The Fluctuating Canadian Dollar:
WHAT IT MEANS FOR CANADIANS

SENATE SÉNAT
CANADA

Report of the Standing Senate Committee on Banking, Trade and Commerce

The Honourable David Tkachuk, Chair
The Honourable Céline Hervieux-Payette, Deputy Chair

March 2016

Ce rapport est aussi disponible en français

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This report and the committee's proceedings are available online at:
www.senate-senat.ca/banc.asp

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MEMBERS

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ORDER OF REFERENCE

Extract from the *Journals of the Senate*, Wednesday, January 27, 2016:

> The Honourable Senator Tkachuk moved, seconded by the Honourable Senator Andreychuk:
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> That the Standing Senate Committee on Banking, Trade and Commerce be authorized to examine and report upon the present state of the domestic and international financial system; and
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> That the committee submit its final report no later than December 31, 2017, and that the committee retain all powers necessary to publicize its findings until 180 days after the tabling of the final report.
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> After debate,
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> The question being put on the motion, it was adopted.

Clerk of the Senate

Charles Robert

EXECUTIVE SUMMARY

It is widely recognized that a decrease in the Canadian dollar's exchange rate has a variety of effects on Canadian households and businesses, and on the country's economy. To better understand the types and scope of some of these effects, the Standing Senate Committee on Banking, Trade and Commerce undertook a brief study of the exchange rate in order to hear from experts about reasons for the fluctuations in recent months and the implications for Canadians.

In general, the committee heard that a floating exchange rate – the value of the Canadian dollar is not fixed in relation to any other currency – is best for Canada's economy, as it acts as a "shock absorber" that reduces negative economic effects. However, witnesses noted that – with a floating exchange rate – the value of the Canadian dollar tends to rise and fall with the price of oil. In the witnesses' view, the decrease in the Canadian dollar's exchange rate since mid-2014 can be almost entirely explained by falling oil prices.

The committee was told that, for households, a lower exchange rate for Canada's dollar means higher prices for imported consumer goods and reduced "purchasing power." That said these higher prices may be at least partially offset for some by lower fuel prices and employment opportunities in certain sectors.

According to witnesses, businesses face higher costs for imported production inputs when the Canadian dollar's exchange rate is lower; however, certain sectors – such as manufacturing, aerospace and tourism – have benefited from increased demand as a result of the low value of the Canadian dollar. The committee heard about several impediments to growth in the manufacturing sector, which may prevent businesses in that sector from fully benefitting from a lower Canadian exchange rate.

The committee heard that while a low exchange rate may lead to Canadian households and businesses paying higher prices for imported goods and services, not all of the consequences of a decrease in the Canadian dollar's exchange rate are negative, and some Canadian households and businesses may benefit. On balance, the value of the Canadian dollar at the time of the Committee's hearings was below what witnesses characterized as the "fair value" for the currency in the long term and based on more normal oil prices.

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INTRODUCTION

Between 3 and 19 February 2016, the Standing Senate Committee on Banking, Trade and Commerce held four hearings on the topic of the recent decline in the Canadian dollar's exchange rate. Witnesses from federal departments and entities, financial institutions, think tanks and business organizations, as well as an individual, provided testimony that addressed the following questions:

- What is Canada's exchange rate system and should the Bank of Canada limit changes in the exchange rate?
- What are some causes of the recent decline in the Canadian dollar's exchange rate?
- What are some effects of the recent decline in the Canadian dollar's exchange rate?
- What other policy issues are relevant to this topic?

This report summarizes the witnesses' testimony in relation to these questions.

QUESTION 1: WHAT IS CANADA'S EXCHANGE RATE SYSTEM AND SHOULD THE BANK OF CANADA LIMIT CHANGES IN THE EXCHANGE RATE?

At various points in the past, Canada has had a system whereby the value of the Canadian dollar was fixed in relation to other currencies. Now, the country has what is termed a "floating exchange rate." The committee's witnesses spoke about whether the Bank of Canada should take action to limit changes in the dollar's exchange rate, and presented some advantages and disadvantages of Canada's floating exchange rate.

The Bank of Canada explained that it follows an inflation-targeting system, whereby it sets the overnight interest rate – its main policy tool – to keep inflation within a 1% to 3% range. Because this tool targets the inflation rate, it cannot simultaneously be used to target an exchange rate. Thus, the Bank emphasized that its inflation-targeting system is incompatible with a fixed exchange rate for the Canadian dollar.

Stephen Murchison, Advisor to the Governor (Bank of Canada): *"I think that the inflation targeting framework, in combination with a flexible exchange rate – and those two things really go together – is the right framework for dealing with the consequences of what we are going through right now in the form of lower commodity prices."*

Most witnesses agreed that a floating exchange rate benefits Canada. Some witnesses, including the Bank of Canada, commented that Canada's inflation-targeting system has served the Canadian economy well, particularly following the recent global financial crisis, and should not be abandoned in favour of a fixed exchange rate for the Canadian dollar.

