



# Publication

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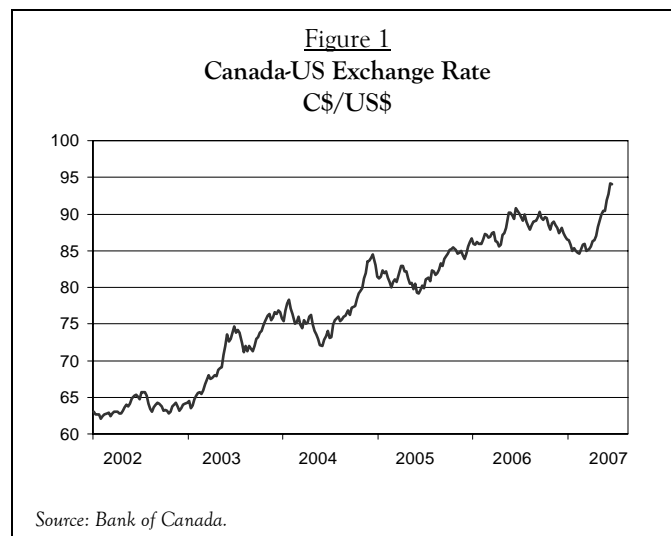
### TAKING FLIGHT: THE CONSEQUENCES OF THE SOARING LOONIE FOR THE BC ECONOMY

After trading in a narrow range for most of 2006, the Canadian dollar has again taken flight. Concerns about the slumping US housing market, rising interest rates, and still robust global commodity prices have helped to fuel a 10% gain in the Loonie relative to the US greenback since early 2007. While this may bring cheer to Canadians travelling or shopping south of the border, it has sparked renewed fears about the competitiveness of our export industries and the broader implications for the nation's economy.

In fact, to date the fallout from the unprecedented multi-year increase in the Canadian dollar has been milder than most analysts anticipated. In part, this reflects Canadian exporters' ability to cut costs and revamp operations. From a macro-perspective, high commodity prices and a healthy domestic economy have lessened the growth-inhibiting impact of an appreciating currency. Now, however, the economic landscape is changing. The American economy is cooling, the outlook for commodity markets is more mixed than it was 18 months ago, and hard-pressed Canadian manufacturers are finding it increasingly difficult to make additional cost savings. Here in British Columbia, the forest industry is bleeding red ink and tourist operators are reporting dwindling numbers of American visitors. All of this underscores the need to pay attention to the currency and its effects on industrial competitiveness and economic growth.

#### Recent History

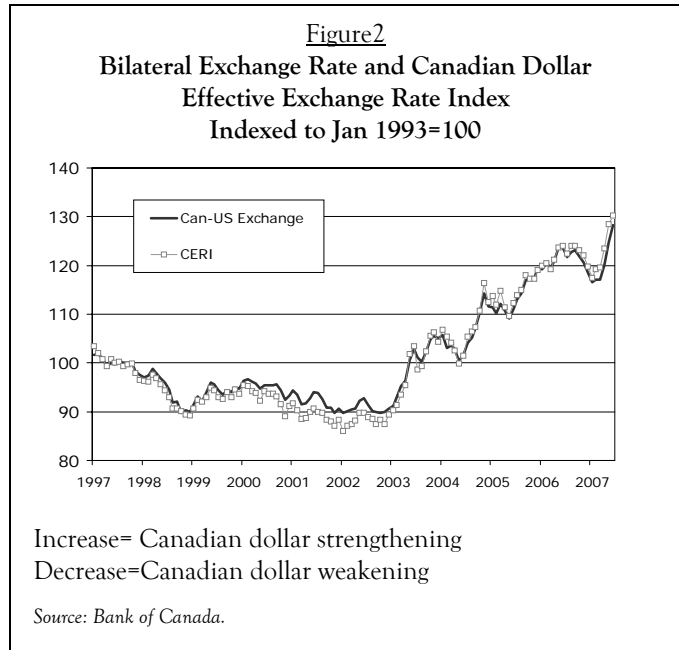
Less than five years ago the Canadian dollar traded for less than 65 US cents. After a long upward march, it recently (and briefly) cracked US 95 cents. This stunning rise began in early 2003 when the Loonie jumped by nearly 20%. The second half of 2004 brought a further surge to almost US 85 cents. After losing ground in early 2005, the dollar hit US 85 cents in the fourth quarter and then traded between US 85 and 90 cents for most of 2006. As 2007 dawned, the dollar was worth





approximately US 85 cents. By June it had passed through US 95 cents before settling at roughly US 94 cents by the end of July.

