Ten Years Later: How Canada's Strong Loonie Still Shapes Our Fortunes

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Remember 62 cents? Canada's currency posted its all-time weakest monthly close against its American cousin exactly a decade ago, making a dramatic U-turn thereafter. Despite leveling off in recent years, the US¢/C$ exchange rate remains 60% stronger than it was a decade ago and is also more than 20% firmer than a trade-weighted basket of other major currencies.

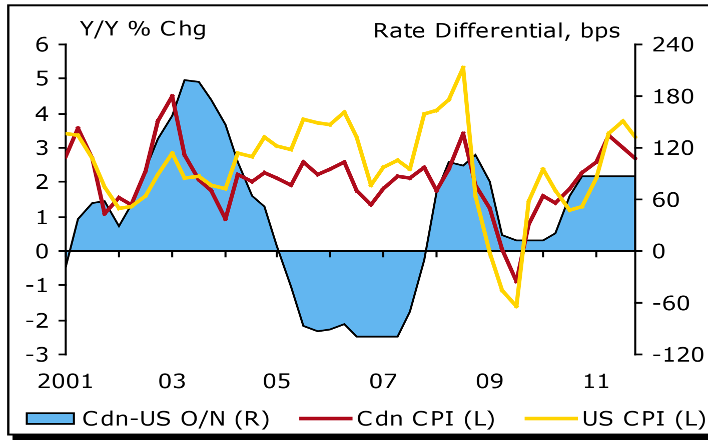
The Canadian dollar's value still fluctuates with the health of the global business cycle and the world's appetite for raw materials. But demand for an equally rare commodity, AAA-rated sovereign debt, and the massive accumulation of foreign exchange reserves abroad in search of portfolio diversity, are likely to maintain enough capital inflows to keep the loonie hovering near parity for the next half decade. In a small open economy, such a currency environment shapes the nature of Canada's economic expansion, with profound impacts for labour markets and regional growth patterns.

The C$ and Inflation

The win from a stronger currency is that, all else equal, it helps mute inflation. Held back by a lofty loonie, Canadian import prices are still some 10% lower than they were a decade ago. By comparison, a cheaper greenback has pushed American import prices up more than 40% (Chart 1). With an inflation-targeting central bank, Canada's tame import prices aren't allowed to show up in trend CPI, since the Bank of Canada has run an easier monetary policy than it otherwise would have to bring inflation to its target. Indeed, Canada's inflation record doesn't look that different from the US (Chart 2). But the cushioning impact on prices alongside a pronounced drag on exports has meant that policy interest rates have been held back, in some cases below those in the US, even during periods where Canada's economy was otherwise outperforming.

Chart 2

Cdn-US Inflation & Overnight Rate Gap



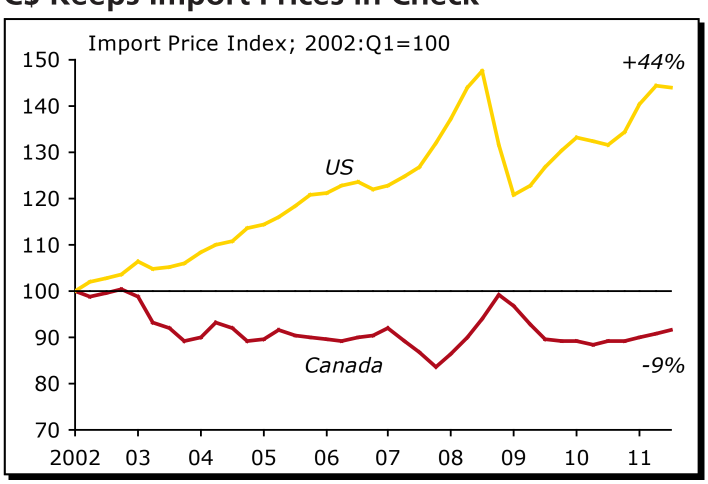
Source: CIBC, Statistics Canada, BLS, Federal Reserve

Manufacturing: Structural, Not Cyclical

The result is an economy tilted toward growth in interest-sensitive sectors and dented in its ability to sustain non-

