

Economics

IN FOCUS

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Getting a bigger slice of the trade pie

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If you want more dessert, you can either buy a bigger pie or carve yourself a bigger slice. It's much the same for exports: you can either keep the same share of a growing global trade pie or try to carve out a larger slice.

With the global economy set to slow down in 2023, particularly in Canada's key advanced economy trading partners, we are unlikely to get a much bigger pie. While in the past that has usually meant a bleak outlook for Canadian exports, this time we seem well positioned to take a bigger slice of the pie, something that we haven't done in a while.

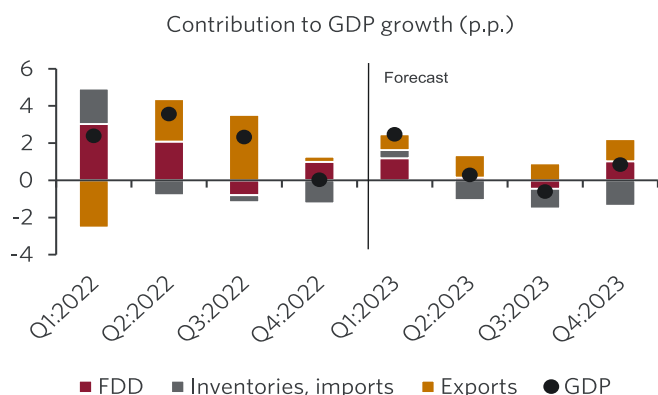
That could be crucial to avoiding a nasty recession as Canada's domestic economy slows under the weight of past interest rate hikes. Household spending should fall through the middle of the year, as consumers cut back on discretionary spending and the housing market continues its adjustment, leading to an eventual decline in final domestic demand (Chart 1). Export gains could be just enough to keep growth averaging close to zero rather than a string of negatives.

Trying to shift into a higher gear

Prior to the pandemic, Canada was systematically losing competitiveness as exports fell short of measures of foreign demand. Nowhere was this more obvious than in the long decline of Canadian market share in US non-energy imports, which fell from about 15% in 2002 to just over 8.5% 20 years later (Chart 2). The lion's share of the decline occurred prior to the financial crisis, as China joined the WTO and took its place in global trade. But our market share continued to erode, even after the onset of the Trump administration's tariff war and the start of the decline in China's own market share.

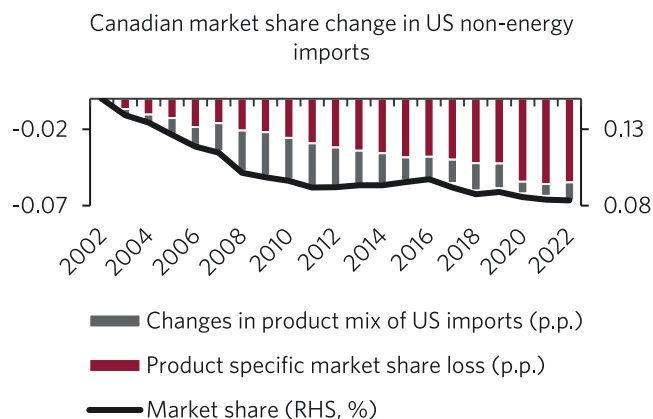
In addition to China, most countries that recorded gains were emerging market economies with cheap labour, including Mexico or Vietnam. However, not all advanced economies lost to the same extent as Canada. Germany, for example, was able to largely avoid any drop in its share of US imports over the two decades preceding the pandemic.

Chart 1: Exports to prevent GDP from falling much below zero



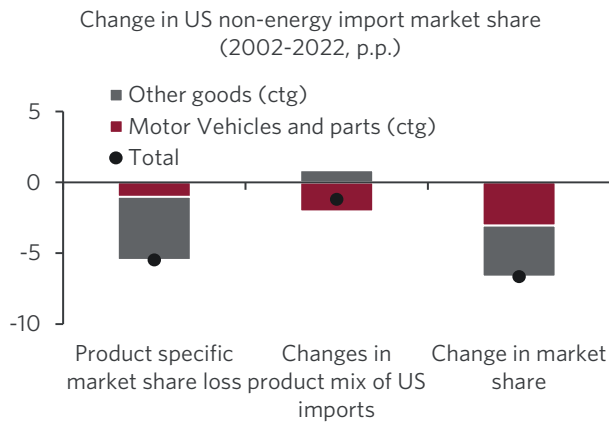
Source: Statistics Canada, CIBC

Chart 2: Canada has consistently lost US import share



Source: US Census Bureau, UN Comtrade, CIBC

Chart 3: Outside of autos, Canadian exporters have been able to pivot



Source: US Census Bureau, UN Comtrade, CIBC

To understand what happened, it is useful to decompose market share changes into two parts: changes in product-specific market share (i.e. loss of competitiveness within product categories), and changes to the product mix of US imports (i.e. the ability of exporters to pivot towards high demand goods). Chart 2 shows that while initially the split was about 50/50, in the post financial crisis era, the loss of market share has increasingly been a competitiveness story, where within narrowly defined goods categories Canada has been elbowed aside by other imports to the US.

