

**THE SENATE**

**LE SÉNAT**

**THE RISING DOLLAR:  
EXPLANATION AND ECONOMIC IMPACTS  
(Volume 2)**

Report of the Standing Senate Committee  
on  
Foreign Affairs

*Chair*

The Honourable Peter Stollery

*Deputy Chair*

The Honourable Consiglio Di Nino

November 2003

The fourth report of the Standing Senate Committee on Foreign Affairs

**Uncertain Access: The Consequences of U.S. Security and Trade Actions for Canadian Trade Policy  
(Volume 1)**

can be downloaded at  
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*Staff from the Parliamentary Research Branch of the Library of Parliament:*

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Michael Holden, Analyst

François Michaud

*Clerk of the Committee*



## ORDER OF REFERENCE

Extract from the *Journals of the Senate* of Thursday, November 21, 2002:

The Honourable Senator Stollery moved, seconded by the Honourable Senator Adams:

**THAT** the Standing Senate Committee on Foreign Affairs be authorized to examine and report on the Canada – United States of America trade relationship and on the Canada – Mexico trade relationship, with special attention to: a) the Free Trade Agreement of 1988; b) the North American Free Trade Agreement of 1992; c) secure access for Canadian goods and services to the United States and to Mexico, and d) the development of effective dispute settlement mechanisms, all in the context of Canada's economic links with the countries of the Americas and the Doha Round of World Trade Organisation trade negotiations;

**THAT** the Committee have power to engage such counsel and technical, clerical and other personnel as may be necessary for the performance of this order of reference;

**THAT** the Committee have power to adjourn from place to place inside and outside Canada for the purpose of this reference; and

**THAT** the Committee shall present its final report no later than December 19, 2003, and that the Committee shall retain all powers necessary to publicize the findings of the Committee as set forth in its final report until January 31, 2004.

After debate,

With leave of the Senate and pursuant to Rule 30, the motion was modified to read as follows:

**THAT** the Standing Senate Committee on Foreign Affairs be authorized to examine and report on the Canada – United States of America trade relationship and on the Canada – Mexico trade relationship, with special attention to: a) the Free Trade Agreement of 1988; b) the North American Free Trade Agreement of 1992; c) secure access for Canadian goods and services to the United States and to Mexico, and d) the development of effective dispute settlement mechanisms, all in the context of Canada's economic links with the countries of the Americas and the Doha Round of World Trade Organisation trade negotiations; and

**THAT** the Committee shall present its final report no later than December 19, 2003, and that the Committee shall retain all powers necessary to publicize the findings of the Committee as set forth in its final report until January 31, 2004.

The question being put on the motion, as modified, it was adopted.

Paul Bélisle  
*Clerk of the Senate*



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## **THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS**

### **INTRODUCTION**

With the Canadian dollar having recorded a sizeable appreciation this year, it should come as no surprise that there has been renewed interest among experts and policy makers in the movement in the Canada-U.S. exchange rate and the effects that this movement has had on bilateral trade and the overall Canadian economy. Not a day seems to go by without some discussion of this important topic in the media, in the business community, in political circles, and amongst the general public.

Three factors can explain much of this interest. The first is the sheer rapidity of the dollar's climb, with the currency having risen by about 20% from January to October. While the dollar also experienced significant growth in the late 1980s and early 1990s, the pace of the rise during that period was much less pronounced, enabling Canadian businesses to adjust much more readily. This time, in the face of a sharper rise, the business response has been more challenging.

A second factor is the growing dependence of Canada on trade with the United States, a subject that the Committee has already analyzed extensively in its June 2003 *Uncertain Access: The Consequences Of U.S. Security And Trade Actions For Canadian Trade Policy* report. Canada-U.S. currency fluctuations matter more now than they used to, given this heightened dependence.

Finally, any analysis of the effects of a currency appreciation of the scope and speed of the one that we are now experiencing must not be limited to its impacts on international trade, notwithstanding trade's importance to the domestic economy. This currency "shock" affects all of us, through its impact on Canada's economic growth, on inflation and the monetary policy that the Bank of Canada implements to restrain it, on the domestic employment situation and on the productivity of the economy.

This report begins with a discussion of the trends that have been observed in the dollar's movement, both recent and historical. The determinants of these currency fluctuations over time will then be explained, and consideration given to both internal and external influences on the dollar's recent appreciation. A second element is an assessment of the economic impacts of the dollar's rise, with the trade impact being reviewed from both a general and sectoral point of view. The report concludes with a discussion of the appropriateness of the existing exchange rate regime in Canada.

## THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS

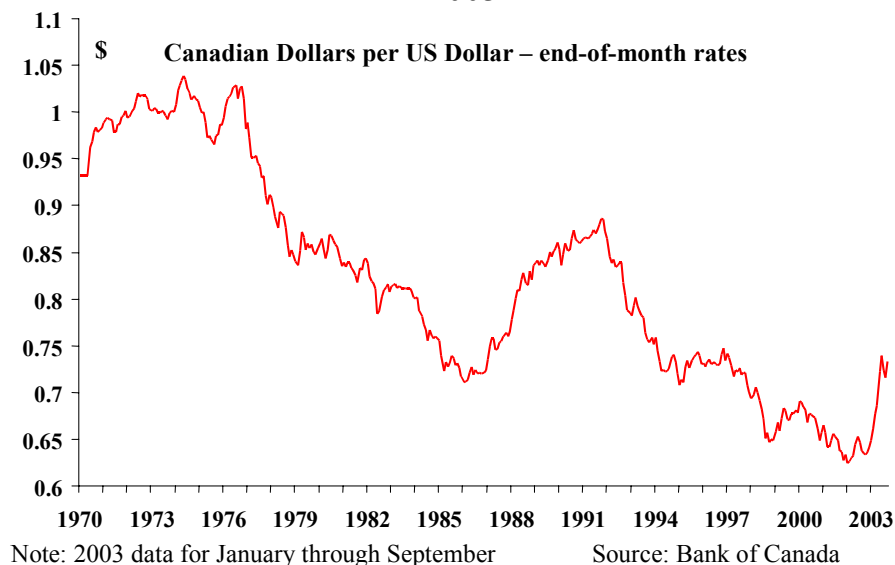
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### EXPLAINING THE PERFORMANCE OF THE CANADIAN DOLLAR

The Canadian dollar has appreciated sharply since the beginning of 2003. Valued at under 64 cents US in the first week of the year, the dollar has risen by roughly 20% through October and is trading at over 76 cents US – its highest level in nearly ten years. As Ted Carmichael (Economist, J.P. Morgan Securities Canada) testified, this surge in the value of the Canadian dollar may be unprecedented in the history of Canada's floating exchange rate. It is all the more remarkable given that, except for a five-year period beginning in 1988, the Canadian currency has been in a decline relative to the U.S. dollar since the mid-1970s.<sup>(1)</sup>

In 1976, the Canadian dollar was trading about at par with the U.S. dollar but fell from about US\$1.01 to 76 cents over the next ten years. This trend was reversed temporarily in the late 1980s and early 1990s when the dollar rose from a low of 71 cents US in 1986 to over 87 cents in 1991. However, this rise proved to be short-lived. A wide range of factors contributed to the dollar falling to a low of about 62.5 cents in April 2002.

**Chart 1 – The Canada-US Exchange Rate, 1970-2003**



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<sup>(1)</sup> It is important to note that although the Canadian dollar fell considerably against the US dollar through the 1990s, its performance relative to other major currencies has been more stable.

## **THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS**

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Although the current rise in the Canadian dollar is attracting considerable attention from experts and policy makers, the fact that the dollar is climbing is not altogether unexpected. Indeed, as Steven James (Director, Economic Analysis and Forecasting Division, Department of Finance Canada) testified, given the positive economic conditions in Canada, economists have been predicting a rise in the value of the Canadian dollar for a number of years. The surprise, therefore, is not the fact that the exchange rate is climbing, but the magnitude and the rapidity of the increase.

### **A. Factors Affecting the Exchange Rate**

Economists have identified, and closely monitor, a broad range of factors known to influence exchange rates. All else being equal, these variables have predictable effects on currency movements. However, since they do not operate in isolation from one another, and since many factors are evident only in hindsight, forecasting or anticipating movements in exchange rates – particularly in the short term – is extremely complex. In fact, as Stephen Poloz (Vice President and Chief Economist, Export Development Canada) wrote in his brief to the Committee, almost any disturbance at all in the domestic or global economy can be shown to affect the exchange rate, making any movement in exchange rates notoriously difficult for economists to anticipate.

The chief difficulty lies in the fact that not only are most of the factors known to affect the Canadian dollar interconnected, but in many cases, any movement in the exchange rate in turn affects the economic conditions that may have precipitated that movement in the first place. For example, a wide margin between exports and imports could result in a large current account surplus in Canada. This surplus implies a flow of dollars into Canada and places upward pressure on the value of the Canadian dollar. However, this increase in the dollar would make Canadian exports more expensive and imports into Canada cheaper and thus close the margin between exports and imports and reduce the current account surplus.

As such, although exchange rate fluctuations are often treated as exogenous shocks to the Canadian economy, the dollar in fact moves in response to prevailing economic conditions and itself influences those conditions as well. As John Murray (Head of International Department, Bank of Canada) stated, exchange rates are not capricious. They move with cause in a way that helps restore macroeconomic balance in Canada.

Despite the complex interaction of factors affecting the exchange rate – in addition to the fact that the exchange rate itself influences economic conditions – witnesses appearing before the Committee were in broad agreement about the major factors that affect exchange rates in Canada. A few of the principal determinants of exchange rate movements are described below.

## **THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS**

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### **1. The Performance of the Canadian Economy**

The most obvious domestic influence on the Canadian dollar is the health of the Canadian economy. A strong economy makes Canada an attractive place to invest because it offers the potential for solid economic returns. This raises demand for Canadian dollars (to invest in Canada) and pushes up the exchange rate. On the other hand, a relatively weak economy offers more limited investment returns and thus demand for Canadian dollars falls.

It is important to note, however, that economic strength is a relative concept. A prolonged period of robust economic growth in Canada will not result in a higher exchange rate vis-à-vis the United States if that country grows at the same, or a higher rate over the same period.<sup>(2)</sup> Similarly, weakness in the Canadian economy will not necessarily translate into a lower Canadian dollar if that weakness also exists in the United States.

A number of macroeconomic indicators are frequently used to gauge the fundamental strength of the Canadian economy. Among the more common of these are government fiscal and current account balances. In both cases, these indicators point to future levels of foreign indebtedness. Fiscal and current account deficits imply increased foreign borrowing while surpluses imply foreign lending (or at least reduced foreign borrowing). In the former case, all else being equal, the Canadian dollar would fall while in the latter, it would rise.

