Canada's State of Trade

Trade And Investment Update - 2010

This publication is available online at: www.international/gc/ca/economist-economiste/performance

ABOUT THIS DOCUMENT

Canada's State of Trade – 2010 was prepared under the direction of Rick Cameron of the Office of the Chief Economist of the Department of Foreign Affairs and International Trade. The report was written by Rick Cameron, with contributions provided by Erik Ens (Chapter VI), David Boileau and Florence Jean-Jacobs (Canadian exports to the United States by truck), Bjorn Johannson (Canadian exports to U.S. regions), Lydia Gosselin-Couture (Intra-firm and affiliate trade between Canada and the United States), and Aaron Sydor (Canadian exports continue to diversify beyond the United States). Statistical assistance was provided by Lydia Gosselin-Couture. The Special Feature was written by Shenjie Chen and Emily Yu. Comments at the drafting stage were provided by Aaron Sydor and Patricia Fuller of the Office of the Chief Economist .

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ISBN 978-1-100-51697-4

Catalogue no. FR2-8/2010

Table of Contents

Figures

Tables

Special Feature

Message from the Honourable Peter Van Loan, Minister of International Trade

Honourable Peter Van Loan
Minister of International Trade

As Canada's Minister of International Trade, I am pleased to present the 2010 edition of *Canada's State of Trade*. This report provides an overview of trends in Canada's international commercial performance over the past year.

Last year was a challenging year for the global economy. While Canadian exports, imports and foreign direct investment flows decreased last year, Canada did better than most. We had the mildest recession of any G7 country, and for the first time in a generation, Canada's unemployment rate is lower than that of the United States.

More importantly, Canada has emerged from the crisis in a strong position. Our government implemented the Economic Action Plan to create jobs and stimulate our economy, and we showed leadership internationally by outlining our plan to return to fiscal balance. We generated results.

All of the major forecasts point to Canada leading growth among advanced nations in the coming years. The strength of Canada's financial system is the envy of the world. By 2015, Canada's debt-to-GDP ratio is projected to be less than half that of the next best G7 country. Furthermore, by 2013 Canada is expected to have the lowest statutory corporate tax rate among the G7.

While Canada remains committed to progress at the World Trade Organization, we are moving forward on an aggressive agenda of free trade negotiations with partners around the world. This includes negotiations with the European Union, Canada's most ambitious negotiations since the North American Free Trade Agreement.

This is in addition to recent successes on free trade agreements with the European Free Trade Association, Peru, Colombia, Jordan and Panama, and ongoing negotiations that include the Caribbean Community, the Dominican Republic, Ukraine and the Central American countries of El Salvador, Honduras, Nicaragua and Guatemala.

Canada is a world leader in promoting free trade and offers key competitive advantages for investors:

- Lowest taxes on new business investment in the G7
- Lowest budgetary deficit and debt-to-GDP ratio in the G7
- Fastest economic growth in G7 for 2010, 2011 and 2012 according to IMF

- World's soundest banking system according to World Economic Forum
- Outstanding quality of life

But we will not rest on our laurels. Our competitors are not sitting still. We will continue making Canada the destination of choice for businesses and investment.

We have taken unilateral action by eliminating nearly all of the tariffs on productivity-improving machinery and equipment as well as manufacturing inputs with the remaining tariffs to go to zero by 2015. This will make Canada the first G-20 country to become a tariff-free zone for manufacturing.

As this report clearly shows, Canadian exporters are continuing to diversify into the fast-growing economies of the world, including many small and medium exporters. Many of them are using the Trade Commissioner Service (TCS) to help them do it. From offices across Canada and around the world, our Trade Commissioners provide a range of services to help Canadian businesses navigate—and succeed in—global markets. This publication contains the results of a new study that shows that businesses that use the service have exports that are 18 percent higher than firms that do not. We are committed to helping more Canadian businesses realize these benefits by tapping into the many tools the TCS provides.

We must continue working together to stay ahead of the curve in this increasingly competitive and rapidly changing global economic environment. Together, we can ensure that Canada remains the best location in the world from which to run a global company, to export and in which to invest, work, live and create.

