Economics

IN FOCUS

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Trade diversification: Breaking up is hard to do

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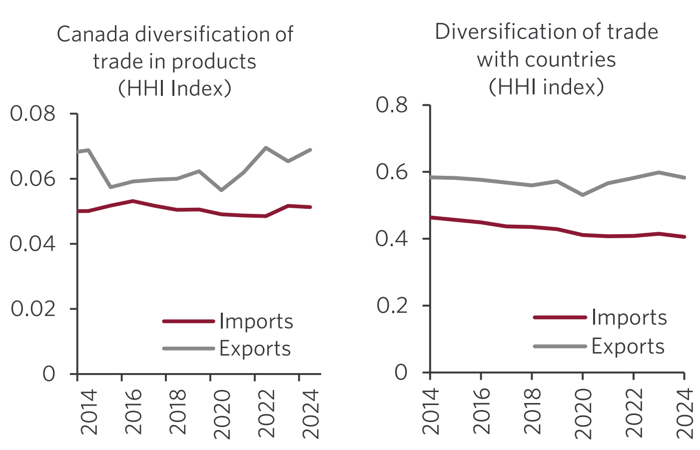
Don't waste a good crisis. Use the current trade dispute with the US as a catalyst to diversify Canada's trade away from the US. We heard that call for action during the first Trump administration and we are hearing it again now. Back then the call was not answered, as Canada's export and import dependency on the US remained unchanged. Don't expect a different outcome this time around. In fact, when it comes to imports, our reliance on our neighbor to the south might rise — the very opposite of diversification.

Trade diversification? Not really

Canada has been trying for decades to reduce its trade dependence on the US. In the 1970s, Trudeau, the father, put forward a "third option" strategy which involved diversifying Canada's trade abroad. In 2007, the Harper government's Global Commerce Strategy stated as an essential objective that Canada expand trade beyond North America. In 2018, Trudeau, the son, stressed that the diversification of trade away from the US was a substantial responsibility of his government in response to Trump 01.

Chart 1: Canada hasn't materially diversified it's trade base in terms of products (L) or countries (R)



Source: Statistics Canada, CIBC

To achieve that target Canada has, over the years, signed no fewer than 15 trade agreements covering 51 countries. The result: nothing to write home about. The HHI index of trade diversification has shown little improvement over recent decades, while failing to move at all during and following the trade dispute with the first Trump administration. That's true for the concentration of both exports and imports by geography and by product (Chart 1).

The reality is that the US market still accounts for 76% of Canada's exports, the same share it did a decade ago, and 50% of imports, only a little less than it did a decade ago. And if anything, the products that Canada ships abroad have become a little less diversified in recent years.

US exports losing ground

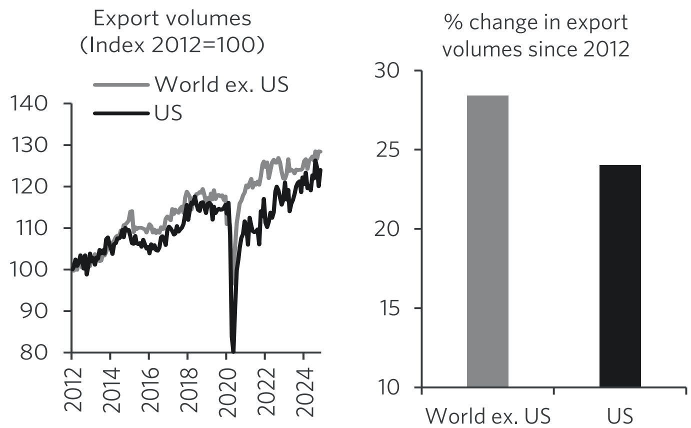
We will dig deeper into the Canadian export picture in an upcoming report. But here we will focus on Canada's import dependency on the US market, and claim that that share might in fact rise in the coming years.

After all, the escalating trade war isn't contained to North American borders of course. It's in many ways emerging as a US vs the rest conflict. And in a global trade war, as was the case in the cold war, third parties such as Canada must choose a side. Under this new order, for example, Australia's economic reliance on China is at odds with its dependency on the US for security. In Canada, we know where our lifeline to economic viability and security lies.

Granted, we can only guess what Trump's endgame is. Is it all about changing the structure of the US economy to become self-sufficient? Are tariffs a way to raise revenue to pay for tax cuts? Is it about the border, or defense spending, or all the above?

What is clear is that one of his goals is to quickly renegotiate the USMCA. And if past experience is a guide, Trump will want Canada to commit to buying more goods that are made in the USA. During Trump's first term, the pressure on China was

Chart 2: US export volumes have lagged the rest of the world



Source: CPB World trade monitor, CIBC

eased notably after Trump and President Xi Jinping announced a truce in January 2020, at which point China pledged to increase its imports from the United States by $200 billion over two years. For various reasons, China did not come close to meeting its pledged target. US exports to China barely reached pre-trade war levels even by 2021. Ditto for the EU, which during the trade war committed to significantly increasing its imports of natural gas and military equipment from the US in exchange for tariff concessions.

