



April 25, 2011

HIGHLIGHTS

- A strong Canadian dollar, in combination with rising unit labour costs, has eroded Canadian exporter's competitiveness in international markets.
- The Canadian dollar is not the whole story behind the headwinds faced by exporters. Indeed, Canada's poor productivity performance over the last decade has played a large role.
- There are some signs that many Canadian businesses have started to take the necessary steps to become better contenders on international markets. The bad news is that more needs to be done.
- Over the long-haul, weak labour productivity will mean that Canadian goods and services may suffer under increased international competition, losing both domestic and international market share.
- In order to regain competitiveness in an international scale, businesses need to revamp business models to become more efficient. This will involve implementing new technology and innovations, increasing spending on research and development, and increasing investment in skills training for the workforce.

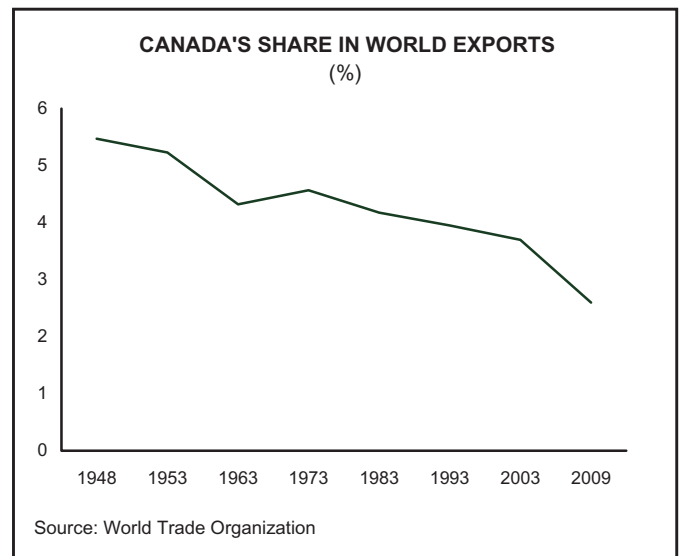
Craig Alexander, SVP and Chief Economist
416-982-8064
mailto:craig.alexander@td.com

Diana Petramala, Economist (Canada)
416-982-6420
mailto:diana.petramala@td.com

COMPETITIVENESS A PRESSING PROBLEM FOR CANADIAN BUSINESSES

Over the last two years, TD economics has been warning that a strong Canadian dollar, in combination with rising unit labour costs, would erode Canadian exporter's competitiveness in international markets. In February, a speech by Deputy Governor Tiff Macklem sent a similar warning. Despite the concerns, the performance of Canadian exports and manufacturing has been firm in recent months. This begs the question: is there reason to be concerned about the competitiveness of Canadian businesses? We believe that the answer is "Yes".

In this report, we show that Canadian businesses have struggled to adjust to the strong Canadian dollar over the last decade. The ability of Canadian exporters to expand in international markets has been diminished as a consequence. In the near term, Canadian exports may continue to benefit from a cyclical rebound in U.S. demand and strong international demand, but the contribution of exports to economic growth will be constrained by weaker competitiveness. Moreover, over the long-haul, poor labour productivity could mean that Canadian goods and services may suffer under increased international competition, losing both domestic and international market share. Going forward, the business sector needs to focus on becoming more innovative, which likely involves greater investment in new machinery and equipment, as well as adopting new processes. The ever more competitive environment also highlights the need for greater emphasis on skills training. The good news is that businesses appear increasingly willing to step up to the plate.



