

Analysis of Problems and Countermeasures in Canadian Foreign Exchange Market

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Abstract: The foreign exchange (forex) market of Canada plays an important role to the country's economic, as the price of commodities, speculative trading, and policies in the global economy impact it. Some challenges discussed in this paper are fluctuations in the Canadian dollar (CAD) value due to fluctuating oil prices, the impact of U.S./monetary policies, and other global policies by analyzing market data and trends. In order to counter such issues, the paper offers the following recommendations: adjusting the monetary policies of the Bank of Canada, diversifying the export products and markets in addition to commodities, and implementing some measures that may help to prevent speculation. Therefore, by using these strategies, Canada gets better market stability in the global market and minimizes the chances of being affected by external market forces. The paper concludes by emphasizing the importance of ongoing policy evaluation and the potential role of digital currencies in shaping future forex dynamics.

Keywords: Canadian forex market, CAD, Speculative trading, Monetary policy.

1. Introduction

The Canadian foreign exchange market, often referred to as the forex market, plays a vital role in both the Canadian economy and the global economy since it is the primary mechanism for trading the Canadian dollar against other global currencies. The evolution of the forex market in Canada started in 1935 with the formation of the Bank of Canada [1]. As international commerce expanded after World War II, Canada moved from the gold standard to a flexible exchange rate regime that would facilitate the movement of capital. Canada's forex market is a crucial component of Canada's financial infrastructure, as it is one of the most significant players in global economies. Today, the Canadian forex market is essential for managing currency risk, enabling international investments, and trade relations between Canada and other countries.

1.1. Importance of Foreign Exchange Market

The foreign exchange market plays a critical role in Canada's economy. Canada has long been a commodity-exporting nation, particularly in energy, metals, and agricultural products; therefore, fluctuations in its currency value affect trade competitiveness [2]. A stronger Canadian dollar increases the price of export goods, thus reducing their demand, while a weak CAD can boost exports by making commodities cheaper to Canadian buyers.

Furthermore, Canada and the United States have closely integrated their economies, with more than three-quarters of Canadian exports going to the United States market. Hence, the USD/CAD exchange rate is crucial in Canadian business, especially in manufacturing, natural resources, and services. For instance, Canada relies heavily on its commodities exports, particularly on crude oil; therefore, the CAD fluctuates whenever the world crude oil prices change.

1.2. Overview

The Canadian foreign exchange (forex) market is a vital structure of the country's financial infrastructure, and it plays an essential role in exchanging CAD and other currencies on a global scale. The market is decentralized since it has no central exchange and mainly comprises electronic trading platforms, interbank markets, and over the counter (OTC) trading [3]. The key participants are large commercial banks, central banks, multinational corporations, hedge funds, and retail traders. For large commercial banks, some of the most influential players in the forex market include the central Canadian banks like the Royal Bank of Canada (RBC), Toronto-Dominion Bank (T.D.), and Scotiabank [3]. These institutions transact large amounts of foreign exchange for their customers, including companies, persons, and states. Banks also trade to take advantage of changes in the price of currencies. Second, large Canadian multinational corporations, including Bombardier, Suncor Energy, and Shopify, engage in forex trading to hedge their risks. These firms may employ currency futures, options, and forwards to hedge the volatility risks in the exchange rates, especially when conducting business involving foreign currencies such as the USD or EUR. Hedge funds and speculative trader participants use various short-term trading tactics to profit from market price fluctuations [4]. They can provide forex market liquidity but are volatile, especially when there is a credit crunch or geopolitical instabilities. Lastly, in recent decades, the development of Internet trading platforms like OANDA, Interactive Brokers, and FOREX.com has facilitated the engagements of individual merchants in the forex business. Spot forex trading or CFD trading is more common for retail traders. However, their contribution to the value change of the forex market is relatively small compared to that of institutional investors. Since the forex market is decentralized, it is active 24/7 in different time zones; however, the major trading hubs are in London, New York, and Tokyo [5]. In Canada, Forex trading and transactions are made chiefly through electronic networks like Reuters, Bloomberg, and EBS and over-the-counter transactions through banks and similar financial institutions.

2. Critical Problems

2.1. Volatility of Canadian Dollar

One of the main factors affecting Canadian foreign exchange is the nature of the country's currency, CAD. Canada is a developed country that relies on its natural resources, particularly oil and gas [6]. Therefore, when the prices of the commodities are expressed in U.S. dollars, the CAD value changes, and there are consistent fluctuations in high volatility levels. Oil prices impact CAD because the need for exports rises when oil prices are high. On the other hand, declining oil prices weaken the CAD due to decreased export earnings [7]. This situation is particularly evident if considered in context with the USD/CAD exchange rate since the United States is Canada's most important trading partner.

