Québec’ Economy: The Challenge of Foreign Markets

Geographic diversification needed quickly to reduce export dependency on the United states

Exports from Québec to the United States fell by 8.1% in 2007, the sharpest drop in 20 years. The outlook for 2008 appears no rosier. The U.S. economy is on the verge of a recession, perhaps already into a downturn, and the appreciation of the Canadian dollar to around parity, as well as the ongoing intensification of international competition, will continue to have an impact. Will the consequences for Québec’s foreign trade be even more devastating? Of course, the United States is still the major foreign customer for our businesses. However, several structural changes that have occurred in recent years seem to have reduced (albeit slightly) our dependence on U.S. demand. But are other markets able to take up the slack? Can we count on expanding ties with other trading partners to soften the current blow? The issue of geographic diversification of Québec exports will be analyzed in this Economic Viewpoint. This will enable us to determine whether Québec’s economy is still as vulnerable as ever to fluctuations in the U.S. economy, and the extent to which it will be so in the years to come.

HARD TIMES FOR EXPORTS

Québec exports have been plying troubled waters since the beginning of the decade. The burst of the technology bubble and the U.S. recession of 2001 put an abrupt halt to a long period of growth (graph 1). At the end of the 1990s, the telecommunications equipment industry was flourishing. The value of shipments abroad reached twelve billion dollars, making this our main export product (less than two billion in 2007). The collapse of that industry was a serious blow to Québec’s trade. Then, in 2001, we were faced with economic contraction south of the border. When the U.S. economy rallied, around mid-2003, several structural changes prevented Québec’s international exports from soaring back to previous levels. The appreciation of the Canadian dollar and competition from emerging countries (especially from Asia, with the rising power of China) for the U.S. market, may be held accountable. Were it not for those changes, shipments of goods to the U.S. would have reaped full benefit from the favourable economic conditions south of the border during that period. However, real recovery in the United States was delayed in the first half of this decade due to the revelation of financial scandals and the uncertainty that came with that.
THE PROPORTION OF EXPORTS BOUND FOR THE U.S. IS DECLINING

It is difficult to determine the extent to which each of these factors is responsible for the lethargy of exports to the south since 2000. One thing is certain: China’s expanding share of the U.S. market was achieved primarily at Canada’s expense, which until just recently was the U.S.’s main supplier (graph 2). Québec did not escape that trend, since its share of exports to the U.S. market eroded at the same pace as Canada’s. In 2007, 74.7% of the province’s international exports were destined for the United States. That proportion has gradually declined since reaching a peak of 85.5% in 2000 (graph 3). Although the U.S. market still offers enormous potential, fierce competition from emerging countries (China in particular) and the appreciation of the Canadian dollar will make it difficult to recover the ground that has been lost. For those reasons, possibilities of expansion in that market are proving to be increasingly limited.

Another factor is the possibility that revived protectionism in the United States after the presidential election of November 2008 may further reduce any potential for growth in several sectors that are key for Québec-based businesses. In fact, this week, both Democratic presidential candidates announced their intention to amend, or even abolish, the free trade agreement with Canada. If the isolationist leanings of American trade policy were to intensify, this would most likely create another obstacle to any growth in exports from Québec to the U.S. Certainly, the impetus observed in the 1990s after the implementation of the North American Free Trade Agreement (FTA) is now just a memory. Exporters will increasingly have to turn towards overseas destinations to achieve growth on the international scene.

HAS GLOBAL DIVERSIFICATION BEGUN?

The reduced dependency on the U.S. market may seem like good news at a time when that economy is threatening to run out of gas. But the real question is: has Québec taken advantage of the structural changes that have occurred in this decade to diversify its international customer base? If the proportion of Québec exports to the U.S. has declined since 2000, the proportion represented by other countries has obviously increased. Is this the result of real growth in overseas exports, or has it happened by default?

A glance at table 1 (page 3) sheds some light on the question. While the United States has lost ground since the beginning of the decade, not only have other destination countries increased their market share, but growth in shipments has also been observed. In order, the Netherlands, Italy and China have played the biggest roles in our international trade, even though their contribution remains marginal. For example, shipments to Italy have surpassed the one billion dollar mark, whereas they were below 300 million dollars in 2000. Exports to most countries have increased significantly, with the exception of those headed for the U.S. and the United Kingdom. The value of overseas exports remains relatively low, but the positive growth indicates that international diversification has gotten underway since the beginning of this decade.
The market share of overseas countries has thus not grown by default, since there have been substantial increases in the value of exports to most of the main countries. On the other hand, although the United States has been carrying less weight in the past few years, the ground won in other markets has not been significant enough to ensure the growth of our international trade. In other words, we are not home and dry. Even though growth in overseas shipments has surpassed 60% since 2000, the gain of nearly seven billion dollars between 2000 and 2007 has not been sufficient to fully compensate for the drop of over ten billion dollars in exports to the U.S. market (graph 4). Therefore, additional efforts must be made to increase our presence on the other continents. Developing new markets and new product niches demands substantial investments in time and money. Some effort seems to have been made, but more will definitely be needed to further increase our presence on the other continents.

