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# THE EFFECTS OF A HIGHER DOLLAR ON THE CANADIAN ECONOMY

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**19 January 2004**

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# TABLE OF CONTENTS

**Page**

INTRODUCTION .......... 1

THE RISING DOLLAR'S IMPACT ON THE CANADIAN ECONOMY .......... 2

A. General Impact on Trade .......... 2

B. Impacts on Specific Sectors of the Economy .......... 4
1. Manufacturing .......... 4
2. Services .......... 6
3. Consumers .......... 7

C. Impact on Inflation and Monetary Policy .......... 7

D. Overall Impact .......... 8

THE RISING DOLLAR IN CONTEXT: CANADA'S NEAR-TERM GROWTH PROSPECTS .......... 10

CANADA

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# THE EFFECTS OF A HIGHER DOLLAR ON THE CANADIAN ECONOMY

## INTRODUCTION

In 2003, the Canadian dollar experienced one of the most rapid periods of appreciation vis-à-vis the U.S. dollar in its modern history. From January through December, the dollar rose from 63.6 cents U.S. to 77.1 cents U.S. – an increase of over 20%. While economists hold different views on how high the dollar will continue to climb, they are widely agreed on one thing: the increase is not a temporary phenomenon. Canadians should not expect a return in the near future to a dollar that is below 70 cents U.S.

The size and speed of the Canadian dollar's appreciation have been a considerable shock to the Canadian economy. Many believe that a higher dollar is unambiguously bad news for economic activity in Canada. Nonetheless, there are numerous benefits to a higher dollar that make the net effect of the higher exchange rate on the Canadian economy far less bleak.

In October 2003, the Standing Senate Committee on Foreign Affairs undertook a study of the factors behind the rising Canadian dollar and the likely effects on the Canadian economy. The Committee's report, *The Rising Canadian Dollar: Explanations and Impacts*, was tabled in the Senate on 6 November 2003.(1)

This paper considers the effects that this rapid currency appreciation could have on Canada's economy. It is the second in a two-part series drawing on the Senate Committee's report and the testimony it received. The first in the series, *Explaining the Rise in the Canadian Dollar*,(2) examined the various economic factors that contributed to the dollar's rise in 2003.

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(1) This report was drafted by Peter Berg and Michael Holden of the Economics Division, Parliamentary Research Branch, Library of Parliament.

(2) Michael Holden, *Explaining the Rise in the Canadian Dollar*, PRB 03-26E, Parliamentary Research Branch, Library of Parliament, Ottawa, 19 January 2004.

The following section explores the effects of a higher dollar on various aspects of the Canadian economy, with particular emphasis on manufacturing and other trade-dependent industries. The final section examines the context in which the currency appreciation has taken place, and considers whether or not Canadians should anticipate slower economic growth as a result of a higher dollar.

## THE RISING DOLLAR'S IMPACT ON THE CANADIAN ECONOMY

### A. General Impact on Trade

The most widely understood, and perhaps most significant, effect of a higher Canadian dollar is its impact on exports, particularly to the United States. In general, a rising exchange rate has negative consequences for Canadian exporters, because it makes Canadian products less competitive and erodes exporters' profit margins. However, the nature of those consequences is affected by whether exports are priced in Canadian or U.S. dollars.

Typically, economic theory assumes that exports are priced in the currency of the country of origin. In such cases, a rise in the Canada-U.S. exchange rate makes Canadian products comparatively more expensive for U.S. consumers to buy. In response, Canadian exporters usually either curtail production or seek other export markets. Alternatively, they could seek to remain competitive in the short term by adjusting their prices to keep them stable in U.S.-dollar terms, thus absorbing the effects of the exchange rate on their profit margins.

In many cases, however, prices for Canadian exports, most notably commodities, automotive and electronic products, are set on international markets in U.S. dollars. In these situations, the rise in the exchange rate would not alter the selling prices in the United States. What would change is the price the exporter in Canada receives when converting U.S.-dollar export revenues back into domestic currency at the higher exchange rate. Since the exporter receives fewer Canadian dollars per U.S. dollar, a higher Canadian currency will lower revenues and erode profit margins.

