TD Economics

Topic Paper

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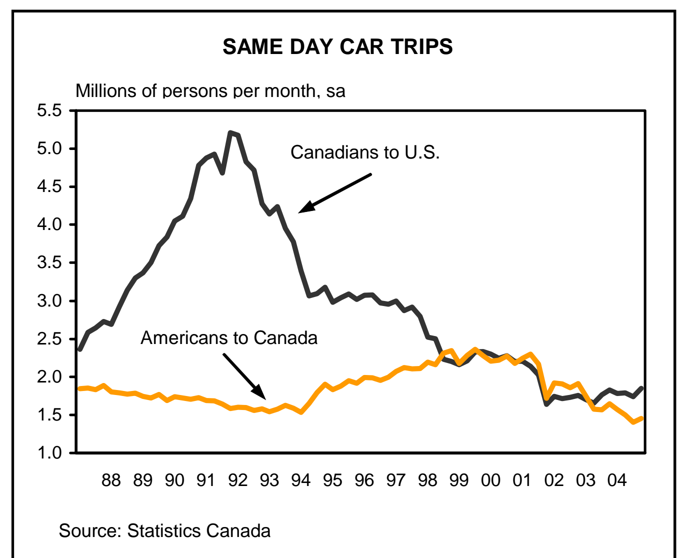
HIGHER LOONIE FAILS TO DRIVE SHOPPERS SOUTH

Forecasters have been closely examining the economic damage incurred over the 1987-91 period – the last time the loonie experienced a sharp appreciation – for insight into the potential fallout from the loonie's recent rise. A major trend that was linked to a higher dollar during that period was the popularity of cross border shopping, which not only dampened consumer spending in Canada, but was also a contributing factor behind the erosion of Canada's international balance of payments. Yet despite today's strong loonie, Canadians have become less enamoured with cross border shopping, suggesting that the potential hit from a higher exchange rate on this front, may not be as bad as some fear.



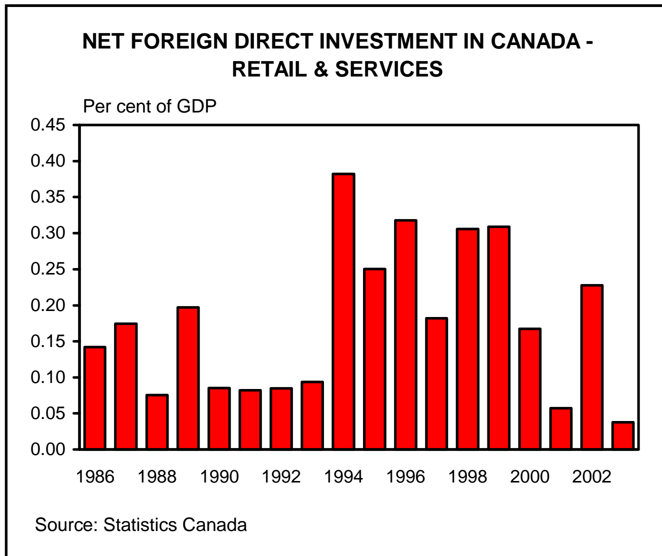
Fewer trips down south….

In 1991, as the loonie appreciated to just over it's implied purchasing power parity value of about 80-84 U.S. cents, the outflow of Canadians travelling to the U.S. surged to more than 80 million person trips a year. Interestingly, nearly three quarters of this outbound travel occurred over the same day. Since most same day travel does not imply vacation activity, which usually occurs over a longer period of time, these travellers have been identified as "cross border shoppers". Such travellers primarily made quick trips over the border to outlet malls in Seattle, Buffalo or Detroit in search of deals on a wider selection of consumer goods rendered cheaper by a significantly higher loonie.

While the recent appreciation of the Canadian dollar has been even greater than in the 1987-91 period, offering a similar cross border shopping opportunity today, same day trips to the U.S. have not responded. In fact, despite a near 80 U.S. cent loonie, the number of same day car trips to the U.S remains lower today than over the past few years when the loonie was hovering below the 70 U.S. cents. Why has this happened? Some have suggested that the threat of further terrorist acts since 9/11 may have discouraged Canadians from travelling to the United States. While this may be a partial factor, the more discernable impact has been the protracted decline of Americans travelling abroad, including to Canada. Meanwhile, Canadian visits to the U.S. have been on a steady secular decline since 1992.

…..since the shopping is better at home

A more compelling explanation behind this slowdown in travel to the U.S. is that despite the increased purchasing power of the loonie, today's shopping deals are still better in Canada. There are two main reasons for this. First, Canadians have witnessed a sharp increase in the number of U.S. retail chains operating in the country over the past



decade. For example, in 1985 only ten U.S. retailers were operating in Canada, while today's total is roughly 100. With this influx of U.S. retailers, once highly sought after American brands have become much easier to find in Canada.