High loonie erodes Canada's competitiveness

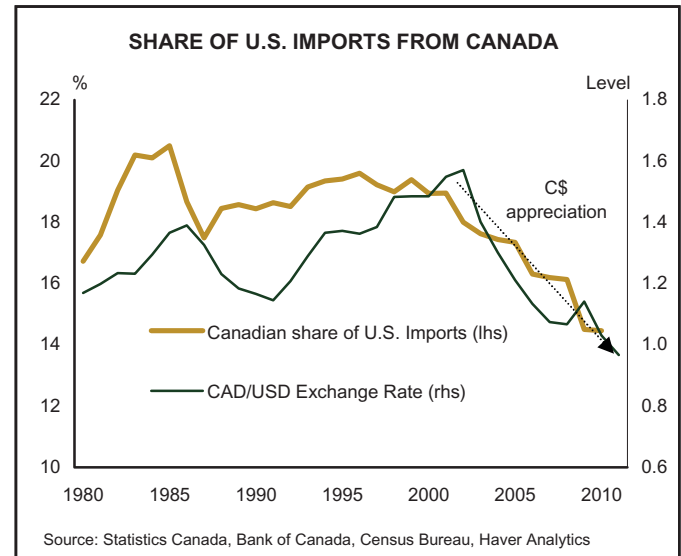
In the 1990s and early 2000s, the Canadian dollar trended lower. It fell dramatically below estimates of long-term fair value (such as the OECD's estimate of purchasing power parity) reaching a low of 62 US cents by 2002. This created an enormous competitive advantage for Canadian exporters, and many suspect that firms used their advantage to avoid making tough decisions to become more innovative, contributing to disappointing business investment and declining productivity growth. However, the tide turned in a dramatic way since 2002, as the currency surged by 41 cents vis-à-vis the U.S. dollar. The increase in the

currency's value not only unwound its undervaluation, but sent it way above its long-term fair value. The shift in the loonie's fortunes reflected several forces: a commodity boom that benefitted the value and the volume of Canadian exports, a better performance of the Canadian economy in many respects than its major industrial nation peers, and relatively better federal fiscal balances when viewed through an international lens. The loonie was also lifted by weakness in the U.S. dollar.

In mid-February, the Canadian dollar stood at 104 U.S. cents. According to the OECD, the long-run appropriate level of the Canadian dollar, given current price levels in Canada, is around 83 U.S. cents. Since the 1970s the currency has never been sustained this far above the PPP. However, the 1990s experience demonstrates that a currency can deviate from purchasing power parity for many years, even decades.

In the wake of the ascent of the currency, not all Canadian exports have been impacted equally. A lofty Canadian dollar might cut into profit margins for commodity exporters, but strong commodity prices on world markets have helped offset the appreciation in the currency. Moreover, a growing global appetite for commodities, driven by emerging markets, has helped support demand for Canadian resources, regardless of the level of the currency. Conversely, non-commodity exporters have confronted the brunt of the currency appreciation.

Outside of the resource sector, the evidence suggests that the rising currency has severely impacted the bottom line of Canadian businesses. While Canada still punches above its weight in global trade, and can boast about its position as a major exporting nation, Canada's share of world exports is declining. In particular, its market share in the U.S. has



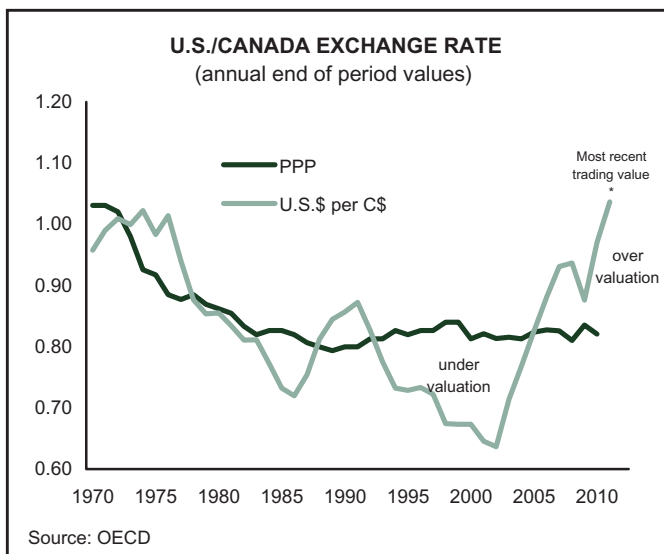
fallen in lockstep with the appreciation in the Canadian dollar. Canada's falling share can partly be explained by the growing importance of China in world markets, but Canada has fared worse than most other countries from the changing composition of the U.S. trade deficit. No other economy has lost as much market share in the U.S. as Canada. So, although Canadian exports have recently been benefiting from a cyclical rebound in U.S. demand, the performance of the Canadian export sector could have been much better.