**GLOBAL DIVERSIFICATION MUST INTENSIFY**

Québec exports’ dependence on the U.S. market should continue to diminish in the next few years. With the dollar staying around parity (graph 5) and the effects of globalization continuing to reshape the foundations of international trade, the current structural changes will continue to do their work. Accordingly, five years from now, the United States will be able to absorb only 70% of the province’s international exports compared with 74.7% at present (over 85% back in 2000). The potential for economic growth in the U.S. will in fact be limited in the next few years, in particular due to the weakness of the residential real estate market.

The probable resurgence of American protectionism after the presidential election this fall could complicate matters further. Indeed, the possibility of NAFTA being revoked or significantly amended has been raised by both Democratic presidential candidates this week. Although positions may...
certainly change after the election, as happened after Bill Clinton became President, this possibility must be taken into consideration.

For all these reasons, it is high time that Québec began prospecting for new markets in order to broaden its horizons on the international scene. It must develop new product niches to carve out a position in the global supply chain (integration trade). Given that this usually involves a certain time lag, the efforts now being made by the Québec government may take a while to bear fruit. This year, the province will court the European countries in hopes of establishing an economic agreement. Although this is a step in the right direction, it would be astonishing to achieve results overnight. It seems a bit late to alleviate the current slowdown of the U.S. economy. Still, developing overseas markets will produce long-term benefits by creating a stabilizing effect for Québec’s international exports, besides promoting their expansion.

ANOTHER AVENUE: TRADE WITH THE REST OF CANADA

Foreign markets are not the only possible outlet for Québec’s exports. The rest of the country also offers considerable potential; indeed, it used to occupy a much larger place in our trade. In the 1980s, approximately half of Québec’s merchandise shipments were headed for other provinces. Then, the entry into force of FTA in 1989 changed the picture considerably over time. FTA was very beneficial for Québec, providing wider access to the world’s largest market. The effect of FTA was to change the direction of trade from east-west to north-south. Exports to the United States gained ground at the expense of the Canadian market. A peak was reached in 2001, when two thirds of shipments out of Québec were bound for the international market, and one third to the domestic market (graph 6). From 2000 to 2007, exports of goods to other countries fell by approximately ten billion dollars, while shipments to the rest of Canada rose by nearly five billion dollars (graph 7). Thus the growth of shipments to the domestic market has not been sufficient to offset the decline in international trade.

Subsequently, the appreciation of the Canadian dollar and increased competition from China in the U.S. market reduced that market’s importance for Québec, to the benefit of the Canadian market. Last year, nearly 40% of Québec’s exports were bound for other parts of the country, while 60% were headed for foreign markets, mainly the United States. Despite this rebalancing, the U.S. market is still the primary destination of shipments out of Québec.

Thus the potential for increased trade opportunities with the United States as a result of FTA is a two-sided coin. After deserting the Canadian market for a period of time, the challenge facing Québec lies in renewing commercial ties. Given the current situation, this is a perfect time to take steps to recapture the domestic market. Indeed, last fall, the governments of Québec and Ontario formally announced their intention of signing a trade agreement to stimulate trade between the two provinces. In particular, the agreement is intended to eliminate trade barriers, and is scheduled to come into force some time in 2008. Although this is certainly a step in the right direction, it remains to be seen how long it may take for concrete action to be taken, and at what point the impact will be perceptible. Since 40% of Québec’s exports are Ontario bound, it is very appropriate to strengthen our ties with our neighbouring province. This strategy of revitalizing trade between the provinces should result in something of a return swing of the pendulum for Québec’s foreign trade. This diversification should make the province less vulnerable to the ups and downs of a single economy, i.e. that of the United States. However, adoption of the Québec-Ontario trade agreement will come too late to offset the impact of a possible recession in the U.S.
GEOGRAPHIC DIVERSIFICATION MUST BE EXPANDED

The causes of the decline in export share to the United States are manifold and, most important, of a structural nature. Given that these changes will continue to limit the potential for growth in exports to the U.S., Québec must put its trade on a new footing. The goal is to develop a broader economic space that offers greater potential for expansion. Two avenues merit exploration with a view to widening the geographic diversification of Québec’s exports: making better use of possibilities overseas, and strengthening our ties with neighbouring provinces, which formerly held a much greater place in our trade. This would reduce Québec’s vulnerability to fluctuations in the U.S. economy. Since that vast market is increasingly sought after by emerging countries, in particular our Asian competitors, a commercial repositioning is necessary for the province.

Certainly, the importance of the U.S. market reflects the continental character of Québec’s exports due to its proximity, its dynamic nature and the existing free trade agreements. Since the potential of the U.S. market will continue to erode, and global markets are more and more open, the possibilities of overseas markets must be given a lot more attention, despite the distance involved and their different characteristics. To successfully expand into overseas markets, which many other countries are also trying to do, Québec will of course have to set itself apart from the crowd by offering products with high technological content. International competition is vigorous, dictating a stronger positioning towards a knowledge-based economy. Creating a wider economic space for Québec is part of the provincial government’s long-term vision; accordingly, every effort must be made to attain that objective, which is essential to the province’s development. On a broader scale, it is important to create conditions that are conducive to achieving that, in particular by investing in education and in infrastructure.

Hélène Bégin
Senior Economist