Formally, the exchange rate is the price at which one currency is converted into another. It is common to measure exchange rates on a bilateral basis - for example, the Canada-US exchange rate tells us what the Loonie is worth in terms of one US dollar. There are different versions of national exchange rates, apart from simple bilateral ones. One is a *trade-weighted* exchange rate, where movements in country A's currency against a basket of other currencies are weighted according to each currency's importance to country's A's foreign trade.



In this connection, the Bank of Canada recently developed a new Canadian-dollar effective exchange rate index (CERI).<sup>1</sup> The CERI is a weighted average of bilateral exchange rates for the Canadian dollar relative to the US dollar, the Euro, the Japanese yen, the UK pound, the Chinese yuan, and the Mexican peso, based on the importance of these countries as Canadian trading partners. Table 1 shows the country weights that the Bank used to develop the CERI.

While this index provides a better picture of how strong (or weak) the Canadian dollar is in an international context, because of the dominance of trade with the United States the CERI and the bilateral Canada-US exchange rate actually track fairly closely (see Figure 2). So while the CERI is useful, in practice the Canada-US exchange rate is what matters for most Canadian businesses.

**An Important “Price”**

For British Columbia, the magnitude of two-way trade and investment with the United States and the fact that much of what the province exports to overseas markets is priced in American dollars means the Canada-US exchange rate is the most important “price” in our economy. Last year BC shipped more than Cdn\$20 billion of goods to the US, representing 61% of the province’s total merchandise exports. British

Table 1	
Currency	Weights used to construct Exchange Index
US dollar	0.7618
Euro	0.0931
Japanese yen	0.0527
Chinese yuan	0.0329
Mexican peso	0.0324
UK pound	0.0271
<small>Source: Bank of Canada</small>	

<sup>1</sup> The CERI replaced the Bank’s trade-weighted index in October 2006.



Columbia also sells several billion dollars in services to the US each year.<sup>2</sup> In addition, the United States is the biggest source of foreign tourists for the province. In 2006, 3.4 million Americans spent one or more nights in BC, while almost 2 million more crossed the border for a same-day visit.

Exchange rate fluctuations have implications for many industries. A higher dollar makes it harder for BC exporters to compete in the American marketplace. More generally, an increase in the value of the Loonie against the greenback results in BC firms receiving less when the revenues they obtain from selling goods priced in US dollars is converted back into Canadian currency.

The United States is also British Columbia's leading source of imports. Last year the province imported goods valued at \$15.5 billion from the US. On top of this are services purchased from the US and the "imports" associated with spending by BC residents visiting the United States. Currency movements affect the prices of imports as well as those of exports. Imports become less expensive (and thus more desirable) when the Canadian dollar rises. One benefit of an appreciating currency is that it puts downward pressure on measured inflation. On the other hand, a stronger dollar can cause domestic suppliers to lose business in the Canadian market, as imported goods become less expensive relative to competing goods produced locally.

### Assessing the Impact

Generally, an increase in the value of the Canadian dollar vis-a-vis the US currency acts to slow economic growth in British Columbia. But the precise impact is difficult to sort out and varies markedly across sectors. Dependence on exports is not uniform among industries that sell in foreign markets. The BC mining and lumber industries, for example, export most of what they produce. The oil and gas industry, while dependent on the US market, sells a substantial portion of its output within the province. BC's film and television production industry is heavily focused on developing products for the American market.

Manufacturing Industry	Ratio (%)	Shipments (million \$)
Wood products	86.1	9,380
Paper products	83.8	5,640
Computer & electronic products	83.6	1,438
Machinery manufacturing	74.5	2,317
Chemicals	62.1	1,312
Transportation equipment	61.3	1,205
Primary metals	55.0	3,258
Plastics and rubber products	39.6	1,402
Fabricated metal products	23.3	2,311
Furniture and related products	23.3	1,024
Food manufacturing	22.8	5,678
Non-metallic mineral products	17.9	1,717
Printing and related activities	16.7	877
Beverage manufacturing	11.3	1,058
<i>Source: Statistics Canada, BC Stats.</i>		

<sup>2</sup> The provincial data on international services trade is less reliable than the data on trade in goods.



Even the various sub-industries that make up BC's diverse manufacturing sector exhibit differing degrees of exposure to foreign trade. Table 2 provides data on the ratio of exports to manufacturing shipments for a number of BC manufacturing industries. It shows that wood and paper products manufacturers are the most reliant on international markets (86% and 84%, respectively, of their shipments are exported). At the other end of the spectrum, BC beverage manufacturers sell just 11% of their output to foreign customers.

