Great hopes are pinned on exports

Growth in Canadian domestic demand has been running out of steam in recent quarters (graph 1). This is due to households exercising greater caution in their purchases, anemic public spending due to deficit-fighting, and modest growth in non-residential investments, as businesses are still hesitant in light of the uncertainty of the global recovery. In 2014, a slowdown in the real estate market is likely to be added to that list. Consequently, the supports for economic growth in Canada will be rather slim in the coming quarters.

In such conditions, great hopes are pinned on exports to support economic growth in this country. In theory, the gradual recovery of the global economy and the rally in U.S. demand should promote sustained growth in Canadian exports. As may be seen in graph 2, this was indeed the case between the end of 2009 and the end of 2011, when Canadian exports kept pace with the rebound in foreign activity. But the relationship between these two variables seems to have ruptured since the beginning of 2012. On one hand, the foreign activity measure has kept rising, as the recovery in the United States and other parts of the world continued. On the other hand, Canadian exports expressed in constant dollars have stayed practically flat since 2012. This new dichotomy is raising considerable concern about the ability of international trade to fill the breach in the country’s economic growth.

Graph 1 – Growth in Canadian domestic demand has been weaker in recent quarters

Graph 2 – For some time now, Canadian exports have not kept pace with rising foreign demand

1 The foreign activity measure compiled by the Bank of Canada reflects the composition of demand for Canadian exports by combining some components of final private domestic demand in the United States and the economic activity of Canada’s other main trading partners.

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Will Canadian export growth meet expectations?

After showing signs of improvement, in the past few quarters Canadian exports have been struggling to take advantage of a rebound in foreign demand. Even though prospects for growth are still favourable in the long term, many problems will continue to impede exports’ progress in the shorter term. Under these circumstances, exports’ contribution to economic growth could be less robust than forecast, thus explaining our recent downward revision of Canadian real GDP for 2014. Moreover, downside risks are clearly looming larger.
AN ATYPICAL RECOVERY
This flat-lining of exports in a period of economic recovery is fairly unusual. Graph 3 shows the growth in exports after the end of each of the main recessions that have occurred in Canada since 1960. At the beginning of the current recovery (in the wake of the 2008–2009 recession), growth in exports was not significantly different from that of previous recoveries. But contrary to recent economic cycles, exports have hit a period of static growth in the past few quarters, something never seen in previous recoveries. As a result, the current volume of exports is clearly lagging behind the volumes seen at this point in previous recovery cycles.

Graph 3 – The rebound in Canadian exports is taking longer than in previous cycles

As far as energy commodities are concerned, it is mainly oil and gas extraction that have been stalling in the past while. The problems of carrying Canadian oil to market and the surge in shale gas production in the United States certainly have a lot to do with this trend. In the short term, the outlooks will in all likelihood be clouded by these difficulties. In the longer term, the outlooks remain positive, as global demand for energy products is rising, and various pipeline projects could potentially come to fruition, resolving the transportation problems.

As for non-energy commodities, the mining sector is the primary culprit behind the weak exports in recent months. We must point out that global supplies have expanded faster than demand in recent years, so the conditions in international markets are less favourable. That said, the expected increase in global demand for commodities in the years ahead should eventually favour Canadian exports of non-energy commodities. However, it must be noted that the current imbalances will prolong the difficulties in the short term.

Finally, the stagnation in non-commodity exports reflects fairly widespread problems in Canada’s manufacturing sector. For example, the volume of manufacturing sales has stayed practically flat since mid-2011. Clearly, Canadian manufacturers are no longer managing to take advantage of the gradual improvement in demand in the United States and other parts of the world.

THERE WILL BE MANY CHALLENGES IN THE SHORT TERM
How do we account for this flat-lining of exports, when all the conditions appear to favour a continuation of the recovery? In graph 4, the volume of merchandise exports is divided into three categories: energy commodities, non-energy commodities and exports of other goods. Non-commodity exports, representing nearly 50% of trade, obviously account to a large degree for the stagnation in total exports. That said, exports of energy commodities (approximately 22% of trade) and non-energy commodities (nearly 30% of trade) have also slowed somewhat in recent months. Clearly, the stagnation in exports is a widespread phenomenon.

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COMPETITIVENESS PROBLEMS RESURFACE
Manufacturers’ recent tribulations are once again shining a spotlight on the harmful effects of the deteriorating competitiveness of Canadian businesses in recent years. The gap between Canadian and U.S. unit labour costs has widened significantly since the year 2000. The difference is even greater if we factor in the appreciation of the loonie when expressing Canadian costs in U.S. dollar terms (graph 6 on page 3).

Apart from the strength of the loonie, this loss of competitiveness is due to fairly lacklustre gains in productivity in recent years (graph 6 on page 3). Clearly, repeated calls for Canadian businesses to modernize their production capacity have yet to bear fruit. Admittedly, the uncertain global economic climate is holding many businesses back from embarking on investment projects. We can only hope that businesses will get serious about
modernizing their production capacity once global economic conditions become more favourable. That said, there will be a time lag between the start of a significant increase in investment and the achievement of greater productivity. Thus, many quarters will go by before any improvement in competitiveness materializes, raising concerns about short-term trends in non-commodity exports.

Some relief could come from a depreciation of the Canadian dollar. The outlook for the loonie is not very good for the upcoming quarters due to the weakness of Canadian domestic demand. However, it would be astonishing if the loonie were to fall below the US$0.95 mark for an extended period of time, a level too high to really have a significant impact on business competitiveness.

Another factor that is affecting Canadian exports is the fierce competition that currently prevails in the United States. After several lean quarters following the great recession, U.S. businesses have spare production capacity. In such conditions, it is obviously more difficult for Canadian businesses to break into the U.S. market. According to the Bank of Canada’s latest survey, Canadian business leaders believe that competition in the U.S. market will remain strong, holding their growth in check. That said, the situation is gradually improving: the U.S. industrial capacity utilization rate is heading back up towards its historical average (graph 7).

In the longer term, there is no doubt that several positive factors will enable Canadian exports to accelerate. However, certain obstacles will clearly hold exports back in the short term. This is confirmed by the latest data on international merchandise trade: exports of goods expressed in constant dollars recorded a pullback of 3.6% in the third quarter of 2013.

Given these conditions, we have revised our forecast for Canadian export growth in future quarters, downwards. The rebound in demand in the United States and other parts of the world should indeed have a positive impact, but the existence of several challenges will no doubt curtail export growth in the short term.

It goes without saying that this will have repercussions on Canadian economic growth. Accordingly, we recently reduced our forecast for real GDP growth in 2014 downwards, from 2.4% to 2.2%. Moreover, the risks remain on the downside, since export trends could well continue to disappoint. In these conditions, the Bank of Canada’s recent decision to adopt a more neutral tone in its monetary policy makes perfect sense, and key interest rates will likely stay at their current levels until mid-2015, at least.

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