ECONOMICS | RESEARCH

CURRENT ANALYSIS

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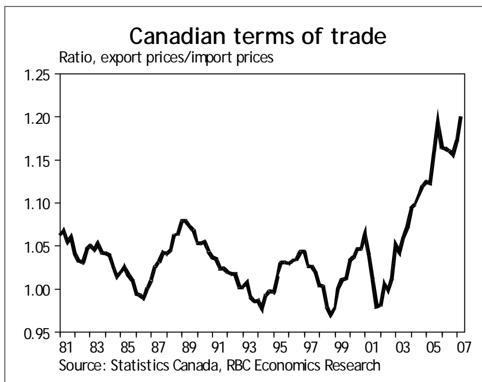

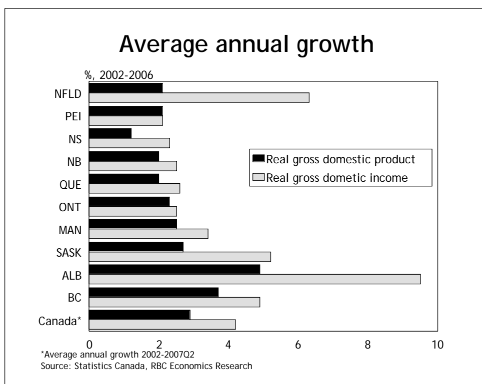

The economic shocks confronting Canada do not all point south

The Canadian economy is currently contending with a number of negative shocks. The most recent is the ongoing financial market turmoil that has emerged from a distressed U.S. housing market and is weighing on the U.S. expansion. In addition, the manufacturing sector is contending with the recent rapid appreciation of the Canadian dollar that is both making export goods more expensive in the U.S. market and making imports more competitive in the Canadian market. Yet, despite these seemingly negative factors, the Canadian economy reported an impressive 51,000 jump in employment in September and a staggering 20% jump in September housing starts to 278,200 units, the third highest annualized level on record. How can this happen given the strong headwinds currently confronting the Canadian economy? One possible explanation is that Canada's economy is also contending with a third shock — a rise in this economy's "terms of trade" — a shock of the positive kind that is much more supportive of growth.

"Terms of trade" is simply defined as the ratio of export prices to import prices. As the accompanying chart shows, Canada's terms of trade have shot up 20% since 2002 after displaying a relatively flat trend during the previous two decades. This recent surge is largely a reflection of the rapid rise in prices for a number of key commodity exports like oil, base metals and grains that have seen sharply rising demand, particularly from recently industrializing economies such as China.

New GDI measure captures the positive "terms of trade" effect

The benefit of rising terms of trade is that more goods can be purchased from export earnings. Unfortunately, this "trading gain" can often drop below the radar screen when doing a scan of the economy because the traditional measure of output — real GDP — fails to capture it for various reasons. In response, Statistics Canada has started to compile an alternative measure of output called real gross domestic income (GDI) that does capture this trading gain. Technically, it does so by deflating nominal net exports by a price measure representative of goods and services consumed domestically (the final domestic demand deflator). More intuitively, the distinction can be made (and paraphrasing a Statistics Canada definition) that real GDP represents the volume of goods and services that the domestic economy produces, while real GDI reflects the volume of goods and services that the economy can purchase with its earnings from this production. Real GDI paints a totally different picture of economic growth in recent years. From 2002 to the second quarter of 2007, real GDP indicates average annual growth of a respectable 2.9%, while the growth rate jumps to a more impressive 4.2% on a real GDI basis.

Not all provinces benefit equally

The positive terms of trade shock has a very disparate impact regionally in Canada depending on the degree of natural resource production compared to consumption. For example, Statistics Canada estimated that, on a real GDP basis, Alberta's economy

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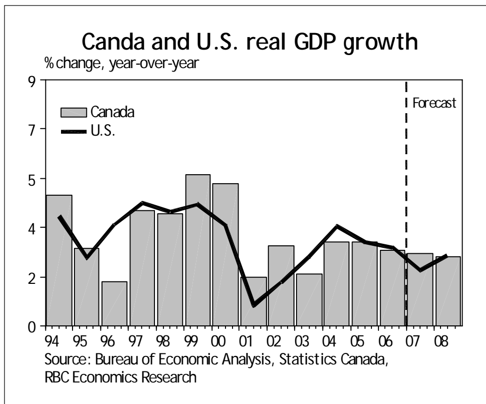

grew by a relatively robust annual average 4.9% between 2002 and 2006. However, on a real GDI basis, the growth rate almost doubles to 9.5%, propelled higher by the strengthening in energy prices. A much weaker GDI performance is evident for Ontario where commodities such as oil are imported and consumed rather than produced and exported. Even so, Ontario's average annual growth in real GDI did manage to move marginally higher to 2.5% between 2002 and 2006 even though its average annual real GDP growth rate was 2.3%. Thus, although Ontario was hit by higher energy import costs, these were offset by rising export prices, likely reflecting the strength in the prices of a number of base metals produced in Ontario. All provinces showed stronger growth on a real GDI basis except PEI where the growth rate was unchanged. Thus, practically all provinces have benefitted from the terms of trade shock, although clearly some more than others.

Implications for Canada's economic outlook and the C$

What does this shock imply for RBC Economics' outlook for economic growth going forward? An economy going through a positive terms of trade shock is likely to experience an appreciation of its currency. Most models of the Canadian dollar acknowledge the importance of commodity prices in determining the value of the loonie. Thus, these models have generally pointed to a strengthening currency in the face of rising oil and base metals prices. However, problems can emerge if too much momentum builds in a currency and it starts to overshoot levels warranted by the key economic drivers. In recent months, there has been growing concern that the Canadian dollar's appreciation may be in excess of that warranted by factors such as historically high commodity prices. Indications of an overvalued currency have resulted in RBC Economics moving towards a slowing in growth in 2008 relative to 2007. This reflects our view that the currency's value will hinder export demand and over-stimulate imports. The favourable terms of trade, however, will limit the slowing to a couple of tenths of a percentage point relative to the 2007 growth rate.

The U.S. economy is a net importer of oil and most other natural resource-type commodities. As a result, that economy has not been experiencing a positive terms of trade shock as has been the case here in Canada. This factor has likely contributed to the Canadian economy outperforming the U.S. economy in 2007 and could help temper the fallout in Canada if the U.S. economy were to weaken markedly in the near-term. However, with the Canadian dollar having strengthened beyond what is deemed consistent with fundamentals in recent months, RBC Economics is assuming that Canadian growth may drop back below the pace expected in the United States for 2008. The impact of historically high export prices will be to limit the underperformance.

The fallout from the weakening U.S. mortgage market and the rapid appreciation of the Canadian dollar both present clear downside risks to economic growth in Canada in the near-term. However, the positive terms of trade shock provides an offsetting upside risk to this outlook. The recent encouraging numbers for September suggest the possibility that the impact could provide even greater benefit over and above simply offsetting the impact of the two negative shocks.

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