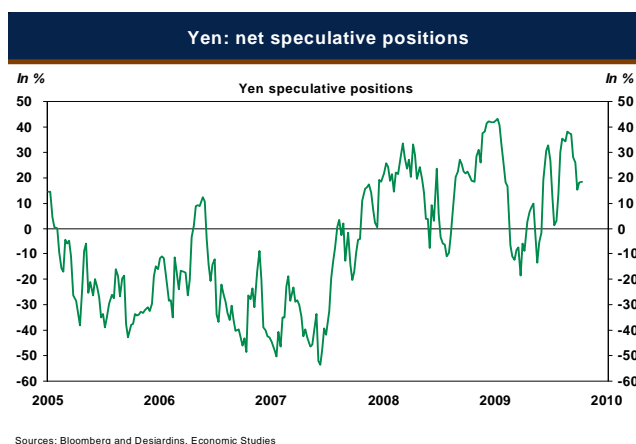
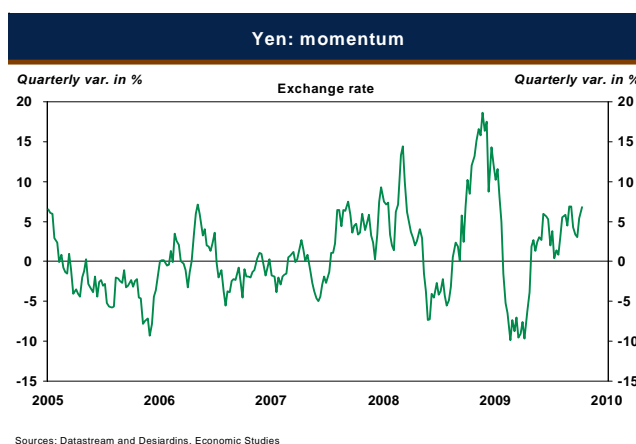
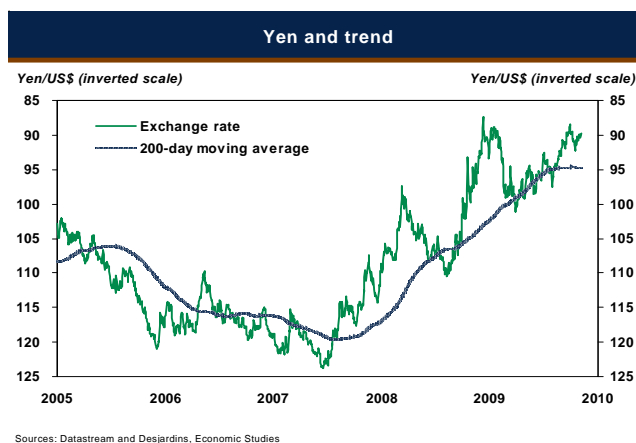
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

# YEN (JPY)

## The yen is taking its time about depreciating further

- The yen's depreciation that began in mid-October already seems to have run out of steam. For several days, Japan's exchange rate held close to 92 yen/US\$, then slid back down to around 90 yen/US\$, where it seems to be stabilizing since November began. Japan's currency is being stimulated by a number of one-off factors. Short-term interest rates are slightly better in Japan than in the United States, and a tax holiday allowing Japanese businesses to repatriate foreign earnings is increasing demand for the yen.
- On a market basis, the recent drop in net speculative positions points to a slight risk of a short-term correction for Japan's currency, while the strong momentum is sending the opposite message. However, the temporary factors that are boosting the yen are behind the increase in momentum, which therefore does not arise as a result of yen speculation. The currency could stay close to current levels for some time.
- Fundamentally speaking, Japan's currency is still overvalued, even though Japan's economy has some positive aspects. The recession ended last spring and economy activity posted another solid performance in Q3, with an annualized gain of 4.8%. The jobless rate also pulled back in August and September, settling at 5.3% after peaking at 5.7% in July. Still, the Japanese economy's rebound is very much influenced by the government's contribution and positive impact of some recovery measures on consumption. Apart from the contribution of government, domestic demand will continue to be affected by soft business profits and the drop in household income. Moreover, the yen's strength is contributing to the difficulties facing Japanese businesses—they would like their products to be more competitively priced in export markets.
- An additional contribution from foreign trade would be a real escape hatch for Japan's economy, which must close a substantial output gap. Meanwhile, inflation pressure is non-existent. Moreover, the price trend has been downward since the year began. The Bank of Japan will probably be one of the last central banks to raise its interest rates, which also argues for a yen pullback.

