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The Economic Consequences of a Lower Canadian Dollar

by Philip Cross

Main conclusions

- **The benefits of a lower exchange rate for the Canadian dollar are likely to be outweighed by the costs.**
- **Export volumes have shown little sensitivity to the exchange rate, with growth in foreign export markets their main determinant. Manufacturers benefit the least from the lower dollar, as they use the most imported inputs. Natural resource industries profit the most.**
- **Prices will rise for important sectors of consumer, business, and government spending in Canada. Energy is affected the most, where an integrated North American market sets one price in US dollars.**

About the author

Philip Cross worked for 36 years at Statistics Canada, the last few as its Chief Economic Analyst. He wrote Statistics Canada's monthly assessment of the economy for years, as well as many feature articles for the *Canadian Economic Observer*. After leaving Statistics Canada, he has worked as a contract researcher for a variety of organizations. He has been widely quoted over the years, and now writes a bi-weekly column for the *National Post* and other papers.

Introduction

After hovering around parity with the US dollar for three years, Canada's exchange rate fell sharply in 2013, ending the year near 90 cents (US). Initially, the lower dollar was greeted with relief, especially for our manufacturing exporters. But as the dollar continued to slide, people became more conscious of the costs to the domestic economy of a lower exchange rate. This commentary looks at why the benefits of a weaker loonie are likely to be small compared with its costs.

Higher prices for many

Our lower exchange rate automatically raises the Canadian price for goods where an integrated North American market sets one price in US dollars—mostly gasoline and some home heating fuels. The lower Canadian dollar already has opened up a gap between the price for these goods in the US and in Canada. In January 2014, for example, the price of gasoline in the US edged up 0.1% from January 2013, while in Canada it was up 4.6%.

Prices for some other products are sensitive to the exchange rate. The cost of fresh fruit and vegetables, mostly imported during our winter months, was up an average of 4.1% in Canada from a year earlier, compared with a slight decline in the US. Other consumer goods where prices will rise include those that consume a significant amount of energy, such as air travel.

Of course, cross-border shoppers face large price increases, since they automatically have to pay more to buy the US dollars to shop in the US. The same increase will face Internet shoppers buying products priced in US dollars. These price increases will not show up in the Consumer Price Index, however, which only measures prices inside of Canada's borders.

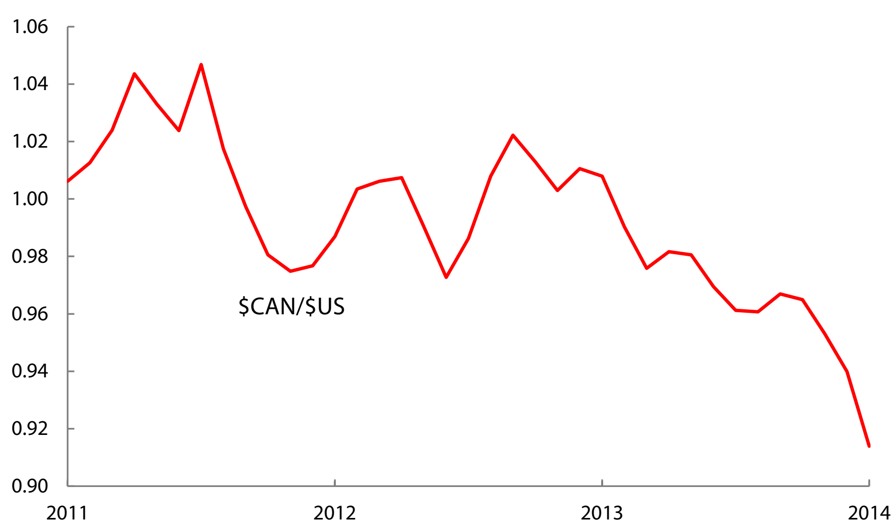
It is not only consumers who will pay higher prices. Business firms import 55% of their machinery and equipment, the type of investment most likely to propel productivity growth. Faced with higher prices, firms will trim their outlays for machinery and equipment, which ultimately will depress productivity and workers' future wages. Meanwhile, governments not only will have to pay more for their machinery and equipment, but will also feel an increased burden from that portion of their debt that is denominated in US dollars. This is particularly the case for provincial governments and their wholly- owned entities such as utilities, which issued large amounts of bonds denominated in non-Canadian currencies.

