Policy Perspectives

Business Council of British Columbia

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Winners and Losers from the Slumping Loonie…. Through a British Columbia Lens

Highlights

- The recent decline of the Canadian dollar relative to the US dollar is the steepest on record over any three-year period.
- The Loonie's fall touches nearly all aspects of the BC economy. Although there are winners and losers, on balance a lower dollar is positive for economic and job growth in the near term.
- A weaker currency makes BC's exports more competitive in international markets. This is the main reason for the aggregate economic lift from a lower dollar.
- The forest industry, tourism, film production, the gateway sector, and parts of the manufacturing and high technology industries are among those that gain from exchange rate depreciation.
- In general, BC consumers are negatively affected, because the sagging dollar results in higher prices for many imported goods and services. It also makes it more costly for Canadians to travel to and purchase goods, property and business assets in the United States.
- The lower dollar is deterring cross-border shopping, which is helping BC retailers operating in close proximity to the Canada-US border. For local consumers who save money from shopping in the US, a depreciating currency is less welcome.
- The weaker Loonie makes imported machinery, equipment and software more costly, which will dampen capital investment and weigh on productivity growth in BC over the medium term.

In the final months of 2012 the Canadian dollar was trading slightly above parity with the US greenback. Nearly three years later, one Canadian dollar is worth ~76 US cents. This marks an unprecedented depreciation of the Canadian currency – more than 25% in a bit less than three years. A decline of this speed and magnitude has significant economic implications.

British Columbia is an open, trade-dependent economy, so the exchange rate affects most sectors of our economy. The exchange rate – particularly the *bilateral exchange rate with the US* – arguably is the most important "price" in the province's economy.

The good news is that, on balance, British Columbia comes out ahead from a weaker currency, mainly because it makes our exports more competitive, particularly in North America markets, thereby supporting growth in export-oriented (and some import-competing) industry sectors. However, as with all price changes, there are losers as well as winners. A depreciating currency makes imported consumer products and business inputs more expensive, which ultimately subtracts from the buying power of household budgets. There is a risk that it may also hamper investment in machinery and equipment, slow productivity growth and undercut the longer-term competitiveness of the Canadian business sector.

The Loonie Sinks

Figure 1 plots the bilateral Canada-US exchange rate, in US cents per Canadian dollar.[1] The value of the Canadian dollar relative to the US dollar has been slipping for three years. At the same time, it should be noted that the dollar has held up better vis-à-vis some other currencies, such as the Euro, the Australian dollar and the Japanese yen. In fact, the story of the slumping Loonie is as much about the rise of the US dollar as it is about developments within Canada or trends in world commodity markets.

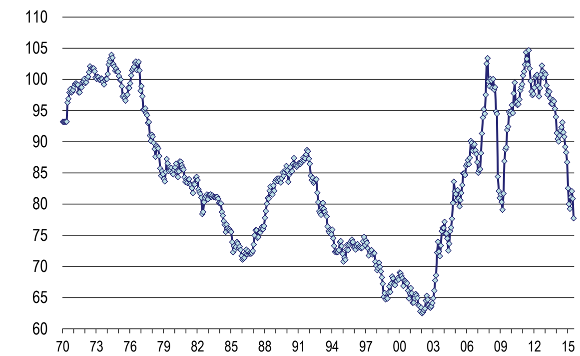
Figure 2 shows the percentage change in the Canada-US exchange rate over a 36-month period. The current down-cycle is the most dramatic over any three-year period on record. Measured over a shorter one-year horizon, the decline of the Loonie during the 2008-09 financial crisis was greater in percentage terms. But that proved to be short-lived, with the Loonie quickly regaining its pre-recession value. The latest drop in the Canadian dollar is more protracted and is having a greater and longer-lasting economic impact.[2]

The effects of the recent depreciation are continuing to unfold. It is possible that the dollar's downward movement has not yet run its course, especially in a world of low prices for oil, metals, and a number of other export commodities of interest to Canada. Oil prices have tumbled by more than half since late 2013, while a basket of non-energy commodity prices is down by about one-fifth over the same period.[3] Plunging commodity prices have delivered a sizable blow to Canada's terms of trade[4] and played an important role in the dollar's slide.