While a stronger Canadian dollar makes it more difficult to be competitive and profitable when exporting into the U.S. market, it offers a considerable benefit on the import side. As the exchange rate rises, imported products become comparatively cheaper for Canadians to buy. For many producers, lower import prices also act as a partial offset to higher export prices. 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% in imported content. A higher Canadian dollar will thus lower the price of the imported components of exports, muting the adverse effect of the currency appreciation on export prices.

Canadian industries also benefit from the fact that many capital goods used in the production process are imported. In particular, about 80% of the machinery and equipment used by Canadian manufacturing firms is imported, primarily from the United States. Since a higher Canadian dollar lowers the cost of those imports, it makes capital investment more attractive, opening the door to potential productivity gains in the Canadian economy.

Overall, however, a higher Canadian dollar will tend to reduce the short-term competitiveness of Canadian products in the U.S. market and to erode the profitability of Canada's exporting firms. Indeed, this effect is beginning to appear in Canada's trade statistics. Preliminary data indicate that in 2003, Canada's exports to the United States fell by 5.1% compared to the previous year. At the same time, Canada's exports elsewhere in the world have continued to grow: preliminary figures show that exports to countries other than the United States were 4.0% higher in 2003.(3)

The increase in exports to non-U.S. destinations demonstrates one of the benefits of a higher Canada-U.S. exchange rate. Although the Canadian dollar has appreciated considerably relative to the U.S. dollar, it has not made significant gains against many other major world currencies such as the euro, yen and British pound. As a result, while the price of Canadian products is higher in the U.S. market, those products remain competitive in other world markets.(4) In other words, the higher Canada-U.S. exchange rate makes it comparatively more

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(3) It is important to note, however, that the higher Canadian dollar is not the only factor affecting Canada's exports to the United States. The ongoing softwood lumber dispute, the partial ban on imports of Canadian beef and a relatively weak U.S. economy during the first half of 2003 have all influenced export growth.

(4) The exceptions are countries that have adopted the U.S. dollar or where the domestic currency is pegged to the U.S. dollar. Examples include China, Argentina and some countries in Central America.

attractive to seek out alternative export markets. Over time, this could help diversify Canada's trade and reduce its dependence on the United States as an export destination.

## B. Impacts on Specific Sectors of the Economy

### 1. Manufacturing

The surging Canadian dollar represents a significant shock to export-oriented and import-competing industries – particularly in manufacturing, which is the sector most reliant on the export market. The extent of the impact, however, varies considerably from one industry to the next. Specifically, two factors determine that extent. The first, and most obvious, is export reliance – the amount of total production that is destined for the export market.

Recent analysis indicates that five industries routinely export at least half of their production: transportation equipment, forest products, computers and electronics, machinery, and electrical equipment and components.(5) These same five industries account for nearly two-thirds of Canada's total manufacturing sector output. Because of the integrated nature of the automobile industry in North America, transportation equipment is by far the most export-oriented Canadian industry. A full 73% of production in that sector is exported. Manufacturing industries that are not especially reliant on exports include food, beverage and tobacco; clothing and related products; printing; and certain metal and mineral industries.

However, to focus solely on industries' export reliance overlooks the fact that many industries use imported inputs in the production process. As noted above, Canada imports as much as 80% of its machinery and equipment, and the declining cost of these imports will help capital-intensive companies deal with the currency shock. The larger the proportion of imported content used by an industry, the less it will be affected by a rising dollar.

As it turns out, the transportation equipment industry that is so export-dependent also displays the highest ratio of imports to total production. Other sectors displaying high levels of import content include computers and electronics, textile and textile mills, clothing and leather production.(6)

