ECONOMIC VIEWPOINT

Canada Will Not Escape the Distortion in Global Trade Arising from the Agreement between China and the United States

The Negative Effects in the Country Will, However, Be Quite Limited

According to the recent trade agreement between the two countries, the Chinese should increase their imports from the United States considerably over the next two years. This will lead to a distorting effect in global trade, as China is expected to in turn reduce its imports from other countries, including Canada. Canadian exports toward China could therefore end up seeing a cumulative decrease of US$5.6B over the next two years. The negative impact on Canada's real GDP will nevertheless be fairly small.

China and the United States called a truce in their trade war in mid-January with an initial agreement aimed at reducing some customs tariffs. China also committed to significantly stepping up its imports from the United States. According to the Phase 1 deal, China will have to increase its imports from the United States by US$200B over two years. This is an ambitious goal that will substantially boost U.S. imports into China (graph 1).

GRAPH 1
The hike in Chinese imports of U.S. goods and services under the trade agreement is very ambitious

Sources: Bureau of Economic Analysis, Office of the United States Trade Representative and Desjardins, Economic Studies

Such a move will, without question, lead to distorting effects in global trade. China is likely to slash its imports from other countries to offset the higher U.S. imports. It is worth noting that economic growth is less robust in China,[1] which diminishes the capacity of the Chinese to significantly expand their total imports. Under these conditions, Canada will not escape the distorting effects, and its trade with China will be negatively affected in the coming years. It remains to be seen what the effects will be on the country's economic growth and how far they will reach.

Canada Will Not Be Spared from the Distorting Effects

Such analysis, however, requires certain assumptions (box 1 on page 2) that are fairly restrictive and generally imply that everything else remains equal (*ceteris paribus*). This therefore means that we assume that the increase in Chinese imports from the United States is fully offset by an equivalent reduction in imports from China's other trade partners. The impact for Canada is estimated based on its relative weight in trade with China for each good or service. In reality, at least one of these assumptions is likely to not hold. Nevertheless, the exercise enables us to establish certain guideposts and form an idea of the extent of the repercussions that the trade agreement between China and the United States will have on the Canadian economy.

[1] China's real GDP growth slowed even before difficulties emerged in connection with the coronavirus (COVID-19).

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BOX 1
Main Assumptions Used

- China fulfils its commitments and increases its imports from the United States as expected.
- China's trade balance remains unchanged. The total value of its imports remains the same. The total increase in imports from the United States is therefore offset by an equivalent reduction in imports from other countries.
- The distorting effects are uniform across other countries. The reduction in Chinese imports is therefore distributed proportionally for these countries, including Canada.
- The decline in Canadian exports to China is not offset by an increase in exports to other trade partners.

To continue the analysis, we have to dissect the deal. The agreement does not cover all goods and services imported by China, but, rather, a proportion divided into four categories. Let us start by saying that close to 40% of Chinese imports from Canada are not part of the goods targeted in the China–U.S. agreement. As a result, they should not be significantly affected.

The first category in the deal is manufactured goods, with China pledging to increase these types of imports from the United States by US$77.7B over two years. The second category is agricultural goods, with a US$32B increase over two years. The third category is energy, which should see a US$52.4B increase in imports from the United States. Lastly, the fourth category is services, with a total increase of US$37.9B.

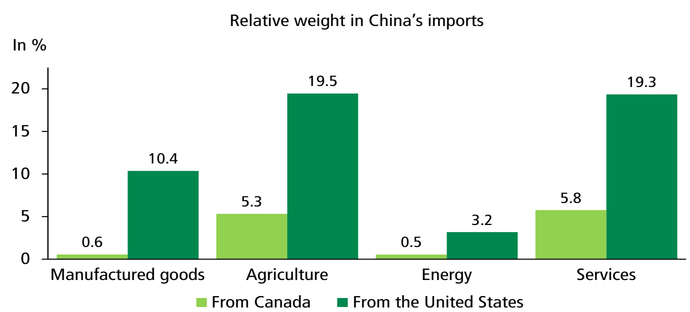
Each of these categories is then subdivided into several types of goods and classified according to a harmonized system (HS) for international trade with a four-digit code (HS-4). World Trade Organization (WTO) data identify Chinese imports for each of these categories (HS-4) based on country of origin, including the United States and Canada.