Chart 1

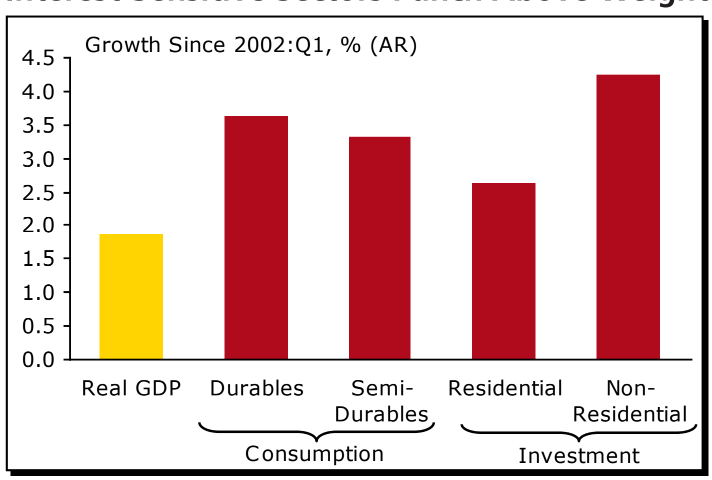
C$ Keeps Import Prices in Check



Source: CIBC, Statistics Canada, BEA

Chart 3

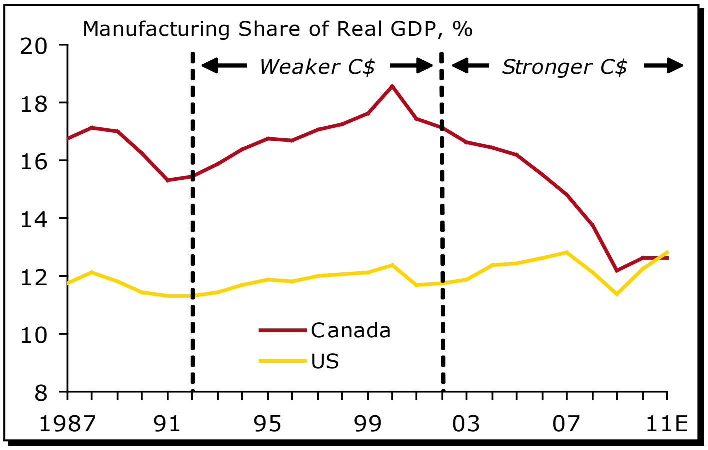
Interest-Sensitive Sectors Punch Above Weight