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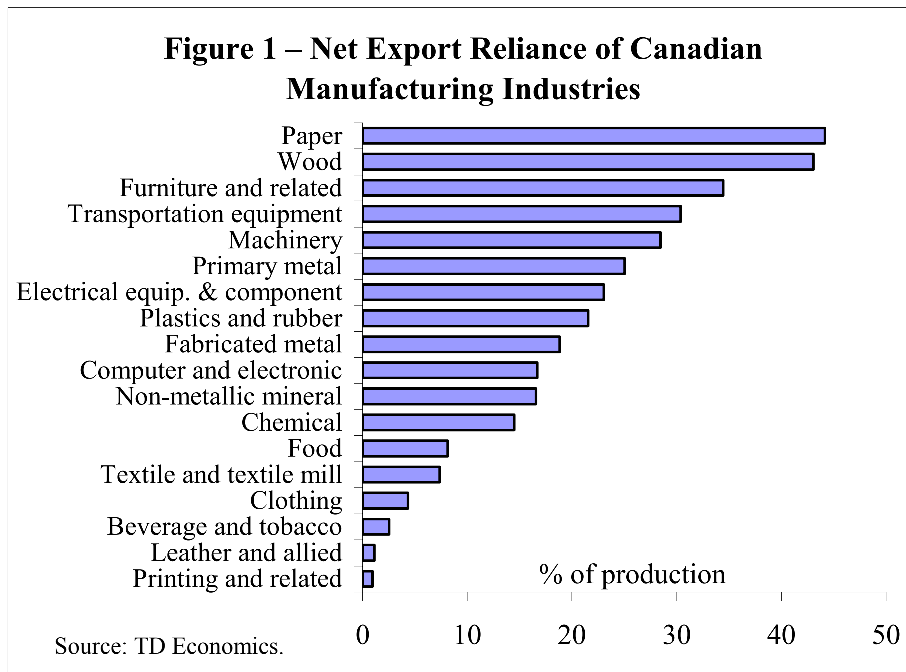
(5) "This Year's Canadian Dollar Rally Will Hit Exporters Hard," *TD Economics Topic Paper*, TD Bank Financial Group, 24 July 2003, p. 2 (available at http://www.td.com/economics).

(6) *Ibid.*, p. 3.

In contrast, industries with relatively low foreign content in their exports typically suffer most from a rise in the value of the Canadian dollar, because their low use of imported parts and components does not enable them to profit from the suddenly cheaper cost of imports. Examples include the wood and paper industries, food, beverage and tobacco industries and non-metallic minerals.[7]




In assessing which industries would be most affected by a higher dollar, it is necessary to combine the effects of export dependence and import content. This calculation produces an estimate of the net export reliance of each industry – a more accurate measure of exchange rate risk. Using this measure, it becomes evident that forest products and related industries such as wood, paper and furniture are the most susceptible to the higher exchange rate. These industries display both a high export orientation and a low import content. The transportation equipment industry is also among the most affected by a higher Canadian dollar. Because of the high import content in that industry, however, the net export reliance is only 30% of production (even though 73% of production is exported).

(7) *Ibid.*

The evidence through the first three quarters of 2003 confirms the effect of a higher dollar on these industries. Exports of wood and paper products saw some of the most dramatic declines, along with transportation equipment, machinery and electronics, and some primary metals.

**2. Services**

Canada’s trade with the United States also includes a strong services component. In general, a higher dollar will have less impact on economic activity in services because the services sector is much more oriented towards the domestic market than the goods-producing sector. In cases where Canadian companies do export services, however, the effect of a high dollar is similar to that on goods exports. In fact, the impact of the rising currency may be even more dramatic for export-oriented service industries because they tend to have higher Canadian content than goods industries. Tourism, in particular, will likely be hardest hit by the rising exchange rate. A higher Canadian dollar makes it cheaper for Canadians to travel abroad, but more expensive for international visitors to come to Canada. Since Canadian tourism is composed of essentially 100% Canadian content, that industry sees little benefit from lower import prices.

While export-oriented service industries may suffer, a number of Canadian service industries oriented to 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. Import-driven industries such as retail and wholesale trade will also benefit considerably from being able to purchase lower-priced goods from abroad.

#### 3. Consumers

While the effects of a higher dollar on producers vary considerably, the effects on consumers are unambiguously positive. A stronger exchange rate lowers the prices of imported products while leaving the prices of domestically produced goods and services unchanged. By improving their spending power, a higher dollar acts as an implicit pay raise to Canadian consumers, helping stimulate the economy through stronger domestic demand. By extension, in the same way that a higher dollar can erode the profitability of exporting firms, it also increases the profitability of companies that sell imported products to Canadian consumers.

### C. Impact on Inflation and Monetary Policy

A higher Canadian dollar benefits the domestic economy also through its effect on inflation and monetary policy. The recent appreciation of the Canadian dollar should dampen the growth in the Consumer Price Index, the most common measure of inflation; as indicated above, a higher dollar lowers the cost of imports while leaving the cost of domestically produced goods unchanged. It should be noted, however, that Bank of Canada research reveals that the impact of currency fluctuations on consumer prices during low-inflation periods (as at present) has been far more modest than those experienced during high-inflation periods.

