IN BRIEF

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How Will the Rising Canadian Dollar Affect Economic Growth?

The robust appreciation of the Canadian dollar (relative to the U.S. dollar) through 2003 has led many to anticipate a slowdown in the Canadian economy. Because our economy is heavily dependent on trade, most of which takes place with the United States, such a dramatic increase in the Canada-U.S. exchange rate will inevitably affect economic growth.

There is a tendency in Canada, however, to focus solely on the negative aspects of a higher Canadian dollar. While certain industries will certainly be hurt by the currency appreciation, other sectors of the Canadian economy will undoubtedly benefit, providing at least a partial offset to the downside of a higher dollar.

THE EFFECT OF A HIGHER DOLLAR ON TRADE

In general, a higher Canada-U.S. exchange rate has a negative effect on Canadian exporters. As the Canadian dollar becomes more valuable, the cost to Americans of buying Canadian products increases, resulting in lower Canadian exports. Alternatively, Canadian companies could keep their U.S.-dollar prices constant to retain market share. However, since they would receive fewer Canadian dollars per U.S. dollar, total revenues, and thus total profits, would fall.

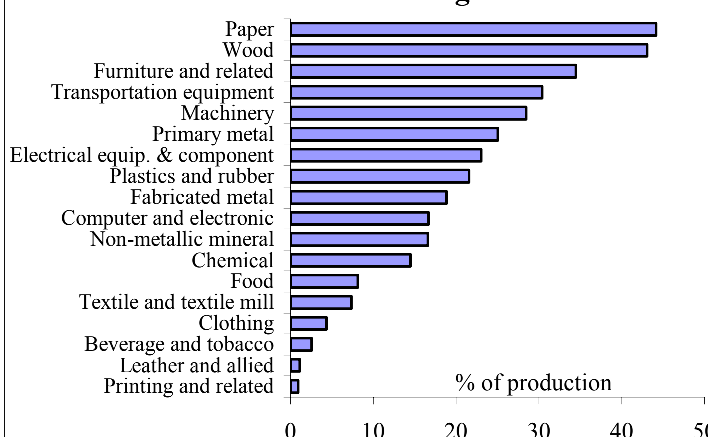
At the same time, many Canadian companies that may not export, but do compete in the domestic market against U.S. products, will have a more difficult time doing so as a higher exchange rate lowers the relative cost of foreign goods.

Nonetheless, the higher Canadian dollar is not all bad news for Canadian industries. Not only do import-dependent firms benefit from lower costs, but so do an increasing number of exporters. As economies around the world become more integrated, a growing proportion of exports are composed of imported materials. On average, Canadian exports today contain approximately 40% imported content. A higher dollar lowers the cost of these imported components, thus partially offsetting the effect on export prices. Furthermore, a large proportion – up to 80% – of the machinery and equipment used in the production process in Canada is imported. A higher dollar thus lowers the cost of capital investment as well.

IMPACT ON SPECIFIC SECTORS OF THE ECONOMY

The overall impact of a higher dollar on Canadian industries depends on two factors: their dependence on the export market, and the proportion of total output that is composed of imported materials.

Figure 1 – Net Export Reliance of Canadian Manufacturing Industries



Source: TD Economics.

As shown in Figure 1, forest products and related industries – wood, paper and furniture – are the manufacturing industries most susceptible to the higher exchange rate. These industries display both a high export orientation and low import content. The transportation equipment industry is also among the most affected by a higher Canadian dollar. There, a heavy dependence on exports is partially offset by a high import content. At the other end of the spectrum, the food and beverage, clothing and textiles, and printing industries are among those in the manufacturing sector least affected by the higher exchange rate.

However, Canada's trade with the United States is not composed solely of goods; it has a strong service sector component as well. In fact, the impact of a higher dollar may be more dramatic for service exporters, because service industries tend to have higher Canadian content than manufacturing industries. In particular, tourism will likely be among the hardest-hit by the rising exchange rate. Not only does a high dollar makes it more expensive for international visitors to come to Canada, but tourism has little to gain from lower input prices.

While export-oriented service industries may suffer, a number of Canadian service industries oriented toward the domestic market will benefit from a higher Canadian dollar. Education, finance, insurance and real estate services all have high investment rates and capital stocks. Since computers, software and other machinery and equipment are manufactured abroad, a high dollar lowers the cost of purchasing those goods.

THE EFFECT OF A HIGHER DOLLAR ON CONSUMERS

For producers, the net effect of a higher dollar is negative. For consumers, however, an increase in the value of the dollar is an unambiguously positive development. A higher dollar lowers the prices of imported goods while leaving the prices of domestic products unchanged. In essence, therefore, it, acts as an implicit wage hike, giving consumers more money to spend elsewhere in the economy.

OTHER FACTORS AFFECTING THE CANADIAN ECONOMY

Although a higher Canadian dollar benefits importers and consumers, and lowers the cost of investment in machinery and equipment, most economists expected it to have a negative effect on the Canadian economy. Indeed, export, employment and gross domestic product (GDP) growth are all weaker through the first three quarters of 2003.

Despite these trends, the rise in the Canadian dollar is expected to have less effect on the Canadian economy than previous currency appreciations, for a number of reasons:

- many Canadian firms have hedged their foreign currency positions to guard against exchange-rate fluctuations;
- the import content of Canadian exports has grown;
- more and more Canadian firms are borrowing in U.S. dollars, acting as an offset to the rising dollar because the cost of their loans has been reduced; and
- increasing numbers of Canadian firms have U.S. operations that are generating U.S.-dollar revenues. Exchange rate fluctuations have little short-term effect on intra-firm trade.

In addition, two other factors could boost economic prospects in Canada. The first is that world commodity prices have strengthened in 2003, helping compensate for the effect of a higher dollar on many resource-based industries. In fact, in some cases the benefit derived from higher commodity prices is far greater than the negative effect of a higher Canadian dollar.

Second, and most important, there is increasing evidence of a strong economic recovery in the United States. Although U.S. labour markets remain weak, preliminary estimates indicate that the economy as a whole grew by a remarkable annualized rate of 8.2% in the third quarter of 2003. A spirited expansion of the U.S. economy should generate additional demand for Canadian exports, and therefore stimulate positive economic growth. Some experts, in fact, suggest that such a development could dwarf the effects of the currency rise on Canada's trade performance.

CONCLUSION

All told, while some Canadian industries will be adversely affected by a higher dollar, the effect on the Canadian economy as a whole is far from unequivocally negative. Several aspects of the domestic economy will, in fact, benefit from a stronger exchange rate. Furthermore, when factors such as the apparent U.S. recovery are considered, the present slowing of the Canadian economy may prove to be only a brief hiccough before stronger growth resumes.