

unanticipated results, at least in the short term.<sup>11</sup> It is equally possible to imagine situations in which the response of the exchange rate to a change in another economic variable, such as the interest rate, is not what is typically expected.<sup>12</sup>

In an open economy like Canada, one of the primary roles of the exchange rate is that of an automatic price adjustment mechanism to account for differences in domestic and foreign macroeconomic policies and conditions. As an adjustment mechanism, a change in the exchange rate can be preceded, for example, by a disequilibrium in the balance of payments. Short-term balance of payments disequilibria can be offset by an accumulation or a depletion of international reserves and/or international borrowing or lending. Neither solution can be extended indefinitely in the long term. For a long-term balance of payments disequilibrium, an exchange rate revaluation can eventually restore equilibrium.

The body of literature on the determinants of currency supply and demand, and ultimately exchange rates themselves, is enormous, but can be roughly divided into two groups: the economic fundamentals approach and the asset market approach. The balance of payments approach, as outlined above, is a fundamentals approach based on relationships between international flows (as they are recorded in the balance of payments) and exchange rates. The asset market approach discounts the role of international flows and considers the exchange rate to be an asset price that is determined in an efficient financial market -- the foreign exchange market. Like other asset prices, the exchange rate is determined by expectations about the future, and not necessarily by current trade or investment flows.

With neither approach lending itself easily or quickly to practical applications, analysts usually have little indication of the actual shapes or positions of currency supply and demand curves. Instead, one of the most widely used techniques for determining equilibrium exchange rates is the purchasing power parity (PPP) theory. In its most accepted form, the theory postulates that the change in the exchange rate between two countries over a period of time should be proportional to the relative

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<sup>11</sup> For example, the Japanese yen appreciated against the U.S. dollar in the mid 1980s, but Japanese exporters chose to accept lower profit margins rather than allow their U.S. market shares to decline. As a result, despite the appreciating yen, the Japanese trade surplus with the U.S. continued to grow.

<sup>12</sup> For example, in January 1995, the Canadian dollar depreciated against the U.S. dollar even though Canadian interest rates were rising.