The Honourable Peter Van Loan
Canada's Minister of International Trade

Executive Summary

2009 was a landmark year. The global economy suffered the worst downturn since the Great Depression of the 1930s, enduring dramatic shifts in global economic and financial markets in an extraordinarily challenging environment. The banking system teetered on the abyss, tested by weak credit markets, a collapse in equity markets, and heightened requirements for liquidity and capital. From August 2008 through mid-2009 output contracted and global trade plunged. Policy intervention on an unprecedented scale was essential to jump-start the recovery. Monetary policy has been highly expansionary and supported by unconventional liquidity provision, while fiscal policy provided a major stimulus in response to the deep downturn. The downturn bottomed out toward mid-2009, and a turnaround has been underway since that time.

Real output contracted by 0.6 percent in 2009—the first and only contraction in global GDP for at least thirty years. The recession was most severe within the advanced economies, which collectively contracted by 3.2 percent last year. Japan and the advanced EU nations were hardest hit, while North America (the United States and Canada) fared somewhat better, and all other advanced nations performed the best. The emerging and developing economies broadly experienced a slowdown in economic activity in 2009, but avoided outright contraction. Together, these economies registered growth of 2.4 percent last year, compared to 6.1 percent a year earlier.

As economies emerge from the global recession, activity remains dependent on highly accommodative macroeconomic policies. Overall, the world looks poised for further recovery at varying speeds. Global growth is projected at 4.2 percent in 2010 and 4.3 percent in 2011. The advanced economies are expected to expand by 2.3 percent in 2010 and growth is expected to edge up to 2.4 percent in 2011. For the emerging and developing economies, growth is expected to reach 6.3 percent in 2010 and 6.5 percent in 2011.

For the United States, substantial monetary and fiscal easing, alongside other policies aimed directly at the financial and housing sectors, helped to stimulate economic activity. After four quarters of contraction, GDP growth turned positive in the third quarter, rising by 2.2 percent (seasonally adjusted annual rate) and accelerated to 5.6 percent in the fourth quarter of 2009, reflecting a pick up in investment and a slowdown in inventory destocking. Nonetheless, for the year as a whole, real U.S. GDP growth was down by 2.4 percent in 2009. Growth in the euro area resumed in the third quarter, but was anaemic in the final quarter of last year: overall growth for the year declined 4.1 percent. The United Kingdom was even harder hit, down 4.9 percent, as growth only resumed in the fourth quarter. For Japan, real GDP contracted for the second consecutive year, falling 5.2 percent last year; however, as the year progressed, Japan's economy picked up mainly due to improvement in overseas economic conditions and to various policy measures.

The pattern of economic recovery has varied within developing Asia, with the larger economies (China, India and Indonesia) escaping a recession, and the smaller export¬oriented economies experiencing a sharp V-shaped business cycle. Overall, emerging Asia's GDP slowed to 6.6 percent growth from 7.9 percent in 2008. By the end of 2009, output in most of Asia had returned to pre-crisis levels, even in those economies hit hardest by the crisis.

As a result of a steep decline at the end of 2008 and early 2009, output in the Latin America and Caribbean (LAC) region contracted by 1.8 percent as a whole. The decline in U.S. activity heavily impacted Mexico, and GDP fell 6.5 percent in that country, while Brazil escaped with only a 0.2 percent contraction. The interconnectedness of European economies led to a rapid transmission of the collapse from developed Europe to developing Europe, resulting in an output contraction of 3.7 percent. Output contracted by 6.6 percent in the Commonwealth of Independent States, led by a 7.9 percent decline in Russia, while Africa and the Middle East managed to avoid the recession, growing by 2.1 percent and 2.4 percent, respectively.

Canadian economic activity was deeply affected by the global recession—real output contracted in the fourth quarter of 2008 and continued to fall over the first half of 2009 before returning to growth in the second half of the year. For the year as a whole, real GDP contracted by 2.6 percent in 2009. It was the second-largest decline in real output since the years of the Great Depression, and not far off from the 2.9 percent decline catalogued during the 1982 recession. Output fell in each province and territory, except Prince Edward Island and the Yukon. Provincially, the largest output declines occurred in the resource-intensive economies of Newfoundland and Labrador, Saskatchewan, and Alberta. Manufacturing output fell across most provinces and in all the territories. Job losses were widespread across Canada, with only three provinces—Saskatchewan, New Brunswick and Manitoba—posting gains over 2008 levels. The unemployment rate slipped 2.2 percentage points to 8.3 percent, as the economy shed some 276,900 jobs, the first setback after 16 years of growth. Lower energy prices exerted significant downward pressure on the CPI last year, as inflation expanded by only 0.3 percent, the lowest rate since 1994.

