CURRENT ANALYSIS
October 2013

Canadian Exports, US GDP Growth and Competitive Pressures

Chart 1

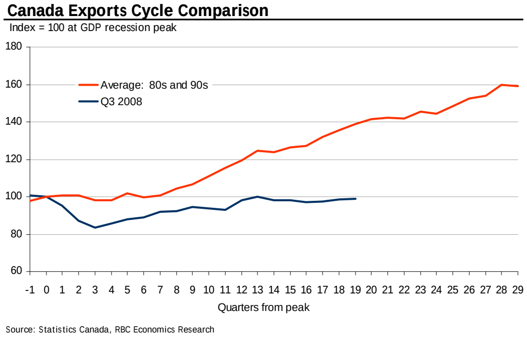


Chart 2

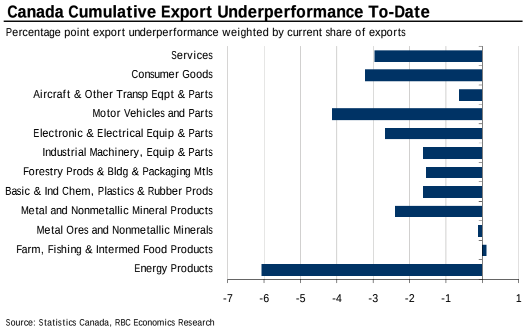
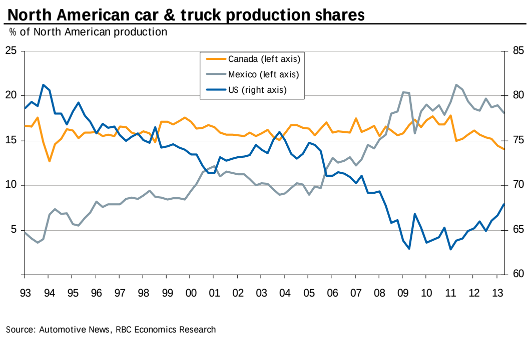


Chart 3



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Canadian Exports Underperforming

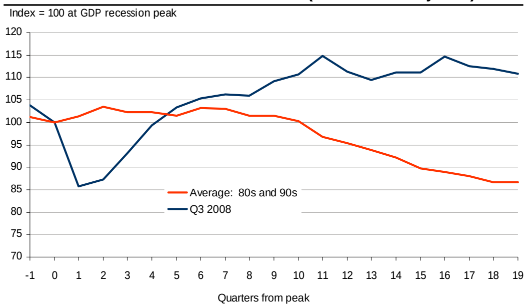
Growth in the Canadian economy slowed in 2012 to a disappointing 1.7% from the 2.5% increase recorded in 2011. The pace of activity in 2013 appears to have continued at a weak, sub-potential, rate with our current forecast assuming real GDP growth of only 1.8%. An important contributor to this disappointing trend has been an unexpected slowing in export growth from 4.7% in 2011 to 1.5% last year and an expected 2.0% this year. Broadly speaking, Canadian exports have substantially underperformed growth relative to recoveries from the last two recessions in the 1980s and the 1990s as shown in Chart 1.

Sector specific issues have played a role but do not explain all of the underperformance in overall exports. Chart 2 provides a breakdown of overall exports into its main categories. The underperformance of energy exports in part reflects increased U.S. domestic supplies of natural gas that are acting to lessen the need to import this energy product from Canada. Weakness in auto exports has occurred despite a relatively strong recovery in demand for new vehicles in the US with data suggesting that rising production to satisfy growing demand is increasingly coming from Mexico and the Southern U.S. instead of Canada (Chart 3). Chart 2 also, however, makes clear that these components alone do not account for all of the underperformance of Canadian exports during the recovery. Practically all categories are under-performing relative to the last two recoveries with only two components, "farm, fishing and intermediate goods" and "metal ores and non-metallic mineral products," managing to match growth in the expansions in the 1980s and 1990s. The underperformance even extends to services exports, which are often optimistically looked upon to provide an offset to weakening goods exports.

The broad-based nature of the underperformance of both goods and services exports imply that more general macroeconomic factors may be at play limiting export growth in recent years rather than sector specific issues. One such factor is relative unit labour costs. Unit labour costs essentially reflect wage increases less productivity gains. As well, any comparison between any two countries, in this case Canada versus the U.S., there is the need to express these measures in terms of a common currency. It has been the case in the current recovery/expansion that Canada's unit labour costs relative to the U.S., on a common currency basis, have deteriorated. This is in contrast to the improvement observed over the last two recessions (Chart 4). In terms of factors contributing to this deterioration, one factor has been the weaker productivity growth in Canada versus the U.S. The more significant factor, however, has been the strong Canadian dollar. Though it depreciated modestly by 1% in 2012 against the U.S. dollar and looks poised to depreciate a further 3% in 2013, the restraint on exports may have emerged as a result of the earlier and marked appreciation of 4.0% and 9.7% in 2011 and 2010, respectively. On balance, the dollar remains close to its level just prior to the recession; however, this contrasts with the depreciation that occurred during recoveries from the recessions in the 1980s and 1990s.