Moreover, Canadian goods and services do not only compete against foreign goods and services abroad – they also compete for market share in Canada. The appreciation in the Canadian dollar has made imports a more important source of goods and services for internal consumption in Canada. In particular, producers have turned to cheaper sources of inputs to production, perhaps as a way to cope with the appreciating currency. The bottom line is that whether you face direct international competition or not, a strong currency can be problematic.

The profitability of manufacturers has been hit particularly hard by the rising loonie, as this export-oriented sector has had to absorb the increase in the Canadian dollar, rather than pass it through to consumers in the form of higher prices. Profit margins for Canadian manufacturers were roughly two percentage points lower during the last decade than they were during the 1990's. This contrasts to other non-manufacturing businesses where profit margins have risen steadily over the last two decades.

Reduced Competition has had an impact

The stronger Canadian dollar, rising unit labour costs, and reduced profit margins have had an impact on the export

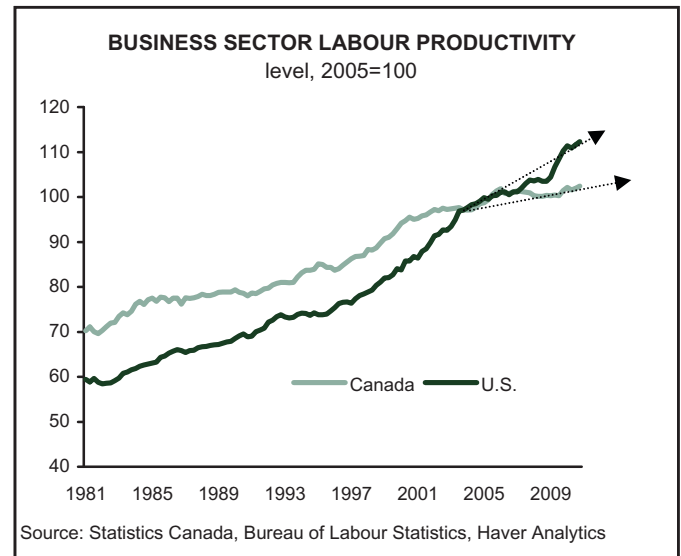


sector. Roughly 4000 exporters closed up shop between 2004 and 2007 according to a Statistics Canada survey. There has been a broad based decline in the number of exporters across industries, but 2000 of those were split evenly between manufacturers and wholesalers. There is evidence that smaller exporters have been most adversely affected, with the lion share in closures coming from firms with less than \$1 million in export sales. To be clear, some of the business failures were related to the recession, but a significant portion were due to reduced competitiveness and declining profitability.

Outsourcing has been used as another coping mechanism. An Export Development Canada (EDC) report noted that sales at Canadian foreign affiliates(outsourcing) rose at double the pace of exports since 2005, while Canadian foreign direct investment doubled between 2000 and 2008. The shrinking export sector has meant that exports as a share of real GDP have fallen from 45% in 2000 to just 33% in 2010. This all suggests that Canada's export sector is shrinking as companies struggle to compete in the wake of a rising Canadian dollar.