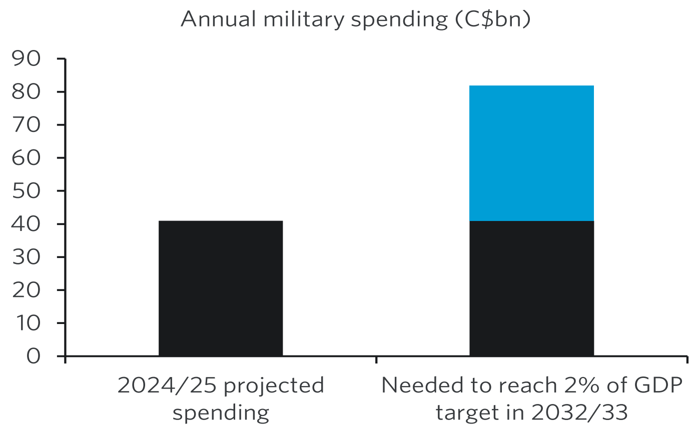
The reality is that the US has underperformed other nations in terms of export gains (Chart 2). Since 2016, growth in US imports has outpaced export gains by 6%-points, and that has left the goods trade deficit $462bn wider, but steady in terms of its share of GDP at about 4%. In line with that, global industrial production is up by over 40% since the Great Recession, but has only rise by 15% in the US. Accordingly, part of any new deal might be the expectation that Canada buys more from the US.

Table 1: Where Canada could buy more US goods

Canada imports, 2024	US % of total imports	Total imports (C$ 000)
Electrical or Electronic Machinery & Equipment	28%	$71,315,991
Pharmaceutical Products	32%	$25,971,642
Pearls, Prec Stones or Metals, Coins & Jewelry	32%	$26,268,438
Organic Chemicals	41%	$10,485,826
Aircrafts and Spacecrafts	41%	$12,055,853
Optical, Medical , Photo, Scien & Tech Instrum	43%	$21,399,662
Articles of Iron or Steel	45%	$16,276,740
Rubber and Articles Thereof	45%	$9,569,918
Nuclear Reactor/Boiler/Mach/Mech Appliances	47%	$113,190,703
Iron and Steel	49%	$11,984,347
Beverages, Spirits and Vinegar	51%	$8,254,591
Motor Vhcl/Trailer/Bicycle/Motorcycle/Etc	57%	$123,759,331
Essential Oil/Resinoid/Perf/Cosmetic/Toilet Prep	61%	$6,797,478
Plastics and Articles Thereof	67%	$26,748,238
Preparatns of Cereals/Flour/Starch or Milk	72%	$6,099,074
Miscellaneous Chemical Products	76%	$9,453,272
Minrl Fuels, Minrl Oils, Bitum Subs & Minrl Wax	77%	$47,392,518
Paper, Paperboard & Artcl Made From These Mtrl	78%	$9,644,678
Miscellaneous Edible Preparations	78%	$5,591,754
Special Classification Provisions: Commercial	87%	$20,270,361

Source: Statistics Canada, CIBC

Chart 3: Canada needs to double military spending



Source: NATO, CIBC

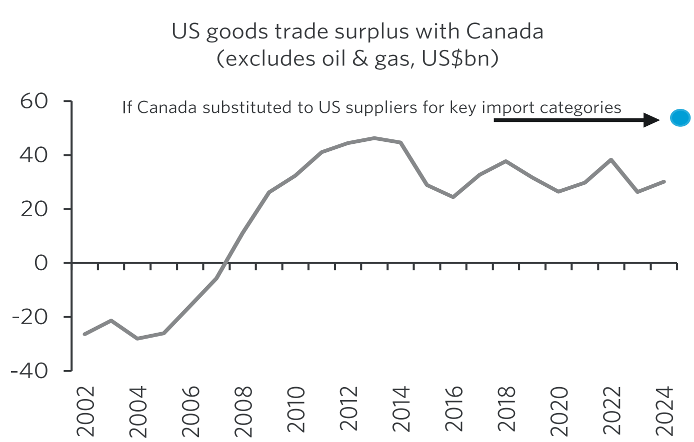
What else/more can we buy from the US?

So what can Canada buy more of from the US? Defense will be a starting point, as Canada has to double its military spending to reach NATO's 2% of GDP target by 2032/33 (Chart 3). As indicated by some politicians in the past few weeks, Canada is able and willing too do that, and might be able to significantly shorten the timetable for achieving the 2% target.

What's more, Table 1 looks at the US' share in Canadian imports by sector. Interestingly, some major sectors such as electrical machinery, pharmaceuticals, and aircraft do not rely heavily on the US as a source of imports. That's where there is plenty of room to substitute towards American-made goods.

If the sectors shown in the table that represent below 50% of Canada's total imports were to raise their US imports share to 50% of total imports (which is the average across industries) then the US' annual trade deficit with Canada could narrow by one-third or by US$23bn. Excluding oil and gas, the US runs a goods trade surplus with Canada, and the above commitment would see the surplus exceed its 2013 peak level (Chart 4).

Chart 4: The US' trade surplus with Canada outside of oil/gas



Source: Census Bureau, CIBC

Bottom line: the hope and the prayer is that President Trump will do more barking than biting when it come to imposing tariffs on Canada. But it's becoming evident that the upcoming renegotiation of the USMCA will require much more sourcing from the US in order to revive its struggling export sector. It appears that Canada has enough room and flexibility to accommodate that demand. But as opposed to calls to diversify Canada's current trade position, our reliance on the US will in fact grow.

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