Witnesses told the Committee that the Canadian economy has seen a noticeable improvement in recent years. Since the late 1990s, Canada has run consistent surpluses on both the budgetary and current accounts, leading to a considerable decline in net foreign debt. In fact, Canada is the only G-7 country with both a current account surplus and a fiscal surplus. This improvement, especially relative to the US position (discussed further below), is supporting the current appreciation in the Canadian dollar.

### **2. Economic Conditions Outside Canada**

Economic conditions outside Canada also play a major role in determining the value of the Canadian dollar. As mentioned above, a relatively strong Canadian economy can have a positive effect on the Canadian dollar. By extension therefore, economic strength or weakness in foreign countries can also affect their domestic currencies, affecting the exchange rate with the Canadian dollar.

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<sup>(2)</sup> Although, if both Canada and the US were to outpace other major world economies, the Canadian dollar would likely rise against those other currencies.

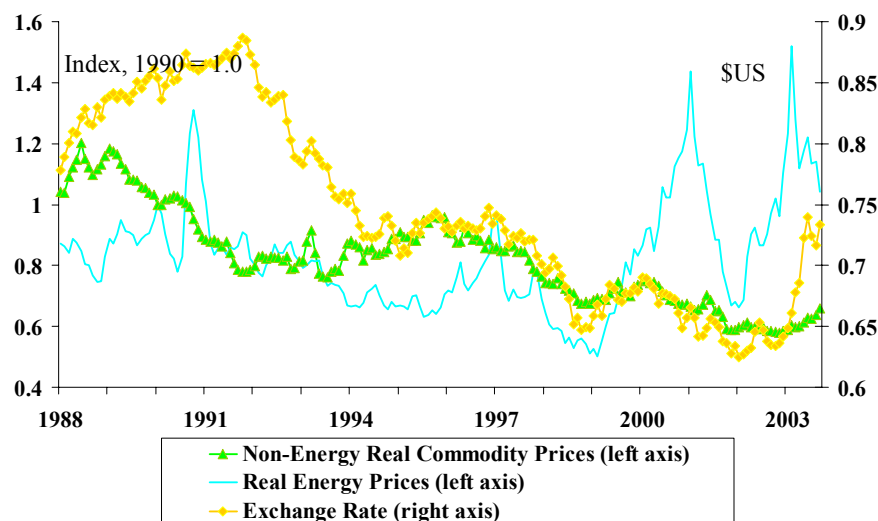
The overall state of the global economy can also have a considerable effect on the value of the Canadian dollar. There are two general reasons why this is so. The first is that in times of economic uncertainty or instability, investors tend to gravitate toward what are considered 'safe' currencies until the uncertainty passes. The U.S. dollar has traditionally been the safe haven of investors. As such, in time of global economic turmoil, the U.S. dollar has typically strengthened relative to most major currencies. Most recently, this occurred during the Asian Financial Crisis and its aftermath, when uncertainty in Asia, Latin America and Russia led investors to flock to U.S. markets.

The second way in which world markets influence the Canadian dollar is through their effect on commodity markets. A strong global economy tends to raise demand for basic commodities while in times of economic weakness, demand falters. The way in which commodity prices affect the Canadian dollar is discussed below.

### 3. World Commodity Prices

Because Canada is a large producer and net exporter of resource-based goods, the Canadian dollar is often referred to as a commodity-based currency; the performance of the Canadian dollar is correlated to the strength of world commodity prices. If commodity prices are high, then resource-based industries are more profitable, making the Canadian economy stronger and thus attracting investment and placing upward pressure on the Canadian dollar. When commodity prices fall, they undercut revenues for resource-based firms, eroding profits, dampening the domestic economy and pushing down the Canadian dollar.

**Chart 2 – Real Commodity Prices and the  
Canadian Dollar**



Note: 2003 data for January through September

Source: Bank of Canada

## **THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS**

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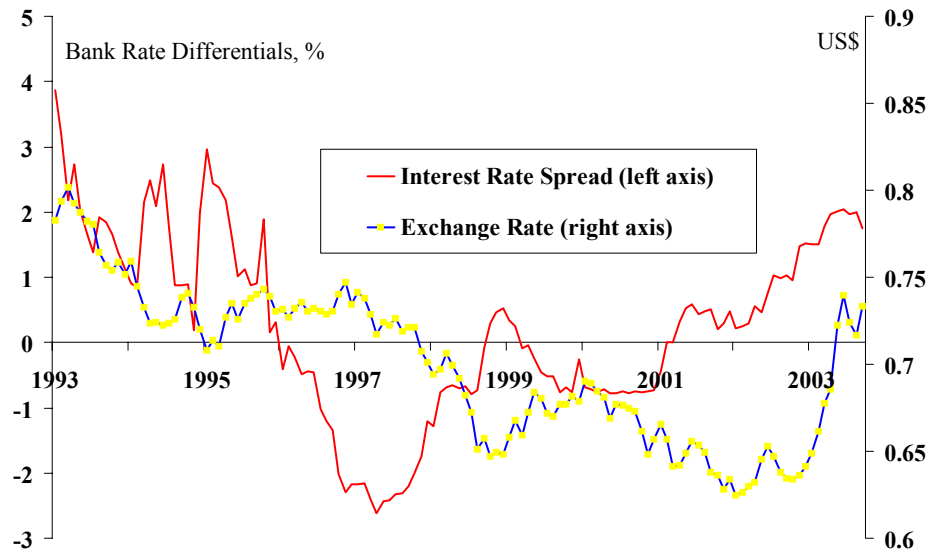
As Steven James pointed out, since movements in the Canadian dollar are correlated to world commodity prices, the exchange rate can act as a buffer against the effects of commodity price fluctuations. A low dollar partially offsets the drawbacks of low commodity prices by making Canadian exports more globally competitive in that low-price environment. Conversely, the benefits of high commodity prices are partially offset by a higher dollar.

Commodity prices were a major factor behind the Canadian dollar's weakness through most of the 1990s. Through the first half of the decade, world non-energy commodity prices were essentially flat, growing in line with Canada's inflation rate. Conditions deteriorated in the second half of the decade, particularly following the Asian Financial Crisis in 1997. Turmoil in the region's financial sector plunged several Asian countries into recession, lowered demand for raw materials and basic goods, causing world commodity prices to fall. Non-energy commodity prices fell by more than 30% from late 1995 to early 1999, with most of the drop taking place in 1997 and 1998. From 1999 onwards, non-energy commodity prices remained weak on average, falling by a further 5.8% through to the end of 2002. For their part, energy prices were also weak through the 1990s, although they have spiked twice in recent years, once in early 2001 when low inventories and strong consumer demand drove prices higher, and again in early 2003 when U.S.-led forces invaded Iraq.

### **4. Interest Rate Differentials**

When Canadian interest rates are higher than those in the U.S. and other countries, Canada becomes a more attractive destination for short-term foreign capital. This results in higher demand for Canadian dollar-denominated short-term assets and thus places upward pressure on the dollar itself. When Canadian interest rates are lower than in the U.S. and other countries, then the opposite holds true and the Canadian dollar typically weakens.

**Chart 3 – Interest Rate Spreads and the Canadian Dollar,  
1993-2003**



Note: 2003 data for January through September

Source: Bank of Canada, Library of Parliament

Although it is not the policy of the Bank of Canada to intervene in exchange rate markets, it has in the past used its influence over interest rates to defend the value of the Canadian dollar. In the late 1990s, for example, the Bank raised interest rates in response to a rapid devaluation of the dollar. Since this move improved the rate of return on Canadian assets relative to U.S. assets, it helped stabilize the value of the currency.

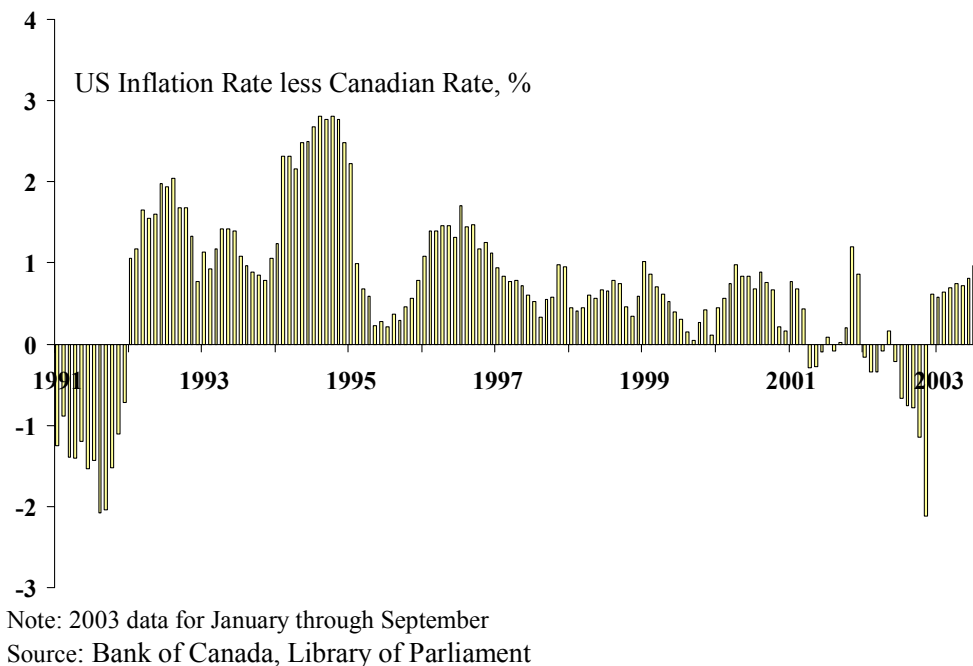
## 5. Inflation Rate Differentials

Differences in inflation rates between Canada and the U.S. also affect currency movements in the long run. Inflation is the rate at which prices rise over time and thus measures the erosion of the purchasing power of a dollar. If prices in Canada were to rise faster than in the U.S., then over time, this would erode the purchasing power – and thus the value – of the Canadian dollar relative to the U.S. dollar. This would be reflected in a decline in exchange rates over time. Similarly, if inflation in Canada was low compared to in the U.S., there would be some upward pressure on the Canadian dollar as a result.

## THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS

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**Chart 4 – Inflation Rate Spreads, 1991-2003**



The Bank of Canada adopted a low-inflation policy early in the 1990s. That policy, combined with a weaker Canadian economy through the first half of the decade kept domestic demand, and thus price growth, relatively low. As a result, inflation rates in Canada were lower than in the U.S. through most of the 1990s. However, the positive effect of lower inflation was unable to stop the decline in the value of the Canadian dollar over that period.

### **6. Investor Confidence and Speculative Investment**

Several witnesses also identified investor confidence and speculation as factors affecting the exchange rate. For the most part, investor confidence is swayed by economic factors – those mentioned above, for example. However, when assessing future growth prospects, factors such as government policies, perception and political uncertainty can all influence exchange rates. Michael McCracken (Chair, Informetrica Ltd.) suggested that in the early- to mid-1990s, the threat of Quebec separatism created uncertainty about the future of Canada and the Canadian economy. This had a negative effect on investors' views of the Canadian dollar.