Canada's relative productivity performance also weighs on competitiveness

Shutting down operations, or shifting them abroad are not the only solution to the erosion in competitiveness. Businesses can cope with a strong currency by revamping business practices to become leaner and more productive. This can be done through measures that boost productivity and lower unit labour costs, such as investing in innovative practices and technologies. Another response to bolster efficiency and competitiveness would be increased investment in skills training. Globalization and the IT revolution



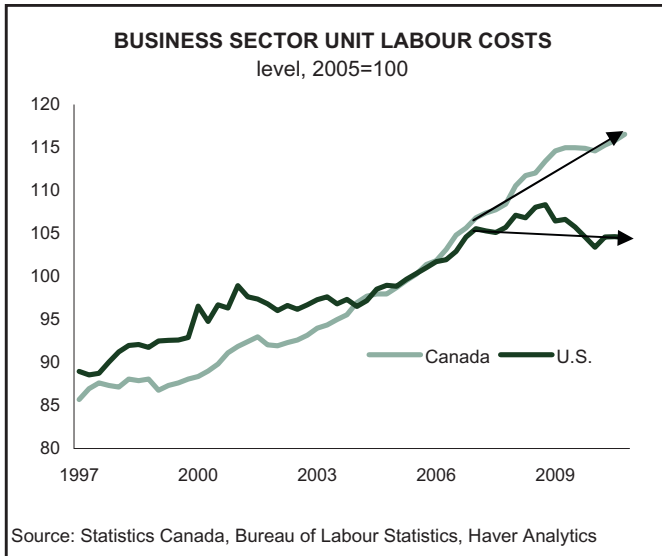
has had a powerful impact on global labour markets. We are seeing a clear trend towards declining opportunities for middle-income middle-skill jobs. Canada can't compete on the basis of labour costs. That means Canada must compete on the basis of highly skilled labour. This highlights the need for firms to invest more in skills training. It also implies that workers will need to pursue more education and skills development.

The trick is to become more efficient than your trading partners. The simple truth is that to be successful in the long run, businesses need a comparative advantage. And, due to the rapidly-changing world, a firm's comparative advantage is often diminished with time, so companies must evolve and find new ways to differentiate themselves from their competitors.

On this front, there is clear evidence that businesses have struggled. The Canadian dollar is not the whole story behind the headwinds faced by exporters. Indeed, Canada's poor productivity performance over the last eight years has played a large role. While the currency appreciated since 2003, labour productivity in the U.S. has grown four times as fast as Canadian labour productivity. This has meant that unit labour costs in Canada have increased three-times as fast as those in the U.S. over the last decade.

While there is always considerable focus placed on "nominal" exchange rates, a more fulsome measure of competitiveness adjusts the value of the currency by the ratio of its unit labour costs relative to that of its major trading partners. If we use this method to compare Canada to the U.S., we see that U.S. businesses have certainly been building a strong cost advantage over Canadian-made products. As of the first quarter of 2011, estimates suggest that Canada's





nominal bilateral exchange rate appreciated vis-à-vis the U.S. by 41 cents since 2002, but adjusted by unit labour costs the Canada-U.S. real exchange rate has appreciated an even larger 55 cents.

Digging deeper into the data suggests that the manufacturing sector has made some progress in responding. Unit labour costs have fallen six percent since 2008, and the appreciation in the Canadian dollar has been the main source of the erosion in competitiveness for this sector since. This compares to 2007 when rising unit labour costs put significant additional strain on the sector.

The automotive industry has been one area in the economy that has taken enormous steps to improve its ability to compete internationally. Prior to the recession, the industry grappled with high pension costs, uncompetitive wage rates and excess capacity. When the recession hit, two of the major North American automakers failed and required government bailouts. The government imposed a number of rigorous restructuring plans on these companies to ensure that they emerged from the downturn as competitive and profitable, measures that we believe have paid off. For the auto industry, our estimate suggests that unit labour costs have fallen back to 2003 levels.

Nonetheless, even allowing for the restructuring in the auto industry, the improvements in manufacturing industries have largely not been enough to make up for the competitiveness ground lost over the last decade. Even with the adjustments over the last two years, productivity in U.S. manufacturing has grown by three-fold that in Canada since 2002. What's more, productivity growth in Canadian manufacturing flat-lined through the last half of 2010, while that in the U.S. continued to soar. Furthermore, in order to alleviate some of the pressures caused by a strong currency,

