Intelligence MEMOS

From: William B.P. Robson

To: Canadian Economic Observers

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Re: **Dollar Weakness is Our Best Tariff Defence**

The Canadian dollar is down about 6 percent against the US dollar since September. The coincidence of its recent ups and downs with the ebb and flow of US President Donald Trump's tariff threats shows that much of its decline reflects concern about US protectionism.

US tariffs on our exports will raise their price for US buyers. That will lower potential buyers' demand – and, with it, their demand for the Canadian dollars they would use to buy them. So the loonie falls in anticipation.

If Mr. Trump's direr tariff threats materialize, the loonie will fall further. If they stick, it will keep falling until the lower cost of our goods, services and assets creates a new balance of supply and demand for Canadian dollars. The diminished purchasing power of a lower currency is hard to like. But we should accept it – even welcome it – as a vital part of our adjustment to US trade aggression. As the Buckley's ads say, it tastes awful – and it works.

Donald Trump seems to imagine that everything produced in the world can and should be produced in the United States. But the tariffs he's using to try to make that happen reduce US demand for foreign currencies, pushing the US dollar up, and making US production less competitive.

The flip side of that is that the lower Canadian dollar will make Canadian production more competitive. A trade war is still a net negative. Tariffs prevent trade that would have benefitted buyers and sellers alike. But even though the lower dollar means Canadians will see higher prices for imports and tradable goods and services generally, it will cushion the blow. It will make Canadian production more cost-competitive and reduce the hit on Canadian output, jobs and earnings. Even as our exports that are hardest hit by tariffs decline, production will shift to goods and services facing lower or no tariffs.

The consumer price index will rise, which may prompt demands for the Bank of Canada to respond with higher interest rates than our economy would otherwise warrant. Once upon a time, the Bank might have responded to those demands. Before it adopted its 2 percent inflation target and became credible in the early 1990s, the Bank used to hike rates when the dollar fell. That was perverse: When a falling exchange rate signals a weakening economy, as it often does, higher interest rates from the central bank are the last thing we need. The Bank is unlikely to respond that way now.

Mr. Trump's threats against Canada's independence don't make the medicine more palatable. What if a lower dollar makes our assets cheaper and thus more vulnerable to US takeovers? We can protect truly strategic assets with foreign investment reviews on security grounds, as the federal government has just announced it will do. That is better than trying to shore up the exchange rate and making us more expensive across the board.

As hard as it may be to swallow, a lower Canadian dollar is a better response to US trade aggression than others we are considering or even implementing.

Retaliatory import tariffs or export surcharges only make sense if they make Mr. Trump back off quickly. Otherwise, they compound the damage by raising prices for Canadian consumers and producers using tariffed imports and getting us into a tit-for-tat exchange with a country much bigger and less export-dependent than we are.

COVID-style handouts – which will be harder for our governments not to provide if they themselves are imposing trade-war-related costs on Canadians – will mean even deeper public debts and higher future taxes. Moreover, the timing and size of fiscal transfers are political decisions, and notoriously favour some regions, industries and classes of recipients over others. In contrast, the exchange rate adjusts continuously to supply and demand and spreads its costs and benefits non-politically. As advocates of such medicine for less developed countries clinging to overvalued exchange rates like to say: "No one can steal a devaluation."

Letting a lower Canadian dollar cushion the blows inflicted by US protectionism will lessen the temptation to engage in self-harming retaliation or spend public money in ways that will leave us weaker. It will help us focus on the tax, spending and regulatory changes that can raise our investment, diversify our exports, strengthen our internal market and make us stronger in the face of whatever Mr. Trump or his successors throw at us. Hard to take or not, it is the right medicine.

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