The Committee also received evidence from Stephen Poloz that while exchange rates may ultimately respond to economic fundamentals over the long run, speculative interests will tend to exaggerate those movements in the short run. A rise in the Canadian dollar could become at least partially self-perpetuating if investors begin to buy into the dollar based solely upon the expectation of future growth.<sup>(3)</sup> The collapse of the tech stock speculative bubble in September 2000 is an extreme example of this sort of speculative investment artificially driving up asset values. Witnesses did not suggest that the Canadian dollar was in danger of a similar scenario, rather that the mere fact that the dollar is rising sharply attracts investor attention.

## **B. Explaining the Recent Surge in the Canadian Dollar**

Of all the factors known to affect the value of the Canadian dollar relative to the U.S. dollar over time, according to John Murray, most long-term movements in the Canadian dollar can be attributed to fluctuations in four of the above-mentioned underlying variables – the difference in Canadian-U.S. inflation rates; interest rate differentials between the two countries; the world price of energy; and the world price of non-energy commodities. While these factors do not explain all movements in the Canadian dollar, they have tracked longer-term changes closely.

### **1. Domestic Conditions**

To some extent, the recent rise in the Canadian dollar is reflective of an improvement in those four factors. The Canadian economy has enjoyed considerable strength in recent years, outpacing GDP growth in the U.S. each year since 1999. While the U.S. Federal Reserve has kept interest rates low in that country in an effort to stimulate economic growth, it has not been incumbent upon Canada to exercise the same tightness in its monetary policy. As shown in Chart 3 above, this has led to a widening gap in interest rates in the two countries. Higher interest rates make Canada a more attractive destination for short-term investment, thus creating more demand for Canadian dollars and pushing the exchange rate higher.

At the same time, data for 2003 to date is showing an improvement in world commodity prices, providing a further boost to the Canadian dollar. Although energy prices have fallen off since February, they remain considerably higher than their levels in early 2002, while non-energy commodities have enjoyed a modest recovery through 2003, rising by over 15% compared to their values of a year earlier.

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<sup>(3)</sup> The opposite would also be true – investors selling the Canadian dollar through the 1990s based on the expectation that it would continue to fall.

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For their part, inflation rate differentials were a partial offset to these factors as higher auto insurance premiums and energy prices temporarily drove Canadian inflation rates above those in the U.S. earlier in the year. More recently, inflation in Canada has fallen to about the same levels as in the United States.

The Bank of Canada operates a mathematical model that plots a “simulated” value for the Canadian dollar over time as a function of these four variables. While the Bank’s simulation of exchange rate values clearly tracks the actual performance of the Canadian dollar since the mid-1970s, a large gap has emerged since the onset of the current rise in the Canadian dollar. While the simulation suggests that the Canadian dollar should have improved only modestly in 2003, the actual rise in the dollar has been anything but modest.

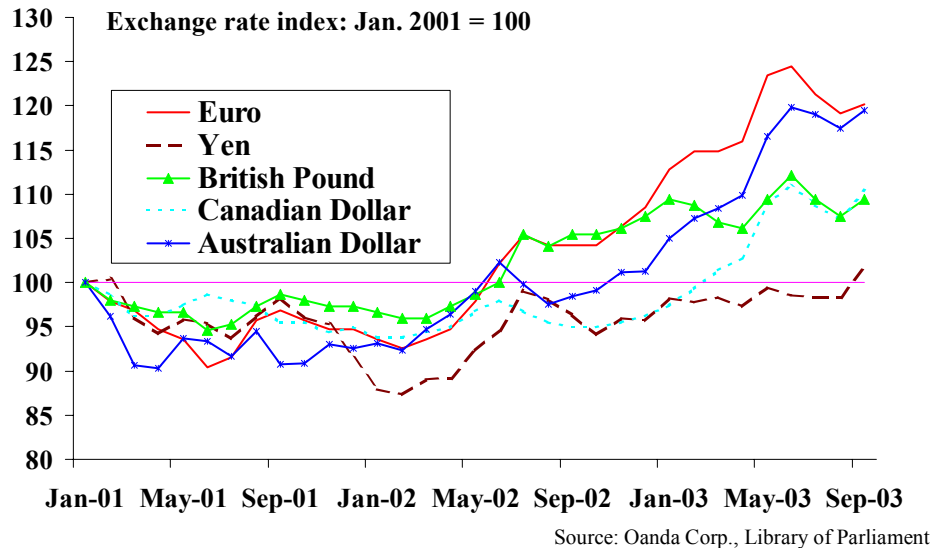
John Murray suggested that there were two possible explanations for the gap between the actual exchange rate and the Bank’s simulated rate. The first is that the Bank’s model is simply lagging behind the actual value of the Canadian dollar and will begin to rise shortly. This would be similar to the situation in the mid-late 1980s when the Canadian dollar rose sharply in advance of the Bank of Canada’s simulation.

The second explanation is that the current rise in the Canadian dollar is representative of more fundamental economic forces at work in the United States. In other words, the current strength in the Canadian dollar is less a result of Canada’s relatively sound economic position, as it is of weakness in the United States. This view was widely shared by other witnesses as well. As Don Drummond (Senior Vice President and Chief Economist, TD Economics) stated, “this is not a Canadian phenomenon per se. This is largely ... a weakening of the U.S. dollar.”

### **2. Fundamental Weakness in the U.S. Economy**

The idea that the rise in the Canadian dollar is largely a U.S.-based phenomenon is evident in the fact that the Canadian dollar is not the only currency to have appreciated in recent months; most major currencies worldwide have made significant gains against the U.S. dollar in 2003. Indeed, some currencies have appreciated even more rapidly than the Canadian dollar. In particular, the euro has soared versus the U.S. dollar, rising by 28.4% from January 2002 through September 2003. The Australian dollar – another ‘commodity currency’ like the Canadian dollar has also risen by nearly as much – 28.3% – over the same period.

**Chart 5 – World Currencies are Gaining Strength Against  
the US Dollar**



As Andrew Jackson (Senior Economist, Canadian Labour Congress) described in his brief to the Committee, the driving force behind the falling U.S. dollar is that country's large trade and current account deficits. The United States imports nearly \$2 of goods for every dollar of exports and is running a current account deficit of around \$600 to \$700 billion annually with the rest of the world. This imbalance must be offset by investment. Since the U.S. must raise funds in order to continue to buy imports, it does so by selling assets such as government bonds.

However, investment is not coming from the private sector. Low interest rates and poor stock market returns in the U.S., along with the expectation of further declines in the U.S. dollar, have deterred private investors from buying U.S. dollar-denominated assets. Instead, the U.S. current account deficit has been largely financed by foreign governments, particularly in Asia, who are using U.S. dollar bonds to build up their foreign exchange reserves or, in the case of Japan, to prevent a large increase in the value of the yen. As a result, net foreign debt in the U.S. has soared in recent years, meaning that an increasing proportion of interest payments on U.S. government bonds are flowing out of the United States. As John Murray stated, the U.S. has gone from being the world's largest creditor in the early 1980s to the world's largest debtor today.

## **THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS**

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The current decline in the value of the U.S. dollar is in large part a response to these conditions. As John Anania (Assistant Chief Economist, RBC Financial Group) stated, with Americans and their governments borrowing heavily, “people are no longer interested in blindly financing the current account deficit in the U.S., something has to give and in the balance, that is the U.S. dollar. It has to depreciate to attract that capital into the U.S. right now.” Stephen Poloz agreed, testifying that exchange rates are in a sense, the “ultimate general equilibrium variable,” working to keep the economic system in balance. A lower U.S. dollar will make that country’s exports more competitive, raise the price of imports and thus help alleviate its trade and current account deficits.

However, the extent to which a lower U.S. dollar will correct these imbalances is limited. A lower dollar will likely improve U.S. trade balances with Canada and the EU, but as John Murray pointed out, the United States’ largest trade deficits are with China and other emerging Asian countries. In many cases, these countries’ currencies are pegged to the U.S. dollar and as such, a devaluation in the U.S. dollar will not improve the terms of trade with these Asian countries. This factor is contributing to the recent pressure by the U.S. on China to revalue its currency.

### **C. Where Will the Dollar Go From Here?**

Although normally such a rapid appreciation in the Canadian dollar might not be considered stable, witnesses were in widespread agreement that the current rise in the Canadian dollar would not be temporary. Instead, it is an appropriate reflection of a change in economic conditions in Canada, the US and around the world. Indeed, no witnesses were surprised at the fact of the dollar rising in 2003; economic conditions had pointed towards such a rise for a number of years. It is primarily the rapidity of the appreciation that was unexpected.

A major reason that witnesses expected a rise in the exchange rate is the view that the Canadian dollar has been undervalued relative to the U.S. dollar for some time. Andrew Sharpe (Executive Director, Centre for the Study of Living Standards) stated that, according to the notion of purchasing power parity (PPP) – a measure of the long-term equilibrium value of the exchange rate at which the price of goods and services in two countries are approximately equal – the Canadian dollar is worth about 84 or 85 cents US.

Other witnesses proposed different measures of what the “appropriate” level of the Canadian dollar relative to the US dollar should be in the near term. John Anania and Jim Stanford (Economist, Canadian Auto Workers) both stated that unit labour costs in Canada and the US were about equal when the Canadian dollar was in the low 70-cent range while George Vasic (Chief Canadian Economist, UBS Securities Canada Inc.) suggested that a trade-weighted basket of Canadian commodity exports indicated a similar value for the dollar.

## THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS

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Of all the witnesses appearing before the Committee, not one suggested that economic forces would push the Canadian dollar back to the 63-cent range in the foreseeable future.<sup>(4)</sup> The main reason for this belief is the view that, while Canadian economic conditions are much improved today compared to the mid-1990s, the appreciation in the Canadian dollar is in fact chiefly the result of a depreciation in the US dollar against most world currencies.

When asked for his view on the future direction of the Canadian dollar, Don Drummond testified that “the backdrop is that you have to believe the US dollar will continue to weaken. They have a huge current account deficit of over 5 per cent of their economy and now their federal government is running about 5 per cent deficits. Almost all their states have deficits. There is no reason to think that Canada will not be on the upside of that. We are roughly in fiscal balance. We have current account surpluses, higher interest rates and commodity prices are firm. The direction [of the Canadian dollar] will be up.”

Some witnesses had alternative hypotheses to explain the decline in the US dollar, but agreed that a lower US dollar was likely here to stay. According to Stephen Poloz, the US dollar had been overvalued since the late 1990s because global economic uncertainty since that time led investors to flock to ‘safe’ currencies like the US dollar, driving its value higher. Anticipating a return to more stable economic conditions in the near future, Mr. Poloz stated that the current devaluation in the US dollar is, in essence, a return to more ‘normal’ conditions.