Outside of these particular products, however, many prices are determined by factors other than the exchange rate. A Statistics Canada study, for example, found that the long-run trend to lower prices for many durable and semi-durable goods is evident in North America and most major nations in Europe over the past decade, despite marked changes in their exchange rates (Baldwin and Macdonald, 2013). This suggests broad global factors, such as technological change that lowered the price of computer and electronic products, and the large shift to China supplying low-cost goods such as clothing, has swamped exchange rate effects.

Limited benefit for exporters

The benefits of a lower exchange rate go primarily to exporters. Firms that earn US dollars from exports will profit from a lower exchange rate, as these US dollars buy more Canadian dollars when

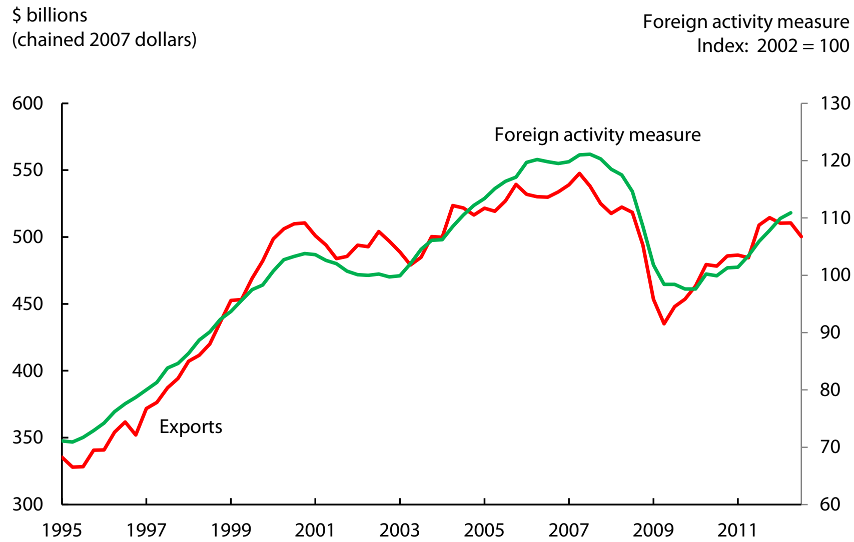
Figure 1: Canadian exchange rate



Source: Statistics Canada, Cansim Table 176-0064.

they are repatriated. But even here, the benefits are likely to be limited, since the volume of exports shows little sensitivity to the exchange rate. As shown in figure 2, the volume of Canada's exports is largely determined by the trend and composition of demand in our major export markets, as summarized by the Bank of Canada's Foreign Activity Measure. The course of exports in the 1990s was largely what would have been predicted based on demand in export markets, receiving little obvious boost from the lower loonie. Similarly, exports after 2002 were almost exactly what the Bank of Canada's Foreign Activity Measure would have predicted, despite the rising loonie.

Figure 2: Volume of exports and the foreign activity measure



Source: Statistics Canada, Cansim Table 380-0004 and the Bank of Canada.

Meanwhile, the stimulus of a lower dollar to exports is likely to be greatest for natural resources, which need it the least, and lowest for manufacturing, which needs it the most. This reflects how manufacturers adapted to the higher dollar over the past decade. When the dollar was near parity with the US greenback, firms hedged their exposure to the high dollar by reducing their reliance on exports and increasing their use of imported inputs. This "natural hedge" reduced the net exposure of manufacturing firms to exchange rate fluctuations by almost ten percentage points in the past decade. Before the dollar began to rise, manufacturers had a maximum net exposure of 27 points to exchange rate fluctuations, as measured by the difference between their exports as a share of output and their imported inputs as a share of output. By 2008, this net exposure had fallen to 18 points. This was the result of firms shifting their focus from export markets to the booming domestic economy, especially for investment goods where resource projects proliferated, while simultaneously increasing their use of imported inputs (Cross, 2013: 8). It is unlikely that firms will reverse these strategies unless they are convinced the exchange rate will stay low for an extended period of time.