Figure 1

Canada-US Exchange, monthly average of noon rate

US cents per Canadian dollar

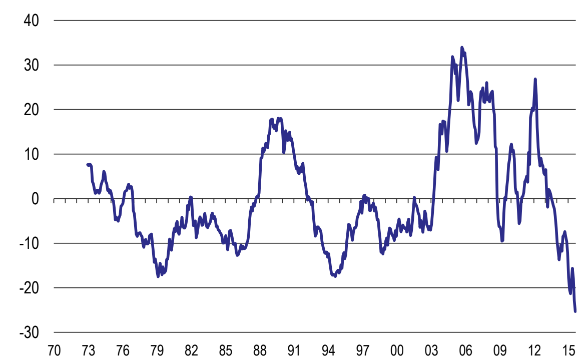


Source: Bank of Canada.

Figure 2

Canada-US Exchange, Change over 36 months

In per cent



Source: Bank of Canada.

[1] Note that there are many "bilateral" exchange rates, one for each Canadian trading partner that maintains its own currency.

[2] The Loonie has lost 21% of its value against the US dollar in the past two years. Between 1976 and 1978 it declined by 18%.

[3] BMO Economics, "Lower Loonie, for Better or Worse," July 24, 2015.

[4] The terms of trade is the ratio of the prices of Canada's exports to the prices of our imports.

The discussion here focuses on the bilateral Canada-US exchange rate. This reflects the fact that the American dollar is by far the most important foreign currency from the perspective of Canada, including BC. Not only is the United States our largest trading partner, accounting for more than half of BC's international exports of goods and services, but approximately 70% of total global trade is transacted in US dollars. All of the major export commodities that BC produces are priced in US dollars on world markets.

Who Benefits

As noted at the outset, the falling dollar is positive for the provincial economy in an aggregate sense, in that GDP growth will be stronger than if the Loonie had not drifted lower. The macroeconomic boost comes primarily through trade/export channels. Any BC industry selling merchandise or services into the US and some other international markets is more competitive today than two or three years ago, and so is likely to benefit via increased sales. Additionally, many local companies involved in international business gain when export receipts denominated in US dollars are converted back into Canadian funds.

A further economic plus stems from the fact that many imported goods and services are now more costly for Canadian buyers, which dampens the demand for such imports and causes some purchasers to switch to domestically-produced items. While this effect is a negative for consumers and households (discussed below), by definition a drop in imports serves to augment GDP growth.

Reflecting the net economic lift from a weaker currency, the BC Ministry of Finance estimates that a one cent depreciation of the Canadian dollar vis-à-vis the US currency increases the provincial government's revenues by $25-$50 million per year.[5] This is mainly due to higher levels of economic activity in exporting and import-competing sectors.

The industry mix plays a role in the exchange rate story. In particular, "trade-exposed"[6] BC industries which have a high share of domestic inputs/content in their production processes will tend to benefit more from a depreciating currency than industries which rely heavily on imported inputs (most of these are priced in US dollars, making them more expensive when the Canadian dollar declines). If imported parts or services make up a large share of the value of final export goods (think the integrated North American automobile industry, where imported parts and equipment account for at least half of the value of the final products coming out of Canadian-based factories), then the higher cost of imported inputs chips away at the gains in cost competiveness that local exporters enjoy when the currency depreciates.

In the Canadian context, British Columbia is positioned to come out ahead under a lower dollar scenario, because many of our "trade-exposed" industries have a high share of domestic content (e.g., labour, raw materials, and electricity).[7] The forest

[5] 2015 BC Budget, p. 37.

[6] These consist of both export-oriented industries and local industries that compete against imports in the Canadian market.