Chart 4

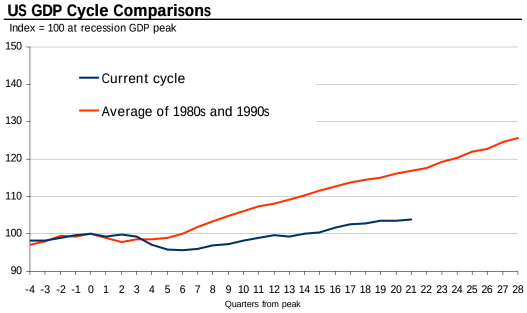
Canada Relative Unit Labour Costs versus US (common currency basis)



Source: Statistics Canada, Bureau of Economics Analysis, RBC Economics Research

Chart 5

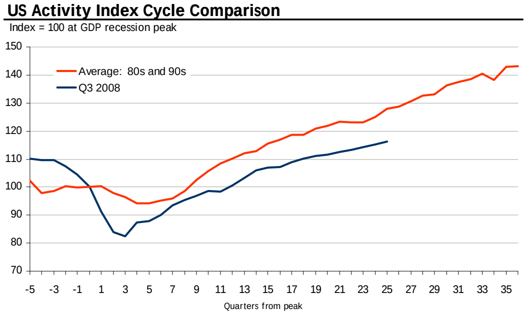
US GDP Cycle Comparisons



Source: Bureau of Economics Analysis, RBC Economics Research

Chart 6

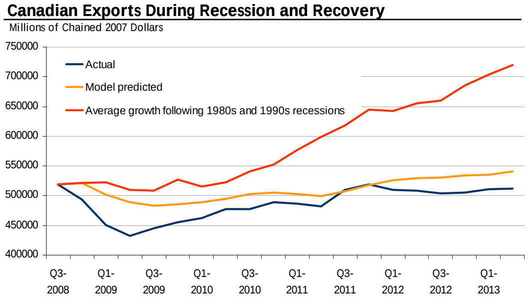
US Activity Index Cycle Comparison



Source: Bureau of Economic Analysis, Bank of Canada, RBC Economics Research

Chart 7

Canadian Exports During Recession and Recovery



Source: Statistics Canada, RBC Economics Research

The impact on relative costs from a strong dollar has been compounded by the modest pace of growth in the U.S. economy, which, despite recent calls for greater geographical trade diversification, still represents the destination of three quarters of Canadian exports. Though U.S. growth did strengthen to 2.8% from 1.8% in 2011, this still represented a pace of activity only slightly above the economy's long-term average growth rate. U.S. growth this year is projected to slow back down to 1.6% as fiscal consolidation took its toll, particularly in the first half of the year, thus once again limiting demand for Canadian exports. Through the recession and recovery as a whole, U.S. GDP growth has significantly lagged its performance following the 1980s and 1990s recessions (Chart 5). This reflects both cyclical and structural factors, as discussed below. Canadian exports can be influenced not just by overall US GDP but also by the composition of that growth. To that end, the Bank of Canada has in the past compiled a separate measure, the U.S. activity index, which isolates those components of overall U.S. GDP that tend to use a significant share of imported materials from Canada. Though this measure has grown more quickly than overall GDP, it too has underperformed relative to earlier recovery periods in the 1980s and 1990s (Chart 6).

A simple model of Canadian exports

To gauge the relative importance of these two factors, we estimated a simple regression equation explaining Canadian exports as a function of relative unit labour costs and U.S. GDP growth. We then calculated model projections based on the actual path of relative unit labour costs and U.S. GDP growth since the pre-recession Canadian GDP peak in Q3 2008. Given the slow pace of U.S. GDP growth and the deterioration in relative unit labour costs realized over this period, our model would have expected export growth to have underperformed average growth during the recoveries from the 1980s and 1990s recessions by about 25%, only slightly less than the 29% underperformance actually observed to date (Chart 7). This suggests that the combination of slower U.S. GDP growth and the deterioration in relative unit labour costs can account for the bulk of the underperformance of Canadian exports during the economic recovery. Moreover, the estimated equation can provide a rough guide to the relative importance of each factor. Our model implies that about two-thirds of the underperformance of exports during the recovery can be explained by weak U.S. GDP growth with the remaining third the result of the increase in relative unit labour costs compared to past recoveries

Impact of the terms-of-trade?

An additional explanation for the slow pace of export growth could be that substantial gains in the Canadian terms-of-trade, driven largely by higher export prices over the last decade, have acted to dampen demand for export volumes. The terms-of-trade is defined simply as the ratio of export prices to import prices. A rise in the terms-of-trade implies that a greater volume of imports can be purchased for a given volume of exports. As a result, a drop in the volume of exports coinciding with an improvement in the terms-of-trade could leave domestic import purchasing power unchanged. In effect, the domestic economy would not be "worse-off" despite lower export volumes. This, however, does not appear to have been the case during the current recovery. While there were substantial improvements in the terms-of-trade early in the recovery, this followed a larger-than-normal deterioration during the recession to leave the measure now roughly in line, relative to the pre-recession level, as at this point following the 1980s and 1990s recessions (Chart 8). This suggests terms-of-trade improvements have not been sufficient to offset the slow recovery in export volumes compared to past recession recoveries.

