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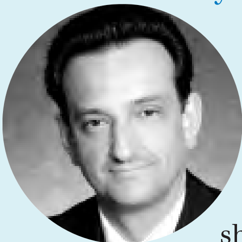
SUMMER 2008

The Lofty Loonie's Legacy

by Michael Gregory, CFA



While the Canadian dollar's flirtation with U.S. parity might not continue indefinitely, last September's crossover has undoubtedly left a lasting impression on consumer and business behaviour. On the consumer side, it sparked cross-border price comparisons and shopping, with longer lines at the border and increased north-bound parcel traffic. Under pressure, domestic retailers have cut prices, with the costs of new vehicles, reading materials and apparel deflating to their deepest rates in over 50 years.

On the business side, for import-competing firms and exporters accustomed to operating with the loonie at a discount, a currency near parity delivers a rude awakening. Just as consumer behaviour seems to have shifted in a non-linear fashion under parity, we judge that a sea change in business practices is unfolding, one in which firms opting to swim with the surge will likely move forward with restructurings.

The Canadian economy has already exhibited adjustments to the loonie's multi-year appreciation. Real exports softened as imports gained strength, narrowing real net exports from a record surplus during early 2002 to the largest shortfall in history by the end of 2007. This shift amounts to more than 13 percent of GDP – equivalent to about four years of steady economic progress. However, the GDP growth headwind has been masked by the fact that Canada's terms of trade soared to record highs in response to commodity prices, stimulating an effective income lift for domestic spending. *Continued on page 2*

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Further adjustments are likely. Since the first quarter of 2002, Canadian unit labour costs have grown faster than in the U.S., a cumulative 16.5 percent compared to 9.6 percent respectively through the last quarter of 2007, mostly reflecting slower productivity growth. In U.S. dollar terms, Canadian costs are up a whopping 89 percent over the past few years because of the loonie's powerhouse performance.

This inflation more than overcame the 28 percent cost advantage accumulated over the previous decade as our dollar depreciated from its highs in the early 1990s, reinforcing the need for Canadian firms to raise productivity, particularly by increasing their capital-labour ratio.

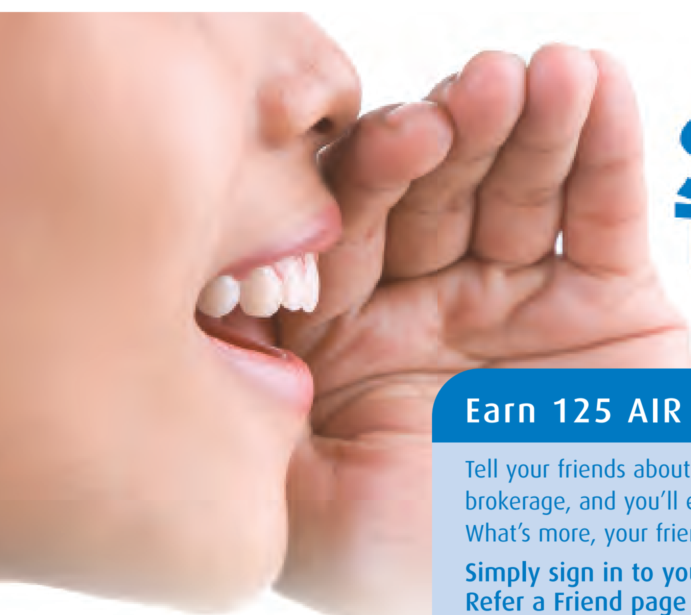
For most of the past three decades, Canadian companies have lagged behind their U.S. counterparts in machinery and equipment spending (as a share of GDP), as our dollar's steady decline provided little incentive for competitiveness-enhancing investment. Note that Canadian firms sharply increased capital spending during the second half of the 1980s to close the investment gap with U.S. companies, adjusting to multi-year Canadian dollar appreciation and, of course, the Canada-U.S. Free Trade Agreement.

The last time Canadian firms spent relatively more on machinery and equipment was around 1976, the dollar's last encounter with parity. Overall, Canadian businesses look ready to meet the current challenge, as balance sheets still hover near their healthiest numbers in generations.

On the downside, higher capital-to-labour ratios will be achieved in part at the expense of the labour force, with employment cuts compounding losses from outright plant and firm closures. Since factory jobs peaked at 2.3 million in late 2002, 375,000 have disappeared from our economy. We could easily see another 300,000 jobs lost in the years ahead.

The Bottom Line: The strong Canadian dollar will continue to inflict economic pain. But the lofty loonie could also spur a productivity boom, with positive longer-term benefits. Recall that in the mid-1980s the record-high, trade-weighted U.S. dollar helped sow the seeds of buoyant national productivity during the 1990s. Canada could be poised for the same.

Michael Gregory is a senior economist and managing director of BMO Capital Markets.



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"How do you build the confidence to stay with a stock, especially if you can't monitor the markets constantly throughout the day?"

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> STOP ORDERS: LIMIT YOUR LOSSES AND PROTECT YOUR PROFITS

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"Stop Orders can introduce a sell-side discipline that makes investing more efficient and rewarding"

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