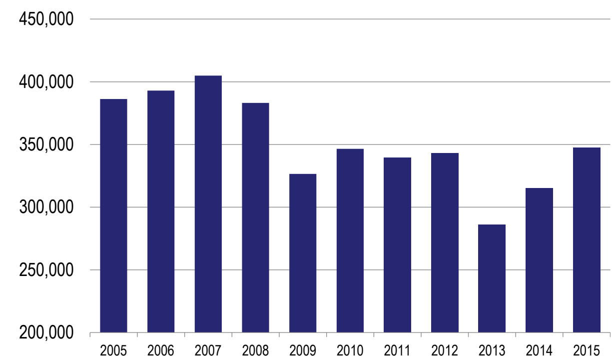
[7] A now dated but still relevant reference is Z. Ghanem and P. Cross, "The Import Intensity of Provincial Exports," Statistics Canada, Canadian Economic Observer, June 2003.

products sector is a good example. With domestically harvested logs and labour being the main inputs into the production process, imported goods and services amount to only 20% of the final value of lumber output. The pulp and paper industry also has a high domestic (and low foreign) input content.[8] In addition to being more competitively priced in the North American market, lumber, pulp and other commodity products are traded in US dollars. So when a BC company sells lumber (or any other commodity) into the US, it realizes a further gain if/when the resulting revenues are converted into Canadian dollars.

Machinery and equipment manufacturers operating in British Columbia (and other provinces) are also more cost competitive owing to the lower Canadian dollar. The resurgent American economy has helped to expand exports in this sector, but the Loonie's recent fall has also contributed to the 21% jump in the province's M&E exports to the US in the past year.

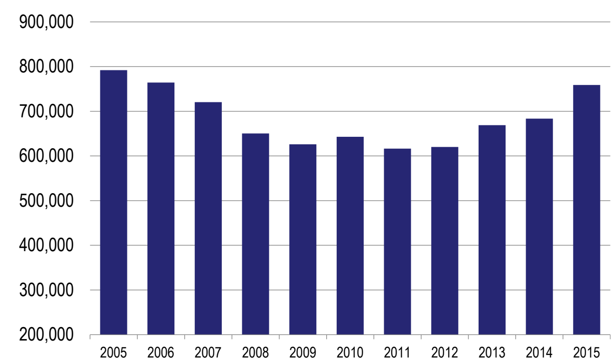
Many service industries whose outputs are "tradable" will also applaud a lower dollar. BC engineering, accounting, environmental, educational, consulting and architectural services, among others, are all "discounted" by 25% for American purchasers today, relative to the situation three years ago. Over time, this should pave the way for increased BC exports of these types of services.

Figure 3
US Tourists Entering BC by Plane, Jan to June*
Number of persons



Source: Statistics Canada, International Travel Survey.
**total number of visitors between January and June of each year.*

Figure 4
US Tourists Entering BC by Automobile, Jan to June
Number of persons



Source: Statistics Canada, International Travel Survey.
**total number of visitors between January and June of each year.*

Tourism and Film/TV Production

The BC tourism industry is in the midst of a healthy rebound that looks likely to persist for several years. Although the tourism experience is locally consumed, it is effectively an "export" because it represents an inflow of external funds into the province's economy.[9] The improving US economy means more Americans are now

[8] The same is true of other resource-based industries in BC, such as base and precious metals, coal mining, and fishing and agriculture.

[9] Specifically, spending in BC by out-of-province tourists counts as an "export." Spending by BC residents travelling within the province does not.

travelling abroad – and spending more freely when they do. And because the American dollar goes much further than it did a couple of years ago, this is enticing more Americans to visit British Columbia and other parts of Canada. The number of US tourists coming to BC by automobile is up by 13% since 2013, while those arriving by air have climbed by one-quarter over the same period.

As with tourism, foreign film and television productions made in BC also effectively constitute "exports." Because movies and TV series can be shot in different jurisdictions, this industry is especially sensitive to currency fluctuations. After a decade in which the Canadian dollar strengthened against the US greenback, a January 2013 article in the Globe and Mail described the poor business conditions then prevailing in the province's film and television industry. Unemployment in the sector was high, and a Save BC film campaign had just been launched.[10] At the time, the BC Film Commission's list of productions shooting in the province included just six series and no big-budget features. In better economic times, BC would have hosted perhaps 30 productions.