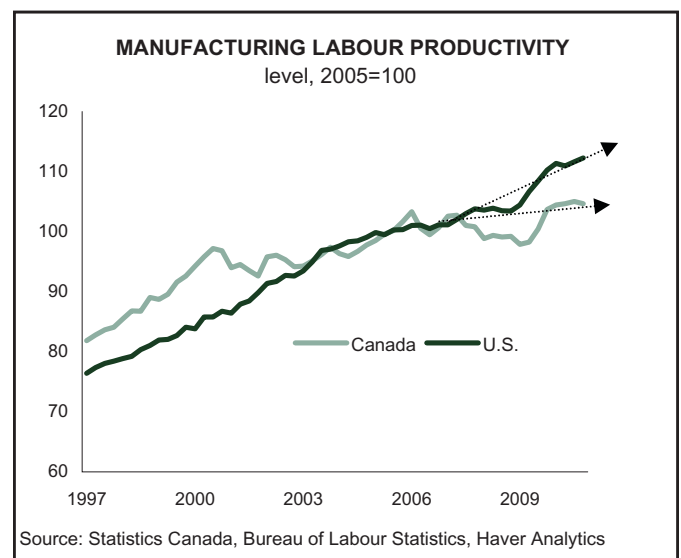
productivity growth in Canada should have been running at stronger pace than that in the U.S., but this has not occurred. To provide a historical example to show that this can occur, from 1997 to 2001, strong business investment and productivity gains led to increased competitiveness for Canadian businesses, as Canada's productivity growth rose well above that of the United States. As such, while the currency depreciated 8 U.S. cents from 74 to 66 U.S. cents, from a competitive point of view, the impact on manufacturers felt like the depreciation was 13 U.S. cents.

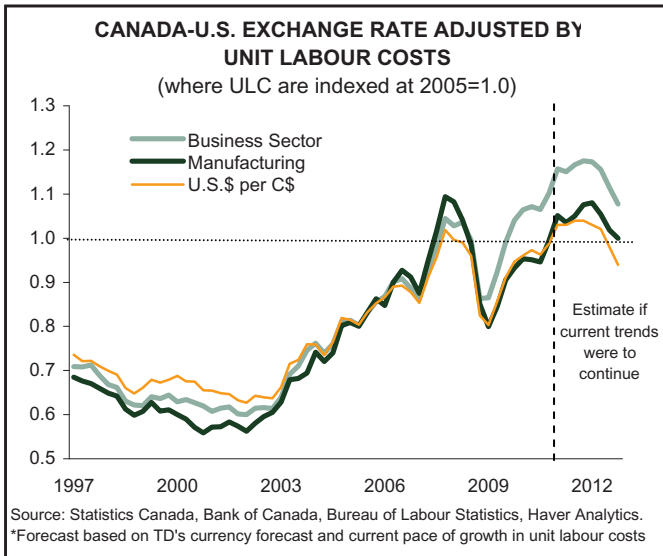
On an international scale, Canada is one of three G7 countries that has experienced a real exchange rate adjusted by unit labour costs that has climbed by more than the nominal bilateral exchange rate – the others are France and Italy. The implication is that rising unit labour costs have helped contribute to the challenges faced by Canadian businesses.

To be clear, we are not saying that increased labour compensation and employment is not beneficial to the economy – the point is that that these trends must be supported by an increasingly competitive economy. If not, the higher compensation and employment will not be sustainable in the long run, as Canadian firms will suffer weaker prospects as more business goes to foreign competitors.

Something's got to give

Looking ahead, the Canadian dollar is likely to remain a competitive challenge. Our view is that robust domestic demand, the relatively better fiscal position of the federal government than that of other major industrialized countries, and firm commodity prices will continue to keep the Canadian dollar above parity versus the greenback through 2011, and within a trading range of 100 to 95 U.S. cents over 2012 and 2013.





below parity, the competitive environment will feel more like the dollar remains well above parity. In other words, the real exchange rate adjusted by unit labour costs could remain near, or above, parity. The implications are that Canadian exporters will find it difficult to rebuild market share in international markets over the next few years, unless businesses make some needed adjustments.