Even if the effect is muted, however, a higher dollar will place downward pressure on inflation in Canada. While inflation is typically not an issue in periods of slower economic growth, this easing of inflationary pressures will nevertheless provide the Bank of Canada with some added flexibility to keep interest rates low in order to stimulate economic growth.

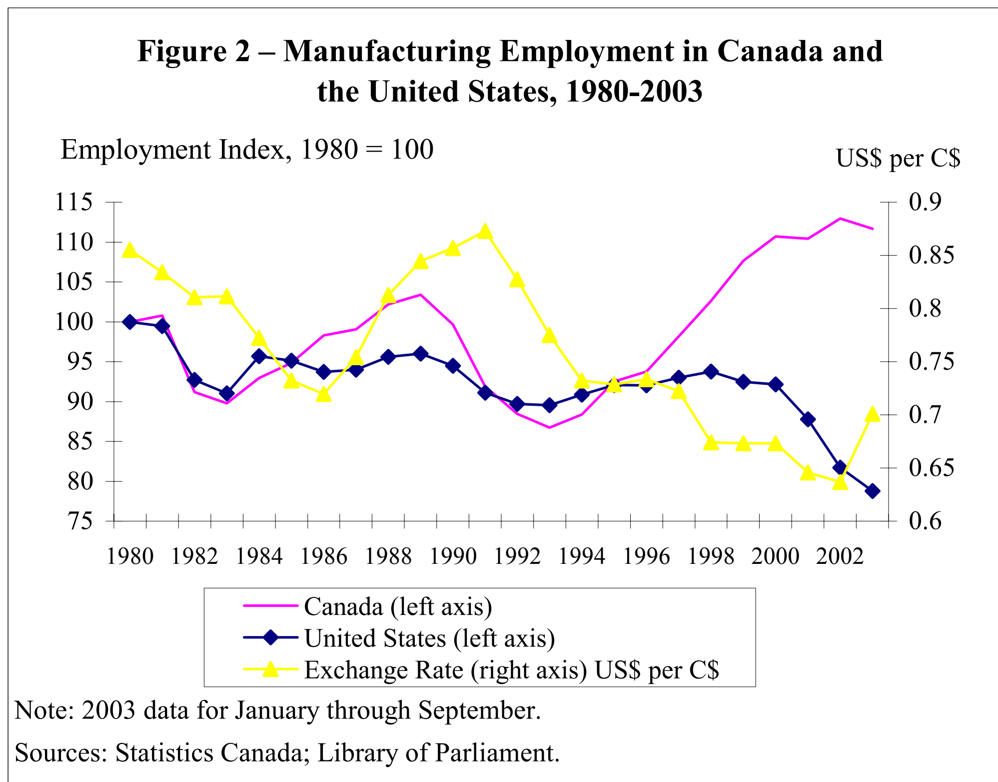
On occasion, the Canadian dollar itself can directly trigger changes in monetary policy. At present, movements in the value of the dollar do not play a large role in shaping Canadian monetary policy; the Bank of Canada is almost exclusively focused on guarding against inflation. Whenever a sizeable currency movement does occur, however, the Bank of Canada attempts to determine whether the change is due to economic fundamentals or a loss of confidence. It normally will intervene only in the latter case.

### D. Overall Impact

The effect of a higher dollar on Canada's trade and trade balances with the United States is the catalyst for a broader impact on the Canadian economy. Even though our economy is affected by many factors beyond the exchange rate, a decline in exports and an increase in imports is expected, all else being equal, to reduce demand for Canadian goods in the short term, thus lowering production and leading to weaker labour markets and slower economic growth.

Over the 1990s, Canada profited from the effects of a declining exchange rate that lowered the cost of Canadian goods in the U.S. market. That lower cost improved the products' relative competitiveness, pushing exports higher and boosting employment, output, corporate profits and economic growth. Canadian exports grew by an average of 7.5% each year from 1995 to 2002, and the Canadian economy has outpaced growth in the United States for the past four years. The Canadian economy also created close to 2.1 million jobs from 1995 to 2002, an average increase of 2.1% per year. Over the same period, the U.S. economy created 11.6 million jobs, an average annual increase of only 1.3%.