**Forecasts:** Temporary factors are delaying the yen's depreciation; it is still overvalued with respect to the Japanese economy's structural weakness. A swing back toward 100 yen/US\$ early next year is the most likely scenario, assuming that the currency's short-term supports dry up.

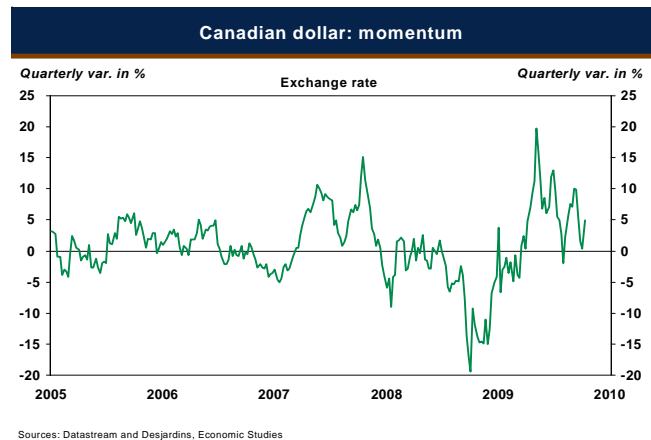
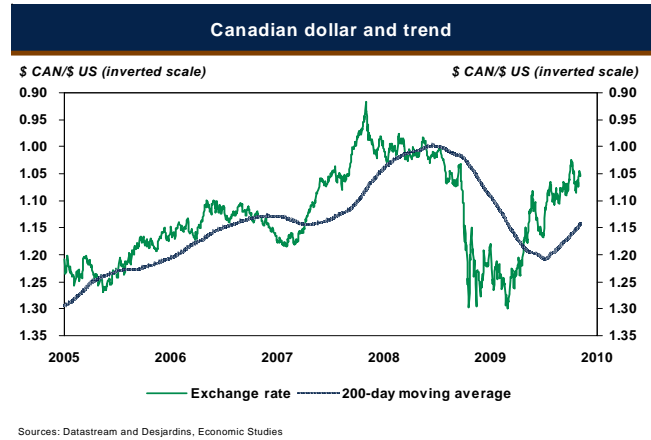


# CANADIAN DOLLAR (CAD)

## Upward pressure on the loonie holds firm

- The Canadian dollar depreciated following the Bank of Canada's (BoC) remarks about the negative impacts its strength was having on the Canadian economy's growth outlook. However, the reaction was ephemeral: the greenback returned to a down trend, energy prices are on the upswing and gold prices have hit a new record, pushing the loonie up again.
- After depreciating to a cyclical low of C\$1.0207 in mid-October, the USD/CAD pair rose to 1.0870 on November 2, then went back on the down trend that took it under 1.05 very recently.
- As we expected in October, very high speculative positions on the Canadian dollar were compatible with the recent correction. Net positions are moderating and momentum is flat, meaning that the loonie could start a consolidation phase.
- The latest statistics show that Canada's economy is starting to see the light at the end of the tunnel. The monthly results for real GDP by industry in July (-0.01%) and August (-0.1%) were not resoundingly eloquent regarding an upswing in activity. However, September's improvement in the trade balance, which has a lot to do with car exports, along with gains in retail sales and housing starts should show economic growth rebounding that month. However, after two months of solid advances, October's job losses signal that the recovery is still shaky.
- The BoC remains prudent in conducting its monetary policy. As forecast, monetary authorities notched up their concerns about the Canadian dollar's strength at their October 20 meeting. The BoC is still confident that Canada's economy will return to growth in the third quarter of 2009 (it is expecting an annualized 2.0% gain).
- With little inflation pressure in sight, the BoC has the leeway it needs to maintain its conditional commitment to keeping its key rate at a low of 0.25% until mid-2010.

**Forecasts:** The recent correction appeared to be a prerequisite for the loonie to start appreciating again. The next few steps will no doubt be slower. However, the emerging signs of economic recovery, negative sentiment about the greenback, and consolidating raw material prices are favourable to the Canadian dollar. Oil prices will have to be higher for USD/CAD parity to be achieved sustainably.