Furthermore, the Committee heard evidence that the decline in the US dollar was taking place with the implicit approval of the US administration. As Ted Carmichael stated, given the ballooning current account deficit and the lack of growth in employment and the economy in general, the US is hopeful that a weaker dollar will increase export competitiveness, stem job losses in manufacturing and stimulate economic growth in that country.

All this is to suggest that the consensus view of the witnesses was that the Canadian dollar will likely continue to be stronger into the near future. The only remaining question is how high it will climb. On this point, many witnesses were reluctant to speculate. The Committee heard that most recent economic projections called for the dollar to reach about 78 cents US or even to pass 80 cents. As Don Drummond stated, his most recent forecast in September called for a 78-cent dollar by mid-2004. However, he admitted that he did not anticipate the dollar reaching 76 cents by the third week of October. For his part, John Anania did not anticipate a specific value for the dollar, but summarised the consensus view appropriately: “The key is that we do not think it [the dollar] is going to fall back down. We think the Canadian dollar will remain valued at today’s levels and perhaps increase in 2004 and 2005.”

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<sup>(4)</sup> However, some, like Jim Stanford, believed that the Bank of Canada should intervene in exchange rate markets by lowering interest rates and pushing the Canadian dollar lower.

## **ECONOMIC EFFECTS OF THE CURRENCY APPRECIATION**

As this Committee's June 2003 report noted, there is no doubt that the exchange rate has historically been an important determinant of our trade performance with the United States. The report also observed that the economic growth differential between the U.S. and Canada contributed heavily to a healthy Canadian export scenario.

Most witnesses appearing before the Committee confirmed these observations. John Murray informed the Committee that the low value of the Canadian currency since the mid-1990s was "one of the important reasons for our strong and improving external position. It is not the only one, however. Other important reasons are the free trade agreement and the remarkable growth of the U.S. economy, as well as the fact that it was hitting its capacity limits whereas we were not, so we were a natural source of products and services to meet that rising demand."

A number of witnesses suggested that the stronger growth south of the border was, in fact, the single most important factor affecting our exports during the 1990s. Steven James mentioned that the exchange rate had not been the only influence driving Canadian exports in the 1990s. He included the North American free trade agreements and the more outward orientation of Canadian firms generally, but especially pointed to the strength of the U.S. economy as a significant factor. James noted the positive current forecasts of robust U.S. economic growth and remarked that such growth, if it were to come about, would be very positive for our export industries.

Someshwar Rao (Director, Strategic Investment Analysis, Industry Canada) provided charts to the Committee suggesting that the strength of the U.S. economy was the principal "driver" of Canada's export performance in the 1990s, although the depreciation of our currency was another important reason for the high export growth. The Canada-U.S. Free Trade Agreement and the North American Free Trade Agreement were considerably less influential, in his view.

Stephen Poloz, in a submission received by the Committee, suggested that the weakness of the Canadian dollar, together with the economic growth differentials between Canada and the U.S., were responsible for the vast majority of the export gains realized during the 1992-2002 period. He placed priority on the latter influence, noting that "trade flows around the world are dictated much less by exchange rates and more by economic growth differentials." George Vasic concurred with this point of view.

While recognizing that the decline in the value of the Canadian dollar had been an important factor in driving trade with the U.S., Don Drummond did not believe that it was the dominant factor. Instead, he tended to place a lot of weight on the importance of free trade agreements. He made the point that even though the dollar had been in a steady state of decline since the early 1970s, trade flows did not really begin to rise relative to the economy until the trade liberalization occurred.

It is possible to surmise that the effects of the currency changes occurring during the 1990s could have been different had the speed of the currency's decline over the 1990s been more pronounced and had firms been in a more difficult position to adjust appropriately. As a number of witnesses observed, the situation now is not the same in that, we are facing a currency shock encompassing a speed of change that is virtually unprecedented.

#### **A. General Impacts on Trade and Investment**

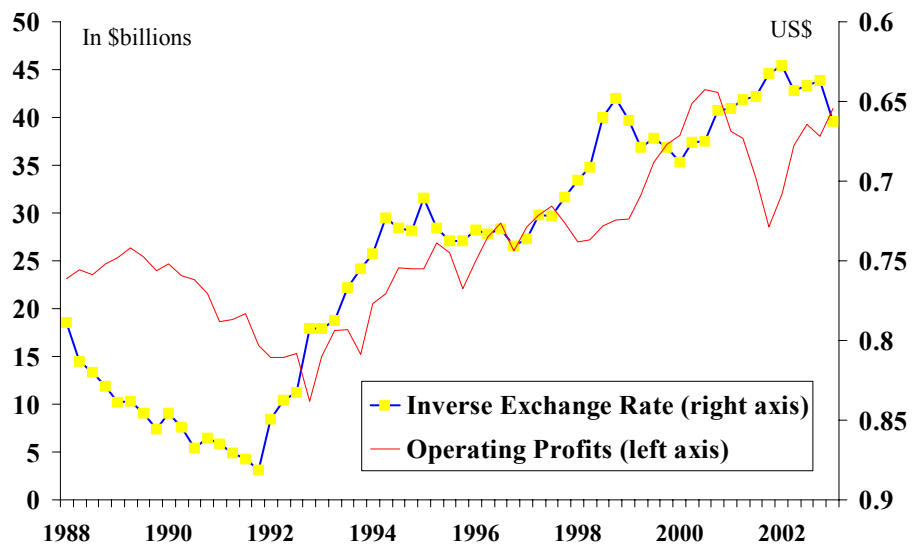
So how are the impacts of the current dollar appreciation being felt? First, there is no doubt that some exporters are curtailing shipments to the U.S. and potentially seeking other markets for their products, just like there are firms importing for the Canadian market who would benefit from the dollar's rise since they can now purchase U.S.-made products at a reduced cost. For these importers, their sales and profits stand to rise owing to the currency appreciation.

Other Canadian exporters are reacting to this appreciation not by raising prices or curtailing product shipments to the U.S. but by enduring a lower rate of profit. Many of Canada's exports, most notably commodities, automotive and electronic products, are priced in U.S. dollars. In these situations, the rise in the dollar would not alter the selling prices – the prices that the buyers would pay. What would change is the price the exporter in Canada receives as the U.S. dollar export revenues are converted into domestic currency at the now higher exchange rate. The conversion of sales to the U.S. market from U.S. dollars to Canadian dollars in financial statements will tend to reduce reported profits. As Stephen Poloz remarked, companies could attempt to recover the profit reduction at some future point or respond to the currency change by boosting efficiency and trimming costs so as to restore their profit margins. On the latter point, George Vasic categorized current profits as being quite high so that any resulting adjustments could be “either delayed or muted.” He generally felt that Canada was fortunately in a favourable economic position to endure the currency appreciation.

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**Chart 6 - The Exchange Rate and Operating Profits of Canadian Corporations**



Source: Statistics Canada, Library of Parliament

Finally, in those instances where exports are not priced in U.S. dollars, some Canadian companies may have to lower prices in order not to lose market share either to American producers or increasingly, to low-cost manufacturers such as China. Regardless of whether the product is priced in U.S. dollars or not, the exporter would continue to price to its foreign market.<sup>(5)</sup>

Fortunately, the story is not all one-sided. In any analysis of the effects of currency movements on trade, one must look at the interaction between shifts in the level of the real exchange rate and Canada's net exports (exports less imports). That is, the effect on imports must be examined as well. As John Murray stated before the Committee, "appreciations have an upside in terms of lower cost of imports and, more specifically, cheaper capital goods, making investment in Canada easier and cheaper and, potentially, but at the margin, promoting productivity growth in this country."

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<sup>(5)</sup> Andrew Jackson informed the Committee that commodity exports to countries other than the U.S. were also affected by the change in the value of the U.S. dollar, since those commodities are priced in U.S. dollars.



## **THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS**

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Steven James pointed to a “substitution of domestic demand away from domestic production and toward imports,” although he did indicate that the magnitude of the pass-through of the higher Canadian dollar into lower import prices could be less now than was previously the case. He also referred to the lower cost of imported materials, parts, machinery and equipment that now prevailed and that, given that a full 80% of Canadian machinery and equipment is imported, “to the extent that lower prices would boost investment you could see higher productivity growth in Canada going forward and higher potential output growth as well.”

The existence of more affordable imports is important since, as Stephen Poloz pointed out, Canadian exports today contain approximately 40% in imported content. While exporters are generally believed to suffer from a rising dollar, manufacturing firms tend to import parts, and especially machinery, from the U.S. and thus they will benefit from a rising dollar (i.e., their input costs will fall). According to Mr. Poloz, manufacturers are much more likely to be partly “globalized” so that the decline in the cost of imported components would improve their profit margins. The bottom line is that the adverse effect of the currency appreciation would be muted somewhat.

In terms of actual numbers, exports to the U.S. have registered a significant drop in 2003. In the January-August 2003 period, exports to the U.S. declined by 3.0% from corresponding 2002 figures. This result contrasts with the rise recorded in our exports to other countries of 3.5%.

It is important to note, however, that while exports to the U.S. have fallen through 2003 to date, this decline cannot necessarily be attributed to the effects of the rising dollar. In addition to the effect of the ongoing U.S. partial ban on beef imports from Canada this year, 2003 marks the third year in a row that exports to the U.S. have declined. In 2001, exports to the US fell by 2.1%, followed by a 1.8% drop in 2002. In both years, the drop in exports occurred while the Canadian dollar was near record low levels.

On the other side of the ledger, imports from the U.S. through 2003 were down by 5.2%, versus an increase of 2.8% for other countries. While this result is surprising, since imports from the U.S. are now considerably cheaper, other factors may be at play. One explanation, provided by George Vasic, is that with such a substantial amount of our exports containing imported content, any reduction in our exports would cause the need for the associated imported product to fall as well.

This seemingly unprecedented increase in the currency has led some to the conclusion that trade diversification away from the U.S. could leave Canada less vulnerable to rapid changes in currency values. In its June 2003 report on the Canada-U.S. trade relationship, this Committee stressed the urgency of diversifying Canada’s trade. We argued that “Canada would be better off if its trade dependence on its single largest market to the south was reduced. This does not mean that our trade with the U.S. should stop growing but rather that trade with other countries should expand at a higher rate.” Undoubtedly, the swift currency appreciation by itself will cause some trade diversification to occur, although the extent of such a shift is not yet fully known.

## **THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS**

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However, greater effort may have to be expended by the federal government “to aggressively seek out comprehensive free trade agreements in Europe and Asia,” as our report also stated. This view was supported by Michael McCracken, who urged the government to “expand export opportunities where you can find them” and to “try to get these other opportunities to happen rather than just chatter about them.” Both Andrew Jackson and Don Drummond also saw the merits of greater export diversification, even if the latter referred to it as a “heroic objective” given that transportation costs for accessing the U.S. market are low and the two countries’ consumer tastes are similar. In terms of priority target markets, Drummond identified China as one with significant potential for Canada.