Since the low dollar made Canada's merchandise exports significantly more competitive, it brought clear benefits to Canada's manufacturing industries. From 1995 to 2002, the Canadian economy created 420,000 net new manufacturing jobs – an increase of 22.1% in seven years. In contrast, the manufacturing sector in the United States lost 1.9 million jobs over the same period – a decline of 11.3%.




Note: 2003 data for January through September.

Sources: Statistics Canada; Library of Parliament.

In the present higher-dollar environment, however, Canada's competitive advantage has been eroded. This fact can be explained in terms of a key indicator that economists use to measure international competitiveness – "unit labour costs," meaning the cost of the labour associated with producing one unit of output. Many economists believe that unit labour costs in manufacturing are equalized between Canada and the United States at an exchange rate of approximately 72 cents U.S. At this level, the labour cost savings of the exchange rate just offset the gap in relative productivity between Canada and the United States. When the dollar exceeds 72 cents, it becomes more expensive to produce in Canada than in the United States. Over time, should Canada's competitive position not improve, there would be an incentive to move production operations south of the border.

With the Canadian dollar now trading at well over 72 cents U.S., Canada's labour cost advantage over the United States has been eliminated. Moreover, relative productivity in Canada slumped in the first half of 2003, in conjunction with a decline in the growth of domestic output, whereas productivity improved south of the border. These developments have dramatically affected Canada's relative competitive position in the short term. The rapid rise of the dollar has harmed profit margins across all export-oriented industries, and this profit squeeze

is forcing Canadian firms to lower costs and improve productivity in order to defend profit margins.[8]

Moreover, although labour markets in Canada as a whole have proved to be resilient in the face of the higher dollar, there has been a general weakening of manufacturing sector employment. Total employment in Canada in 2003 grew by 2.2%, only slightly below the growth rate in 2002. In the manufacturing sector, however, lower exports to the United States and the need to improve competitiveness have contributed to a decline in employment. The number of manufacturing jobs in Canada in 2003 was 1.4% lower than in 2002, when the lower dollar helped manufacturing employment to grow by a healthy 2.3%.

## THE RISING DOLLAR IN CONTEXT: CANADA'S NEAR-TERM GROWTH PROSPECTS

Since Canada is an open economy, dependent on exports to maintain its economic prosperity, the appreciation in the value of the Canadian dollar vis-à-vis its U.S. counterpart through 2003 will, all else being equal, have a dampening effect on the economy. A higher dollar will impose transitional costs on the Canadian economy, decreasing Canadian exports, increasing imports, lowering trade balances and reducing the country's GDP growth rate. Experts generally predict that the strong Canadian dollar will restrict economic growth also in 2004.

Several organizations use economic models to estimate the extent to which exchange rate shocks will affect the Canadian economy. For example, according to a model run by the Bank of Canada, the combined 12% rise in the Canadian dollar in the first half of 2003 would lead to a 1.8 percentage point reduction in real economic growth over the next 12 months. For its part, the federal Department of Finance anticipates a reduction in GDP growth of roughly 1% in both 2003 and 2004.

However, the performance of the Canadian economy does not depend exclusively on the value of the Canadian dollar. In the past, Canada has sometimes seen healthy growth while the dollar appreciated and has witnessed sluggish growth in times of falling exchange rates. Furthermore, if a drop in the exchange rate always led to a predictable acceleration of economic growth, then a long-term growth strategy for Canada – or indeed for any country – would be to constantly try to push the domestic currency lower. Clearly, other factors also play a role in determining the strength of the Canadian economy.

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(8) Some economists believe that a higher dollar encourages productivity by forcing Canadian firms to be more competitive and at the same time lowering the cost of productivity-enhancing imported capital.

Moreover, the changing structure and nature of the Canadian economy is clouding the relationship between exchange rates and economic growth. Specifically, some economists believe that the effect of the current exchange rate appreciation may not be as dramatic as previous appreciations, because: (a) many Canadian firms have hedged their foreign currency positions to guard against exchange-rate fluctuations; (b) the import content of Canadian exports has grown, and the U.S. dollar's decline and associated drop in the price of these imports thus helps to maintain firms' export competitiveness; (c) more and more Canadian firms are borrowing in U.S. dollars – a strategy that helps offset the effect of the rising Canadian dollar because the cost of those loans is reduced; and (d) increasing numbers of Canadian firms have U.S. operations that generate U.S.-dollar revenues.