Outside of motor vehicles and parts, Canadian exporters have in fact been able to pivot towards in-demand goods, which has limited overall market share losses (Chart 3). However, a steady decline in the demand for the types of motor vehicles made in Canada has more than offset that gain.

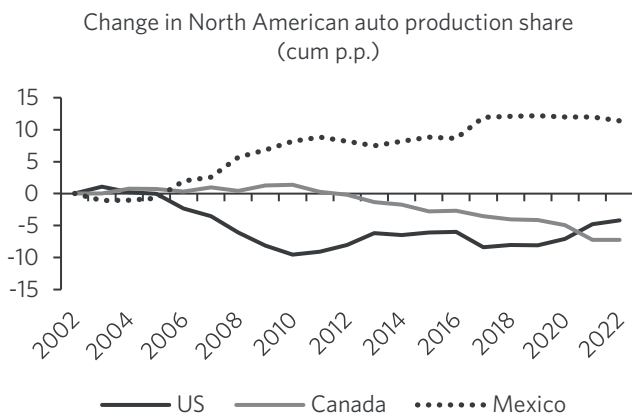
Auto makers may have deliberately assigned models that they knew were losing popularity to higher cost Canadian plants, while putting vehicles set to gain share into lower cost plants in Mexico or even the US South. Moreover, the recent supply chain

issues that affected the industry were particularly harmful to Canadian exports. Since Canada produces smaller vehicles, car companies, facing a shortage of chips, opted to use the ones they could get to produce more higher-end and higher-revenue vehicles made elsewhere. Therefore, the pandemic may have had a larger, but temporary impact, on assembly shares, and we expect Canadian exports of motor vehicles to gradually recover some of that lost ground.

While this article has focussed on Canada's ability to compete with other imports into the US market, it's worth noting that in autos, there's also been some slippage of late against vehicles made in the US itself. Initially, it was US production, not Canadian, that gave way to increased production in Mexico (Chart 4). An appreciation in the Canadian dollar in 2010 may have been the catalyst for the start of a long slide in Canada's production share, marked by a number of permanent plant closures. But a weaker C\$ in recent years failed to arrest that trend, perhaps because earlier plant closures were not offset by new openings as we reached a more competitive exchange rate.

Looking beyond vehicles, we've also seen broader losses in Canada's share of non-energy US goods imports within narrowly defined product categories. These market share losses have been large and persistent. Were we to include US production, those losses would likely be more pronounced. Importantly, while Canadian manufacturing mostly kept pace with its US counterpart in the immediate aftermath of the financial crisis, a gap started to open up in the years preceding the pandemic (Chart 5).

Chart 4: Canada's share of North American auto production in decline



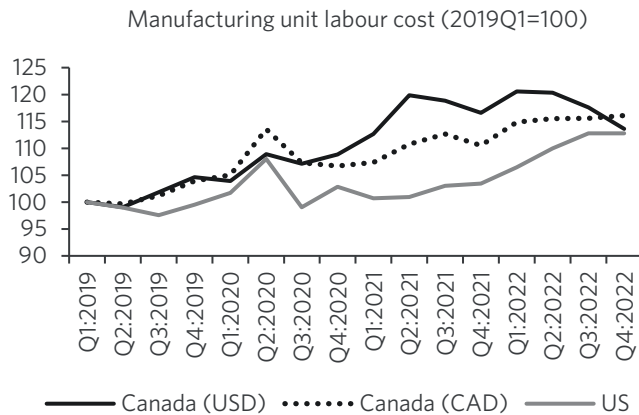
Source: Automotive News via Haver Analytics, CIBC

Chart 5: Canadian manufacturing unable to keep pace



Source: Statistics Canada, BEA

Chart 6: Productivity growth has been slow in Canada



Source: BEA, BLS, Statistics Canada, CIBC

The problem is that labour productivity has been abysmal in Canada since the pandemic started, and we are still lagging the US. COVID has had a temporary impact on the ability of some productivity statistics to accurately represent the situation, as measures of output and hours were distorted. We look for that to dissipate later this year, but it is unlikely to erase all of the underperformance Canada has seen. When looking at manufacturing unit labour costs specifically, Canada has been trailing the US since the beginning of the pandemic (Chart 6). The picture looks a little better when adjusting for the exchange rate, thanks to a recent depreciation of the Canadian dollar. While some of the recent strength in unit labour costs reflects high wage growth, the trend higher really represents a lack of progress in terms of productivity. And it is crucial that productivity rebounds if we are to get decent export growth, particularly in the longer term, and regain some of our previous slice of the pie.