Furthermore, most witnesses referred to the floating exchange rate as a "shock absorber" that mitigates negative economic effects. In particular, witnesses – including Finance Canada – pointed out that the recent decrease in commodity prices has negatively affected the sectors linked to commodities. However, in their view, the floating exchange rate has led to a shift in productive resources away from the negatively affected commodity and related sectors to non-energy exporting sectors that are benefitting from the lower exchange rate for the Canadian dollar.

Glen Hodgson, Senior Vice-President and Chief Economist (Conference Board of Canada): *"I'm a strong devotee to a floating exchange rate. I know it has costs, but I think that, for our economy, through the whole business cycle, it has advantages. Therefore, if I have a vote today, I vote in favour of maintaining the same policy. For me, if it ain't broke, don't fix it."*

Although the decline in the Canadian dollar's exchange rate means higher prices for imported goods, leading to greater costs for individuals and businesses that purchase such goods, some witnesses asserted that these costs are lower than they would have been if Canada still had a fixed exchange rate. For example, the Conference Board of Canada, the Bank of Canada and the C.D. Howe Institute concluded that, in the absence of a floating exchange rate, wages and prices would have to adjust downward following a negative economic event; otherwise, production and employment would have to adjust, resulting in lower sales and reduced employment. The

Conference Board of Canada also highlighted that a floating exchange rate allows open capital markets, with no requirement for controls on the flow of funds into and out of Canada.

Daniel Schwanen, Vice President, Research (C.D. Howe Institute): *"If the exchange rate didn't or couldn't adjust, businesses and workers would be stuck with trying to adjust wages downward to remain competitive. If they were unable to do that, then quantities would have to adjust. Employment and investment would suffer even more than they are now."*

Herbert Grubel, who appeared as an individual, supported a fixed exchange rate for Canada. He remarked that, since each province uses the Canadian dollar, there are fixed exchange rates across provinces. In his view, it might make sense to have fixed exchange rates between some countries, including – for example – Canada and the United States. He explained that floating exchange rates can lead to large and unpredictable fluctuations in the Canadian dollar's exchange rate, with the result that some businesses – such as those in which decisions are affected by the Canadian dollar's exchange rate – may be unwilling to invest because they are unable to anticipate the future exchange rate. He therefore maintained that a fixed exchange rate would increase business investment in Canada because it reduces uncertainty. The C.D. Howe Institute countered that the benefits of the floating exchange rate outweigh the increased business investment that might result from a fixed exchange rate.

Herbert Grubel, Senior Fellow (As an Individual): *"If [floating exchange rates are] so good, why don't we have a separate currency for Alberta? And if Alberta, well, how do we know whether it is not better to have a separate currency for Edmonton, or for any of the suburbs?"*

The Conference Board of Canada and the C.D. Howe Institute also stated that a fixed exchange rate exists among the eurozone countries, and that this approach has been a significant factor contributing to their slow economic growth. In Mr. Grubel's view, Greece's inclusion in the eurozone has constrained the government's ability to spend. He also stated that countries that have adopted a fixed exchange rate for their currency relative to the U.S. dollar, such as Panama, have prospered because of this decision.

The Bank of Canada highlighted the importance of a fixed exchange rate among regions with similar economies but not among regions whose economies might react differently to economic shocks, such as Canada and the United States. Although the Bank believed that a fixed Canada–U.S. exchange rate would be the most likely choice if the value of the Canadian dollar were to be fixed in relation to another currency, it noted – for example – that the decrease in commodity prices has had opposite effects in the two countries, leading to decreased growth in Canada and increased growth in the United States.

QUESTION 2: WHAT ARE SOME CAUSES OF THE RECENT DECLINE IN THE CANADIAN DOLLAR'S EXCHANGE RATE?

In highlighting some of the causes of the decline in the Canadian dollar's exchange rate, the committee's witnesses focused on commodity prices, Canadian economic growth relative to that in the United States and other factors that affect the exchange rate.

A. Commodity Prices

Most witnesses identified the fall in global commodity prices, and particularly in the price of oil, as the most significant factor leading to the recent decline in the Canadian dollar's exchange rate. The Royal Bank of Canada estimated that 75% and 14% of this decrease reflected the fall in energy and non-energy prices respectively. According to Desjardins Group, the correlation between the Canadian dollar and the price of oil is an "almost immutable law."

