dollar, our import prices rise; an increase in the Canadian dollar results in cheaper imports.[26]

Harris found that the prices of Canadian exports, in Canadian dollars, are not sensitive to the Canada-U.S. exchange rate. Exporters base their prices on Canadian dollar costs and movements in the value of the currency are passed through to customers. If the Canadian dollar declines against the U.S. dollar, prices faced by U.S. importers of Canadian goods fall; if our currency rises, the price of Canadian exports rises. Harris cautions, however, that this contrasts with some other evidence on export pricing.

The upshot of Harris' work is that the Canadian trade balance responds to changes in the value of the Canadian dollar as economic theory would suggest. A decline in the value of the dollar improves the trade balance and a rise in the value of the dollar worsens the balance.

Trade Hysteresis

Trade hysteresis refers to a permanent change in trade patterns or volumes following a temporary change in the exchange rate. In other words, if the exchange rate climbs and then falls, and the trade balance responds to the climb but is not corrected by the fall, that is an incidence of trade hysteresis.

The standard J-curve explanation of the relationship between exchange rates and the trade balance is related to the concept of trade hysteresis. The J-curve theory says that, immediately following a currency devaluation, the trade balance worsens because the volumes of exports and imports respond slowly to relative price changes. For the new exchange rate equilibrium, imports are too high and exports too low. The term J-curve came about as a description of the shape of the time path of the trade balance, plotting time along the horizontal axis and the balance of trade along the vertical axis. In the J-curve analysis, the trade balance slowly responds to the new exchange rate; in the case of trade hysteresis, the balance responds to an initial exchange rate movement in one direction but does not respond, or at least not as quickly, to a subsequent reversal.

[26] Some of the response of import prices is due to the way in which they are calculated by Statistics Canada. In some cases, a U.S. price is taken and multiplied by the exchange rate to obtain a Canadian import price. Then, the pass-through of exchange rate changes is guaranteed.