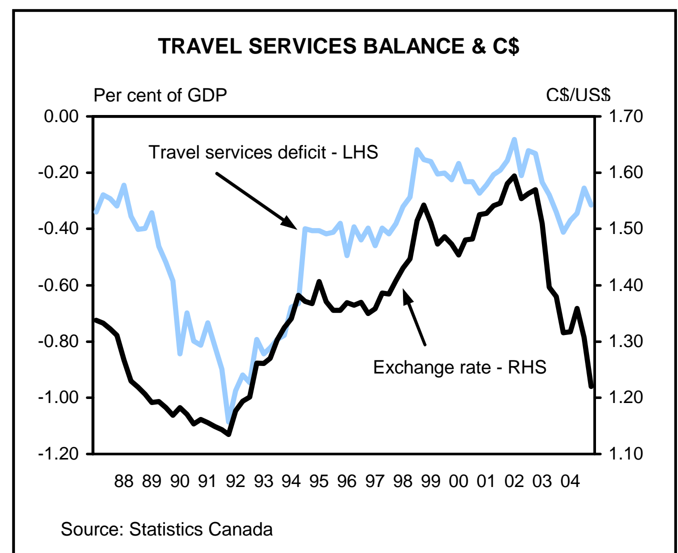
Second, the fastest growing retailing trend over the last decade has been the "category killer" – superstores, big boxes and warehouse clubs, which today have moved from single standing units to clusters called power centres. The sheer size of some of these retailers (a Home Depot outlet is roughly 18 times larger than a traditional department store) offers Canadian consumers a depth of merchandise assortment that was never available to them over the 1987-91 period. Moreover, these retailers have incorporated new technologies including direct electronic connections with suppliers and sophisticated shipping systems that help to keep their prices low and competitive. If anything, the passthrough from today's higher loonie simply allows many of these companies to become even more price-competitive. For example, Canadian consumers have continued to enjoy a general decrease in the price of men's and women's clothing over the past few years, with the consumer price index of the latter recently declining to a 14-year low. As such, once the cost of gas and the inconvenience of potential delays at border crossings are factored in, there is really very little incentive to seek out shopping deals in the United States compared to the past.

It should be noted that cross border shopping's failure to make a comeback could also be linked to the recent proliferation of on-line retailing, but only partly so. While the Internet offers Canadian shoppers the opportunity to buy foreign goods on-line, eschewing the need to physically travel to make a purchase, on-line retailing is not practical for many goods that were in high demand for most cross border shoppers. For example, goods such as clothing and consumer electronics are not well suited for sale on the Internet since they generally require physical inspection before being purchased.

Not as big a hit to net trade in services

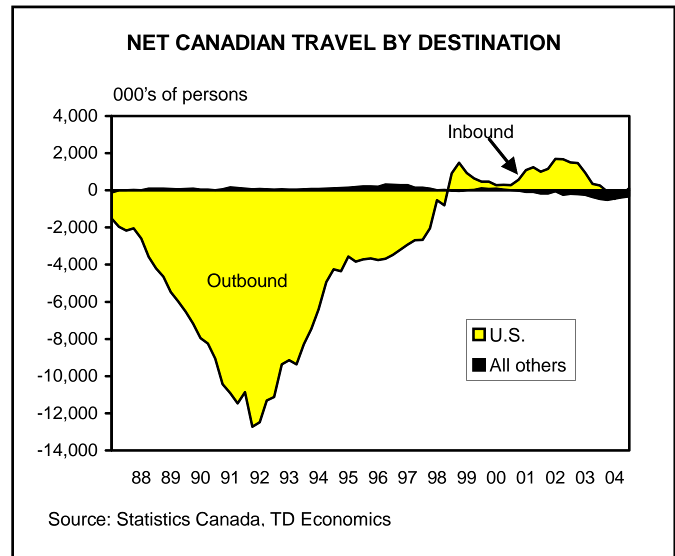
While the demise of cross border shopping has indirectly supported economic growth by not dampening domestic consumer spending as it did in the 1987-91 period, there is also a more direct positive via the impact on the international balance of payments in the current account. Specifically, when Canadians travel to other countries, even when its over the same day, most of the goods purchased during such visits as well as any related expenditures on things like meals or accommodations, are treated as an import of travel services. Conversely, receipts from foreigners visiting Canada are treated as an export of travel services. Since Canadians are not making as many cross border shopping visits, it has effectively suppressed the growth in travel service imports, which ultimately supports the international travel account in the balance of payments.

Indeed, over the 1987-91 period, when the appreciating loonie set-off the huge increase in cross border shopping, the travel services deficit plunged dramatically, hitting an all-time high of more than 1 per cent of GDP. Consequently, this was another factor that eroded the current



account balance with the blame squarely focussed on the higher loonie. As the loonie began its long and steady depreciation after 1992, the travel services balance experienced a significant improvement as fewer Canadians traveled to the U.S. to shop while inbound travel, principally by Americans, began to increase. By early 2002, the travel services deficit was the smallest ever at 0.1 per cent of GDP as exports of Canadian travel services, mostly to Americans, began to increase. Not surprisingly, this also coincided with the loonie hitting a record low of 62 U.S. cents.

But given the lack of resurgence in cross border shopping today, the travel services deficit has not experienced as much of a deterioration, even though the recent appreciation of the loonie has been stronger than during the 1987-91 period. Some commentators have rightly pointed out that Canadians have merely decided to visit other countries instead of the United States. However, the appreciation of the loonie against other non-U.S. currencies has not been as strong compared to the greenback, so the currency incentive to travel to non-U.S. destinations is also not as large. Consequently, those net outflows are some 60 times smaller than comparable outflows to the U.S. during the heyday of cross-border shopping, so the impact on the travel balance is simply not as pronounced. Since the travel account is also one of the largest components in Canada's overall trade in services, net service exports have also recently shown greater resilience to the higher Canadian dollar than net merchandise exports. As such, the negative impact of a higher Canadian dollar on overall trade performance has not been as bad as many had feared.



That said, there is one major caveat that should be mentioned. If the Canadian dollar appreciates beyond Statistics Canada's estimated purchasing power parity value of 83.5 - 85 U.S. cents, the lure of cross border shopping could easily make a comeback and consequently trigger a larger deterioration of the balance of payments. But its resurgence would only be due to the fact that a Canadian dollar above 85 U.S. cents would buy the same basket of goods in the U.S. for less than it would cost on this side of the border. Fortunately, our forecast for the loonie remains range-bound at 80-83 U.S. cents over the next year suggesting that the best shopping deals will still be found at home.

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