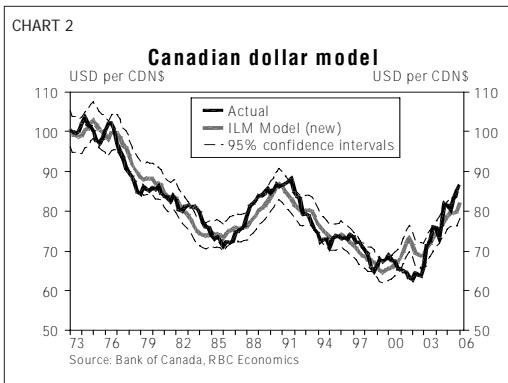
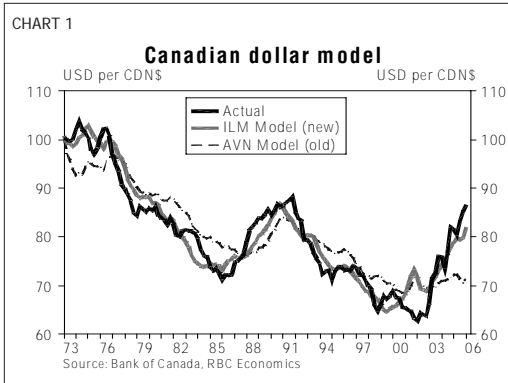


CANADIAN DOLLAR'S STRENGTH BASED ON FUNDAMENTALS

August 10, 2006



Researchers at the Bank of Canada unveiled an update to the model for the Canadian dollar in late May. The new model named the ILM equation is deemed to more accurately account for the impact of energy prices on the currency. The analysis shows that a structural break took place in the third quarter of 1993 at which point higher energy prices switched from being a negative to a positive factor for the currency. The change occurred as regulatory and trade agreements supported an increase in Canadian net trade in energy products.

Chart 1 shows that the updated model more accurately tracks the appreciation in the currency from 2003 to the present than the Bank of Canada's previous equation. Importantly, from a monetary policy point of view, the updated model indicates that almost all of the currency's most recent appreciation is backed by fundamental factors in contrast to the previous model, which did not adjust for the structural break in the impact of energy prices on the currency's movements and suggested that much of the currency's most recent rise was not backed by fundamental forces.

The models

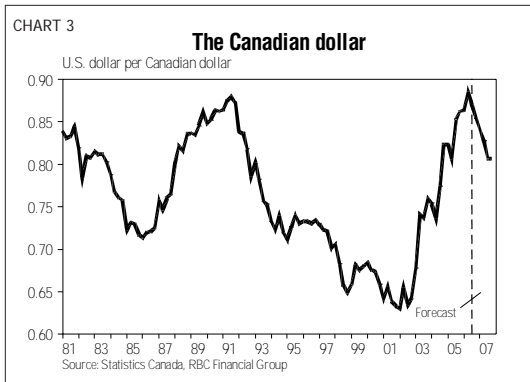
The models include energy and non-energy commodity prices and the spread between Canadian and U.S. interest rates to explain movements in the currency. Canadian exports of commodities, which made up about 35% of total exports in 2002, increased to about 42% in 2006, with rising exports of energy products accounting for about 63% of the rise.

It, therefore, makes sense that the sharp run-up in energy prices and the gradual increase in other commodity prices in the past four years boosted demand for the Canadian dollar, resulting in a dramatic increase in the value of the currency. Energy products made up 19% of total exports as of May 2006 with net trade in energy products making up close to 100% of the net trade balance.

We examined the period from the second quarter of 2003 to the first quarter of 2006 to compare the results of the two models because in early 2003 the currency was trading at levels consistent with the results of both the old and new models.

The dollar appreciated 21.9% during that period with the older equation showing only a 2.8% appreciation based on fundamental factors, while the updated model showed a 16.4% increase. And, even when the currency traded above the new model's predicted value, the exchange rate remained almost exclusively within the 95% confidence interval (see Chart 2).

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Policy implications

The demand-driven increase in the value of the Canadian dollar means that the currency is responding to a change in the terms of trade, meaning that no policy response is required to offset the impact of its appreciation in order to realign supply and demand. Recent comments from the central bank that the currency's appreciation was "mostly" based on fundamental factors raised concerns that policymakers would make policy decisions aimed at tempering speculative forces affecting trade in the Canadian dollar. The updated model for the currency should reduce these concerns.

Canadian dollar likely to weaken modestly

RBC Economics forecasts that energy prices will weaken in the second half of 2006, while non-energy commodity prices hold relatively stable and the short-term interest rate spreads between Canada and United States are little changed. Incorporating these forecasts into the Canadian dollar model shows a modest weakening in the currency by year-end. The results of the ILM equation show the currency trading at about 85.25 U.S. cents in the fourth quarter of this year based on RBC's forecasts for the model's parameters. This is in line with RBC's official 85.5 U.S. cent forecast for the Canadian dollar.

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