Tourism is another industry that is quite sensitive to currency fluctuations, especially in terms of the effect on short-term and more discretionary visits. The strengthening Loonie has clearly contributed to the worrisome fall-off in the number of US tourists visiting British Columbia over the past few years.

On balance, industries that are preponderantly oriented toward the domestic market, such as financial services, construction, personal services and retail trade, tend to benefit from a higher Canadian dollar, while export-oriented industries suffer. Although an appreciating currency can hurt retailers with a particular focus on the tourism sector, the lower cost of imports is positive for consumers and thus for the retail industry as a whole.

A given industry's vulnerability to currency shifts is determined by more than just its direct exposure to export trade. Also relevant are its reliance on imports and how strong demand is for what it produces. Many BC industries, including some that export a significant fraction of their output, import raw materials, parts and components that are used in the production process. A rising Canadian dollar reduces the cost of imported materials and components, thus at least partially mitigating the negative effect of currency appreciation for a substantial number of local exporters. The more import-intensive an industry is, the less affected it is likely to be by a stronger dollar.

Another mitigating factor is the state of external demand, particularly in the case of commodities. BC's growing mining sector, for example, has benefited from soaring prices for coal and metallic mineral products. So while the Canadian dollar has risen sharply since 2002, higher global prices have provided a cushion that has more than offset the adverse impact of an appreciating currency on the mining industry. If global coal and metal prices soften, then Canadian mining companies are likely to become more concerned about the consequences of the strong dollar.

By their very nature, primary resource and related downstream manufacturing industries have low import content because the raw materials, energy and labour used in production are mainly sourced locally. In contrast, some other segments of manufacturing, such as electronic products and transportation equipment, source many of their production inputs internationally. A study by Statistics Canada estimated the "import content of exports" across the country and found that just 19% of BC's exports were made up of imported goods/services. This compares to a national average of 33% and fully 53% in the case of



Ontario's exports.<sup>3</sup> The Statistics Canada study noted that the relatively low proportion of import content in BC's exports is "largely due to the concentration of exports in the resource sector, with lumber, pulp and oil and gas contributing nearly half of all exports."<sup>4</sup>

One reason why the Canadian forest sector has suffered from the high dollar is the low import content of lumber and pulp and paper products. Estimates indicate that an increase of one US cent in the value of the Loonie reduces the aggregate revenue of BC forest companies by \$160 million. Thus, the rise in the dollar since the start of 2007 has delivered in the vicinity of a \$1.5 billion hit to the bottom line of BC's struggling forest industry. This comes on top of the other challenges facing BC wood producers - declining American housing starts, low lumber prices, and a 15% export tax on lumber shipped into the US under the latest softwood lumber agreement.

### A Closer Look at Manufacturing in BC

Taken as a whole, BC's manufacturing sector has been hurt by the multi-year rise of the Canadian dollar. As summarized in Table 3, despite several years of generally strong economic growth in the United States, the value of BC's overall manufacturing exports to the US slipped by 2.3% from 2002 to 2006, with many individual manufacturing industries experiencing a steeper drop. The high dollar is not the only reason why exports of manufactured goods to the US have fallen, but it has been a significant factor.

Yet even in manufacturing, the fallout from the soaring Loonie has not been as bad as economists anticipated. Many BC manufacturers have adapted and found ways to remain competitive in the teeth of a stronger currency.

One way firms have responded is by boosting investment in productivity-enhancing machinery and equipment. Purchasing new capital

<u>Table 3</u>			
<b>Growth in BC Manufacturing Exports to the US, per cent</b>			
	1994 -1998	1998 -2002	2002 -2006
Food Mfg	67.7	56.3	-8.1
Beverage Product Mfg	-12.3	23.2	-6.5
Clothing Mfg	106.2	-2.9	-33.2
Wood Product Mfg	12.1	5.6	-3.6
Paper Mfg	-5.5	8.9	-7.0
Printing & Related Activities	122.6	72.7	-30.5
Petroleum & Coal Products Mfg	26.2	41.5	18.5
Chemical Mfg	-11.0	23.0	11.6
Plastics and Rubber Products	180.1	76.6	8.9
Non-Metallic Mineral Products	116.8	31.1	-26.3
Primary Metal Mfg	82.9	-10.1	45.6
Fabricated Metal Product Mfg	106.9	52.5	-1.0
Machinery Mfg	115.0	8.8	11.7
Computer & Electronic Product Mfg	131.3	-2.3	-5.1
Electrical Equip. & Component Mfg	86.0	49.2	9.8
Transportation Equipment Mfg	161.8	-4.6	-21.2
Furniture & Related Product Mfg	94.7	83.4	-3.3
Miscellaneous Mfg	108.0	131.0	-18.9
<b>Total Manufacturing</b>	<b>31.3</b>	<b>12.9</b>	<b>-2.3</b>

Source: Statistics Canada

<sup>3</sup> Ghanem, Z and P. Cross, "The Import Intensity of Provincial Exports," Canadian Economic Observer, Statistics Canada Catalogue no. 11-010 (June 2003).