New opportunities in the old world

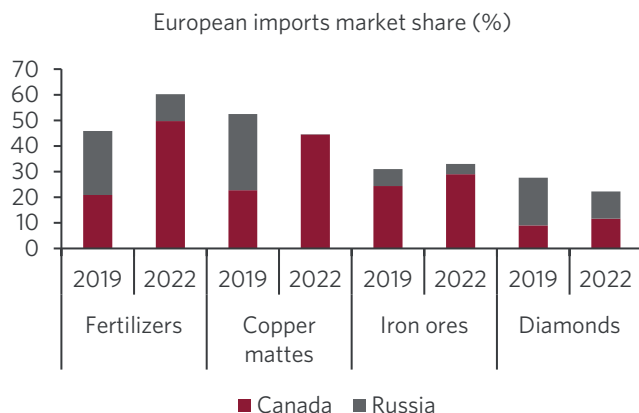
The global geopolitical situation has given Canada new export opportunities. One of those is the result of the tragic war in Ukraine, which has disrupted production of certain key goods in that country and led to sanctions on exports from Russia. That has allowed Canadian exports to replace some Russian goods in European markets (Chart 7). For certain goods, both countries already represented a significant share of the European import market, but Canada's share has grown markedly in 2022 while Russia's share has dwindled. And these markets are not small. For instance, the EU imported about \$14bn in diamonds and \$11bn of iron ores in 2022, which leaves significant potential gains to be made as Canadian exporters increase their presence.

There are also other markets where Canada has the potential of becoming an even bigger player. That includes wheat, where a bad crop held back exports earlier last year, but where things started to rebound later in 2022 (Chart 8). The outlook for such markets will, however, continue to depend heavily on weather developments in Canada and in competing growing regions.

Finally, tensions between China and its trading partners in North America and Europe could also lead to new opportunities. Obviously, there are few goods where Canada is a real alternative to China, whose main competitors are most often other countries in Asia, or even Mexico. But there are still certain goods where the two economies each hold a significant market share. Those include certain cereals, key minerals such as graphite and mica, as well as many wood and paper products. Canada therefore has the potential to snatch further market share.

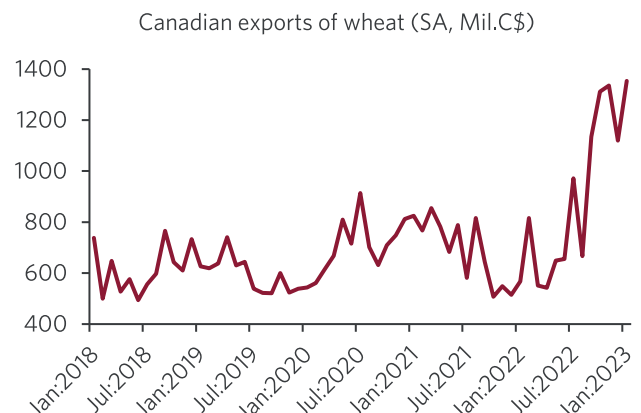
Buy America provisions, from which Canada is often exempt, are also changing where companies locate future production, particularly for green technologies. A major European automaker has recently announced that it will build its first

Chart 7: Canada has replaced Russia in some markets



Source: UN Comtrade, CIBC

Chart 8: Canadian exports of key commodity could grow



Source: Statistics Canada

overseas electric vehicle battery plant in Ontario, although government assistance played a role in steering it that way.

Exchange rate developments represent one potential cloud on the horizon for Canadian exporters. The end of Fed tightening looks to be the catalyst for the US dollar to give back some of its gains, and that backdrop can serve to strengthen the loonie against the greenback. But the value of the Canadian dollar, will be a key determinant. We expect CAD to reach 1.28 next year as a result. Given the ongoing challenges with productivity growth, if Canada is to remain competitive in the export market, and seize all the opportunities discussed above, we probably cannot afford a much stronger Canadian dollar than that. So while much of the focus has been on the impact of the earlier loonie depreciation on inflation, some attention has to be paid to the impact of a potential appreciation on the export outlook and competitiveness if we are to grow our slice of the global pie.

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