Finally, several witnesses told the Committee that a stronger Canadian dollar relative to that of the U.S. will make the existing assets of Canadian companies more expensive for potential American investors. In this situation, therefore, it would not be unreasonable to expect a reduction in the purchases of such assets to occur.

### **B. Sectoral And Provincial Effects**

While the recent increase in the Canadian dollar-U.S. dollar exchange rate represents a shock for our export-oriented and import-competing industries, the impacts across industrial sectors are uneven. Focusing on the former set of industries, largely found in the manufacturing sector, the effect of a currency appreciation depends on both (a) export reliance (i.e., the ratio of exports to production) and (b) import content. While there is no question that the quick rise in the value of the dollar has harmed Canada’s export performance and company profitability, it is not the case that all exporters will experience sharply negative effects.

The first variable to consider is the level of export dependence. According to analysis by the TD Bank Financial Group, five industries, accounting for two-thirds of manufacturing production, rely on exports for at least 50% of their production: transportation equipment, forest products, computer and electronic, machinery, and electrical equipment and components.<sup>(6)</sup> According to Don Drummond, forestry-related industries are extremely sensitive to exchange rate changes, given that they export almost their entire output.

To examine export dependency is insufficient, however; one must also consider the ratio of imported inputs to production. For example, Canada imports as much as 80% of its machinery and equipment, the declining cost of which will help capital-intensive companies deal with the currency shock. The larger the above ratio, the less affected by a rising dollar companies will be.

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<sup>(6)</sup> “This Year’s Canadian Dollar Rally Will Hit Exporters Hard,” *TD Economics Topic Paper*, TD Bank Financial Group, July 24, 2003, p. 2. (available at <http://www.td.com/economics>).

## THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS

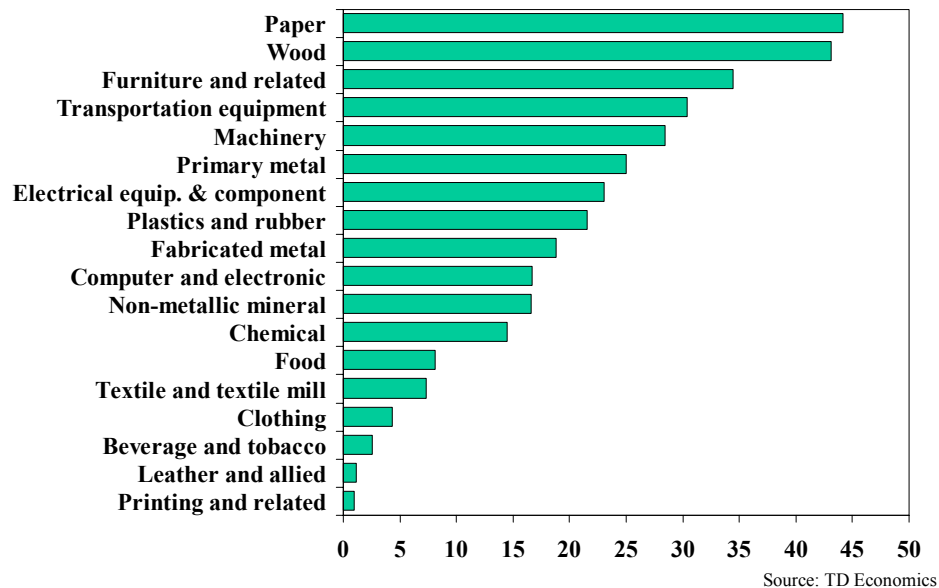
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The amount of imported content varies by industry, with those with high foreign content in their exports being hurt the least from a currency appreciation. As it turns out, the transportation equipment industry that is so export dependent also displays the highest ratio of imports to total production. Other sectors displaying high levels of import content include computer and electronic, textile and textile mills, clothing and leather production.(7)

In contrast, industries with relatively low foreign content in their exports are typically the most affected by a rise in the value of the Canadian dollar, in that the low use of imported parts and components does not enable firms to profit from the suddenly cheaper value of imports. Examples of industries at the low end of the import content scale are the wood and paper industries, which import very little; the food, beverage and tobacco industries; and non-metallic minerals.(8)

The real measure of exchange rate risk is derived by subtracting the industry import ratios from the export ratios to obtain estimates of the net export reliance for each industry. Once the import content is factored in to the initial export dependence numbers, it becomes evident that the most susceptible to the exchange-rate risk are the paper and wood industries. These industries, apart from having already been hard hit by 27% U.S. customs duties, display both a high export orientation and low import content.

**Chart 7 - Net Export Reliance of Canadian Manufacturing Industries**



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

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

## **THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS**

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Notwithstanding the fact that his industry embodies a high degree of import content, and should be partially aided by a rise in the Canadian dollar, Jim Stanford pointed out that the automotive products sector (assembled vehicles and parts) had already experienced a 50% decrease in the net trade surplus in the first half of 2003. If the dollar were to remain at 75 cents or higher, the surplus would be totally eliminated. He also said that while exports of energy products and other resources, apart from lumber, were “booming,” those of technology-intensive products were not faring as well.

As Stephen Poloz and George Vasic reminded the Committee, Canada’s trade with the US is not composed solely of merchandise, but it has a strong service sector component as well. According to Mr. Poloz, services currently account for approximately 20% of total Canadian exports. However, as Don Drummond pointed out, the services sector is much more oriented towards the domestic market than is the goods sector. In general, therefore, a higher dollar will have less of an impact on economic activity in services.

In cases where Canadian companies do export services, the effect of a high dollar is the same as with goods exports. However, in many cases, the impact will be more dramatic because, as Stephen Poloz stated, service industries tend to have higher Canadian content than goods industries. The most severely hit industry in Canada is likely tourism. A higher Canadian dollar makes it cheaper for Canadians to travel abroad, but more expensive for international visitors to Canada. Since Canadian tourism is composed of essentially 100% Canadian content, that industry does not benefit at all from lower import prices.

However, as John Anania observed, a number of Canadian service industries, which may not be export-driven, 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. For their part, import-driven industries like retail and wholesale trade will benefit considerably from lower-priced goods from abroad.

As a final observation, one could assess which provinces have been most affected by the rise in the value of the currency. As the submission from Don Drummond pointed out, the answer to this question depends on their relative export intensities and their industrial structure. Quebec and Ontario appear to have been the most adversely affected in the aggregate, with British Columbia a close third owing to its dominant forest industries. Notwithstanding this analysis, Drummond urged Committee members to place greater emphasis when considering the currency issue on sectoral rather than regional effects.

### **C. Other Effects on the Canadian Economy**

#### **1. Competitiveness and Employment**

Jim Stanford attributed much of the job growth since the mid-1990s (450,000 net new manufacturing jobs), increased competitiveness of Canadian investment locations, higher standard of living and overall economic prosperity to the low value of the Canadian dollar. "Our economy, by virtually every real indicator you can imagine, improved by leaps and bounds since the mid 1990s, and the fact that our currency was at low levels was a crucial part of that."

With the higher dollar, the competitiveness situation has now changed. A key indicator that economists use to measure international competitiveness is "unit labour costs," or the labour costs associated with producing one unit of output. According to Mr. Stanford, unit labour costs in manufacturing are equalized between the two countries at an exchange rate of approximately 72 cents US. At this level, the labour cost savings just offset the gap in relative productivity gap between Canada and the United States. Mr. Stanford informed Committee members that "we need an exchange rate of U.S. 72 cents or lower so that we can maintain the absolute level of unit labour costs in Canadian manufacturing at a competitive level." If the dollar were to track any higher than 72 cents, it would become more expensive to produce here than in the U.S. and, according to Mr. Stanford, there would be an incentive to move production back south of the border.

With the Canadian dollar now trading at over 76 cents U.S., Canada's labour cost advantage over the U.S. has been eliminated. Moreover, relative productivity in Canada slumped in the first half of this year in conjunction with both a decline in domestic output growth and the productivity improvements south of the border.

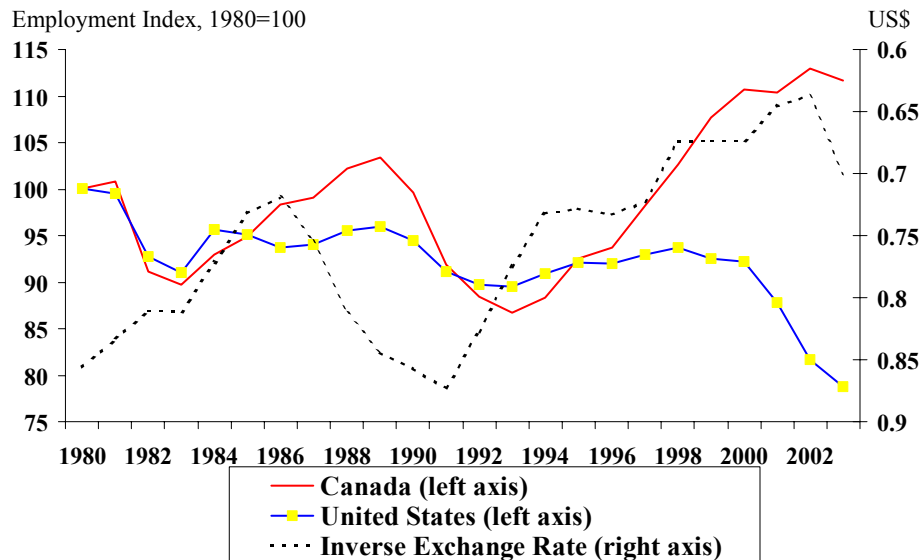
These developments have dramatically affected Canada's relative competitive position in the short term. The rapid rise of the dollar has harmed profit margins across all export-oriented industries and this profit squeeze is forcing Canadian firms to lower costs and improve productivity in order to defend profit margins.

This points to a stagnation or reversal of Canada's healthy employment gains of 2002. Not only have manufacturers tried to lower costs by reducing employment levels, but the rise in the Canada-U.S. exchange rate has also made the hiring of new labour less attractive relative to capital (i.e., machinery and equipment), because the currency's appreciation has lowered the cost of capital imports. All told, the first half of the year saw a net loss of 64,000 manufacturing jobs in Canada.

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**Chart 8 - Manufacturing Employment in Canada and the United States, 1980-2003<sup>1</sup>**



Admittedly, not all of these job losses can be attributed exclusively to the currency appreciation. More difficult economic conditions in the first half of 2003 could account for many of the employment reductions. Another point to consider is that the dollar's appreciation could well benefit Canadians in the future through a possible improvement in productivity, as the next section of the report will discuss.