<sup>4</sup> Ibid.



equipment has been made easier because much of it is imported (at a lower cost thanks to the rising dollar) from the United States. While there is a cyclical aspect to business capital spending, the strong dollar undoubtedly has contributed to a noticeable jump in spending on machinery and equipment in the BC manufacturing sector, from \$920 million in 2002 to a planned \$1.5 billion this year.<sup>5</sup>

Another strategy used by manufacturers is outsourcing and tapping into global supply chains. As with other manufacturers across North America, some BC companies are shifting parts of their production to China and other lower cost countries. Outsourcing back-office operations and business processes to specialized offshore or North American service providers is another way that companies can trim costs. In general, globalization and the growing importance of trade in goods and services within the wider economy have opened up more opportunities for Canadian manufacturers to adapt to the advancing dollar.

### **Macroeconomic Impact**

A rising dollar tends to weaken demand for the goods and services produced by export-oriented industries, while at the same time boosting consumer spending and stimulating investment. However, in net terms, a stronger currency is negative for economic growth in BC (and indeed in Canada as a whole). It erodes the competitive position of both export-oriented industries and other local industries that compete with imported products. While consumers gain from cheaper imports and some BC companies may step up investment in imported machinery and equipment, both of these developments lead to a higher level of imported goods, which is a further drag on economic growth.

National level economic indicate that the negative impact of a higher Canadian dollar is substantial. The model used by the federal Department of Finance predicts that a 1% rise in the Loonie vis-à-vis the US dollar trims real GDP growth by 0.1 percentage point over the subsequent five quarters.<sup>6</sup> If this is accurate, then the Loonie's surge in 2005-2006 is still dampening growth, and the 10% rise so far this year could cut Canada's GDP growth by perhaps one percentage point over the next few quarters.

Some Bank of Canada research suggests the impact of a stronger currency may be even greater and more protracted. One previous Bank study pointed to a 0.3 percentage point reduction in Canada's GDP growth for every 1% increase in the exchange rate over a two year period.<sup>7</sup> Recently, however, the Bank scaled back this estimate to a 0.1-0.2 percentage point decline in GDP growth associated with a 1% rise in the exchange rate.

The Loonie's path also has implications for government fiscal balances. According to the BC Ministry of Finance, a 1% increase in the Canadian dollar against the US currency translates

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<sup>5</sup> Statistics Canada, Capital and Repair Expenditures by Sector and Province, CANSIM Table no. 029-0005.

<sup>6</sup> TD Economics, Special Report, "Loonie Tunes – Understanding the Rally in the Canadian Dollar and its Consequences" (February 10, 2004).

<sup>7</sup> Ibid.

