

Tiff Macklem: Global growth and the prospects for Canada's exports

Remarks by Mr Tiff Macklem, Senior Deputy Governor of the Bank of Canada, presented to the Economic Club of Canada, Toronto, 1 October 2013.

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Introduction

Good afternoon and thank you for the invitation to address the Economic Club of Canada.

Canada has thrived by being open to the world, and having the world open to us. Our citizens hail from, travel to, and work in countries across the globe. We participate in global governance, offer our assistance and expertise in disasters and conflict, and, most importantly for our prosperity, we are traders.

Historically, exports have been an important driver of Canada's economic growth. Today, they account for about a third of our national income.

This is my topic today – exports. How is global demand likely to shape our export performance, and what should we be doing to take full advantage of an expanding world market?

Canada's export performance

To cultivate and serve international markets, our exporters have been smart, creative and competitive. They need to be. Canadian exporters operate in a global marketplace with aggressive competitors and a global economy continually in flux. Changes to the geography and composition of growth over the past dozen years have been nothing less than transformative. Growth in the emerging-market and developing economies is now outpacing that of the advanced economies, creating both new markets and new sources of competition. And the knowledge economy is becoming an important source of trade in services. The financial crisis has, in many ways, only accelerated these changes.

Our exporters are adapting but it has been gut-wrenching.

In the wake of the financial crisis, our exports were harder hit than in any post-war recession, decreasing by about 17 per cent over three quarters. This was more than triple the decline experienced in the 1990–91 recession. Many Canadian exporters either went out of business or turned inward to Canadian markets. From the peak in 2008 to the trough in 2010, the number of exporters fell nearly 20 per cent, dropping by almost 9,000 firms.

After a surge in the second half of 2011, exports have again lost momentum, falling back by about 1.2 per cent. They remain 6.5 per cent or \$35 billion below their pre-recession peak, and more than \$130 billion below where they would be in an average export recovery (Chart 1). There is much lost ground to make up.

This weakness largely reflects anemic foreign demand – this is the weakest post-war U.S. recovery. But it is being compounded by a longer-term trend: our share of world exports has been in decline for more than a decade. Since 2000, Canada's share has fallen from about 4.5 per cent to about 2.5 per cent.¹ Part of this decline is the inevitable consequence of the entry of China into global markets. But even allowing for this, Canada has fared poorly. Our loss of global trade share has been the second largest in the G-20.

¹ D. de Munnik, J. Jacob, and W. Sze, "The Evolution of Canada's Global Export Market Share," Working Paper No. 2012-31, Bank of Canada, October 2012.

Following the financial crisis, the Bank's strategy for monetary policy was to support domestic demand while the recovery in exports took hold. The first part of the strategy worked. Final domestic demand recovered quickly in Canada.

But a side effect has been the emergence of imbalances in the household sector, reflected in rising household leverage, stretched valuations in a number of housing markets, and an increase in the incidence of highly indebted households. Today, there is a more constructive evolution of those household imbalances.

This is good news. It reduces the risk of an abrupt and painful correction down the road.

But this new-found and welcome household prudence is dampening growth. To replace this growth, we need a rotation in demand toward exports and business investment.

Unfortunately, this rotation has proven elusive.

This is consequential – growth in Canada has slowed. In the year leading up to this past June, growth averaged only 1.4 per cent, compared to 2.6 per cent the year before. With Canada's potential output estimated to be growing at about 2 per cent, growth in demand has not kept pace with the expansion in production capacity, and economic slack has increased.

To absorb the current material degree of slack in the economy, demand needs to grow measurably faster than supply. That means growth of at least 2½ per cent.

The Bank is currently revising its forecast, and we will publish our latest outlook in our October *Monetary Policy Report*. But in broad strokes, we expect household and government spending together to contribute about 1½ percentage points of growth. So to reach at least 2½ per cent GDP growth, we will need at least a 1 percentage point contribution to growth from net exports and investment. That means together exports and investment need to grow by at least about 4 per cent after taking into account their import content.

In the past year, net exports and investment made no contribution to growth.

Conditions are propitious for business investment to accelerate. Corporate balance sheets are exceptionally strong, and corporate borrowing rates remain very low, even if they are off their troughs. But investment is unlikely to accelerate until businesses are confident that demand is picking up.

The key is exports.

As firms see their order books filling up, they will unlock their investment plans. The typical lag between a pick up in exports and an acceleration in investment is about six months.

So the crucial question is: What are the prospects for our exports?

To address this question, I will start by reviewing the outlook for global growth and the demand for our exports of goods and services.

Global outlook

Advanced economies are contributing more to growth

The U.S. economy is reaping the benefits of bold measures to repair its financial system and exceptionally expansionary monetary policy. Private demand has gained momentum, despite considerable fiscal drag imposed by tax increases and sequestration cuts and a sluggish labour market.

Household deleveraging in the United States is well advanced. Through a combination of defaults, increased savings and gains in asset valuation in house and equity prices, household net worth is now back to 2007 levels (Chart 2).

Housing starts and resales are recovering, and house prices are now up almost 18 per cent from their trough. The once mighty U.S. consumer is coming back, albeit more prudently, and this is underpinning growth excluding fiscal policy in the 3½ to 4 per cent range.

Headline GDP growth, however, is much weaker, owing to significant fiscal drag, which we estimate will subtract 1¾ percentage points from growth this year (Chart 3).

While this is dampening GDP growth, our exports are more geared to private U.S. demand, which is stronger. The recovery in housing, in particular, is creating new demand for Canadian exports of lumber and building supplies.

In Japan, the Abenomics “Three Arrows” policy revolution has so far produced impressive results.² The immediate impact was to push equity prices significantly higher, depreciate the yen by roughly 20 per cent, generate expectations of positive inflation and push real long-term interest rates into negative territory. This is now translating into faster growth, which averaged close to 4 per cent, at annual rates, in the first half of this year. To sustain this momentum, bold monetary policy measures will need to be followed by more difficult structural reforms – the third arrow.

In Europe, there are early signs of recovery. The intersecting downward spirals of fiscal austerity, bank deleveraging, declining economic activity, increasing government debt burdens and rising non-performing loans are abating. Euro area growth is now positive and, encouragingly, the structural imbalances at the root of the euro crisis are also showing signs of improvement. The substantial current account deficits in the peripheral countries have been largely eliminated (Chart 4) and, more significantly, the competitiveness of the peripheral countries relative to Germany has begun to improve (Chart 5). This bodes well.