Today, with the Canadian dollar down by 25%, the picture is much different. BC film productions are at a record high, the number of people working in the industry has risen sharply, and local studios are running flat out.

Who Loses…

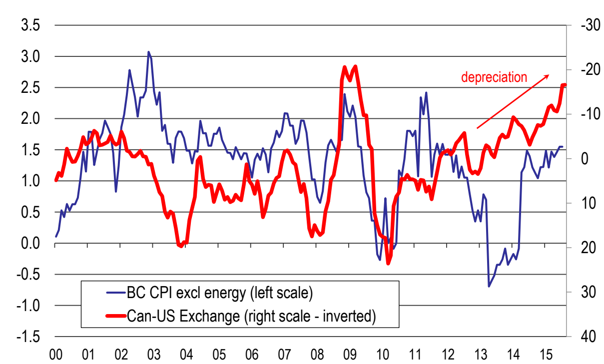
In broad terms, a lower dollar has a negative impact on the economic welfare of most individuals and households in British Columbia. Here, a number of considerations come into play.

The first and most significant is the higher cost of imports. A majority of the goods consumed by BC households are imported, with many priced in US dollars.[11] A weaker currency makes these imports more expensive. Faced with rising costs, retailers and other BC businesses naturally seek to pass these costs on to domestic consumers in the form of higher prices. The Bank of Canada estimates that the "pass-through" effect from the recent depreciation of the Canadian dollar pushed up the national core consumer price index by between 0.4 and 0.6 percentage points, and increased overall CPI inflation by between 0.7 and 0.9 points.[12]

Figure 5

BC CPI and Canada-US Exchange Rate (US cents/$)*

annual per cent change



Source: Statistics Canada, Bank of Canada.

**excludes energy and scale for exchange rate is inverted*

[10] The Globe and Mail, Jan. 20, 2013, on-line article.

[11] For example, vehicles, appliances, some fruits and vegetables, many processed food products, almost all pharmaceutical and consumer electronic products, etc. Unlike the situation with goods, most of the services purchased by BC households are either produced locally or "imported" from other Canadian provinces.

[12] Bank of Canada, Monetary Policy Report, July 2015 (p.16).

Figure 5 plots the annual changes in the Canada-US exchange rate and core consumer prices in BC. As with the previous figures, the exchange rate is measured in US cents per Canadian dollar. In this case, however, the scale for the exchange rate is inverted, so we can more clearly see the correlation between a depreciating currency and higher consumer prices.

The pass through effect is most evident in the case of food. In recent years, food prices have been pushed higher in both Canada and the United States by drought and disease. But lately the impact of the faltering Loonie has become more apparent, as the rise in food prices in the US has decelerated while it has picked up momentum in Canada. Global food price pressures are still the dominant force keeping food costs in Canada elevated, but the Bank of Canada estimates that one third of the increase in food prices this year can be attributed to currency depreciation.

British Columbians who spend time in the US are keenly aware of another downside of the Loonie's slide. Many BC residents will now be reconsidering whether to cross the border, with some choosing instead to vacation in Canada and others shortening their stateside visits. Although this counts as a negative development for the individuals directly affected, to the extent that more British Columbians opt for domestic travel rather than out-of-province trips this is another factor bolstering activity in the province's tourism sector. Over the first half of 2015, the number of British Columbians travelling to the US by car for vacations was down by 11% compared to the same period in 2014.

A Comment on Cross-Border Shopping

Cross-border shopping represents a spending "leakage" within the BC economy. The plummeting Loonie is clearly reducing cross-border shopping by BC residents. Looking again at figures for the first six months of 2015, the number of same-day crossings to the US is down by 22% from the 2013 peak. This is a positive trend in the eyes of many retailers in the lower mainland, particularly those in the Langley, Cloverdale, South Surrey and Abbotsford areas. For some BC households, however, savings from shopping in the US have helped to stretch strained budgets, and for them the Loonie's diminished buying power is not a happy prospect.