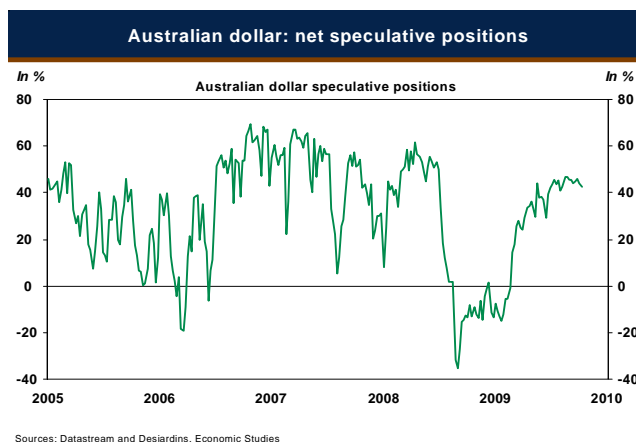
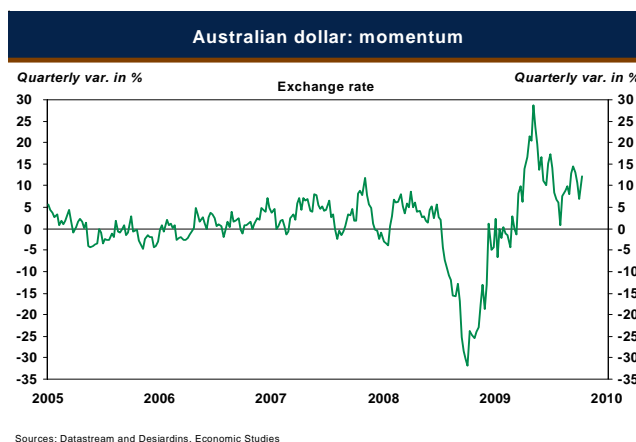
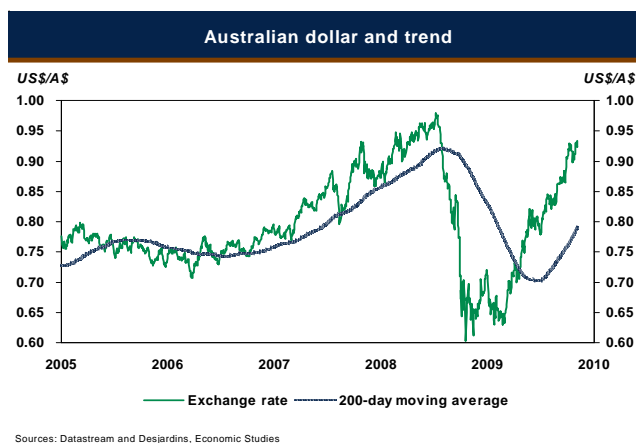


# AUSTRALIAN DOLLAR (AUD)

## Fundamentals continue to favour the aussie

- The Australian dollar retreated a few cents at the end of October after brushing the US\$0.93 mark; recently, however, it made back its losses, reaching a new cyclical peak of US\$0.9409 on November 16. The currency's rise is backed by a number of factors, including booming commodity prices, Australia's strong economy, the soft greenback and monetary firming initiated in Australia.
- However, market indicators signal that there is less and less room for the aussie to keep appreciating. Momentum and net speculative positions have been at levels that are consistent with a correction by the currency for several weeks now. The currency's many supports should still shield it from violent, permanent corrections.
- The economic and financial crises that shook the global economy did not hit Australia as hard. Unlike the other industrialized nations, Australia only saw its real GDP decline for one quarter. Its proximity to China and India, two countries in which growth accelerated recently, is an asset to Australia's economy. Its exports should surge on strong demand for natural resources from Asia and it will take additional investment to meet the demand.
- The Reserve Bank of Australia was the first central bank in an industrialized country to raise its interest rates. It has announced two 25 basis point increases since the beginning of October and the movement should continue. Australia's monetary authorities quickly about-faced when the more pessimistic scenarios that had been predicted did not materialize. Aside from foreign trade and investment, consumer spending is also progressing nicely, helped by rebounding consumer confidence as well as the Australian government's sizeable economic stimulus plan. What's more, Australia's inflation rate has not declined as much as it has elsewhere and the economy's quick recovery should fan price pressures. The Australian dollar's rise is still helping to contain inflation by reining in some activity sectors and cutting prices on imported products.