Source: CIBC, Statistics Canada

Chart 4

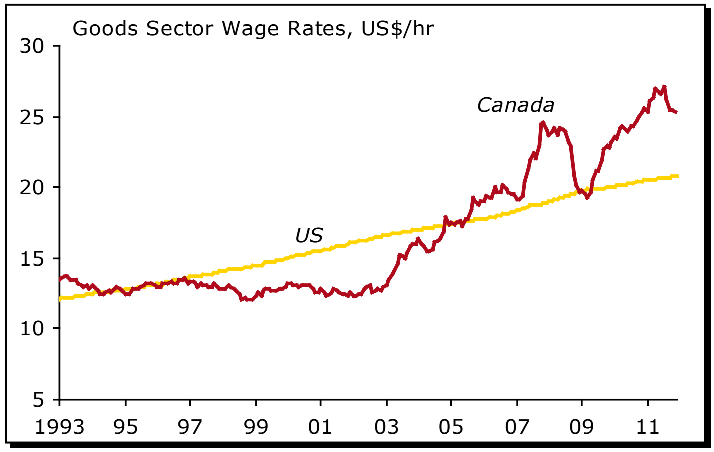
Factory Footprint Shrinks in Canada



Source: CIBC, Statistics Canada, BEA

Chart 6

Cdn Labour More Expensive vs. US



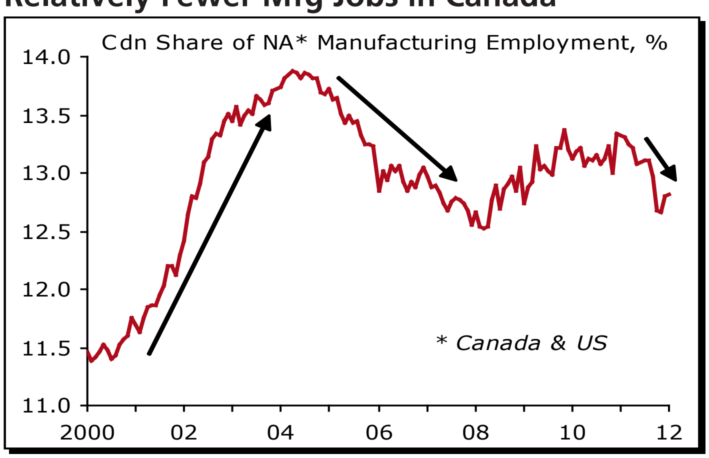
Source: CIBC, Statistics Canada, BLS

resource exports from manufacturers. Canadian interest-sensitive demand has grown twice as fast as the overall economy since 2002 (Chart 3), accounting for nearly 60% of real GDP gains and punching well above its weight.

Factory output in Canada has seen a revival from the depths of the 2008 recession, when the lights were turned out during a collapse in global trade. But beyond the one-time recovery from cyclically depressed demand, the factory sector's growth prospects look to be seriously impaired by the structural hit from a strong Canadian dollar. Manufacturing's share of GDP has plummeted since the C$ turned the corner, but it has also lost ground on a relative basis vs. the US, where the factory sector's footprint has held steady (Chart 4). And in the labour market, expect Canadians to hold down an ever-smaller share of North American factory jobs. A sharper recession stateside temporarily arrested that trend in 2008-09, but Canada is once again losing share (Chart 5).

Chart 5

Relatively Fewer Mfg Jobs in Canada



Source: CIBC, Statistics Canada, BLS

The crux of the issue is that the climb in the Canadian dollar has pushed goods sector wages (and other local costs) well above those stateside in common currency terms (Chart 6). As a result, Canada is no longer a cost-effective location for a host of non-resource-related manufacturing activities. Initially, shutdowns were seen in sectors like apparel and furniture that had earlier hung on in part due to an undervalued exchange rate. More recently, Canada has lagged in attracting or retaining facilities for autos and parts, rail cars, steel mills, and other goods where the competition is now more weighted to US producers.

Today's scary headlines are borne out in the data. A decade ago, Canada enjoyed a $20 bn trade surplus in autos and parts; today, the country has a deficit in autos trade of $12 bn (Table 1). Elsewhere, a once modest shortfall in machinery and equipment trade has been transformed into a yawning trade deficit.

Meanwhile, Canadian manufacturing capacity has swooned, as plant closures and the depreciation of

Table 1

Cda's Trade Balance: Sustained Surplus No More

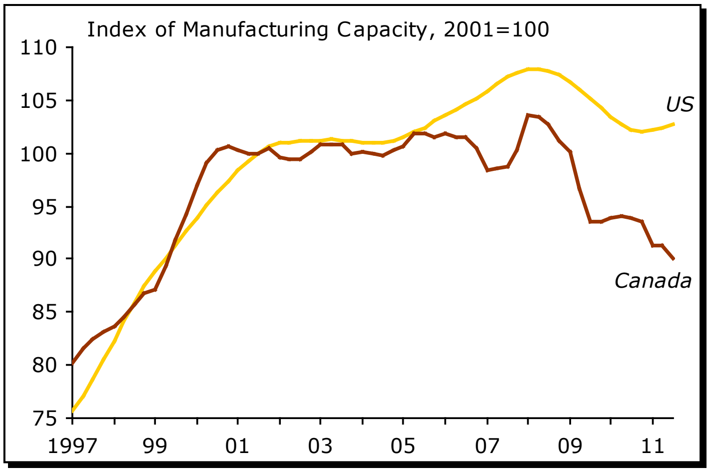
Cdn Merchandise Trade Balance	2001 $bn	2001 % of GDP	2011 $bn	2011 % of GDP
Agricultural & Fishing	10.7	*1.0*	8.4	*0.5*
Energy	38.0	*3.4*	58.9	*3.4*
Forestry	37.4	*3.4*	19.9	*1.2*
Industrial Goods & Mat.	-0.6	*-0.1*	19.0	*1.1*
Machinery & Equip.	-9.4	*-0.8*	-44.1	*-2.6*
Autos	20.0	*1.8*	-11.9	*-0.7*
Other Cons. Goods	-26.6	*-2.4*	-43.2	*-2.5*
Total Balance	**70.7**	***6.4***	**1.4**	***0.1***