Nevertheless, Europe is far from being out of the woods. Growth is likely to remain subdued and downside risks remain. Still, the situation is better than it was six months ago, and much better than a year ago.

Growth in China looks solid, but other emerging markets are losing momentum

In China, growth has slowed to a still-solid pace of 7½ per cent, and confidence is improving. Growth is being spurred by robust investment, particularly in infrastructure, as well as expansionary credit conditions. Supported by “consumption-friendly” structural reforms, growth is expected to rotate toward consumption, although this process is likely to be very gradual.

In contrast, a number of other emerging markets have experienced increased financial volatility and weakening growth prospects. Against the background of a steepening U.S. yield curve, there were broad-based capital outflows across emerging markets through June and July as investors pulled back from risk (Chart 6). Since then, markets have become more discriminating, focusing on emerging markets that appear more vulnerable owing to a combination of current account deficits, inflation and slower growth (Chart 7).

While there has been some stabilization in the financial markets, credit spreads have widened in these emerging-market countries, and their currencies have depreciated sharply (Chart 8). To limit the depreciation, authorities in affected countries have responded with a series of measures to stem capital outflows, including currency interventions, capital controls and higher policy interest rates. While such measures may provide temporary relief, they are not without cost. Ultimately, the best defense is undertaking the fundamental reforms necessary to putting one’s own house in order.

² The “three arrows” are: (i) adoption of a 2 per cent inflation target with unprecedented quantitative monetary easing to achieve the target within approximately 2 years; (ii) substantial fiscal stimulus in the near term followed by fiscal consolidation starting mid-2014; and (iii) structural reforms to promote long-term growth.

Expectations of stable, solid growth in China will support commodity prices, which, overall, remain high by historical standards. However, the recent slowing in other emerging markets, combined with some retreat from risky assets, has exerted downward pressure on many commodity prices in recent months, particularly base metals. In aggregate, commodity prices are expected to remain relatively stable through 2015, with the effects of modest expected declines in oil prices offset by a gradual rise in the prices of non-energy commodities.

How will these global developments affect our exports?

To address this question, I will look at our exports from three perspectives: our trade geography, or who we sell to; our competitiveness in global markets; and our product mix.

Our trade geography

Over the past dozen years, our trade geography has worked against us because our major trading partners have been growing more slowly than the global economy. From 2001 to 2007, the rise of China and other emerging-market countries outpaced growth in U.S. demand. The crisis only magnified this. Emerging markets now account for 80 per cent of global growth (Chart 9). But only 12 per cent of our exports go directly to fast-growing emerging markets while 85 per cent go to slow-growing advanced economies. Compared with our peers, Canada's direct exposure to emerging markets is tiny when measured as a share of exports (Chart 10).

To illustrate the magnitude of this trade geography effect, suppose Canada had the same level of exposure as the United States to emerging markets (Chart 11). Foreign demand for our exports would be \$60 billion higher.

Going forward, our trade geography should improve as the recovery in advanced economies, and particularly the United States, gains momentum. Emerging markets are likely to remain the principal source of growth in the next several years, but as the United States and other advanced economies recover, they are expected to regain at least part of the share of global growth that they lost in recent years (as projected in Chart 9). This will be positive for our exports.

At the same time, Canadian exporters are developing new markets in the fastest growing emerging markets. One-third of firms report they have already started exporting to new markets in the past two years, and about half plan to expand into new countries over the next two years. The top two destinations are Brazil and China.³

In addition to direct exports to developing economies, Canadian exporters are also embedded in global supply chains. Participating in supply chains means that Canadian businesses benefit from trade with countries such as India and China not only by selling directly to them, but also by supplying firms in the United States and other advanced economies that are selling to the emerging markets. As the pendulum swings from off-shoring to on-shoring, Canadian firms need to secure and grow their presence in global supply chains.

Our competitiveness

A second factor influencing our exports is competitiveness. Between 2000 and 2012, the labour cost of producing a unit of output in Canada compared with the United States, adjusted for the exchange rate, increased by 75 per cent (Chart 12). The majority of this loss of competitiveness reflects the appreciation of the Canadian dollar (shown in blue), but weak productivity growth in Canada relative to the United States also played a significant role (shown in green).

³ [Export Development Canada's semi-annual survey of Canadian companies](#), released June 27, 2013.

This decline in competitiveness is manifest in our shrinking share of the U.S. market. Not only did the U.S. import market contract relative to the rest of the world, Canada's share of that market shrank (Chart 13).

What if we hadn't lost competitiveness? What would our exports be had our competitiveness stayed at its 2002 level?

If Canada's exports had grown in tandem with those of the U.S. and global economies – in other words, taking the weakness of the global economy as a given and excluding oil – our goods exports would have been \$71 billion higher (Chart 14).

There are many factors that affect business investment and productivity, including access to risk capital, the regulatory environment, infrastructure and skills mismatches. This makes productivity particularly hard to predict. But looking ahead, stronger exports should encourage more investment and this, in turn, should increase productivity. As firms fully utilize existing capital, productivity can be expected to rise. And new investment typically embodies new technologies, so as this new investment comes on line, workers will have more and better capital to work with. Better tools help make workers more productive, which should improve our competitiveness.

Our product mix

The third factor is what we export – our product mix. Here, there are two forces at play, which have been moving in opposite directions.

From 2000 to 2007, strong growth in advanced and emerging economies created strong global demand for machinery and equipment and consumer goods. This shift in the composition of global demand did not play to Canada's strengths. Machinery and equipment and consumer goods are a smaller proportion of our exports than in the average world export basket.

Commodities, on the other hand, have worked in the other direction. In the last several years, the boost from the commodity intensity of our exports has turned the product mix effect to a net positive for Canada, with the rise in our energy exports more than fully offsetting the drag from machinery and equipment (Chart 15).

Energy commodities have become an increasingly important share of our exports. In 2000, energy made up 11 per cent of our exports. Today it is almost 20 per cent. And oil is now by far our most important commodity. Its share of commodity production roughly doubled in the past decade, to close to 50 per cent today (Chart 16).