Improvements underway, but businesses still face an uphill battle

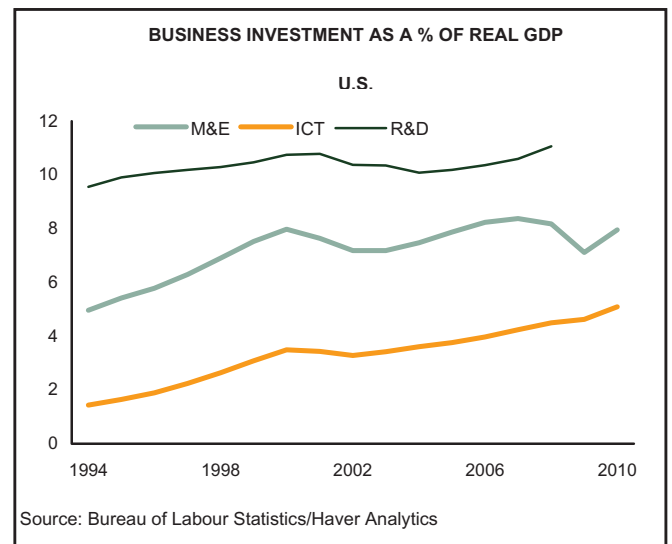
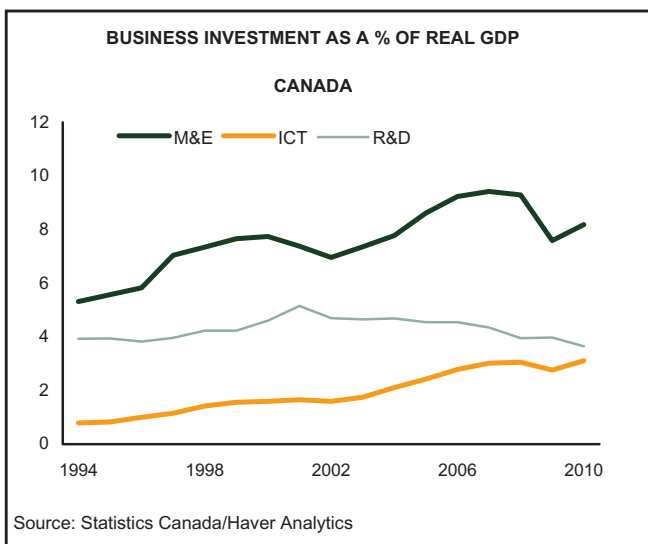
The good news is that there are some signs that many Canadian businesses have started to take the necessary steps to become better contenders in international markets. Most notably, a sharp rebound in business investment in 2010 will likely help boost productivity in the future. Moreover, the most recent Bank of Canada business outlook survey indicated that businesses recognize the need to make such capital outlays in order to become more competitive, not just in international markets, but also on home turf. On the flip side, investment intentions only point to a modest increase in 2011. The soft investment intentions are partly a confidence issue, as businesses remain concerned about the number of risks facing the global economic and financial recovery, as well as an elevated Canadian dollar. We do think that as risks abate, solid balance sheets, rising profits, low interest rates, and favourable government policy, such as reductions in corporate income taxes, accelerated depreciation allowances, along with the introduction of the harmonized sales tax in Ontario and B.C., will lead to a more robust investment profile.

It is our view that businesses must seize the opportunity to implement the needed investment to boost productivity and become more competitive, however it may not

Businesses should also be prepared for more volatility in the Canadian dollar, and possible upside risks to the base case currency projection. Should domestic demand surprises on the upside, and the Bank of Canada moves earlier and more aggressively in hiking interest rates, or commodity prices climb unexpectedly – all of which are risks to the outlook – the Canadian dollar could continue to climb. Furthermore, should markets start to price in greater concern over the U.S. fiscal deficits over the medium term, a Canadian dollar above parity could be here to stay.

If current trends in labour productivity continue, given our Canadian dollar outlook, Canada's position as a world leader in trade will continue to deteriorate. For the business sector as a whole, this could imply that productivity continues to grow at half the pace of the U.S., and Canadian unit labour costs grow at double the pace of that in the U.S.