BMO Financial Group and the Canadian Chamber of Commerce estimated that, for every $10 decrease in the price of oil, the value of the Canadian dollar tends to fall by between 3¢ and 5¢. The Bank of Canada noted that its index for commodity prices dropped by more than 50% between mid-2014 and the end of 2015; the most important reason for this decline was the decrease in the price of energy.

Dawn Desjardins, Vice President and Deputy Chief Economist (Royal Bank of Canada): *"[Royal Bank of Canada's] models suggested that three quarters of the decline that we've seen in the Canadian dollar reflects [the] drop we've seen in energy prices. About 14 per cent of that drop we can attribute to non-energy commodities and only about 2 per cent to that interest rate differential."*

The Canadian Chamber of Commerce pointed out that the decline in commodity prices was partly due to reduced economic growth rates in emerging markets, which are significant consumers of commodities; particular mention was made of China.

Jimmy Jean, Senior Economist (Desjardins Group): *"The depreciation of the Canadian dollar … reflects nothing more than the fulfilment of an almost immutable law. Oil dictates our terms of trade, and therefore our currency's fluctuations."*

As well, the Canadian Centre for Policy Alternatives suggested that one cause of low oil prices is large increases in the amount of oil produced. Desjardins Group said that the current situation is not unlike a "bubble" in oil production, and commented that low interest rates following the recent global financial crisis resulted in significant investments in oil production when the price of oil was high. According to it, these investments have led to too much oil production capacity on a global basis, and oil production currently exceeding the demand for oil, resulting in a low price. Some witnesses, including the Canadian Chamber of Commerce and the Canadian Centre for Policy Alternatives, estimated the extent to which supply currently exceeds demand: on average, an excess of 1.2 million to 2 million barrels per day of oil were produced in 2015.

Hendrik Brakel, Senior Director, Economic, Financial and Tax Policy (Canadian Chamber of Commerce): *"We used to joke that the oil prices and Canadian dollar are like an old married couple because they go everywhere together. Sometimes one wanders off, but they always get back together in the end. Historically … a $10-increase in the price of barrel of oil usually affects the loonie by about 3 cents."*

B. Canadian Economic Growth Relative to U.S. Economic Growth

In addition to oil, witnesses identified the divergence between Canadian and U.S. economic growth rates, and the resulting impacts on monetary policies, as significant in explaining the recent decline in the Canadian dollar's exchange rate. The Royal Bank of Canada estimated that the difference in short-term interest rates between Canada and the United States accounted for 2% of the decline in the Canadian dollar's exchange rate.

Witnesses, including the C.D. Howe Institute and Scotiabank, suggested that U.S. economic growth is expected to exceed that in Canada, leading to an increase in demand for U.S. dollars and a decrease in the Canada–U.S. dollar exchange rate.

As evidence of the United States' relatively strong economy, the Canadian Centre for Policy Alternatives suggested that, with an unemployment rate below 5% at the beginning of 2016, the United States was at "full employment"; it implied that Canada was not at "full employment" at that time.

Armine Yalnizyan, Senior Economist (Canadian Centre for Policy Alternatives): *"The exchange rate we're talking about is with respect to the U.S. dollar, and the U.S. economy is far stronger than ours right now."*

Some witnesses, including the Canadian Centre for Policy Alternatives and the C.D. Howe Institute, highlighted that economic growth expectations affect monetary policy decisions. The Canadian Centre for Policy Alternatives, for example, emphasized that expectations of strong U.S. economic growth led the U.S. Federal Reserve to raise its interest rate target in December 2015, the first time that it had done so in almost a decade. BMO Financial Group noted that the Bank of Canada reduced its interest rate target twice in 2015, and acknowledged that it was unusual for Canadian and U.S. central banks to be adjusting rates in opposite directions.

The Canadian Imperial Bank of Commerce suggested that the decline in the price of oil led Canadian and U.S. central banks to implement differing monetary policies. Thus, it argued that this divergence was not a separate cause of the decline in the Canadian dollar's exchange rate, but was itself an outcome of the low price of oil.

As evidence of the divergence in some interest rates resulting from differing monetary policies, the Royal Bank of Canada found that – in June 2014 – two-year bonds issued in Canada had an interest rate that was 0.6 percentage points higher than the rate for U.S. bonds; more recently, however, two-year bonds issued in Canada have had an interest rate that is 0.3 percentage points lower than the equivalent U.S. rate.

Witnesses noted that U.S. economic growth and interest rates that are higher than those in Canada have drawn investment away from Canada and towards the United States, putting downward pressure on the Canada–U.S. exchange rate. The Canadian Chamber of Commerce suggested that this outcome is a reversal of the situation that existed following what it characterized as the great financial crisis, when Canada – which experienced a relatively less severe crisis – was seen as a "safe haven" for international investors.

