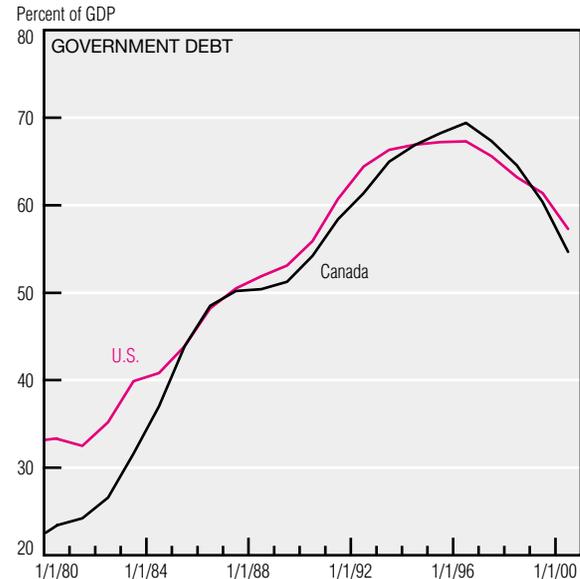
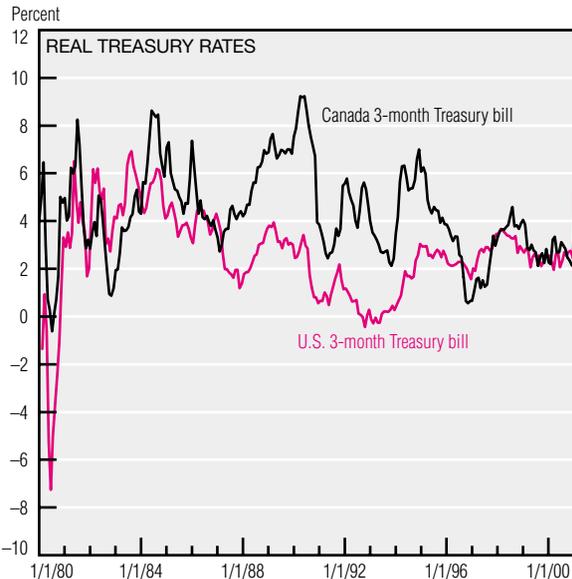
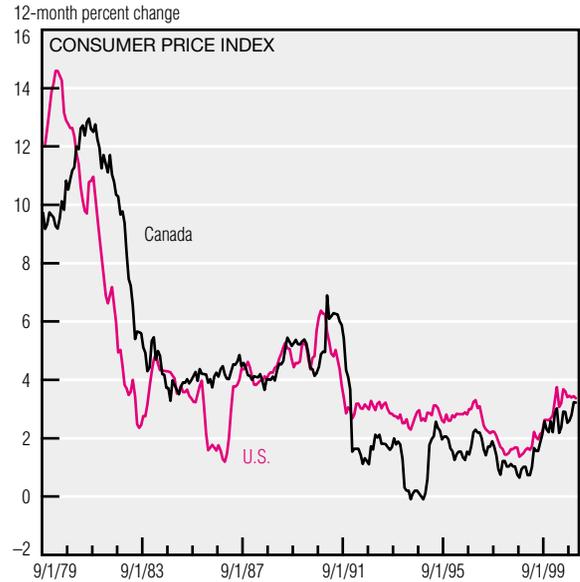
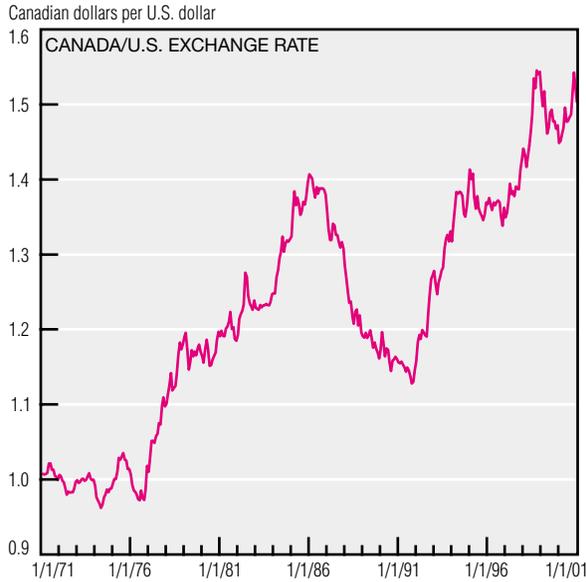


## The Canada/U.S. Exchange Rate



SOURCES: U.S. Department of Commerce, Bureau of Labor Statistics and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; International Monetary Fund, International Financial Statistics; Bank of Canada; and Statistics Canada.

Before 1976, the exchange rate between the U.S. and Canadian dollar was typically not far from one. The U.S. dollar appreciated significantly against Canada's in 1976–85 and again between 1991 and the present. The reasons behind these appreciations, especially the present one, are a puzzle.

Currencies may appreciate or depreciate relative to one another for several reasons. If one country's inflation rate is higher than another's, then one might expect the currency of the higher-inflation country to depreciate because its real value is eroding faster. Although in-

flation rate differentials may explain the initial run-up in the exchange rate, they do a poor job of explaining the run-up after 1991—Canada's inflation rate has been consistently *lower* than that of the U.S. during this period.

If one country's real interest rate is lower than another's, the currency associated with the lower rate would be expected to depreciate. Real interest rate differentials in Canada and the U.S., measured by real Treasury bill rate differentials, cannot explain exchange rate movements. Canada's real interest rate was *higher* than the U.S.'s in 1984–86 and

from 1991 to the mid-1990s, periods when the exchange rate appreciated.

A country with consistently higher government deficits than another may experience a currency depreciation, possibly because of fear that it will pay off its debt by the inflationary method of simply printing money. As a percent of GDP, federal government debt in Canada has closely tracked that of the U.S. for the past 15 years. Hence, levels of federal debt, like inflation and real interest rate differentials, fail to explain Canada/U.S. exchange rate movements after 1991.