Nevertheless, relative to other advanced economies, Canada's downturn was short and mild. Measured from peak-to-trough, Canada experienced the smallest contraction within the G7, with a 3.3 percent decline in GDP. Moreover, after reversing the decline in the third quarter, the recovery has gained momentum over the fourth quarter of 2009 and into the first quarter of 2010.

The decline in economic activity triggered the sharpest decline in world trade in more than 70 years. In volume terms, global merchandise trade fell 12.2 percent; however, in value terms, the reduction was even steeper, at 23 percent. Falling energy and commodity prices were behind a significant portion of the trade losses, but declines were widespread, particularly in durable goods. All major countries and regions registered declines in both the value and volume of their merchandise exports in 2009. World services exports also declined 13 percent, marking the first time since 1983 that services trade declined. Echoing the better overall Asian economic performance in 2009, China displaced Germany as the world's leading merchandise exporter last year. For Canada, merchandise exports plunged 31 percent in US dollar terms, while imports were down 21 percent on the same basis. For services, Canadian exports and imports were off by 12 percent and 11 percent, respectively, again in US dollar value terms. Weakness was evident throughout much of the year, but began to pick up in the second half of the year as the global economy moved into recovery phase.

Canadian exports and imports of goods and services to and from all major markets declined between 2008 and 2009. In Canadian dollar terms, exports of goods and services to the world fell by 22.1 percent, while imports declined by 13.6 percent. The bulk of the decline was disproportionately attributable to trade with the United States, as that country was responsible for 82.0 percent of the overall decline in exports and 65.2 percent of the decline in imports from 2008 to 2009.

The effects of the global economic downturn were pervasive in Canada's goods trade. Exports of Canadian goods experienced a 24.5 percent drop, the result of declining volumes and values. Export volumes were down 16.7 percent over 2008 levels, and export prices fell by 9.3 percent. All but five of some 62 major export commodities posted losses over the year. Energy products led the downward movement in Canada's exports trade in 2009, accounting for 37.0 percent of the decline. A 35.6 percent cut in prices was the main driver behind the declines in energy trade, although volumes experienced slight declines as well. Industrial goods and materials were responsible for about 25 percent of the overall decline, with automotive products (down 14.3 percent) and machinery and equipment (down 10.3 percent) accounting for the bulk of the remaining losses.

At the same time, import volumes were down 16.0 percent while prices squeezed out a slight increase of 0.6 percent, resulting in a 15.5 percent decline in total imports. All imports sectors also declined, with the exception of agricultural and fishing products. The losses were fairly evenly divided among energy (27.7 percent), automobiles (24.2 percent), industrial goods (24.1 percent), and machinery and equipment (21.3 percent). Of the 61 major import commodities, only fifteen commodities posted gains over 2008 values.

Drilling down to the more specific products driving Canadian trade, other petroleum gases (primarily natural gas) and crude oil accounted for about one third of the total decline in exports, one fifth of the decline in imports, and over half the decline in the trade balance in 2009. Falling energy prices (down well over 30 percent) lay at the heart of the decline, as they retreated from their historical highs recorded a year earlier. However, volumes were also down, likely reflecting the tough economic climate. On the export side, lower trade with the United States was behind the decline, while for imports, Canada purchased less crude oil from Algeria, the United Kingdom, Norway and Angola.

The financial difficulties experienced by major North American auto manufacturers and falling demand in the U.S. and Canadian markets curtailed trade in the automotive sector, further exacerbating a downward trend that began in 2005. Passenger vehicles and automotive parts bore the brunt of the declines. At the same time, exports of trucks were more than halved, while imports declined at much lower rates. In addition, imports of piston engines fell at more than twice the rate of exports, reflecting the malaise in the sector.

For non-energy resource products, both prices and volumes fell across most commodities helping to lower the value of exports for the year. In agriculture, beef exports continued to be hampered by trade restrictions and pork exports experienced headwinds via an association with the swine flu. Wheat was responsible for well over half the decline in cereals exports, with barley, oats and corn making up the remainder of the decline. Both canola seed and canola oil suffered sizeable cutbacks to their export levels as well.

In minerals and metals, trade is very sensitive to economic conditions. In times of economic booms, trade is very robust, while during a downturn in economic output, the demand for these products is weakened. Thus, trade in these products was heavily impacted by the global, synchronized recession of last year. Canadian exports were down to almost all developed countries, most notably to the United States. Reduced output in the North American automotive sector also contributed to the weakness in this sector. Trade losses were widespread, in particular for aluminum, iron and steel, and nickel products.