Hendrik Brakel, Senior Director, Economic, Financial and Tax Policy (Canadian Chamber of Commerce): *"We had gone through this great financial crisis with no bailouts, our banks the strongest in the world, and so we saw huge portfolios flows going into Canada because we were the safe haven. Now the U.S. is doing better so there's not the same need for a safe haven and, finally, investors are more aware of some of Canada's vulnerabilities."*

C. Other Factors Affecting the Canadian Dollar's Exchange Rate

Witnesses also provided their views about a variety of factors that, in addition to commodity prices and Canada's economic growth relative to that in the United States, could be influencing the Canadian dollar's exchange rate.

BMO Financial Group thought that concerns about Canada's fiscal outlook following forecasts of larger-than-anticipated federal deficits and provincial budgets that are in – or are close to being in – deficit may be putting downward pressure on the Canadian dollar's exchange rate. However, TD Bank Group and Finance Canada disagreed with this view; the former indicated that the federal debt level is low and so larger deficits should not be problematic, and the latter suggested that the low yields on Canadian bonds demonstrate that investors still want to buy these bonds.

Witnesses also suggested that negative sentiment in financial markets about the Canadian economy contributed to the fall in the Canadian dollar's exchange rate. Witnesses provided their estimates for the "neutral value" of the Canadian dollar, or the value that the dollar would have in the absence of this negative sentiment. On 4 February 2016, the day of their appearance, witnesses stated that – in their view – the "neutral value" was between 2¢ and 5¢ higher than the Canadian dollar's exchange rate on that day. Scotiabank commented that, recently, the Canadian dollar's exchange rate seemed to be more affected by the fall in commodity prices than was the case in other countries – such as Australia – that would be expected to experience similar effects from this fall in commodity prices, and that this difference may be attributed to negative sentiment.

A few witnesses mentioned some factors that have influenced the Canadian dollar's exchange rate in the past but that do not explain its recent decline. TD Bank Group reported that international differences in productivity growth or taxation might have explained changes in this exchange rate in the 1990s, but these factors are not as relevant today. Similarly, the C.D. Howe Institute suggested that a long-run determinant of this exchange rate is the country's productivity growth relative to that in other nations.

QUESTION 3: WHAT ARE SOME EFFECTS OF THE RECENT DECLINE IN THE CANADIAN DOLLAR'S EXCHANGE RATE?

In addressing selected impacts of the recent decline in the Canadian dollar's exchange rate, the committee's witnesses spoke about some effects on households and on businesses.

A. Some Effects on Households

Witnesses mentioned both negative and positive impacts on Canadian households of the recent decline in the Canadian dollar's exchange rate. For example, they noted the adverse consequences for Canadian households' purchasing power, or the amount of goods and services that they can buy with a given amount of Canadian dollars. They also remarked that the lower exchange rate may increase employment prospects for some Canadians.

1. Purchasing Power and Consumer Prices

According to the witnesses, the main impact on Canadian households of the recent decline in the Canadian dollar's exchange rate is higher prices for imported goods and services, which decreases their purchasing power. The Canadian Centre for Policy Alternatives observed that the price of U.S.-made goods has increased between 30% and 40% since the exchange rate began its decline. Witnesses mentioned, in particular, that the prices of fresh fruits and vegetables have increased significantly over the last two years, which has disproportionately affected households that spend a greater share of their income on food. BMO Financial Group commented that, between November 2014 and November 2015, the prices for fresh vegetables increased 13.0% in Canada and increased 0.4% in the United States, signifying that the price increases in Canada for these products can be explained almost entirely by the Canadian dollar's lower exchange rate.

Stephen Murchison, Advisor to the Governor (Bank of Canada): *"[I]t is true that households are going through hard times, especially those who buy more fruits and vegetables, and even more so since it is winter, as our exports are higher in the winter than in the summer."*

Doug Porter, Chief Economist (BMO Financial Group): *"[F]or consumers, the lower currency is clearly bad news. Over the past year, Canadian prices for fresh vegetables are up by more than 13 per cent as of mid-November. Just to put that in perspective, U.S. fresh vegetable prices, over the same period, have risen by just 0.4 per cent, so that entire 13 per cent rise can be put down to the weakness in the currency alone. All in, the hit to consumer buying power points to a period of slower real consumer spending growth versus the U.S. and versus the rest of the economy. In fact, we would argue that a weak currency is probably a bigger risk to Canadian consumers at this point than record household debt."*

Scotiabank suggested that the longer the Canadian dollar's exchange rate remains low, the more likely it is that Canadian firms will pass on the higher prices of the imported goods and services they use in their production processes to consumers in the form of higher prices, a situation that would lead to higher expectations for inflation.