But recently, energy transportation bottlenecks in North America have been limiting this positive product mix effect. While oil sands production is rising steadily, transportation capacity has become increasingly problematic. All realistic scenarios for U.S. energy independence include Canadian crude production. But we have to get it there.

In the coming years our product mix is likely to provide less of a boost than it has over the past five years. As I mentioned earlier, commodity prices are expected to remain relatively stable through 2015 but some of our export sectors that particularly suffered, such as forestry, should pick up.

Services exports: a growing opportunity

Finally, let me say a few words about our exports of services. We tend to focus on exports of goods, but services have the potential to become a more important source of Canadian national income.

Services already account for 15 per cent or \$75 billion of our exports. This is more than either motor vehicles and parts or machinery and equipment. And unlike motor vehicles and machinery and equipment, our services exports were relatively stable throughout the recession (Chart 17).

The global growth of the knowledge economy is changing the composition of our service exports. We have been – and are – selling the products of our intellectual labours to the world. This includes management services, computer services and information, financial services and engineering services. Services being exported range from new apps to security and training software, data analytics, multimedia, online services, and social media management systems.

More than 60 per cent or \$46 billion of our service exports are commercial services, some 40 per cent of which are purchased by non-U.S. clients. About 50 per cent of financial and insurance services, one of the largest categories of service exports, go to markets outside the United States. And while exports of management services to the United States and the European Union have slowed since 2005, they have grown in other countries. This trend underscores one of the significant strengths of our services exports: they are more diversified than our goods exports. More than 20 per cent are to non-OECD countries.

Conclusion

Let me try to summarize. To put a meaningful dent in the remaining slack in the Canadian economy, we need annual growth of at least 2½ per cent. Achieving this requires a rotation in demand toward exports and business investment.

The conditions are in place for investment to accelerate but, in an uncertain world, firms need to see demand pick up before they will commit. An improving global outlook, particularly for advanced economies, should boost our exports. To fully reap the benefits of this lift, we must strengthen our competitiveness while developing new markets and securing our position in global supply chains.

As we said in our September 4 policy statement, uncertain global conditions appear to be delaying the rotation towards exports and investment. Near-term growth now looks a little less choppy than initially projected. We are now expecting growth in the third and fourth quarters of this year to be in the 2 to 2½ per cent range before strengthening next year as the rotation to exports and investment gains momentum.

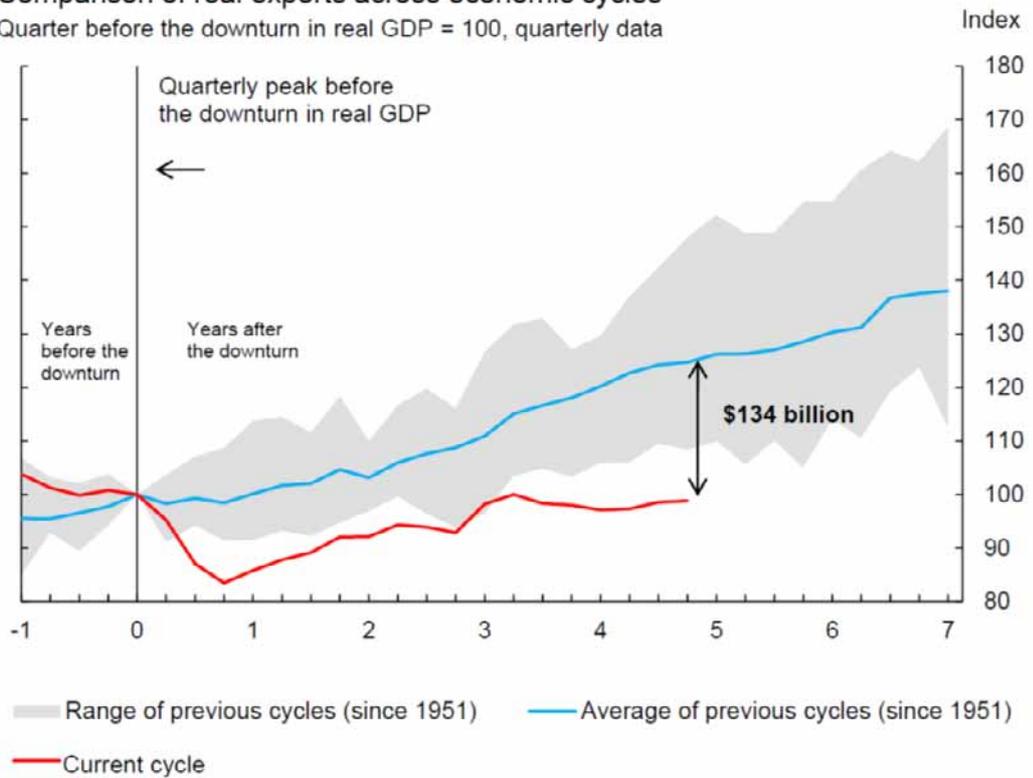
There is a risk that this rotation is delayed further. At the same time, some recent surveys and other evidence, including the pick-up in firm creation, suggest that firms are becoming more optimistic. And once the sequence of stronger exports, rising confidence, increased investment and stronger productivity is launched, it could well gain traction faster than expected. We will be monitoring this dynamic closely.

With inflation subdued, monetary policy remains highly stimulative to provide time for the recovery in exports and investment to take hold.

This is not the first time we have faced the challenge of restoring our exports against shifting global tides. From beaver pelts to building materials, we have experienced plunges in the markets for our goods. We recovered by developing new goods and services and entering new markets. There can be no doubt that we have the entrepreneurial spirit, the skills, the educated work force and the expertise to compete successfully in the global marketplace. But that does not make it easy.