This allows us to determine that Canada represents[2] 0.6% of all Chinese imports under the first category of the deal. Canada's relative weight in Chinese imports under the third category is similar at 0.5%. For goods under the second category corresponding to agriculture, Canada's proportion is somewhat higher at 5.3% (graph 2). Close to a third of these goods fall into category HS1205, which is essentially canola.

The sectoral details for the fourth category corresponding to services are, however, more difficult to define based on the documentation enclosed with the agreement. In total, Chinese services imports from Canada accounted for 5.8% in 2016.

[2] According to data for 2017, the most recent year for this type of data within the WTO.

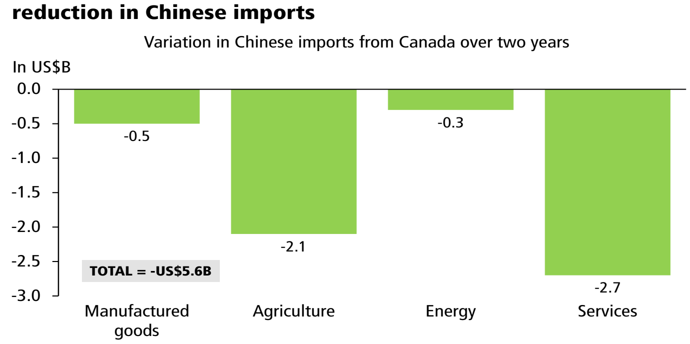
GRAPH 2
Canada's relative weight in Chinese imports is fairly low



Sources: World Trade Organization and Desjardins, Economic Studies

These ratios can then be used to establish the proportional reduction in Chinese imports from Canada for each category and sub-category. China's total imports from Canada could thus fall by approximately US$5.6B after the two years of the agreement (graph 3). The hardest hit sectors will be agriculture and services. If Canada does not offset this reduction with higher exports to its other trade partners, Canadian total exports could see a cumulative drop of US$5.6B over the period.

GRAPH 3
Agriculture and services are expected to be hardest hit by the reduction in Chinese imports



Sources: World Trade Organization, Office of the United States Trade Representative and Desjardins, Economic Studies

Converted into Canadian dollars and expressed in real terms, this represents a total decline of about 0.3% of 2021 real GDP (table 1). This estimate is approximate, of course, because the reality may deviate somewhat from some of the postulated assumptions. Also, will the total value of Chinese imports truly remain the same or will it jump significantly due to greater openness to foreign markets? Will the distorting effects be distributed proportionally among China's other trade partners, including Canada? Under the circumstances, the impact on Canada's real GDP could be slightly less pronounced or somewhat higher between -0.1% and -0.5%. That said, the outcome is still the same. The negative effects associated with the distortion resulting from the trade agreement between China and the United States will, in all likelihood, be quite subtle in Canada.

TABLE 1
The distorting effects resulting from the agreement between China and the United States will be quite subtle in Canada

	CANADA'S RELATIVE WEIGHT[1]	DECREASE IN CHINESE IMPORTS FROM CANADA[2]	IMPACT ON 2021 REAL GDP[3]
Manufactured goods	0.6%	-US$0.5B	-0.2%
Agriculture	5.3%	-US$2.1B	
Energy	0.5%	-US$0.3B	
Services	5.8%	-US$2.7B	-0.1%
TOTAL	n/a	-US$5.6B	-0.3% (between -0.1% and -0.5%)

n/a: not available; [1] Relative weight in Chinese imports subject to the agreement; [2] After two years; [3] Compared to current scenario.
Sources: World Trade Organization, Office of the United States Trade Representative, Statistics Canada, Datastream and Desjardins, Economic Studies

Other Difficulties Could Arise

At first glance, the finding of this analysis is rather reassuring with quite limited effects for Canada, all in all. However, this will not be the only obstacle hindering the Canadian economy in the coming years. The energy sector continues to be fragile. Global economic growth will also be less robust, with unclear consequences for Canada's international trade. The negative impact of the distortion of international trade may therefore be an added factor that when considered alone seems insignificant, but when combined with these obstacles could be greater and therefore have notable consequences for Canada's economic growth.

The Bank of Canada will obviously remain alert under the circumstances. As they already mentioned recently, the monetary authorities could consider cutting key interest rates if disappointments were to continue to accumulate in the Canadian economy. It is clear that the effects of the distortion of global trade will be something to consider.

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