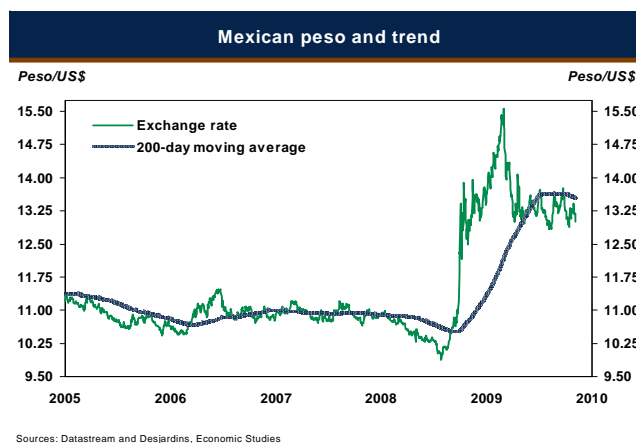
**Forecasts:** The Australian dollar's strength has solid underpinnings, but market indicators point to limited gains in the near term. The currency is also vulnerable to a resurgence in concern about the strength of the global economy's recovery, which would normally favour the U.S. dollar. The AUD/USD pair should consolidate close to current levels by year's end before making further substantial gains.



## MEXICAN PESO (MXN)

### Budget issues are a drag on the peso

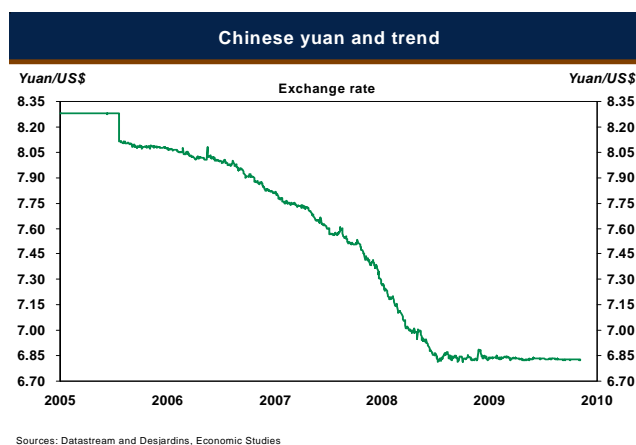
- The peso has been volatile in the last few weeks. After appreciating in early October, it shifted to a down trend until the beginning of November. The USD/MXN pair went from just under 13 pesos on October 19 to over 13.40 pesos on November 6, as the greenback regained some altitude and fears that Mexico's debt would be downgraded were magnified by the struggles the government faced in getting its budget passed. Subsequently, signs of an imminent agreement about the budget benefited the peso. It remains to be seen whether the credit rating agencies believe the Mexican government's efforts are ambitious enough.
- The Mexican economy seems to be recovering, but the pace of growth is very slow. The monthly indicator of Mexico's economic activity was below expectations in August, and industrial output only rose by 0.15% in September.
- The Bank of Mexico kept its key rate at 4.25% in October. Inflation remains high, but the down trend continues, as the annual rate went from 4.9% in September to 4.5% in October.



## CHINESE YUAN (CNY)

### The pressures on the yuan will intensify

- China's exchange rate continue to be held just over 6.8 yuan/US\$, but this could change in the next few months. China's economic pace accelerated again in the third quarter, going to an annual change of 8.9% from the second quarter's 7.9%, putting additional pressure on the currency.
- Chinese authorities justified taking a break in the yuan's appreciation with a desire to limit the collateral damage to the country's exporters as a result of the global recession. This argument has lost some credibility given the global economic recovery that has begun. In September, the annual change in Chinese exports remained negative at -15%, but this is still an improvement from previous months. Moreover, domestic demand is firming up. Among other things, sales of passenger vehicles exceeded one million units in September, a first for China. In addition to easing international pressure, the yuan's appreciation could be good for Chinese consumers by bolstering their buying power. This would also allow China to acquire a more independent monetary policy that would give it better control over its monetary growth and inflation.