For example, between 2014 and 2016, the global oil price dropped from over \$100 per barrel to below \$30 per barrel [8]. This drop in oil prices resulted in the devaluation of CAD, which initially was at 0.905 USD/CAD in mid-2014 and reached 0.7551 USD/CAD in January 2016. A deterioration of similar magnitude or even more affected Canadian exporting firms and domestic consumers who could import goods at a higher cost, thus increasing the inflation rate.

2.2. Impact of Global Economic Policies

The effects of global economic policies, especially those set by key trading partners like the USA, are another vital concern that affects the Canadian forex market. Decisions regarding the U.S. economy impact CAD first-hand extensively since Canada is the U.S.'s primary trading partner and a critical entity in the international currency system. For example, the various interest rate policies the U.S. Federal Reserve implemented directly influence the USD/CAD exchange rate. When the Federal Reserve raises the interest rate on its financial assets, the quantity demanded of the U.S. dollar increases, decreasing the value of the CAD [9]. However, when the interest rates in the United States are low, the CAD rises because the Canadian assets are relatively more appealing. This was evident in 2017-2018 when the Federal Reserve instituted consecutive hikes in the interest rate to work with the vigorous growth in the American economy and inflation [10]. Some experts have pointed out that while the U.S. dollar was appreciating, the Canadian dollar was depreciating, thus increasing the cost of imported goods for businesses and consumers in Canada.

Other conditions contributing to volatility in the forex market include Interest rate policies, Trade liberalization, Tariffs, and geopolitical conflicts. For instance, the recent reformation of the North American Free Trade Agreement (NAFTA) to the United States-Mexico-Canada Agreement (USMCA) market raised many uncertainties in the forex market, which made the CAD fluctuate, resulting in forex traders anticipating interruptions in trading [11]. Similarly, the US-imposed tariffs on Canadian steel and aluminum in 2018 also created a downward pressure on the CAD as markets anticipated retaliation measures and risks of economic losses from exports from Canada. Other factors related to the CAD are geo-political tensions like the trade war between the U.S. and China or the Russia-Ukraine war. During conflicts and political instabilities, people move their money towards safer currencies like the USD, leading to a decline in risk-oriented currencies like CAD.

2.3. Speculation and Market Manipulation

Speculative trading is another source of short-term fluctuations in the forex trade in Canada. Hedge funds and other high-frequency traders speculate on currency movements and use forex for profit rather than investing. Speculative trading is part of providing liquidity to the market; however, it is associated with increased volatility, especially during periods of uncertainty. Short-term traders are reactive to news events, economic data, and changes in market sentiment, which lead to CAD price volatility that Canadian actual economic conditions may not drive. For instance, during the COVID-19 outbreak, forex traders participated in high risk-taking as major global central banks like the Bank of Canada proceeded with emergency monetary policies through lower interest rates and large-scale quantitative easing [12]. Fluctuations in CAD were sharp due to mini adjustments forced by speculation in these policies, with traders overreacting to self-made economic shifts.

There have also been cases of market manipulation in global forex markets, which raise concerns about the legitimacy of currency trading. 2013-2014, several large banks were fined billions of dollars for conspiring to manipulate the F.X. market, including the USD/CAD rate, based on coordinated prices and rig bids. While such practices have been regulated since then, manipulation is likely the case, especially given the growing use of algorithms. Such speculation and occasional manipulation of the rates also cause short-term volatility when predicting future business and investment unit exchange rates. Such unfair trading practices imply a need for more corporate governance, regulation, and standardization in forex markets to prevent market instabilities.

3. Countermeasures

3.1. Monetary Policy Adjustments

One of the most direct and effective ways to address volatility in the Canadian foreign exchange market is through the Bank of Canada's monetary policy change. Given that the Bank of Canada is the leading authority in charge of the Canadian national currency, the CAD has various mechanisms for influencing this currency and meeting global economic challenges. Interest rate adjustments are one of the most effective ways of stabilizing the currency as they are the most common payment measures between Canada and other countries.

For example, when the Bank of Canada increases interest rates, Canadian assets are more inviting to foreign investors as the returns are higher. This brings demand for CAD and causes an appreciation of the currency in the foreign exchange market. On the other hand, by reducing the interest rates, the policy discourages investors from investing in Canadian assets, and consequently, CAD depreciates. Historical literature provides evidence that these adjustments can effectively reduce currency fluctuations. For instance, during 2017/2018, the U.S. Federal Reserve hiked its interest rates several times; in response, the Bank of Canada also embarked on rate hikes to prevent the depreciation of CAD [13]. This policy synchronization assisted in keeping the stability of the USD/CAD exchange rate during a period of global economic tightening.