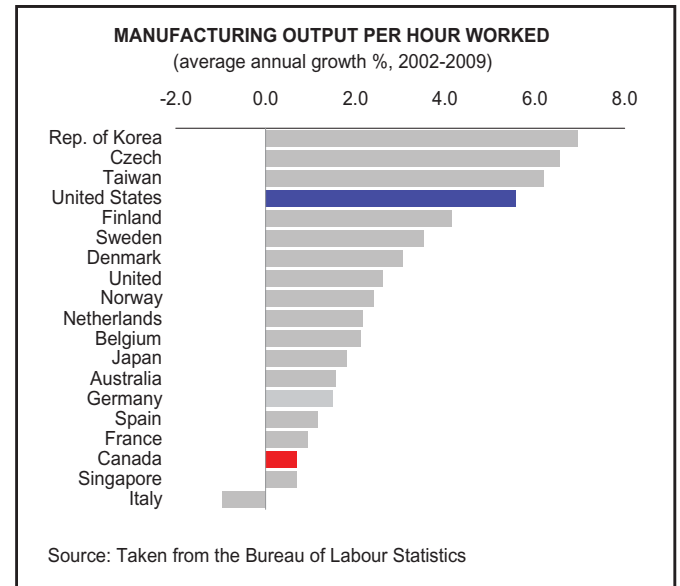
Moreover, even as the Canadian dollar eventually dips



be enough to close the productivity gap with the United States. While shaky confidence over future prospects may be holding Canadian firms back from making major capital outlays, business investment in the U.S. has already eclipsed pre-recession levels. Moreover, as the accompanying charts on page 5 shows, U.S. companies spend far more on business investment, computers and software in particular, and research and development as a share of real GDP, than in Canada. The implications being that labour productivity in the U.S. will continue to outpace that in Canada. Given intentions to engage in businesses investment, we anticipate an uptick in Canadian labour productivity growth from an annual average of 0.7% over the last five years, to 1.2% over the next five years, but still run below the 1.5% per year expected in the United States. What's more, to avoid further loss in international market share, Canada's productivity growth rate would need to increase to a 2.0-2.5% annual rate over the next five years to keep labour costs under control. This is not unprecedented and would be akin to what happened between 1997-2002 when increased spending on machinery and equipment helped drive stronger productivity gains. Business investment would need to advance by 10-15% per year over the next five years to get this type of productivity growth. Alternatively, investing in skills training for the workforce tends to have a slightly greater positive impact on productivity than investing in machinery and equipment. Nonetheless, given an aging population, a mix between increased spending on investment and skills training is likely the best solution.

Business should take note that becoming more competitive need not be a daunting task. Companies do not have to be innovators – they could simply become imitators of high-productivity foreign firms. Businesses could also take advantage of the high-flying loonie and import more machinery and equipment. The growth in Canadian investment abroad suggests that Canada is integrating into the global economy. This provides opportunities to learn from innovation and technology that works elsewhere. It also allows for firms to outsource basic tasks, and work on higher value-added production domestically.

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To sum up

Overall, adjusting to the rise in the loonie over the last decade has been an uphill battle for Canadian businesses. The above analysis has focused on comparing Canada to the U.S. simply because the U.S. is a world leader in innovation and productivity, and happens to be Canada's strongest trading partner. However, when you compare Canada on an international scale, the situation seems dismal. Canada's productivity performance over the last decade ranks third last when compared to 19 developing and developed economies, just behind Italy and Singapore. A focus on productivity is becoming more and more important, particularly as lower cost economies, such as China, are becoming more efficient at producing higher value manufactured goods.

In order to regain competitiveness on an international scale, firms need to revamp businesses models to become more efficient. This will involve implementing new technology and innovations, increasing spending on research and development, and specialized skills training programs for the workforce. While this might seem like a lot of work, the good news is that there will be lots of opportunity to do so, and closing up shop is not the best solution to a lofty loonie.