### **2. Productivity Gains: A Potential “Upside”**

A number of witnesses told the Committee that one of the most important impacts of a stronger currency was the effect it would have on productivity in Canada. Productivity is key to the long-run improvement of living standards. Increasing economic output per unit of input improves international competitiveness which, in turn, can lead to higher output, profits, wages and, in the long run, employment gains. Most witnesses felt that an increase in the Canadian dollar would have a positive effect on productivity – the “silver lining” of a higher dollar, as George Vasic stated.

Andrew Sharpe identified four channels through which exchange rates are believed to affect productivity. In two cases, a high exchange rate is believed to positively affect productivity while the other two cases are thought to have the opposite effect.

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The first channel is the exchange rate sheltering hypothesis, also known as the “lazy manufacturers hypothesis.” According to this theory, lower exchange rates increase firms’ relative international competitiveness, making them more profitable but reducing the incentive to make productivity-enhancing investments. A number of witnesses dismissed this theory as largely implausible. As Jim Stanford stated, “The level of competition amongst Canadian manufacturers is incredibly intense – there is no gentlemen’s club where they sit down together to talk about the economy. They are out to eat each other’s lunch. Moreover, anyone can come to Canada and take advantage of those relative low prices with a low dollar and still use new technology and new productivity to improve their profit margins.” The Committee also heard that a low dollar only increases competitiveness with respect to foreign suppliers; domestic competition remains unaffected.

The second channel is the factor price hypothesis. As alluded to above, when the exchange rate appreciates, this should make the use of capital more attractive than labour in the production process since the exchange rate affects the cost of imported equipment and software more than the cost of labour. Over time this would lead to an increase in the use of capital, a decrease in labour intensity, and an improvement in productivity.

The third way in which exchange rates can affect productivity is by affecting firms’ capacity to invest (the productivity investment effect). Since a lower exchange rate increases competitiveness and profitability, it leaves firms with more money to invest in productivity-enhancing improvements.

Finally, there is the foreign investment effect. Lower exchange rates make it more attractive for foreign companies to invest in Canada because of the resulting lower labour costs. Firms can bring their machinery, equipment and technological innovations to Canada, potentially leading to strong productivity gains. This effect is limited, however, by the extent to which Canada attracts foreign direct investment.

On balance, Andrew Sharpe felt that a stronger dollar would, in most sectors, increase productivity and competitiveness. Most witnesses agreed – largely because of the effects of the factor price hypothesis. Canadian firms import up to 80% of their equipment, machinery and software from the United States. As John Anania stated, “we have found in the past that Canadian companies tend to depend a little bit more on labour than capital. That has key implications, as far as labour productivity is concerned. The larger your capital stock, the more productive your labour force will be.” As such, the substitution of capital for labour raises productivity, potentially offsetting any loss in export competitiveness because of the higher dollar.

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How the various industries will benefit (from an investment point of view) from a higher dollar depends on the amount of machinery, equipment and software used in the production process in relation to the value added that the industries in question contribute. Within the manufacturing sector, capital-intensive industries such as primary metals, oil and gas, chemicals and paper head the list. Apart from manufacturing, education and related services, truck transportation, broadcasting and telecommunications and agriculture also stand out.<sup>(9)</sup>

Not all of the witnesses, however, were disciples of the “high dollar high productivity” scenario. Jim Stanford argued for the productivity investment effect – that the existence of a low dollar would strengthen productivity and that a higher dollar would cause profit margins to decline. In turn, lower profits would result in less money being available for investment purposes.

This view was shared by Michael McCracken, who pointed out that a currency appreciation would dampen retained earnings and corporate profits, thereby reducing investment flows. He noted that ultimately how industries react to cheaper imports of machinery and equipment will depend on what the adverse effects of the currency appreciation on the industry or sector in question are.

In his brief to the Committee, Andrew Jackson supported the foreign investment effect. He remarked that the fall in the value of the dollar in the 1990s had “helped compensate for the relatively poor investment record of Canadian business, particularly investment in new plants and in research and development,” by attracting new foreign investment in a number of economic sectors.

Still another witness, Someshwar Rao, suggested that the focus on the currency and its effect on productivity may be misplaced. “The problem seems to be in the future. If we want to improve our trade performance, it is not so much the dollar that we should worry about – we cannot control the dollar – but it is the productivity that we have to worry about. That will improve our real wages and at the same time improve our cost position and trade performance.”

In his submission to the Committee, Mr. Rao observed that the improvement in Canada’s cost competitiveness relative to the U.S. can be entirely attributed to the depreciation of the currency. However, increased cost competitiveness does not automatically translate into a rise in a country’s standard of living unless it is brought about through an increase in productivity. On that score, Canada has not performed very well as its labour productivity in manufacturing rose by only 50% of the U.S. rate in the 1990-2002 period. By 2002, the economy-wide labour productivity level gap between the two countries was 16% and that in manufacturing a full 35%.

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<sup>(9)</sup> “Hidden benefits of a stronger Canadian dollar,” *Current Analysis*, RBC Financial Group, May 2003, p. 3.



Don Drummond agreed that improving productivity growth was of critical importance to the long-run success of the Canadian economy, trumping the issue of the appreciating Canadian dollar. He stated “I do not think the fluctuations or the rise in the dollar are the main issue. The main issue for the Canadian economy is our substandard productivity performance vis-à-vis the United States. If we can find the key to resolving that, our dollar would probably continue to rise under those circumstances, but we would probably not care much about it. We would be in a competitive position and our standard of living would rise.”

### **3. Impact on Inflation and Monetary Policy**

Will the appreciation of the Canadian dollar lead to lower inflation and, if so, will that development lead the Bank of Canada to lower interest rates? Undoubtedly, exchange rate movements can have a direct effect on the prices of traded goods and services and, thus, on inflation. The recent appreciation of the Canadian dollar should result in a dampening of the growth in the Consumer Price Index (CPI), a commonly used measure of inflation. A higher dollar lowers the cost of imports while leaving the cost of domestically-produced goods unchanged. It should be noted, though, that Bank of Canada research reveals that in countries such as Canada, the impact of currency fluctuations on consumer prices during low inflation periods (such as the one now being experienced) has been far more modest than those experienced during high inflation periods.

At the present time, 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 occurs, the Bank of Canada attempts to determine if the change has been caused by fundamentals or by a loss of confidence. In the former case, it normally refrains from taking action based on simply the exchange rate level. For example, it decided in mid-October not to raise interest rates, sensing that other positive economic developments (e.g., the strength of the U.S. economy and its demand for Canadian exports; the rebound in the global economy as evidenced by the surge in commodity prices) were serving as offsets to the exchange-rate effect.

The Committee heard mixed views on whether the Bank of Canada should more explicitly take into account fluctuations in the Canada-U.S. exchange rate when conducting its monetary policy. Stephen Poloz informed the Committee that maintaining the overriding objective of the Bank to achieve a low, stable inflation rate represented an appropriate monetary policy. To him, achieving stability in the rate of inflation implies that, over time, the economy will attain an output level approaching full employment. Andrew Sharpe and John Anania also voiced their approval of the Bank’s current policy direction.

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However, not everyone appearing before the Committee shared these views. Other witnesses informed the Committee that the Bank of Canada should broaden its focus to help moderate the effects of the currency fluctuations. For example, Mike McCracken told the Committee that the Bank of Canada should concentrate on more than just the CPI and that the federal government should respond to the current exchange-rate situation with lower interest rates. The latter suggestion was echoed by Andrew Jackson in his submission to the Committee.

Jim Stanford also argued that the Bank of Canada should devote greater attention to the exchange rate in its conduct of monetary policy. In essence, he believed that the Bank should adopt a broader and more flexible monetary policy rule, as opposed to simply targeting inflation.

### **D. Overall Consequences for Growth: The News May Not Be As Bad As It Seems**

Economic theory informs us that an appreciation of the dollar will impose transitional costs on the Canadian economy, lowering Canadian exports, raising our imports, negatively affecting our trade balance and lessening this country's GDP growth rate. Experts generally predict that the strong Canadian dollar will restrict economic growth both this year as well as in 2004.

However, forecasts of the consequence of a currency appreciation can vary. As Don Drummond noted, a Bank of Canada model indicates that 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 calls for a reduction in GDP growth of roughly 1% in both 2003 and 2004.

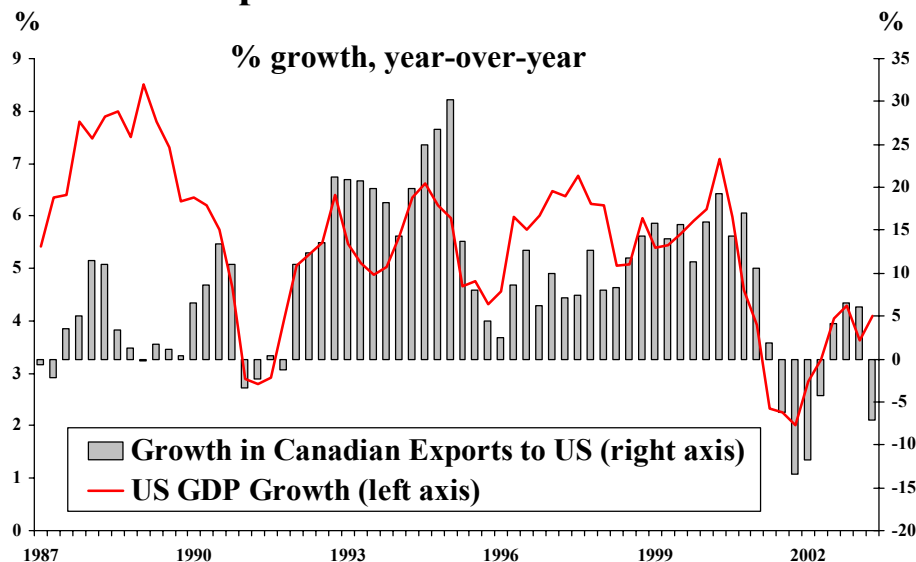
In his appearance before the Committee, Stephen Poloz cast additional doubts on the accuracy of forecasting the impacts of currency changes on growth. He suggested that the typical rule of thumb for an open economy such as Canada is that a 1% appreciation leads to a 0.3% decline in our GDP during the following 12 months. However, he argued that it is virtually impossible to determine the effects of movements in the exchange rate on the Canadian economy. As the argument goes, the effect of currency fluctuations depends on the source of the movement so that the above simple theoretical analysis does not always work. Moreover, the Canadian economy is changing, so that any effects are more uncertain over time. In other words, the observed relationship between the dollar and the economy is fundamentally ambiguous.

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Regardless of whether or not it is possible to precisely determine the impact of the currency appreciation on the Canadian economy, Donald Drummond cautioned that the effect may not be so dramatic as compared to previous appreciations because: (a) many Canadian firms have hedged their foreign currency positions to guard against exchange-rate fluctuations; (b) the import content of our exports has grown, and the dollar's decline and associated drop in the price of these imports serves as a useful offset for firms' profit situation; (c) more and more Canadian firms are borrowing in U.S. dollars, serving as an offset to the rising dollar because the cost of their loans has been reduced; and (d) increasing numbers of Canadian firms are generating US dollars in their U.S. operations.