Chart 1: Weakest postwar recovery in exports

Comparison of real exports across economic cycles
 Quarter before the downturn in real GDP = 100, quarterly data

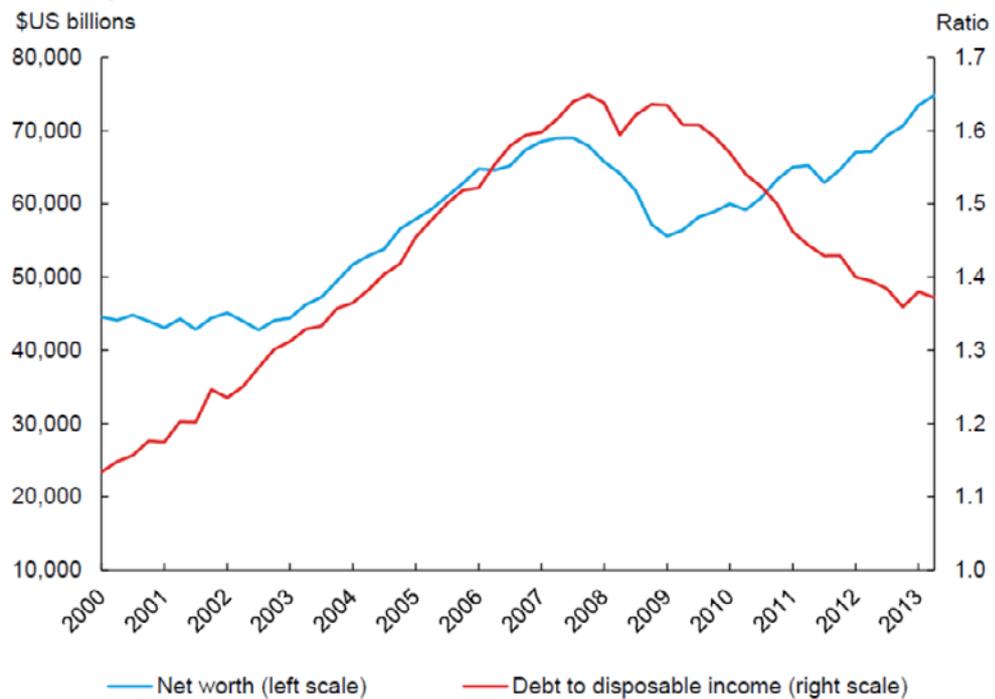


Sources: Statistics Canada and Bank of Canada calculations

Last observation: 2013Q2

Chart 2: Net worth of U.S. households has substantially recovered

Quarterly data

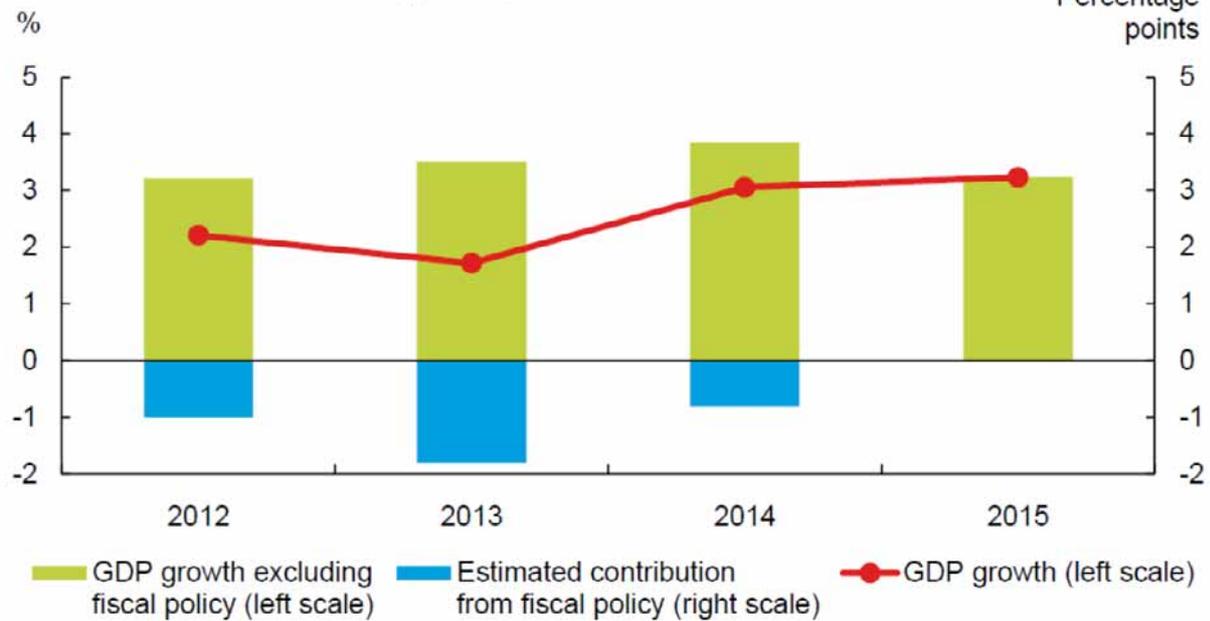


Note: U.S. household debt calculations include the unincorporated business sector.
 Sources: U.S. Federal Reserve and U.S. Bureau of Economic Analysis