That said, witnesses also commented that while the Canadian dollar's lower exchange rate has made it more costly for Canadians to buy imported goods and for Canadian businesses to buy imported inputs, the prices of energy products have decreased as a result of lower global commodity prices; to some extent, the effect of lower energy prices may offset the effect of higher prices for imported goods. Desjardins Group highlighted that, in the first three quarters of 2015, Canadian households spent $6.7 billion less on fuel than they did in the same period in 2014, an amount that is equivalent to $470 per household.

Jimmy Jean, Senior Economist (Desjardins Group): *"In the first three quarters of 2015, households spent $6.7 billion less on fuel compared with the same period in 2014, equivalent to savings of $470 per household."*

According to the Bank of Canada, the decrease in commodity prices has conflicting impacts on inflation. It explained that, on one hand, a fall in demand for goods and services resulting from reduced economic growth caused by lower commodity prices tends to lower inflation; on the other hand, increased import prices resulting from a low exchange rate for the Canadian dollar tends to increase inflation. According to the Bank, the impacts of the recent decline in the Canadian dollar's exchange rate on the country's inflation rate are expected to last one year, and to add between 0.9 and 1.1 percentage points to the inflation rate.

Jean-François Perrault, Senior Vice President & Chief Economist (Scotiabank): *"By and large, a weaker currency implies a lower standard of living for Canadians."*

Scotiabank stated that a low exchange rate for the Canadian dollar implies a reduced standard of living for Canadians. BMO Financial Group asserted that, at this point in time, the decline in the Canadian dollar's exchange rate is potentially more harmful to Canadian consumers than is their level of indebtedness.

Export Development Canada spoke about an indicator that measures the net effect of changes in the price of oil on the production and consumption of oil products in a country. According to it, the recent decrease in the price of oil has led to a net cost of $25 billion in Canada, but a net benefit of $110 billion and $125 billion in the United States and Europe respectively.

2. Employment Prospects

In addition to the effects on household purchasing power of a decline in the Canadian dollar's exchange rate, the Bank of Canada suggested that the higher price of imported goods makes Canadian goods more attractive, leading to higher growth in non-resource sectors and more employment opportunities for households.

B. Some Effects on Businesses

As with households, witnesses spoke about positive and negative effects of the decline in the Canadian dollar's exchange rate on Canadian businesses. For example, one negative effect is higher costs for imported production inputs. Regarding positive effects, some businesses and sectors benefit from a decline in the exchange rate, while others are harmed. In particular, the manufacturing sector was identified as benefiting from the decline in the exchange rate, although witnesses said that there are several impediments to the sector's growth.

1. Higher Costs for Imported Products

Witnesses mentioned that Canadian businesses whose products have a high proportion of imported inputs but are sold domestically, such as retailers and wholesalers, experience proportionally more negative effects when the Canadian dollar's exchange rate declines than is the case for other businesses. The Canadian Federation of Independent Business noted that, in January 2016, 40% of its members reported that the exchange rate was a major concern for them, and that the percentage of respondents identifying it as a major concern tended to rise when the rate fell.

> **Ted Mallett, Vice-President and Chief Economist (Canadian Federation of Independent Business):** *"[C]lose to 40% of our members are saying that currency is a major concern for their business. …[T]hat number … [has] quadrupled since 2012."*

2. Effects on Particular Businesses and Sectors

Regarding benefits for businesses of the decline in the Canadian dollar's exchange rate, witnesses indicated that a lower rate would help exporters whose products would become more competitively priced as a consequence of the decline. The Canadian Chamber of Commerce mentioned that exports fell by 1% between 2014 and 2015, which it characterized as a small overall decline given the large decrease in energy exports resulting from the fall in the price of oil in 2015. It suggested that the decline in energy exports was almost offset by increased exports of services and manufactured goods. Moreover, the Canadian Chamber of Commerce commented that, between 2014 and 2015, auto exports had increased by 14%, aerospace exports by 29% and communications technology exports by 13%.

The Bank of Canada observed that, among sectors that are sensitive to changes in the Canadian dollar's exchange rate, 21 sectors had an upward trend in exports, including pharmaceuticals, motor vehicle engines and parts, and industrial machinery; Export Development Canada added the aerospace sector to this list. Desjardins Group pointed out that 37,400 jobs had been created in the manufacturing sector in 2015, the highest amount since 2012, and that employment has increased in only five of the last 15 years. Furthermore, witnesses suggested that a lower exchange rate may lead businesses to use Canadian-made inputs rather than imported inputs, with positive effects on domestic producers.