Most importantly, four other points need to be made to mollify existing concerns about the adverse effect of the rising dollar on the Canadian economy. The first is the potential for productivity gains, which has been already discussed in the report. Reduced costs and enhanced productivity are essential to future competitiveness and long-term economic growth. Second, a strong Canadian dollar boosts the real purchasing power and net worth of Canadian consumers and investors. It can be thought of as the equivalent of a national pay hike for many in society. Third, the U.S. economic recovery in the past few months has been very robust, and forecasts generally expect a continuation of this positive performance into 2004. 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 our trade performance. According to Stephen Poloz, "the Canadian economy will see solid growth next year and it will see increased international trade in spite of and because of the rise in the Canadian dollar."

**Chart 9 - The Relationship Between Canadian Exports and US GDP Growth**



Source: Statistics Canada, Library of Parliament

## **THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS**

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Fourth, the global recovery underway is causing a surge in basic commodity prices, a development that is of benefit to Canada. For example, as Mr. Poloz indicated to the Committee, the world price of nickel had increased by a full 70% during the past year, more than offsetting the effects of the concurrent rise in the Canadian dollar.

In sum, while the currency appreciation has been unprecedented in terms of its speed and there will no doubt be costs in the transition to a more appropriate valuation of the Canadian dollar, the Committee was informed that many of the effects of the exchange rate development may be offset by other developments in the North American (e.g., strong U.S. economic growth) and global economies (e.g., higher commodity prices). At the same time, many witnesses noted that a higher dollar presents the opportunity for productivity gains, an improvement in our international buying power and a higher standard of living in Canada.

## **A FINAL WORD**

As a final consideration, the Committee also received evidence on what form of exchange rate regime would be best for Canada. Other than the period from 1962 to 1970, during which Canada's exchange rate with the United States was fixed, market forces have determined the value of the Canadian dollar from World War II to the present. Since 1971, when the U.S. delinked its dollar from gold, Canada's monetary system has been anchored exclusively by flexible exchange rates. No other developed country can claim such a sustained and generally crisis-free track record with flexible rates.

The Committee, in its June 2003 report, had already expressed its concern that the costs of abandoning the Canadian currency (i.e., loss of the dollar as a "shock absorber," elimination of sovereignty over monetary policy) would far exceed any reduction in transactions costs that could arise from a monetary union with the U.S.

Virtually all of the witnesses appearing before the Committee agreed that the exchange-rate flexibility currently in place continues to be the best option for Canada, and that there is no need to consider alternative exchange rate systems. John Murray informed the Committee that not only does short-run exchange volatility impose only limited costs, currency flexibility offers important advantages such as policy independence and the ability of the currency to partially insulate the Canadian economy from external economic shocks. Andrew Sharpe concurred with the importance of having an adjustment mechanism in place to shelter the economy from such shocks.

Jim Stanford was of the opinion that the "policy independence granted by the exchange rate, as well as the shock-absorbing features of it, are important, particularly if we were to consider a monetary union or common currency because we would lose the ability to set domestic interest rates. That would be a huge mistake." According to Mr. Stanford, the introduction of a common currency would equal dollarization, with the most that Canada could anticipate receiving from this monetary development would be one seat on the Federal Reserve Board.

The view that a monetary union, involving a brand new North American currency, was not in the cards was also shared by Don Drummond. For him, a common currency between Canada and the U.S. should only be considered if the structure of the two countries' economies were similar. At the present time, he stated, Canada is considerably more dependent upon commodities for its economic performance than is its southern neighbour and this situation will not likely change in the foreseeable future.

## **THE RISING DOLLAR: EXPLANATION AND ECONOMIC IMPACTS**

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In contrast, Ted Carmichael wondered whether currency fluctuations were, in the long term, “beneficial for increasing Canada-U.S. trade, making Canada-U.S. trade more stable over time and adding to the ability of the Canadian economy to create wealth, jobs, increase productivity, and so on.” While he admitted that a flexible exchange rate system was useful in absorbing exogenous shocks, he felt that the fluctuations in the dollar had themselves “destabilized the Canadian economy” and that it was not healthy to have the dollar’s movement cause such large shifts in the relative competitiveness of Canadian industry. He advocated the introduction of a common North American currency (encompassing Mexico, the United States and Canada) and thought that this longer-term issue should be debated in the same way as the short-term currency appreciation issue is now being discussed.

One point that everyone appearing before the Committee could agree on was that it did not make much sense to fix, or peg, the Canadian dollar to that of the United States. We heard that it is very difficult to know with precision at what rate to fix it and that such a move to greater exchange-rate fixity might involve some unintended consequences. To quote from Carmichael, fixed exchange rates “come under pressure and eventually do not hold. Sometimes they lead to exchange crises that lead to great destabilization in the economies in question.” John Murray gave the Committee the case of the 1997-98 Asian financial crisis as an example of the unfortunate effects of unsustainable currency pegs.

Finally, another problem with fixed exchange rates is the burden that they place on a country’s monetary policy. As Don Drummond put it, in those countries fixing their currencies “you have to dedicate your interest rate policy to fixing the exchange rate. That gives you the worst of the worlds. The interest rates can wreak havoc on your domestic economy much more readily than the changing of exchange rates, so in trying to address a situation that some might think is undesirable you create a much worse situation.”

**Organizations**

**Bank of Canada**

- Mr. John Murray, Head of International Department

October 7, 2003

**Canadian Auto Workers (CAW)**

- Mr. Jim Stanford, Economist

October 8, 2003

**Centre for the Study of Living Standards**

- Mr. Andrew Sharpe, Executive Director

October 21, 2003

**Department of Finance Canada**

- Mr. Steven James, Director, Economic Analysis and Forecasting Division

October 7, 2003

**Export Development Canada**

- Mr. Stephen Poloz, Chief Economist

October 21, 2003

**Industry Canada**

- Mr. Someshwar Rao, Director, Strategic Investment Analysis

October 7, 2003

**Informetrica Limited**

- Mr. Michael McCracken, Chair

October 8, 2003

**J.P. Morgan Securities Canada**

- Mr. Ted Carmichael, Economist

October 8, 2003

**RBC Financial Group**

- Mr. John Anania, Assistant Chief Economist

October 21, 2003

**TD Economics**

- Mr. Don Drummond, Senior Vice-President & Chief Economist

October 22, 2003

**UBS Securities Canada Incorporated**

- Mr. George Vasic, Chief Canadian Economist

October 22, 2003

**APPENDIX II:**  
**SELECTED DOCUMENTS RECEIVED BY THE COMMITTEE FOR THIS STUDY**

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**Brief**

**Canadian Labour Congress**

- Mr. Andrew Jackson, Economist

October 8, 2003



**Organizations**

**Agricultural Producers Association of Saskatchewan**

- Mr. Dave Brown, Vice-President

February 21, 2003

**Agriculture and Agri-Food Canada**

- Mr. Rory McAlpine, Acting Director General, International Trade Policy
- Mr. Ian Thomson, Acting Director, Western Hemisphere Trade Policy Division

February 5, 2003

**Alberta Canola Producers Commission**

- Mr. Kenton Ziegler, Chair
- Mr. Ward W. Toma, General Manager

February 19, 2003

**Asia-Pacific Foundation of Canada**

- Mr. John Wiebe, President and Chief Executive Officer

March 26, 2003

**British Columbia Lumber Trade Council**

- Mr. John Allan, President

February 17, 2003

**Canadian Agri-Food Trade Alliance**

- Mr. Ted Menzies, President
- Ms. Patty Townsend, Executive Director

February 5, 2003

**Canadian / American Border Trade Alliance**

- Mr. Jim Phillips, President and Chief Executive Officer

March 18, 2003

**Canadian Association of Petroleum Producers**

- Mr. Pierre Alvarez, President

February 19, 2003

**Canadian Cattlemen's Association**

- Mr. Dennis Laycraft, Executive Vice President

February 19, 2003

**Canadian Centre for Policy Alternatives**

- Mr. Bruce Campbell, Executive Director

March 26, 2003

**APPENDIX III:**  
**WITNESSES WHO CONTRIBUTED TO VOLUME I OF THIS STUDY**

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**Canadian Manufacturers and Exporters**

- The Honourable Perrin Beatty, President and Chief Executive Officer

April 1, 2003

**Canadian Trucking Alliance**

- Mr. David H. Bradley, President and Chief Executive Officer
- Ms. Elly Meister, Vice President, Public Affairs

April 9, 2003

**Canadian Vehicle Manufacturers' Association**

- Mr. David C. Adams, Vice-President, Policy

April 1, 2003

**Canadian Wheat Board**

- The Honourable Ralph Goodale, P.C., M.P., Minister of Public Works and Government Services and Minister responsible for the Canadian Wheat Board

May 14, 2003

- Mr. Ian McCreary, Director
- Mr. Victor Jarjour, Vice-President
- Ms. Alexandra Lamont, Policy Advisor

February 21, 2003

**Canfor Corporation**

- Mr. Kenneth O. Higginbotham, Vice-President, Forestry and Environment

February 18, 2003

**Centre for Trade Policy and Law**

- Mr. William A. Dymond, Executive Director

February 3, 2003

**Communications, Energy and Paperworkers Union of Canada**

- Mr. Fred Wilson, National Representative

February 11, 2003

**Department of Citizenship and Immigration**

- Mr. Daniel Jean, Acting Assistant Deputy Minister, Policy and Program Development

April 9, 2003

**APPENDIX III:**

**WITNESSES WHO CONTRIBUTED TO VOLUME I OF THIS STUDY**

---

**Department of Foreign Affairs and  
International Trade**

- The Honourable Pierre Pettigrew, P.C.,  
M.P., Minister of International Trade  
  
February 3, 2003
- Mr. Marc Lortie, Assistant Deputy Minister  
(Americas)  
  
April 8, 2003
- Mr. Doug Waddell, Assistant Deputy  
Minister, Trade, Economic and  
Environmental Policy  
  
March 19, 2003
- Mr. Carlos Rojas-Arbulú, Trade  
Commissioner, Mexico Division  
  
April 8, 2003
- Mr. Claude Carrière, Director General,  
Trade Policy Bureau  
  
February 3, 2003  
March 25, 2003

**Department of Foreign Affairs and  
International Trade**

*(continued)*

- Ms. Elaine Feldman, Director General,  
Export and Import Controls Bureau  
  
March 19, 2003
- Ms. Suzanne Vinet, Director General,  
Trade Policy II, Services, Investment and  
Intellectual Property Bureau  
  
March 25, 2003
- Mr. Bruce Levy, Director, Transborder  
Relations with the United States  
  