Last observation: 2013Q2

Chart 3: Fiscal consolidation is reducing U.S. growth

Contributions to real GDP growth, annual data

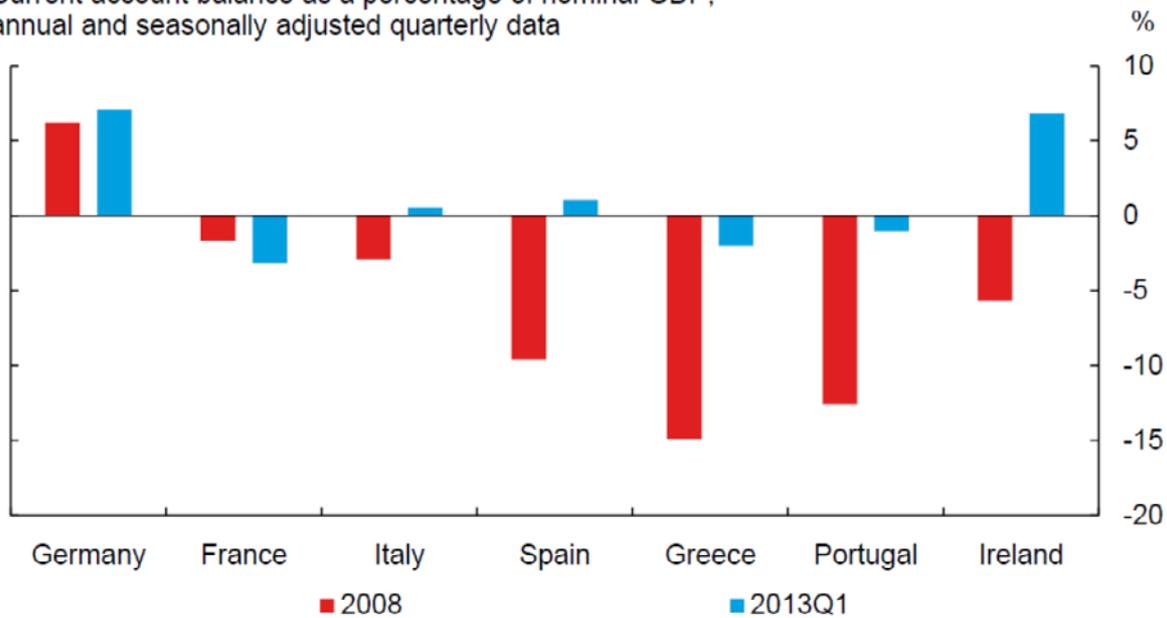


Note: The contribution of fiscal policy to growth includes both direct government expenditures and the indirect effects on other components of aggregate demand.
Sources: U.S. Bureau of Economic Analysis and Bank of Canada calculations and projections

Chart 4: Euro-area current account imbalances have improved

Current account positions in the euro area

Current account balance as a percentage of nominal GDP; annual and seasonally adjusted quarterly data

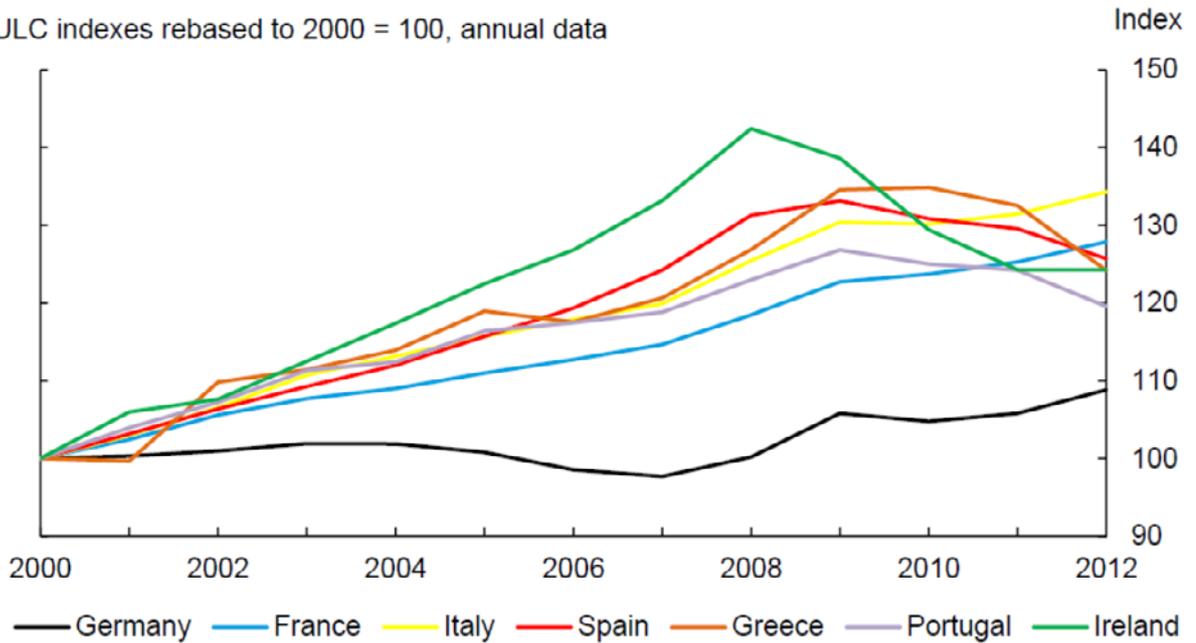


Sources: Statistical Office of the European Communities, Bank of Greece, Hellenic Statistical Authority, International Monetary Fund, World Economic Outlook Database April 2013, and Haver Analytics

Last observation: 2013Q1

Chart 5: The competitiveness of peripheral Europe is improving

Nominal unit labour costs in the euro area
 ULC indexes rebased to 2000 = 100, annual data



Sources: Statistical Office of the European Communities, Haver Analytics

Last observation: 2012

Chart 6: Capital outflows from emerging-market economies accelerated this summer as investors pulled back from risk

Net inflows to major emerging-market countries over 2013
 Weekly data



Note: Net inflows are calculated as the sum of net bond and equity flows to Argentina, Brazil, Chile, China, India, Indonesia, Korea, Mexico, Russia, South Africa and Turkey.
 Source: EPFR

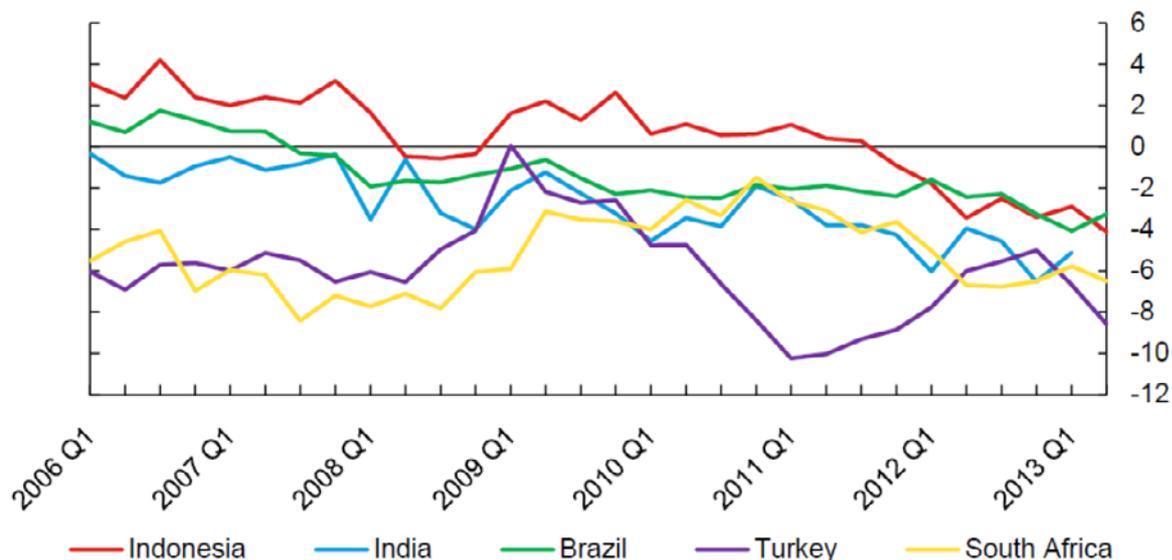
Last observation: 4 Sep 2013

Chart 7: Emerging-market economies with current account deficits have been vulnerable to global financial turbulence