> **Stephen Murchison, Advisor to the Governor (Bank of Canada):** *"Among industries that are sensitive to exchange rate movements, 21 are showing an upward trend in shipments. ... Included in this group are industries such as pharmaceuticals, motor vehicle engines and parts, and industrial machinery, which have also seen higher employment since the middle of 2014."*

According to BMO Financial Group, businesses that export and that use mostly domestic inputs – such as services providers – tend to experience the biggest gain in competitiveness when the Canadian dollar's exchange rate declines. The Canadian Imperial Bank of Commerce noted that the services of Canada's web developers, aerospace engineers and architects are now compensated at one half the level of their U.S. counterparts. The Conference Board of Canada observed that this percentage is much higher for the services sector than for the manufacturing sector; the former uses about 50% Canadian inputs in its production processes.

The Canadian Imperial Bank of Commerce indicated that income generated by services sector exporters and by exporters of manufactured goods is roughly equal if a "value-added" approach is taken in calculating the income. In its view, because the services sector's costs are far less affected by a decline in Canada's exchange rate than are those in the manufacturing sector, the services sector may benefit relatively more from a decline in the exchange rate.

Some witnesses also mentioned that Canada's tourism sector benefits from the low exchange rate for Canada's dollar because vacationing abroad is more expensive for Canadians and vacationing in Canada is less expensive for foreigners. The Canadian Chamber of Commerce noted that, between 2014 and 2015, the number of U.S. tourism visits increased by 8%. TD Bank Group estimated that, compared to 2014, increased vacationing in Canada by U.S. tourists would increase their spending in Canada by between $1 billion and $2 billion in 2015; tourism-related spending would be greater still when Canadians vacation domestically rather than abroad. It estimated that, overall, the increase in tourism that is expected to result from the decline in the exchange rate would cause gross domestic product to rise by between $4 billion to $5 billion in 2015. In the view of the Canadian Federation of Independent Business, increased tourism particularly benefits the Atlantic provinces.

Derek Burleton, Vice President and Deputy Chief Economist (TD Bank Group): *"[I]t's not only that Americans are finally coming back to Canada, and we expect about a $1-billion to $2-billion boost in American spending in Canada relative to 2014 levels over the next year, … we also know Canadians are visiting the U.S. less, and some of that money will be redeployed in Canada... . Together that double benefit is probably going to deliver a boost to the Canadian economy in the order of $4 billion to $5 billion"*

According to Finance Canada, commodity producers have also benefited from the decline in the Canadian dollar's exchange rate. Since oil and other commodities are usually priced in U.S. dollars, Canadian commodity producers receive more Canadian dollars for their U.S-denominated sales when the exchange rate falls.

A few witnesses commented on the effects that a low exchange rate for the Canadian dollar might have on the housing sector. The Canadian Centre for Policy Alternatives indicated that, between 2009 and 2015, Canadians had purchased U.S. real estate

Armine Yalnizyan, Senior Economist (Canadian Centre for Policy Alternatives): *"[W]e will see some repatriation of capital that migrated south with our snowbirds because Canadians purchased $92 billion worth of U.S. real estate from 2009 to 2015. Now that they're getting 40 per cent more for what they purchased, some of that money will be coming back."*

valued at $92 billion, but it speculated that some Canadians may sell their real estate in order to have a return of 40% or more on their initial purchase. Similarly, Scotiabank mentioned that – when valued in U.S. dollars – the average price of a Canadian house is now nearly 6% lower than a year ago, suggesting that Canadian real estate may be more attractive for individuals who wish to purchase Canadian real estate using U.S. dollars.

Witnesses also spoke about the potential for increased investment in Canada. In the view of the Canadian Centre for Policy Alternatives, the decline in the Canadian dollar's exchange rate provides U.S. firms with an incentive to produce more in Canada because it is less expensive to pay wages in Canadian dollars; it suggested, for example, that Canada's film sector could experience increased foreign investment. Export Development Canada indicated that the low exchange rate could increase the likelihood that U.S. firms will acquire Canadian businesses, especially if they are facing constraints on their productive capacity in the United States.

3. Impediments to Growth in the Manufacturing Sector

Several witnesses suggested that resources and jobs could be expected to shift from the commodities sector to export-oriented manufacturing subsectors when the Canadian dollar's exchange rate declines, but identified five impediments to growth for Canadian manufacturers: a lack of productive capacity in Canada; the use of hedging by Canadian businesses; low global demand for manufactured goods; a lack of Canadian competitiveness; and the inclusion of Canadian firms in U.S. supply chains.

Doug Porter, Chief Economist (BMO Financial Group): *"Manufacturing does generally benefit from the drop in the currency, as its products become more competitive and/or profit margins expand, but it's questionable whether Canada still has the export capacity to fully take advantage of the more competitive currency."*

The Canadian Imperial Bank of Commerce commented that, since the Canadian dollar's exchange rate started to decline, Canadian manufacturing businesses have lost some of their productive capacity. The Conference Board of Canada concluded that only five Canadian sectors currently have the capacity required to increase production in order to take full advantage of the fall in the exchange rate.