Imported Machinery and Equipment

Most of the machinery and equipment that BC companies use is both imported and priced in US dollars. Unfortunately, the depreciating Canadian currency is making the purchase of new machinery, equipment and advanced process technologies significantly more costly for BC firms. As a result, some companies will postpone equipment and technology upgrades, and many others will scrimp on acquiring sophisticated capital goods. As discussed above, the lower Canadian dollar makes BC exports more competitive, which can provide a cushion for exporting firms and lessen the need to trim costs in order to remain competitive. Overall, we judge the depreciating currency to be a negative development from the perspective of strengthening business sector productivity and the province's long-term competitive position, because it is likely to depress new business investment in machinery, equipment, and leading-edge process technologies.

Concluding Thoughts

While BC's economy is facing headwinds, including slower global growth and sluggish commodity markets, the lower Canadian dollar will support economic growth in the near-term – and probably over the medium-term horizon as well. The currency's decline is providing a well-timed boost to BC's international export sector, which amounts to nearly one quarter of provincial GDP.[13] If the Canadian dollar had not depreciated, and assuming the same economic backdrop as today, BC's real GDP growth rate in 2015 would be below the 2.0%-2.4% range that most forecasters are now looking for.

The exchange rate, however, affects almost all sectors and elements of the economy. Higher prices for imported goods, and the Loonie's reduced buying power for provincial residents vacationing in, travelling to, or seeking to purchase assets in the United States, represent a loss of economic welfare for BC households. In the long run, a depreciating currency is not an effective way to improve the economic well-being of residents, workers or businesses. Indeed, as noted in a recent C.D. Howe Institute study, there is reason to worry that a weaker Canadian dollar may detract from the country's long-term economic growth and competitiveness by blunting the pressures on business managers and owners to improve productivity and accelerate innovation.[14]

Box 1 summarizes the winners and losers from the Canadian dollar's decline.

Canadian Dollar Drop:
BC Winners and Losers

Winners…

- Exporters (especially firms with high domestic value-added per dollar of export sales)
- The BC tourism industry
- Other BC service providers capable of generating export business
- Retailers in communities exposed to lost sales from cross-border shopping
- Inward Canadian investment (real estate, other assets). Canadians will channel more investment into domestic assets; some foreigners will view the Loonie's fall as a buying opportunity

Losers…

- Households generally (a dollar of Canadian income now buys less on a global basis; many imports cost more; and it's more expensive to shop in, travel to or buy property in the US)
- Businesses with a high proportion of US value-added inputs per dollar of sales
- BC companies looking to expand in the US or to purchase American assets
- Firms that have issued debt in US dollars
- Professional sports teams involved in North American leagues

As to where the Loonie is headed, it is notoriously difficult to forecast currency movements, and we make no specific predictions here. We will say, however, that the principal factors influencing the bilateral exchange rate with the United States all point to continued weakness in the Canadian dollar. Slow global growth and the structural change underway in China's economy mean world prices for Canada's major commodity exports are likely to remain under downward pressure for some time. That Canada's economy is expected to grow more slowly than the US economy for at least the next two years also limits any upside for our

[13] This includes exports of services as well as goods.
[14] Peter Howitt, "Mushrooms and Yeast: The Implications of Technological Progress for Canada's Economic Growth," C.D. Howe Institute Commentary, Number 433, September 2015.

dollar. Related to the growth differential, the US Federal Reserve will almost certainly hike its overnight lending rate well before the Bank of Canada follows suit, and this can be expected to further dampen investors' enthusiasm for Canadian-dollar assets. Taking a longer-term view, Canada looks destined to continue to lag behind the United States in productivity levels, and likely also in average productivity growth rates, which is yet another factor that may depress the Loonie's value relative to the American dollar going forward.

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