Meanwhile, resource industries stand to benefit the most from the lower exchange rate. Oil and gas has the largest net exposure to exchange rate fluctuations, with a gap of 65 points between its share of exports in output and imported inputs. This industry will welcome the boost to profits from the lower dollar, but hardly needs it in the current environment of rising prices for its output. Prices for natural gas hit a 5-year high of over $6 per million British thermal units in February 2014 thanks to the series of cold snaps in the Eastern US. The price of Canadian crude oil, as measured by Western Canadian Select, has soared from $50 a barrel in early November 2013 to almost $80, reflecting the start-up of BP PLC's repurposed heavy oil refinery in Whiting, Indiana, and higher demand for home heating oil (Cattaneo, February 14, 2014). Prices for forestry products have recovered as US housing starts regained the million unit mark, while prices for agricultural products remain attractive. Metals producers are most in need of a lower exchange rate to boost depleted earnings.

Besides small pockets of exporters, the other major beneficiary of a lower exchange rate is Canadians who are invested abroad and who pocket more Canadian dollars when they repatriate these investments. This is a dubious benefit for the Canadian economy. It rewards people for not investing in Canada, at the cost of lowering the value of all assets in Canada. The losses foreigners will feel on these investments will make Canada a less attractive place to invest in the future, while encouraging Canadians to invest more abroad.

The myth that devaluation leads to prosperity

The myth that a low exchange rate encourages economic growth took hold in Canada in the aftermath of the 1990-1991 recession. Over the rest of that decade, Canada's manufacturing growth was led by low-wage industries such as clothing, textiles, and furniture, where employment rose 29.7% from 1992 to 2000. The flimsy basis for this allocation of resources was fully revealed after 2002, when a rising dollar and China's entry into the WTO devastated output and employment in these industries. In retrospect, one can only look back with wonder and astonishment that governments and firms in Canada thought our future lay in investing in low-wage industries predicated on a chronically low exchange rate. Even the surge in output during the 1990s in autos and high tech firms, notably at Nortel and JDS Uniphase, was partly a figment of a low exchange rate, which enabled these exporters to reap export earnings in US dollars while paying their Canadian workers the equivalent of 63-cent US dollars. It was a business model doomed to fail when the exchange rate started to soar late in 2002.

One of the reasons for the myth in Canada that devaluation leads to prosperity is a flaw in the models of the macroeconomy. Large econometric models such as that from the University of Toronto invariably interpret devaluation as stimulating the economy, and appreciation as a menace to growth. The U of T model, for example, regularly warned that the rising loonie in 2003 and 2004 could trigger a recession. Instead, Canada's GDP growth clocked in at a steady 3%. The fundamental problem is that these models predict an adverse impact from a rising exchange rate on exports, but struggle to identify the subtle and indirect benefits of lower prices and interest rates. The reverse is now happening; the models predict that a lower dollar will give a boost to exports earnings, but they largely miss the costs of higher domestic prices and financing costs of debt denominated in US dollars.

Conclusion

The benefits of the lower exchange rate for the Canadian dollar are likely to be outweighed by the costs. The benefit to manufacturers will be limited, since they have successfully adopted strategies to cope with the higher dollar over the past decade. Natural resources are positioned to profit more from the lower dollar than manufacturing, when most resource industries already are enjoying buoyant conditions. Meanwhile, the lower dollar will boost some prices for consumers and businesses, and raise the financing costs of borrowers abroad.

It is not clear if the dollar will continue to depreciate, having dipped below 90 cents (US) late in February. Like most exchange rate movements, the reasons behind the slide of the Canadian dollar in 2013 are not well understood (Steve Poloz, then with the EDC, forecast late in 2006 that the dollar would fall to near 80 cents in a year; instead it shot past parity). One of the few benefits of the lower loonie is to discredit the idea that our exchange rate had become a "petro-currency," since oil prices on world markets were steady for most of the year as the dollar slid, while the price for Western Canadian Select actually rose sharply at year end when the glut of bitumen in the mid-Western US shrank. Without a link between energy prices and the exchange rate, the acrimonious and misleading debate about Canada's manufacturing sector suffering from "Dutch Disease" becomes moot.

Notes

1 By comparison, total manufacturing employment rose 23.8% between 1992 and 2000. Source: Statistics Canada Cansim Table 281-0005, *Survey of Employment, Payroll and Hours*.

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