**Table 1**  
**Currency market**

Country – Currency*	Spot price		Percentage return since				Last 52 weeks		
	Nov. 16		1 month	3 months	6 months	1 year	Higher	Average	Lower
<b>North America</b>									
Canada – dollar	1.0440		0.37	-4.43	-10.68	-14.63	1.3001	1.1641	1.0286
Canada – (CAD/USD)	0.9579		-0.36	4.63	11.96	17.14	0.9722	0.8590	0.7692
Mexico – peso	12.9970		-1.14	0.81	-1.61	-0.26	15.3835	13.5612	12.8078
<b>South America</b>									
Argentina – peso	3.8138		-0.20	-0.70	2.28	15.11	3.8545	3.6782	3.3130
Brazil – real	1.7117		-0.13	-6.68	-17.42	-24.81	2.5935	2.0783	1.6990
<b>Asia</b>									
China – yuan renminbi	6.8270		0.00	-0.11	0.01	0.01	6.8860	6.8340	6.8225
Hong Kong – dollar	7.7501		0.00	-0.01	-0.01	0.00	7.7599	7.7516	7.7498
India – rupee	46.0050		-0.48	-4.55	-6.70	-5.80	51.9835	48.6023	45.9750
Japan – yen	89.13		-1.94	-6.11	-6.39	-8.18	101.07	94.00	87.36
South Korea – won	1,154.90		-0.78	-6.80	-8.10	-17.50	1,570.65	1,305.58	1,154.90
<b>Europe</b>									
Denmark – krona	4.9690		-0.51	-5.18	-9.89	-15.61	5.9827	5.4247	4.9536
Euro zone – (EUR/USD)	1.4978		0.69	5.22	10.18	18.14	1.5018	1.3760	1.2510
Norway – kroner	5.5580		-0.93	-8.60	-14.87	-19.72	7.2360	6.4506	5.5325
Russia – ruble	28.6555		-2.69	-9.49	-10.61	4.62	36.3638	31.5054	27.3142
Sweden – krona	6.7979		-2.24	-5.51	-14.10	-14.64	9.3156	7.7656	6.7831
Switzerland – swiss franc	1.0073		-1.24	-5.98	-8.83	-15.51	1.2247	1.1029	1.0065
United Kingdom – (GBP/USD)	1.6773		2.61	1.46	9.93	13.13	1.6965	1.5477	1.3669
<b>South Pacific</b>									
Australia – (AUD/USD)	0.9369		2.23	12.53	25.07	45.00	0.9369	0.7512	0.6113
New Zealand – (NZD/USD)	0.7485		0.97	10.38	27.93	35.28	0.7589	0.6063	0.4924

\* In comparison with the U.S. dollar, unless otherwise indicated.

Note: Currency table base on previous day closure.

**Table 2**  
**Currency market: history and forecasts**

End of period	2008		2009				2010			
	Q3	Q4	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
<b>American dollar</b>										
Canadian dollar (USD/CAD)	1.0630	1.2189	1.2630	1.1628	1.0692	1.0417	1.0417	1.0204	1.0000	1.0000
Euro (EUR/USD)	1.4047	1.3901	1.3277	1.4027	1.4617	1.5200	1.5500	1.4800	1.4200	1.3800
British pound (GBP/USD)	1.7825	1.4378	1.4334	1.6469	1.5994	1.6500	1.6500	1.6500	1.7000	1.7000
Yen (USD/JPY)	106.00	90.74	98.91	96.33	89.77	95.00	100.00	100.00	100.00	103.00
Australian dollar (AUD/USD)	0.7700	0.6500	0.6910	0.8000	0.8500	0.9400	0.9600	0.9700	0.9500	0.9200
Mexican peso (USD/MXN)	10.80	12.50	14.17	12.00	13.10	12.50	11.75	11.00	11.00	11.00
Chinese yuan (USD/CNY)	6.82	6.82	6.83	6.82	6.82	6.80	6.70	6.60	6.50	6.40
Effective dollar* (73 = 100)	76.13	79.41	83.23	77.70	74.31	72.00	72.00	74.00	77.00	78.00
<b>Canadian dollar</b>										
American dollar (CAD/USD)	0.9407	0.8204	0.7918	0.8600	0.9353	0.9600	0.9600	0.9800	1.0000	1.0000
Euro (EUR/CAD)	1.4931	1.6943	1.6769	1.6309	1.5628	1.5833	1.6146	1.5102	1.4200	1.3800
British pound (GBP/CAD)	1.8947	1.7525	1.8103	1.9149	1.7100	1.7188	1.7188	1.6837	1.7000	1.7000
Yen (CAD/JPY)	99.71	74.44	78.31	82.85	83.96	91.20	96.00	98.00	100.00	103.00
Australian dollar (AUD/CAD)	0.8185	0.7923	0.8727	0.9302	0.9088	0.9792	1.0000	0.9898	0.9500	0.9200
Mexican peso (CAD/MXN)	10.16	10.26	11.22	10.32	12.25	12.00	11.28	10.78	11.00	11.00
Chinese yuan (CAD/CNY)	6.42	5.60	5.41	5.87	6.38	6.53	6.43	6.47	6.50	6.40

f: forecasts; \* Trade-weighted against major U.S. partners.

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