Note: Excludes special trade transactions & other BOP adjustments

Source: CIBC, Statistics Canada

Chart 7

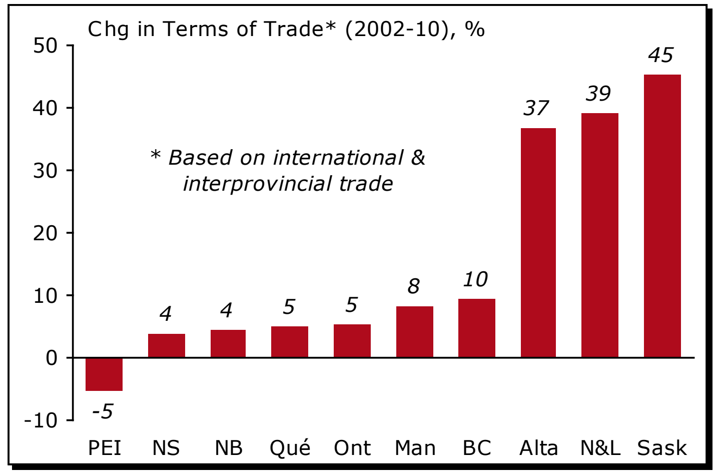
Manufacturing Capacity Falling in Canada



Source: CIBC, Statistics Canada, Federal Reserve

Chart 8

Terms of Trade: Changing Regional Fortunes



Source: CIBC, Statistics Canada

existing capital have swamped new investment. The trend is distinctly more favourable south of the border (Chart 7), where new facilities capture the boost from a more competitive US dollar exchange rate. Lower corporate tax rates in Canada have simply not been enough of a drawing card to alter that trend. Moreover, Canada's tax advantage is threatened by a US pledge to slash corporate income tax rates and signs that some provinces could delay (or partially reverse) business tax cuts.

Granted, a strong Canadian dollar lowers the cost of manufacturing equipment, much of which is priced in US dollars. But it also makes it even more profitable for business to use their high-valued loonies to buy that equipment and install it in facilities in the US, or even Mexico. Canada can get back to higher use of its existing capacity, but barring a big correction in the currency, or a sharp shift in relative wages, factory growth will subsequently stall.

The Currency and Canada's Economic Map

The other consequence of the strong loonie / high resource price environment has been a remaking of Canada's economic map from coast-to-coast. Provincial terms of trade highlight the shift in regional fortunes. As the producers of higher priced commodities, Alberta, Newfoundland & Labrador and Saskatchewan have enjoyed a huge advantage over Central Canada and the Maritimes (Chart 8).

As the largest province, Ontario's plight garners plenty of attention. Real GDP growth in that province has now trailed the rest of the country for nine straight years—underperformance that has coincided with C$ appreciation. Had Ontario kept pace with the rest of the country, its economy would be almost 10% larger than it is today, making it much easier for the government to dig itself out of deficit. Growth in another factory-focused province, Québec, has also lagged, but a shallower downturn in 2008-09 has meant that the degree of underperformance was less striking.

Expect this underperformance to continue, with average annual real GDP growth in Canada's industrial heartland—Ontario and Québec—likely to trail that seen in Canada's most resource-rich regions by at least 1% over the coming five years. The gap in nominal GDP growth rates could be double that, given expected trends in key commodity prices. In Alberta, Saskatchewan and to a lesser extent British Columbia, investment dollars will flow more freely, sowing the seeds of future productivity gains. More plentiful and lucrative job opportunities will spur superior rates of labour force growth. And with resource royalties pouring in, government sector restraint will be considerably less punitive.

Canadian dollar appreciation may have largely run its course, but the adjustment process isn't over. Notwithstanding recent gains in manufacturing, plants will continue to be lost to international competitors. And within Canada, labour will continue to seek out brighter opportunities in the West. As economic, fiscal and political power consolidates in Western Canada, regional income inequality will soar and inter-provincial tensions will rise. Canada's monetary authorities can avoid accelerating that process by keeping rates on hold for longer, but even a sidelined Bank of Canada won't prevent a further hollowing out of Canada's manufacturing heartland.