Considered more broadly, two major factors could override the effects of a higher dollar and allow the Canadian economy to continue to grow. The first is the recent 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. Aiding this recovery is the decline in the U.S. dollar, which is making imported goods more expensive in the United States and lowering the cost of American goods on the international market. A spirited expansion of the U.S. economy should generate additional demand for Canadian exports and therefore 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.

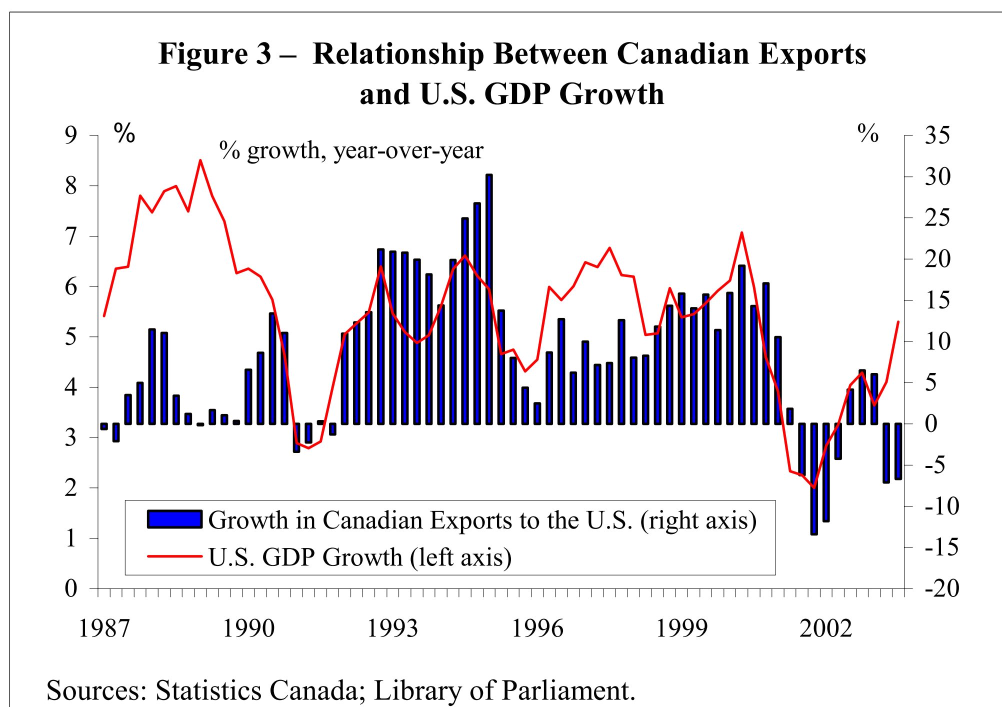


**Figure 3 – Relationship Between Canadian Exports and U.S. GDP Growth**

Sources: Statistics Canada; Library of Parliament.

Second, as the U.S. economy recovers, it will add momentum to the current global economic recovery. This global recovery is causing basic commodity prices to strengthen, a development that benefits Canada. Higher commodity prices will help offset the effects of a stronger dollar for Canada's resource-based industries, which, as mentioned above, are among the most vulnerable to the higher exchange rate. For example, the world price of nickel increased by a full 70% during 2003, more than offsetting the effects of the concurrent rise in the Canadian dollar. Reinvigorated U.S. demand will place further upward pressure on commodity prices, further aiding the Canadian economy.

In sum, while the rapid appreciation of the Canadian dollar against the U.S. dollar through 2003 will likely impose costs on certain industries, the effect on the Canadian economy as a whole is not entirely negative. To be sure, export-dependent industries with low levels of foreign inputs – tourism and forestry, for example – will be hard hit by the higher dollar. At the same time, however, many Canadians are benefiting from a stronger exchange rate. Consumers enjoy an implicit pay hike as lower import costs improve their purchasing power. Furthermore, the cost of imported capital, machinery and equipment falls, benefiting a wide range of sectors in the Canadian economy. Finally, a recovering U.S. economy and higher world commodity prices will improve Canada's growth prospects as well. In other words, the higher Canadian dollar is not necessarily bad news for the Canadian economy.