In the wood, pulp, and paper sector, exports have been on a downward trend for some time. For wood products, the downturn in the U.S. housing sector has helped curtail exports. For paper products, slumping newspaper circulation and advertising around the world has depressed the market for newsprint. Pulp exports have likewise been affected. Exports to the United States accounted for much of the declines.

In advanced manufactures, trade levels were generally down from 2008 levels. Gas turbines (largely used in the aircraft sector) registered a relatively small decline in exports, while imports advanced. Exports of telephone equipment and parts experienced another sharp decline, as imports were unchanged. Bucking the overall trend, exports of television receivers and video monitors and projectors advanced by nearly two thirds at the same time as imports declined. The bulk of the declines occurred in trade with the United States.

The financial crisis was characterized by major credit constraints stemming from undercapitalized financial positions in the banking sector. Credit was both expensive and difficult to access. As a result, cross-border capital flows withered. Investment flows such as bank loans and portfolio investment were most severely affected, but foreign direct investment (FDI) was affected too. Global FDI flows have been halved in the two years since the financial crisis erupted, with the bulk of the decline occurring in 2009. All major countries and regions experienced reductions in FDI inflows, including Canada, where inflows to the country fell at a more rapid pace than the global average. As a result, the stock of FDI in Canada was up by only 1.6 percent—well below the 9 percent annual average over the last decade—and reflected slower investment activity, especially from the United States.

At the same time, flows of Canadian direct investment abroad (CDIA) fell 44.1 percent to $46.3 billion. However, despite the positive outflows, the stock of CDIA declined by 7.5 percent ($48.4 billion) in 2009. This was the result of a revaluation effect of a substantially stronger Canadian dollar at the end of last year, and was concentrated in assets in the United States. The resurgence of the Canadian dollar against most foreign currencies toward year-end subtracted about $72 billion from the overall position of CDIA last year. Without the currency effect, CDIA would have increased by between $23 billion and $24 billion over the year. Investment was down across most sectors, although increases were posted for finance and insurance, and information and cultural industries. Positions were down across most major regions, with the exception of Asia and Oceania where CDIA edged up 2.2 percent.

The information boxes in this year's *State of Trade* report examine three separate, but interdependent, facets of Canada-U.S. trade in goods—trade by U.S. sub-national region, trade by affiliation, and trade by mode of transportation. By U.S. regional destination, there has been a shift away from the Great Lakes and Mid-East regions toward faster-growing markets in the South and West. This trend continued during the recession, notwithstanding that these regions were among the hardest hit by the U.S. housing crisis. The industry mix of the Great Lakes region, home to much of the troubled U.S. auto industry, has been a drag on Canadian exports, especially in the present decade.

At the same time, the share of Canada-U.S. trade that is intra-firm continues to trend downward, particularly due to a decline in trade in automotive products and less intra-firm trade within the auto sector. Nonetheless, among the G7, Canada has the highest share of trade in goods with the United States accounted for by U.S. affiliates. Finally, examining where and how Canadian goods cross the U.S. border reveals that the concentration of goods entering the United States by border crossings has decreased. This is attributed to a decline in the share of Canadian goods moved by truck via the Detroit-Windsor crossing over this decade, and, in particular, to the collapse in auto trade.

Special Feature: The Impact of Trade Commissioner Service on Canadian Exporter Performance

Until the recent development of new data bases, little was known about the characteristics and dynamics of Canadian exporters at the firm level. This year's feature article marries the Statistics Canada Exporter Registry database with the Foreign Affairs and International Trade Canada (DFAIT) Trade Commissioner Services (TCS) client management database to examine linkages between exporter performance and the TCS, which is the Government of Canada's export promotion service.

This feature article presents the first-ever econometric assessment of the impact of the TCS on Canadian exporter performance: the results show this impact is consistently positive. Exporters that receive assistance have an average export value 18 percent higher than comparable exporters that did not access this service. TCS assistance also plays a very strong role in helping firms to diversify into new markets: TCS clients export to 36 percent more markets than non-clients. In addition, the TCS has a positive impact on product diversification.

The article also explores exporter performance more generally and shows that the entry of firms into new markets, rather than growth in sales by existing exporters, has been the growth engine for Canada's exports in recent years. New entrants drove the increase in exports to Asia and Latin America. In the U.S. market, the entry of new exporters was critical in offsetting the exit of many firms from this market. Small and medium-sized firms have been at the forefront of the entry into new markets. Their share of every regional market has increased, and in Asia, they account for nearly half of export sales.