Structural/Demographic Factors

Not all of the slow recovery in Canadian exports is due to a weak cyclical recovery from the recession. Part is also the result of longer-term demographic trends that are contributing to a more structural slowing in growth both at home and abroad. [We have noted recently](#) that, while cyclical factors have undoubtedly played a role, much of the slowing in U.S. GDP growth during the current economic recovery relative to that observed following historical downturns has reflected longer-term structural factors including the pattern of female labour force participation rates and the aging of the population. U.S. GDP is about 11% below its average path following the 1980s and 1990s recessions. About half of that underperformance, however, can be explained by slower potential GDP growth (Chart 9) due to longer-term structural, rather than short-term cyclical, factors.

This has significant implications going forward. The cyclical component of weakness in U.S. GDP will eventually be reversed, leading to stronger growth in Canadian exports. Indeed, we expect this cyclical recovery to begin to emerge later this year as the drag from fiscal consolidation in the U.S. eases. Reversal of structural demographic factors that are weighing on underlying potential GDP growth are both more difficult and slower to be realized. These longer-term trends will persist going forward and will limit the pace of growth in the U.S. economy. This, in turn, will continue to limit the pace of Canadian export growth relative to the performance observed during past economic recoveries.

Implications for the outlook

In addition to offering an explanation for the slow pace of growth in Canadian exports over the recovery period to-date, the model can also be used to project forward export growth through the end of next year. A couple of key implications emerge from these projections. The first is that export growth is still likely to pick up going forward which will allow for a long-awaited rotation of the drivers of economic growth to external rather than just domestic factors in Canada. While relative labour costs are likely to remain historically high in Canada, they are no longer expected to increase substantially going forward. In fact, our forecast assumes some weakening in the Canadian dollar will result in modest declines in relative labour costs in the near-term. Along with a modest pickup in U.S. GDP growth as the contractionary effect of fiscal consolidation begins to ease, this bodes well for export growth to strengthen going forward. The model projections are consistent with our current forecast for Canadian export growth to strengthen to a 6.6% pace in 2014 following a lacklustre 2.0% increase expected in 2013.

The second implication is that, despite stronger export growth, the level of exports is unlikely to return to a path that would converge with the average path following the prior two recessions. Part of the slowing in Canadian exports relative to past recession recoveries has been due to cyclical weakness in the U.S. economy. Some, however, has also been the result of a slowing in underlying potential GDP growth, both at home and in the U.S. with longer-term demographic trends working to lower the pace of underlying growth relative to that observed during recession recoveries in the 1980s and 1990s. While we expect export growth will strengthen, underlying slowing in the U.S. economy due to demographic factors will likely leave the trajectory of Canadian exports well below that observed following past downturns (Chart 11).

Chart 8

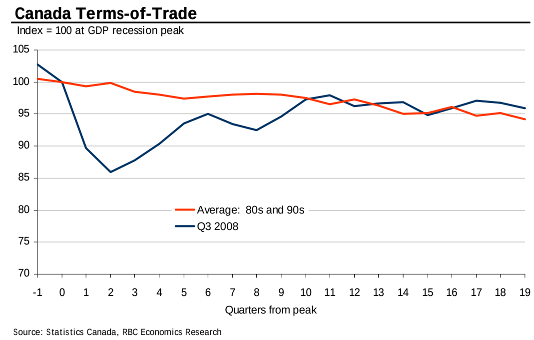


Chart 9

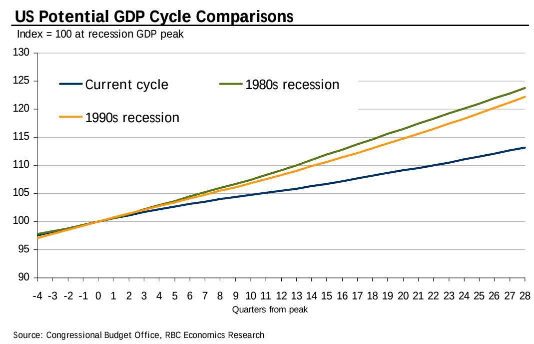


Chart 10

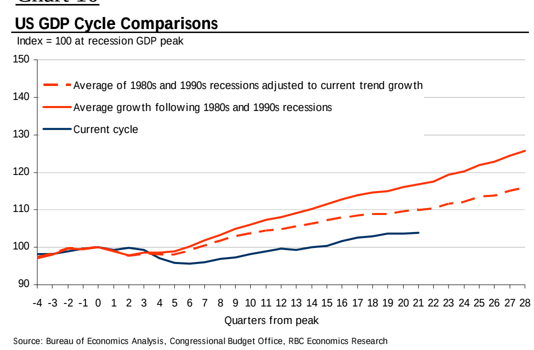


Chart 11