February 3, 2003
- Mr. Claudio Vallé, Director, Technical  
Barriers and Regulations  
  
April 8, 2003
- Mr. Graeme C. Clark, Acting Director,  
Mexico Division  
  
April 8, 2003
- Mr. Matthew Kronby, Counsel, Deputy  
Director, Trade Law  
  
March 25, 2003

**APPENDIX III:**  
**WITNESSES WHO CONTRIBUTED TO VOLUME I OF THIS STUDY**

---

**Doman Industries Limited**

- Mr. Bob Flitton, Manager, Real Estate and Governmental Affairs

February 17, 2003

**Embassy of Mexico in Ottawa**

- H.E. Maria Theresa Garcia S. de Madero, Ambassador of Mexico to Canada

April 8, 2003 &  
May 5, 2003

- Ms. Cecilia Jaber, Deputy Head of Mission

May 5, 2003

- Mr. Carlos Pinera, Representative of the Mexican Secretariat of the Economy in Canada

April 8, 2003

- Mr. Fernando Espinosa, Economic Attaché

April 8, 2003

**Fisheries Council of Canada**

- Mr. Ronald W. Bulmer, President

March 18, 2003

**Forest Products Association of Canada**

- Mr. Avrim Lazar, President

February 11, 2003

**Fraser Institute**

- Mr. Fred McMahon, Director, Centre for Globalization Studies

February 18, 2003

**Free Trade Lumber Council**

- Mr. Frank Dottori, Co-President
- Mr. Carl Grenier, Senior Vice-President

February 11, 2003

**Government of Mexico**

- The Honourable Luis Ernesto Derbez Bautista, Secretary of Foreign Affairs
- Mr. Geronimo Gutiérrez, Undersecretary of Foreign Affairs

May 5, 2003

**Independent Lumber Remanufacturers Association**

- Mr. Russ Cameron, President

February 18, 2003

**APPENDIX III:**

**WITNESSES WHO CONTRIBUTED TO VOLUME I OF THIS STUDY**

---

**Industrial, Wood & Allied Workers of Canada**

- Mr. Kim Pollock, National Director, Public Policy and Environment

February 17, 2003

**Maritime Lumber Bureau**

- Ms. Diana Blenkhorn, President and Chief Executive Officer

February 11, 2003

**National Farmers Union**

- Mr. Darrin Qualman, Executive Director

February 21, 2003

**Nova Scotia Fish Packers**

- Mr. Denny Morrow, Executive Director

March 18, 2003

**United Steelworkers of America**

- Mr. Dennis Deveau, Government Liaison, Legislative Department

April 1, 2003

**Western Barley Growers Association**

- Mr. Douglas McBain, President

February 19, 2003

**Weyerhaeuser**

- Mr. David A. Larsen, Vice President, Government and Public Affairs

February 17, 2003

**Wild Rose Agricultural Producers**

- Mr. Brent McBean, Director

February 19, 2003

**APPENDIX III:**  
**WITNESSES WHO CONTRIBUTED TO VOLUME I OF THIS STUDY**

---

**Individuals**

**Professor Don Barry**

International Relations  
University of Calgary

February 20, 2003

**Mr. Anthony Campbell**

Consultant

March 18, 2003

**Mr. Peter Clark**

Partner  
Grey, Clark, Shih and Associates, Ltd.

February 3, 2003

**Professor Theodore Cohn**

Department of Political Science  
Simon Fraser University

February 18, 2003

**Professor Gilbert Gagné**

Department of Political Studies  
Bishop University

February 3, 2003

**Mr. Billy Garton**

Partner  
Bull, Housser & Tupper

February 17, 2003

**Mr. Charles Gastle**

Partner, Shibley Righton

February 11, 2003

**Professor Richard Harris**

Economics Department  
Simon Fraser University

February 17, 2003

**Professor John Helliwell**

Department of Economics  
University of British Columbia

February 18, 2003

**Mr. Lawrence L. Herman**

Counsel  
Cassels, Brock & Blackwell LLP

February 4, 2003

**Mr. Jon Johnson**

Partner  
Goodmans LLP

February 4, 2003

**Professor Laura Macdonald**

Associate Professor and Director, Centre for  
North American Politics and Society  
Carleton University

April 8, 2003

**APPENDIX III:**

**WITNESSES WHO CONTRIBUTED TO VOLUME I OF THIS STUDY**

---

**The Honourable Roy MacLaren**

Former Minister for International Trade

February 4, 2003

**Professor George MacLean**

Political Studies  
University of Manitoba

February 21, 2003

**Ms. Kathleen Macmillan**

President, International Trade Policy  
Consultants

February 3, 2003

**Professor Donald McRae**

Business and Trade Law  
University of Ottawa

February 3, 2003

**Professor Armand de Mestral**

Faculty of Law  
McGill University

February 27, 2003

**Professor Rolf Mirus**

Director, Centre for Economic Research,  
School of Business  
University of Alberta

February 20, 2003

**Mr. Tim O'Neill**

Executive Vice-President and Chief  
Economist  
BMO Financial Group

March 26, 2003

**Professor Richard Ouellet**

Assistant Professor, Faculty of Law  
Laval University

February 27, 2003

**Mr. Les Reed**

Forest Policy Consultant

February 17, 2003

**Mr. Steven Shrybman**

Lawyer  
Sack Goldblatt Mitchell

February 27, 2003

**Mr. David Usherwood**

February 19, 2003

**APPENDIX III:**  
**WITNESSES WHO CONTRIBUTED TO VOLUME I OF THIS STUDY**

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**Fact Finding Mission: Washington, D.C., April 28 – May 1st, 2003**

**American Consumers for Affordable Homes**

- Ms. Susan E. Petrunias
- Mr. Bruce H. Hahn, President, American Homeowners Foundation
- Mr. Kent Knutson, Vice President, Governmental Relations, Home Depot
- Mr. Jonathan Gold, Vice President, International Trade Policy, International Mass Retail Association
- Mr. Michael S. Carliner, Staff Vice President, Economics, National Association of Home Builders
- Mr. Jason M. Lynn, Legislative Director, National Association of Home Builders
- Mr. Michael Strauss, Legislative Communications Director, National Association of Home Builders
- Ms. Pamela J. Slater, Legislative Representative, Consumers for World Trade
- Mr. Donald Ferguson, Geduldig and Ferguson
- Mr. Gary Horlick, Wilmer, Cutler and Pickering

May 1st, 2003

**American Enterprise Institute for Public Policy Research**

- Mr. John C. Fortier, Ph.D., Research Associate

April 29, 2003

**Americans for Better Borders Coalition**

- Ms. Theresa Cardinal Brown, Coalition Co-Chair
- Mr. John Murphy, Vice-President, U.S. Chamber of Commerce

April 30, 2003

**Canadian Embassy in the United States of America**

- Ambassador Michael F. Kergin, Ambassador of Canada to the United States of America
- Mr. Bertin Côté, Minister (Economic) and Deputy Head of Mission
- Mr. Peter Boehm, Minister (Political)
- Mr. William R. Crosbie, Minister-Counsellor (Economic and Trade Policy)

April 29-30, 2003

May 1, 2003



**Canadian Embassy in the United States of America**

*(continued)*

- Mr. Ariel N. Delouya, Minister-Counsellor (Congressional and Legal Affairs)
- Mr. Terry R. Colli, Director, Public Affairs
- Mr. Alan H. Minz, Counsellor (Trade Policy)
- Mr. Christopher A. Shapardanov, Counsellor (Political Affairs)
- Ms. Birgit Matthiesen, Economic and Trade Policy Division
- Ms. Catherine Vézina, Multilateral Affairs

April 29-30, 2003

May 1, 2003

**Congressional Research Service**

- Mr. Ian F. Ferguson, Analyst in International Trade and Finance

April 29, 2003

**Embassy of the United States of America, Ottawa**

- His Excellency Paul Cellucci, Ambassador of the United States of America to Canada
- Mr. Michael Gallagher, Minister-Counsellor for Economic Affairs

Ottawa, April 28, 2003

**Murphy Frazer & Selfridge**

- Mr. Paul Frazer

April 29, 2003

**Northern Border Caucus**

- Congressman Earl Pomeroy (D-ND), Co-Chair
- Mr. Michael Morrow, Senior Staff Assistant, Trade Subcommittee, Ways and Means Committee
- Ms. Juliet A. Bender, LEGIS Fellow, Trade Subcommittee, Ways and Means Committee
- Mr. Jasper MacSllarrow, Senior Legislative Assistant, Congressman Rick Larsen
- Mr. Beau Schuyler, Senior Legislative Assistant, Congressman John Turner
- Mr. Darin T. Beffa, Legislative Assistant, Congressman George R. Nethercutt Jr.
- Ms. Lori Mrowka, Legislative Assistant, Congressman Bart Stupak
- Ms. Andrea Salinas, Legislative Assistant, Congressman Fortney H. (Pete) Stark

May 1st, 2003

### **APPENDIX III: WITNESSES WHO CONTRIBUTED TO VOLUME I OF THIS STUDY**

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#### **Office of the United States Trade Representative**

- Mr. John M. Melle, Deputy Assistant U.S. Trade Representative for North America
- Ms. Sharon Bomer Lauritsen, Deputy Assistant U.S. Trade Representative for Agricultural Affairs
- Ms. E. Sage Chandler, Director for Canadian Affairs

April 29, 2003

#### **Permanent Mission of Canada to the Organisation of American States**

- Ms. Gwyneth Kutz, Counsellor and Alternate Representative of Canada to the Organization of American States

May 1st, 2003

#### **Senate Committee on Governmental Affairs**

- Senator Susan M. Collins (R-ME), Chair
- Mr. Rob Owen, Counsel, Senator Susan M. Collins
- Ms. Jane Alonso, Legislative Assistant, Senator Susan M. Collins

April 30, 2003

#### **Senate Subcommittee on International Trade**

- Senator Craig Thomas (R-WY), Chairman
- Mr. Bryn N. Stewart, General Counsel, Senator Craig Thomas

April 29, 2003

#### **United States Department of Commerce**

- Mr. William Henry Lash III, Assistant Secretary of Commerce for Market Access and Compliance
- Mr. Andrew I. Rudman, Acting Director, Office of NAFTA and Inter-American Affairs
- Ms. Geri C. Word, NAFTA Compliance Team Leader
- Mr. Carlos Busquets, Canada Desk Officer
- Mr. Pierce Scranton, Special Assistant

May 1st, 2003

#### **United States House of Representatives**

- Congressman Amo Houghton (R- Corning)
- Mr. Bob Van Wicklin, Legislative Director, Congressman Amo Houghton

April 29, 2003

**APPENDIX III:**

**WITNESSES WHO CONTRIBUTED TO VOLUME I OF THIS STUDY**

---

**University of Maryland**

- Professor Peter Morici, Professor of  
International Business, Robert H. Smith  
School of Business

April 29, 2003