Current account as a percentage of GDP for hard hit emerging economies

Seasonally adjusted, quarterly data

% of GDP



Sources: Bank of Indonesia, Reserve Bank of India, Banco Central do Brasil, Central Bank of the Republic of Turkey, South African Reserve Bank

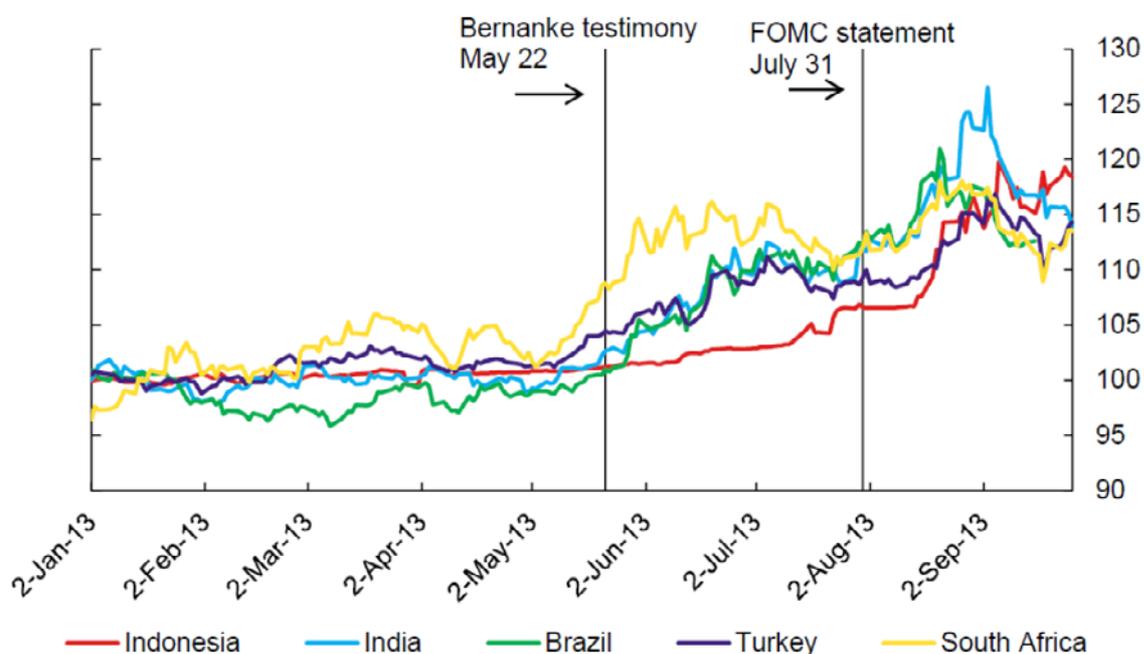
Last observation: 2013Q1 for India, 2013Q2 for all others

Chart 8: Capital outflows have led to significant currency depreciation in several emerging-market economies

Nominal exchange rate of hard hit emerging economies

Daily data, January 2013=100, local currency/US\$

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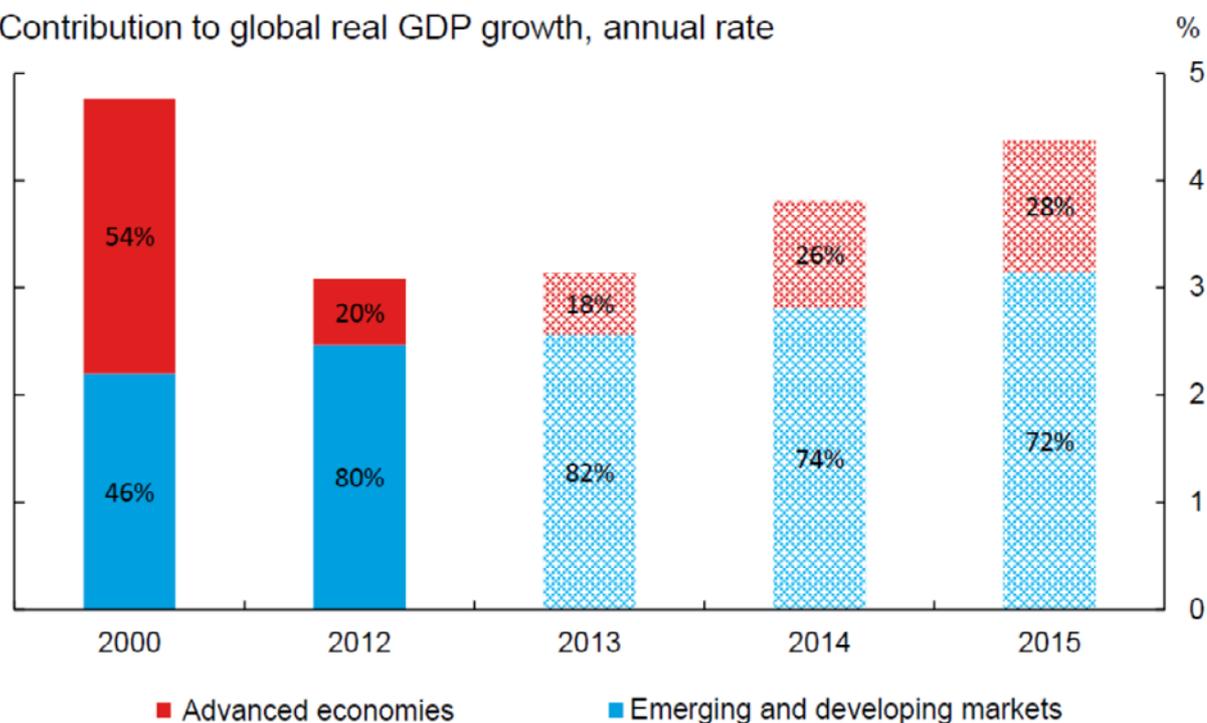