Also, the Bank of Canada can directly affect the forex market by purchasing or selling CAD to regulate its value. While such direct intervention has yet to be implemented in the past decade, this policy is still relevant in extreme conditions that endanger the market's stability in the economy. A case of successful intervention can be illustrated with the instance that happened in the early 2000s when the Bank of Canada sold a large amount of CAD to make sure that it did not overvalue during the commodities price growth [14]. The intervention also helped to stabilize the Canadian dollar and shield exporters from the adverse effects of CAD overvaluation. However, while changes in interest rates and forex interventions make profits in the short run, they entail certain risks. Low interest rates, for instance, over a long period may lead to inflation while attempting to intervene in the market, which, in every instance, makes investors lose confidence in the currency. Hence, the freedom to change the monetary policy should only be done in a way that understands the trade-off between obtaining stability of the currency and stability of the general economy.

3.2. Diversification of Export Base

To stabilize the long-term value of the CAD, Canada must decrease its dependence on its natural resources and expand the list of export destinations for its goods [15]. Also, volatility in commodity prices, especially oil, plays out on CAD fluctuations, which deliver high and volatile volatility that is hard to maneuver through monetary policy. By diversifying the range of goods and services exported to foreign markets, Canada is adjusting to commodity price fluctuations and establishing a more favorable forex environment. The strategies adopted by other countries with resource-based economies, such as Australia and Norway, are helpful examples of how diversification can effectively manage forex volatilities. For instance, it has been a conscious effort to diversify from sectors including technology, education, and healthcare, thus transforming Australia from a mining-dependent economy. This has helped foster more stability in the Australian dollar (AUD) in the last decade because the synopsis is not so vulnerable to complaints of global prices [16]. Likewise, Norway has utilized its oil wealth to develop robust sovereign wealth fund assets and invest in renewable energy and other sectors, insulating the Norwegian krone (NOK) against the real impact of fluctuating oil prices.

In the case of Canada, diversification of exports would entail expanding on technology, manufacturing, and renewably sourced energy producers. Newer developments, including the focus on the manufacturing of electric cars and the growth of tech cities like Toronto and Vancouver, are examples of progress. Thirdly, Canada may strengthen its focus on diversifying its trading partners to include other regions where the demand is expected to emerge in the future, such as Asia and Latin America [17]. Expanding the base of exports in Canada can lead to a more diversified economy that is not so sensitive to the performance of the oil market and, hence, more stability of the CAD in the future.

3.3. Regulation of Speculative Trading

Economic uncertainty and speculation are a significant source of short-term price fluctuations in the forex market since traders frequently operate quickly to respond to business developments and report results. Thus, while speculation can offer liquidity to the market, it also poses a danger of large unexplained fluctuations in currency values that do not correspond to the underlying realities of the economies involved. Hence, restrictions on futures trading are among the measures aimed at preventing wild swings and aligning the CAD with more stable economic fundamentals.

The first strategy of controlling speculative trading entails tightening reporting and disclosure norms on large players as contemplated under the European Markets Infrastructure Regulation (EMIR). EMIR, which the European Union developed to address the issues of derivatives markets, requires all financial institutions to report all over the counter (OTC) derivative transactions to an overseeing authority [18]. This results in more market openness, allowing regulators to observe prominent speculative positions and identify instances of market manipulation or excessive risk-taking.

Canada could apply the same approach to enhance the regulation of speculative forex trading. This entails real-time reporting of positions and trades by major players like hedge funds and investment banks; this way, regulators can immediately discern the source of market instability and step in should the latter be perceived as a speculative activity that threatens economic stability. Besides, transaction taxes on short-term trades can be viewed as a measure to prevent speculation due to high frequency. Taxes like these have been named Tobin taxes and suggested in many countries to solve the problems stemming from frequent large trading that negatively affects currencies [19]. Even though adopting such regulatory measures may encounter resistance from specific segments of the financial industry, such as the H.F. traders, the gains associated with the diminishment of risk and enhancement of stability override its drawbacks. More rules and supervision would improve the situation on the forex market and make the CAD rate reflect Canada's economy's absolute position rather than speculative actions.

4. Conclusion

Canada heavily relies on the value of its currency to compete against other global currencies in the global arena. However, the Canadian foreign exchange (forex) market is sensitive to several macroeconomic factors. The vital macroeconomic factors affecting the Canadian foreign exchange market include fluctuations in the price of commodities, leading to a fluctuating exchange rate for the Canadian dollar, international policies, and speculation in foreign currency trading. Some measures have been suggested to solve these problems, including varying the monetary strategy, expanding the range of export products, and controlling excessive trading. Taking preventive measures to avoid risks that can impact the forex market for extensive periods is crucial. This implies that policies should be constantly monitored and reviewed to deal with such occurrences in the ever-changing global financial market.

Further research in this area should extend to the evolving role of digital currencies in forex markets and how such developing economic policies can reshape the trading dynamics. Future diversification in Canada's economy, especially in the energy and technology sector, will likely provide new paths for Canada to reduce its dependence on commodities, thus enabling better long-term currency stability and market growth.

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