Stuck in Neutral: Canada Needs to Accelerate Exports to Emerging Markets

by Benjamin Tal and Andrew Grantham

Since the end of World War II, trade has been central to Canada’s economy and its prosperity. Sitting directly north of the world’s largest economy gave Canada’s exporters a geographical, and cultural, advantage.

However, policy makers and exporters themselves have looked to expand markets for Canadian goods to both tap into new opportunities and lessen the dependence on a single market. The need for diversity was brought home by the recent prolonged recession in the US which hurt many Canadian companies dependent on exports stateside.

Despite good intentions, and nine free trade agreements beyond the US, Canadian firms have not made many inroads exporting to other countries.

The volume of Canadian exports today is at the same level it was a decade ago. And after rising for most of the previous decade, the share of non-US exports in total exports has hardly changed in the past four years. In fact, recently it has been moving in the wrong direction. Furthermore, within the non-US space, all recent activity was concentrated in one country—China. This uni-diversification is certainly not what the architects of Canada’s nine free trade agreements with non-US partners have envisioned. But the relative success of Canadian exporters in China should be seen as an indication that Canada can and should compete in other emerging markets.

The Lost Decade

Global trade in goods has surged by 70% since 2002. In Canada the volume of imports has risen by 45% while the volume of exports was essentially unchanged. Regardless of how you look at it, this was a lost decade for Canadian exports. And for a small, open economy, this is not a positive trajectory.

It is easy and perhaps convenient to link the export malaise of the past decade to the surge in the value of the Canadian dollar. But the reality is much more multidimensional. A quick glance at Chart 1 suggests that the 35% appreciation in the value of the loonie between 2000 and 2007 indeed worked to slow the pace of export expansion. But despite this massive appreciation, exports still managed to expand at a pace of just over 1.5% a year.

Chart 1

Source: Statistics Canada, CIBC
Furthermore, a detailed sectoral analysis of the impact the rise in the C$ had on Canadian manufacturing suggests a much more complex picture than you get from a textbook. Chart 2 maps the relationship between vulnerability to a rising dollar (based on export dependence, import competition at home, and savings on imported components) and actual GDP growth. In theory, this chart should have shown a clear downward sloping trajectory. But as can be easily seen, that was not the case.

Yes some high vulnerability sectors such as paper manufacturing and furniture did underperform. But equally vulnerable sectors such as machinery and electrical equipment actually outperformed. Ditto for the other side of the spectrum, where low vulnerability sectors such as textiles and chemical manufacturing disappointed. Similar sectoral analysis by labour market performance and export penetration to the US resulted in equally mixed pictures. Simply put, the evidence suggests that the dollar’s appreciation is only one factor out of many that impacted the trajectory of exports over the past decade. Other factors such as US demand, diminishing returns from NAFTA, increased competition from emerging markets and a notable cost cutting by US manufacturers may be just as important.

Regardless of the source of the weakness, the key question is to what extent Canadian exporters are adjusting quickly enough to reverse that trend. The US economy is finally showing signs of life, but with restrictive fiscal policy and no leveraged-based surge in household spending, the American economy of tomorrow will fall well short of generating the demand Canadian exporters enjoyed prior to the great recession.

It’s a Small World After All

That reality is not escaping Ottawa which in recent years has intensified its efforts to diversify the country’s export machine. And at first glance there appears to be some success. The share of non-US exports in total Canadian exports rose from 13% in the beginning of the decade to today’s 25%. The bad news is that this ratio has been stuck at 25% for more than four years (Chart 3). So despite intensifying efforts, Canadian export diversification is losing momentum. In fact, on a year-over-year basis, our exports to non-US destinations are now falling.

But the story goes beyond speed. Chart 4 tells the tale. Almost all of the improvement in export diversification over the past decade came from two sources: the UK and developing countries. A closer look at the trade flows to the UK reveals that virtually all of that gain was due to the 300% increase in the price of gold—hardly an inspiring diversification story. So we are left with developing countries as the key source of Canada’s export diversification of the past decade. And a quick glance at Chart 5 suggests that this diversification story is also very concentrated, and becoming more so.

The lone bright spot has been in the very competitive Chinese market. Since 2003, China has accounted for more than half of the growth in developing market
exports. But in the past five years, it has accounted for all of the growth. Exports to all other developing countries (with the exception of tiny Bulgaria) have actually seen declining shares of our EM exports.

Wins in China Shows Canada Can Compete

Of course, rapid growth in China over the last decade suggests that focus is no bad thing. However, China has slowed and authorities aim to refocus the economy more towards domestic consumption. That will require a different product mix that Canadian companies may not, at present, be positioned to fill. Also, competition in China is fierce and rising fast, with companies around the world seeing its vast population as potential purchasers of their goods and services.

What the experience in China does show, though, is that Canadian companies can compete and succeed in developing markets. Although the share of Chinese imports stemming from Canada remains quite low (a little over 1%), it has at least edged up over the last 10 years (Chart 6, left). In contrast, most other developed countries have seen their share of Chinese imports fall over that
same period. And it is not an oil story, with petroleum only a small proportion of Canadian shipments destined for China.

Particularly noteworthy is how well Canadian companies are competing with their Southern neighbours. Of the top 15 Canadian exports to China, 10 overlap with the top US exports (Chart 6, right). That means over half of Canadian exports to China encounter strong US competition. But even with a strengthening C$, that is a battle some sectors have been winning. Improvements in market share within areas such as oil seeds, grain & fruit, along with pulp and aircraft, are proof of that fact.

On the reverse, there is only limited evidence that competition from China is forcing Canadian companies to withdraw from American markets. China has seen its greatest penetration into the US in areas such as clothing, toys and games and more recently electrical goods (Chart 7, left). While not unimportant areas for Canadian exporters, they were never the main focus of Canadian trade with the US. Those areas made up only around 15% of Canadian exports to the US a decade ago. And even though that percentage has dipped a little, they still account for around 12% today (Chart 7, right).

Canadian firms have rightly been looking beyond the US market, as growth there fails to reach pre-recession levels. However, that diversification has been largely limited to China. And given slower and shifting growth dynamics there as well, that poses its own risks. But what the Chinese experience shows is that despite a strong currency, Canadian companies have been able to compete and win in a very competitive emerging market environment. That should encourage them to broaden their horizons into other growth markets in the decade ahead.

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