Source: Wall Street Journal

Last observation: September 26 2013

Chart 9: Emerging-market economies now account for bulk of growth

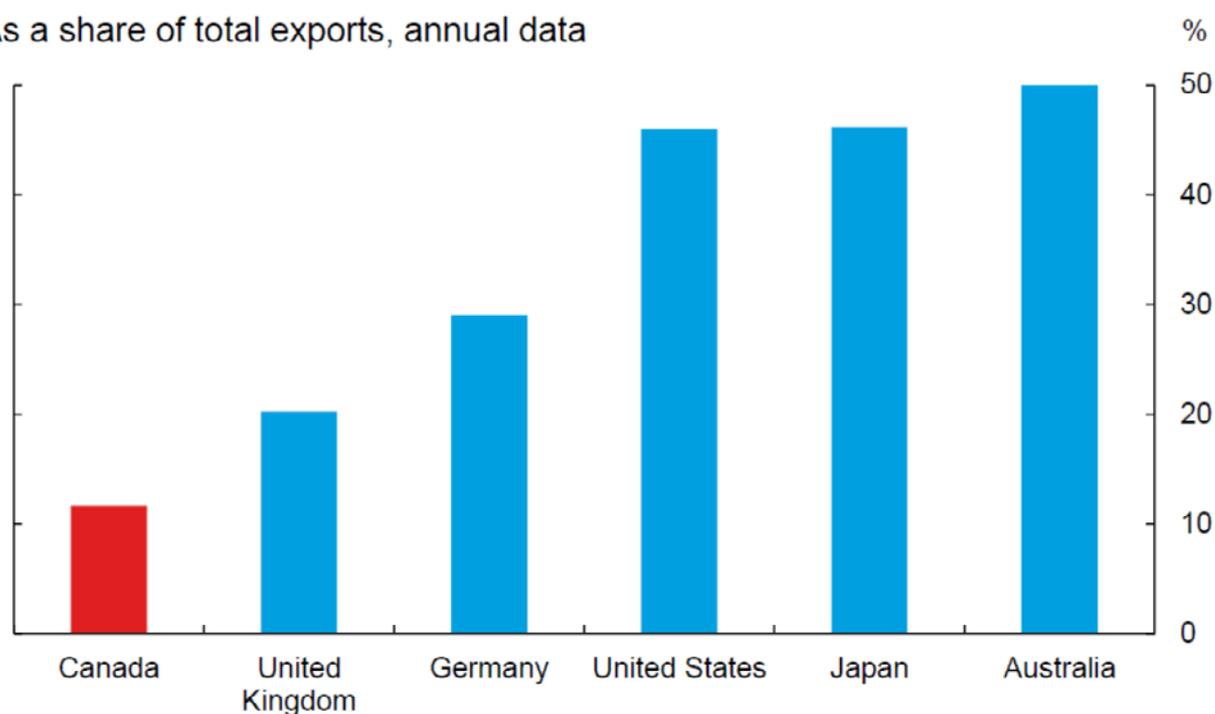
Contribution to global real GDP growth, annual rate



Note: Shaded columns represent projections.
 Source: IMF *World Economic Outlook*, April 2013 via Haver Analytics

Chart 10: Canada's exposure to emerging-market economies is relatively small

As a share of total exports, annual data

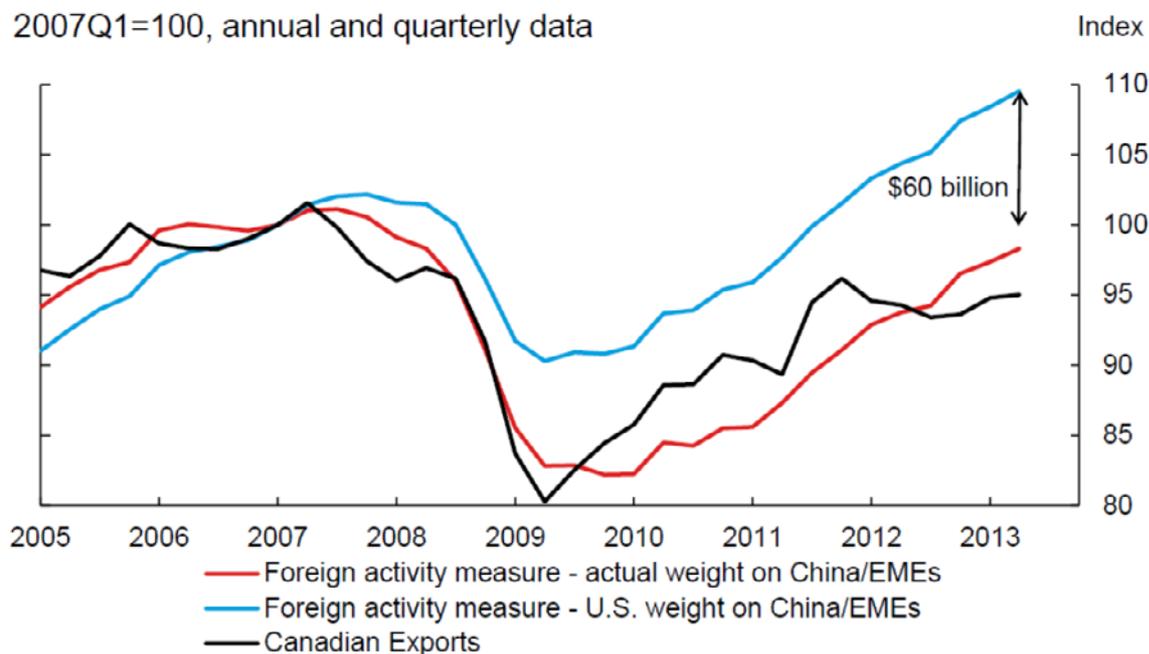


Source: IMF

Last observation: 2012

Chart 11: Demand for Canadian exports would be \$60 billion higher with the same level of exposure as the U.S. to emerging-market economies