Witnesses outlined several factors that could slow the rate at which businesses make new investments in order to expand their productive capacity. For example, they said that some machinery and equipment is imported from the United States, and is more expensive for Canadian firms when the Canada–U.S. dollar exchange rate declines. Scotiabank noted that more than 60% of the machinery and equipment used by Canadian businesses is imported, and the Royal Bank of Canada emphasized that the price paid by Canadian businesses for

Phil King, Director, Economic Analysis and Forecasting, Economic and Fiscal Policy Branch (Finance Canada): *"A substantial portion of machinery and equipment purchased in Canada is imported from abroad. As the dollar falls, this makes such investment more costly. When investment is hampered, future output and productivity growth can also be affected."*

imported machinery and equipment had risen 20% over the last 12 months. Desjardins Group explained that Canadian businesses may raise the prices charged to consumers to offset, at least in part, the higher cost of imported machinery and equipment.

Dawn Desjardins, Vice President and Deputy Chief Economist (Royal Bank of Canada): *"[T]he price of imported machinery and equipment has moved up, and Canadian companies rely on investing in this machinery and equipment from abroad in U.S. dollars. So those costs have risen. When we look at the prices of imported machinery and equipment, they're up 20 per cent relative to a year ago. That's a pretty big disincentive for some companies in terms of investment."*

Mr. Grubel, the C.D. Howe Institute and the Canadian Federation of Independent Business suggested that uncertainty about future changes in the Canadian dollar's exchange rate leads to reduced business investment. The Canadian Chamber of Commerce explained that, because machinery and equipment is depreciated over time, businesses often invest with a 10- to 20-year time horizon in mind; if they are unsure of the likely exchange rate in the future, they might be uncertain – for example – about the extent to which the currently higher demand for their products that exists because of the lower exchange rate will persist, and might therefore be unwilling to invest. Export Development Canada estimated that it usually takes one or two years between a positive economic event and the decision by businesses benefitting from this event to invest. However, it cautioned that this period may be too short at the present time because Canadian businesses have experienced adverse economic conditions linked to the global financial crisis. Scotiabank cited the pessimism of Canadian businesses as a factor that has delayed their investment decisions.

The Royal Bank of Canada, Scotiabank and Export Development Canada stressed that purchasing insurance contracts to protect themselves against the effects of exchange rate fluctuations gives firms greater certainty. In their view, however, such purchases may increase the amount of time before export-oriented businesses increase their production following a decline in the Canadian dollar's exchange rate because the insurance reduces the incentive that they might otherwise have to change their behaviour.

BMO Financial Group and the Canadian Imperial Bank of Commerce said that, because the values of the currencies of several other countries are also depreciating against the U.S. dollar, Canadian exports are not necessarily becoming less expensive than those of other countries.

Royce Mendes, Director and Senior Economist (Canadian Imperial Bank of Commerce): *"Weak global growth combined with depreciation of other currencies is making it more difficult for Canada to fully take advantage of the decline in the exchange rate."*

TD Bank Group referenced the Mexican peso, whose exchange rate has fallen to almost the same extent as that of the Canadian dollar. Because the exchange rates of these two currencies have fallen together, Canadian exports are not necessarily becoming more competitive in the North American market when compared to Mexican exports.

Furthermore, BMO Financial Group indicated that some non-labour costs – such as electricity – have been rising, particularly in Ontario; these rising costs have decreased Canadian exporters' competiveness. Scotiabank emphasized that a higher cost for imported machinery and equipment hinders the ability of Canadian businesses to increase their productivity and therefore their competitiveness. Similarly, the C.D. Howe Institute concluded that Canadian businesses might have greater difficulty in attracting talented employees when a given salary in Canadian dollars is worth less than it is in U.S. dollars, which limits Canadian businesses' competitiveness.

The Canadian Imperial Bank of Commerce and TD Bank Group noted that some of Canada's manufacturing subsectors are providing goods to U.S. manufacturers as inputs into their production processes; because the U.S. dollar's exchange rate is high relative to other currencies, U.S. manufacturers are less profitable than before the rate increased. In the view of the Canadian Imperial Bank of Commerce and TD Bank Group, U.S. manufacturers' reduced profitability decreases demand for the Canadian-made goods that are inputs into U.S. manufacturing processes.

QUESTION 4: WHAT OTHER POLICY ISSUES WERE DISCUSSED BY WITNESSES DURING THE STUDY?

Witnesses discussed several other policy issues during the study, including those related to Canadian productivity growth, skills training and infrastructure.

