It is easy to accept on an intuitive level that the integration of capital markets and the increase in international capital flows have led to more exchange rate volatility. Yet, the causation is not that simple. It is difficult to separate the effects of the integration of capital markets from other events such as the shift from fixed to flexible exchange rates. Indeed, if one traces the causes of financial integration back to large current account imbalances or technological changes, for example, one could argue that it was those changes that caused exchange rates to be more volatile. It is important to keep in mind that financial integration did not take place in isolation. The same factors that caused capital markets to become more integrated caused exchange rates to become more volatile.

4.3.1 Short-term Fluctuations

The bubble theory of exchange rates attempts to explain how exchange rate movements can lead away from, rather than towards, an equilibrium based on real economic variables.[14] There is evidence to suggest that speculative bubbles have influenced the exchange value of the Canadian dollar.[15] Speculative bubbles are essentially a short-term phenomenon, but their impacts on firms involved in international trade should not be casually dismissed.

A Reduction in Trade

A primary concern of firms involved in international trade is the risk associated with uncertain exchange rates. An exporting firm whose revenues are in a foreign currency faces fixed costs -- assuming its inputs are domestically sourced -- and potentially variable revenues. The profit outlook for trading firms is, therefore, subject to an additional degree of uncertainty compared to firms active only in the domestic market.[16]

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[14] See R.G. Harris, *Trade, Money and Wealth in the Canadian Economy.* Toronto: C.D. Howe Benefactors Lecture, 1993, p. 34.

[15] See W. White, *op. cit.*, p. 18, and A.K. Rose, "Discussion," following S. van Norden, "Regime Switching and Exchange Rate Bubbles." In *The Exchange Rate and The Economy.* Ottawa: Bank of Canada. 1993, p. 323.

[16] That is not to say that firms servicing the domestic market do not face any exchange rate risk. It is difficult to imagine a large Canadian firm whose inputs have no foreign content. Exchange rate movements can alter the prices of foreign sourced inputs.