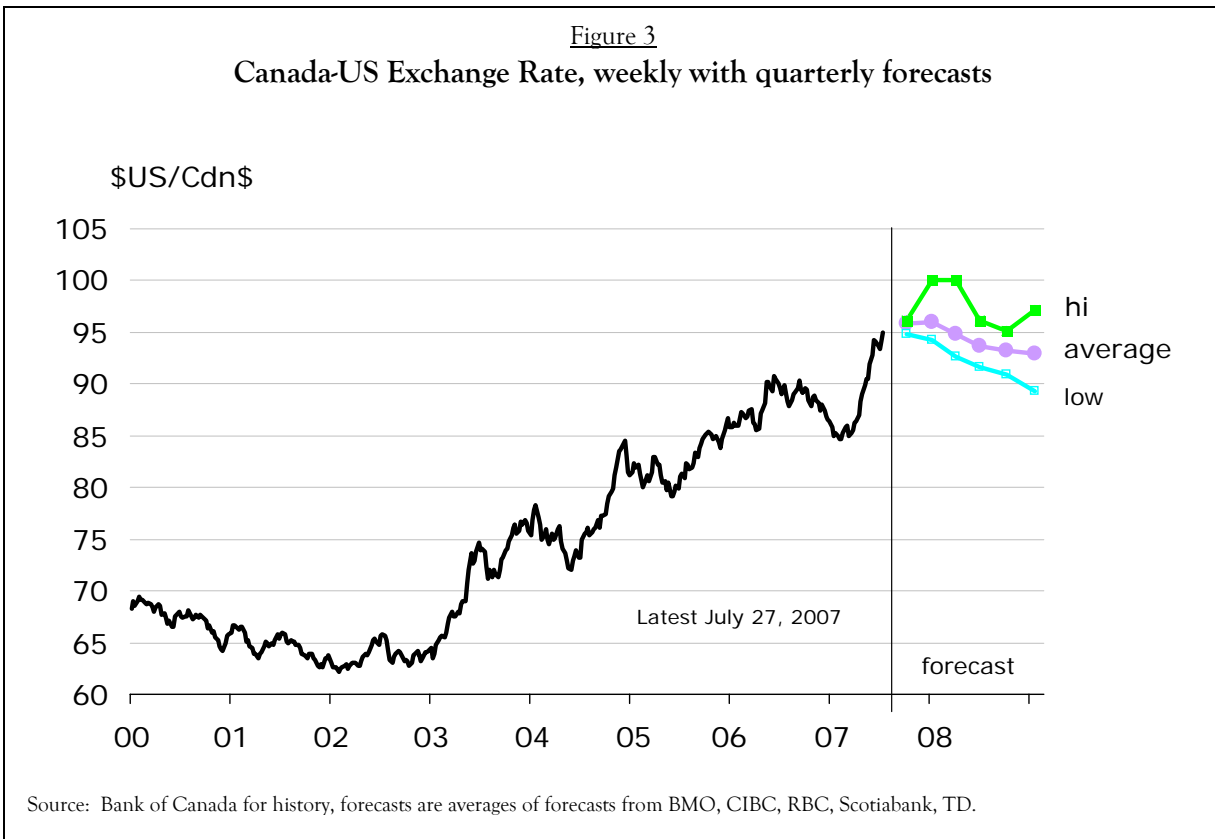


into a \$25-\$40 million drop in provincial revenues, mainly due to reduced economic activity in export industries.<sup>8</sup> The 2007 provincial budget assumed an average exchange rate of US 86.9 cents for 2007, well below the recent level. If the Canadian dollar stays at its current level of US 94-95 cents for the rest of the 2007-08 fiscal year, the province could see a drop of \$250 million or more in revenue compared to the estimate provided in the 2007 budget.

### Conclusion

The run-up in the Canadian dollar since early 2003 is unprecedented. Many Canadian companies have seen their profit margins shrink and their competitive positions damaged as the Loonie has gone from strength to strength. Yet the overall BC economy has performed well, with incomes rising briskly, the unemployment rate tumbling to a record low, and the construction sector in the midst of a remarkable multi-year boom. Even with the trade sector acting as a drag on economic growth, domestic demand has remained sufficiently buoyant to keep the province on a solid expansion path. And the good news is that most forecasters expect this to continue over the balance of 2007 and through 2008.

Where is the Loonie headed from here? Individual forecasts vary, but on average the economics departments of the five biggest Canadian chartered banks see the dollar staying fairly close to its recent levels (see Figure 3 below). A few forecasters expect further exchange



<sup>8</sup> BC Budget and Fiscal Plan – 2007/08-2009/10, pp. 57, 95.



rate appreciation with the Loonie approaching parity with the US greenback in 2008, while others expect it to retrace some of its recent gains. High global energy and metals prices, a weakening US dollar, rising Canadian interest rates, and strong foreign capital inflows all suggest the Loonie is unlikely to fall below the US 90 cents mark anytime soon. However, from a longer-term perspective, the dollar should eventually drop back to something in the US 85 cents range, which is more consistent with estimates based on the theory of “purchasing power parity.”<sup>9</sup>

In the meantime, it is clear that the strong Loonie is taking a measurable toll on a number of industries that are important to BC’s economy, including lumber, pulp and paper, several other segments of manufacturing, and parts of tourism. The outlook for BC’s film and television production sector in 2008 is also clouded by the high dollar. Manufacturing, in particular, has become the soft underbelly of our economy. Many manufacturers across the country are grappling with what one economist has aptly described as “a trio of compounding problems” – the strong dollar, relentless foreign competition, and the housing-led slowdown in the United States.<sup>10</sup> Looking ahead, there appears to be little relief in sight for the manufacturing sector and other industries exposed to a rising dollar, at least in the near term.

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<sup>9</sup> PPP theory holds that exchange rates in the long run are based on the amount of goods and services that each can buy.

<sup>10</sup> Aron Gampel, Scotiabank Global Economic Research, [Economic Commentary](#) (June 14, 2007).