Several witnesses identified Canada's productivity as an area on which the federal government should focus, and described several impediments to productivity growth. The Canadian Federation of Independent Business noted that Canada's geography and the proximity of its cities to each other are an impediment to productivity growth because they do not allow small businesses to expand easily to neighbouring regions. Mr. Grubel and the C.D. Howe Institute suggested that government intervention limits businesses' ability to expand and increase productivity. Scotiabank asserted that, for reasons of corporate culture, Canadian businesses are less likely than their U.S. counterparts to make the investments needed to innovate and increase productivity. The Conference Board of Canada, Desjardins Group and the Canadian Federation of Independent Business explained that internal trade barriers negatively affect productivity growth.

Herbert Grubel, Senior Fellow (As an Individual): *"I think that … in the Western world … we have killed the goose that lays the golden egg by excessive regulation."*

Some witnesses characterized the skills of Canadian workers as an impediment to productivity growth. The Canadian Chamber of Commerce and the Canadian Imperial Bank of Commerce identified a "skills gap" in Canada, with some Canadian businesses unable to find individuals with the skills that they require. The Canadian Imperial Bank of Commerce suggested that, in particular, more students should be encouraged to graduate in the "STEM" fields: science, technology, engineering and mathematics. According to Scotiabank,

Jean-François Perrault, Senior Vice President & Chief Economist (Scotiabank): *"Schools [in Canada] are pumping out, by and large, people in the right fields, but for whatever reason they're not being used as much in our firms as they are in other countries."*

the proportion of students graduating in Canada in the STEM fields is high compared to other G7 countries, but businesses are not employing these graduates. The Canadian Chamber of Commerce said that efforts should be made to increase Aboriginal educational outcomes.

Witnesses also spoke about government infrastructure spending. Some commented that infrastructure spending has positive effects in the short term, in terms of increased economic activity, and in the long term, in terms of increased productivity. The Conference Board of Canada estimated that, for $1.00 that a government spends on infrastructure, the economy benefits by $1.20. The Canadian Centre for Policy Alternatives and the Conference Board of Canada suggested that Canada requires $177 billion in infrastructure spending to maintain and repair broken or lost infrastructure. Mr. Grubel said that infrastructure spending decisions should occur at a local level, and with funds raised through taxation rather than through borrowing.

Glen Hodgson, Senior Vice-President and Chief Economist (Conference Board of Canada): *"In the short term, … infrastructure spending is one of the best forms of stimulus for the economy, because our analysis shows that for every dollar you spend, you get more than a dollar benefit for your economy. A typical multiplier would be $1.20 for $1 spent."*

A few witnesses identified the importance of infrastructure to transport Canadian oil and gas to foreign markets. The Canadian Chamber of Commerce estimated that the absence of this infrastructure costs Canadian businesses $50 million a day in oil revenue. However, Export Development Canada cautioned that governments should encourage diversified Canadian exports, and that the oil and gas sector is not highly diversified.

Peter Hall, Vice-President and Chief Economist (Export Development Canada): *"Export Development Canada has been a huge proponent, over the last decade at least, of diversification of our markets beyond our traditional markets. Not to ignore our traditional markets — they are our bread and butter — but diversification and in all industries. The least diversified industry that we have, on the export side of things, is oil and gas."*

APPENDIX A: WITNESSES

Category	Date of Meeting	Witness
Federal Departments and Entities	3 February 2016 listen/watch	Peter Hall, Vice-President and Chief Economist (Export Development Canada)
		Phil King, Director, Economic Analysis and Forecasting, Economic and Fiscal Policy Branch (Finance Canada)
		Stephen Murchison, Advisor to the Governor (Bank of Canada)
Financial Institutions	4 February 2016 listen/watch	Derek Burleton, Vice President and Deputy Chief Economist (TD Bank Group)
		Dawn Desjardins, Vice President and Deputy Chief Economist (Royal Bank of Canada)
		Jimmy Jean, Senior Economist (Desjardins Group)
		Royce Mendes, Director and Senior Economist (Canadian Imperial Bank of Commerce)
		Jean-François Perrault, Senior Vice President and Chief Economist (Scotiabank)
		Doug Porter, Chief Economist (BMO Financial Group)
Think Tanks and Individuals	17 February 2016 listen/watch	Herbert Grubel, Senior Fellow, Fraser Institute (As an Individual)
		Glen Hodgson, Senior Vice-President and Chief Economist (Conference Board of Canada)
		Daniel Schwanen, Vice President, Research (C.D. Howe Institute)
		Armine Yalnizyan, Senior Economist (Canadian Centre for Policy Alternatives)
Business Organizations	18 February 2016 listen/watch	Hendrik Brakel, Senior Director, Economic, Financial and Tax Policy (Canadian Chamber of Commerce)
		Ted Mallett, Vice-President and Chief Economist (Canadian Federation of Independent Business)