2007Q1=100, annual and quarterly data



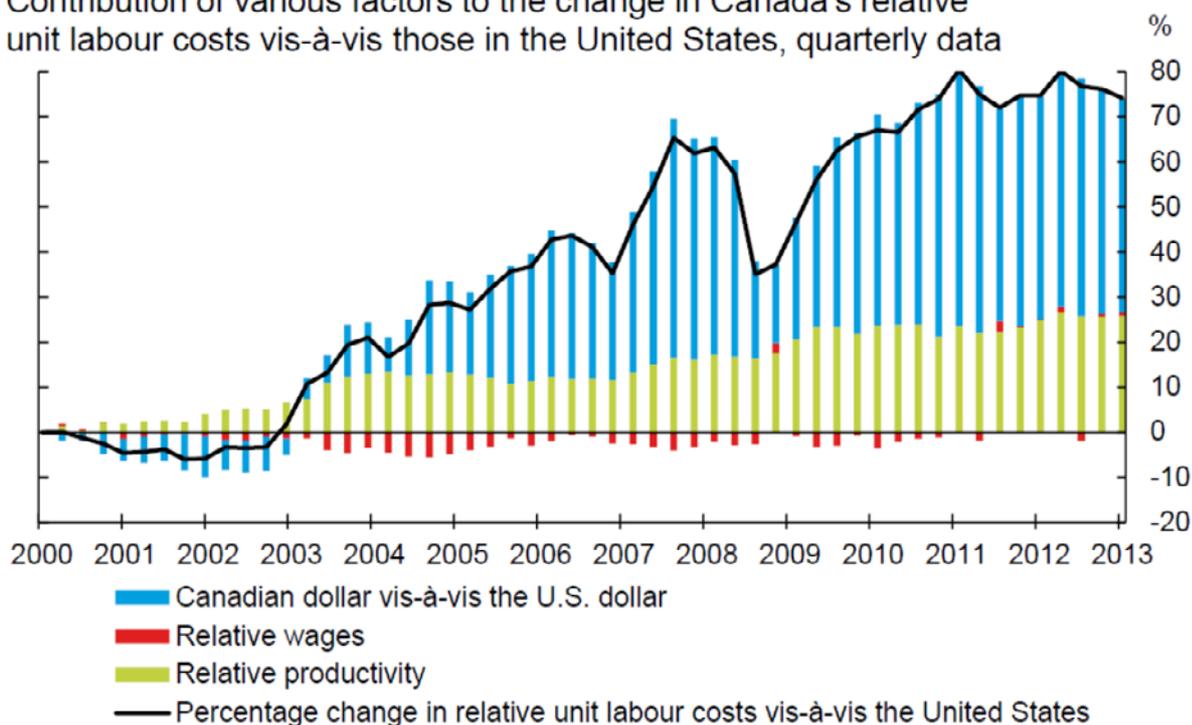
Note: Bank of Canada foreign activity measures calculated based on 2012 share of Canada and US exports to China and select EMEs. The numbers displayed represent the gap between 2013Q2 exports and the level of exports implied by the recalculated foreign activity measures. Values expressed in 2007 chained dollars.

Sources: International Monetary Fund, Statistics Canada, and Bank of Canada calculations

Last observation: 2013Q2

Chart 12: Canadian firms have lost competitiveness

Contribution of various factors to the change in Canada's relative unit labour costs vis-à-vis those in the United States, quarterly data

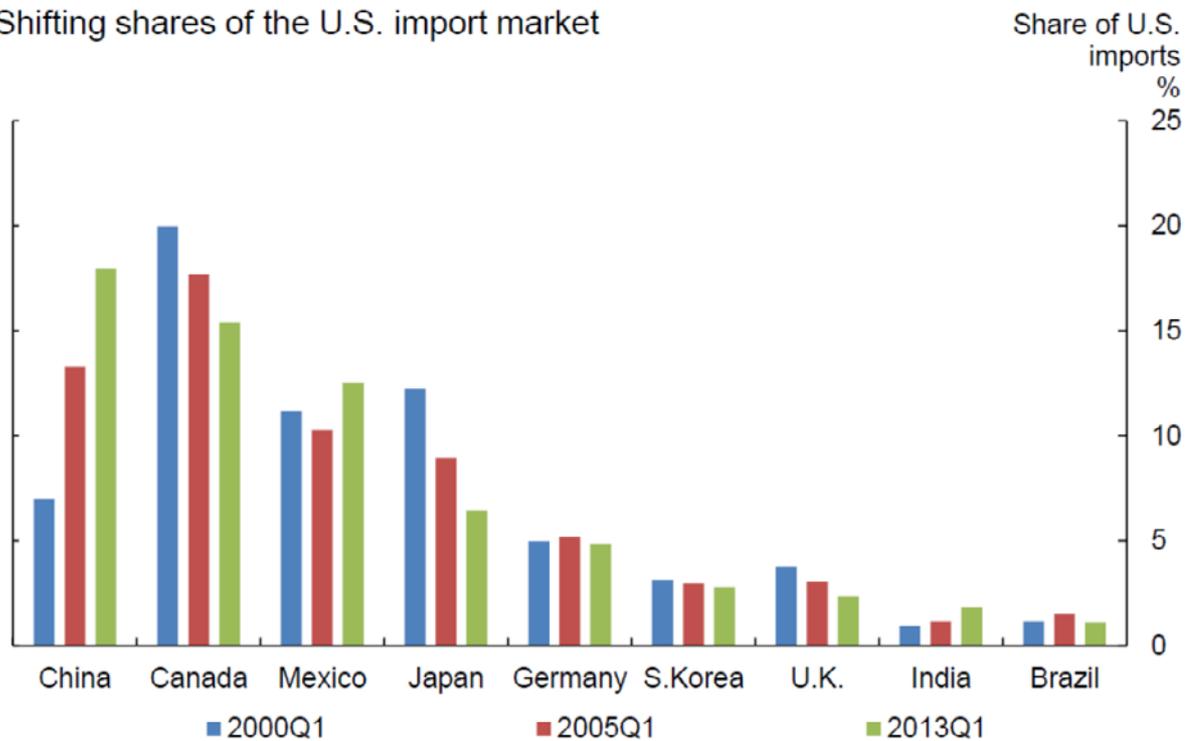


Sources: Statistics Canada, U.S. Bureau of Economic Analysis and Bank of Canada calculations

Last observation: 2013Q2

Chart 13: Canada has lost more share of the U.S. market than many of its peers

Shifting shares of the U.S. import market



Source: U.S. Bureau of Economic Analysis

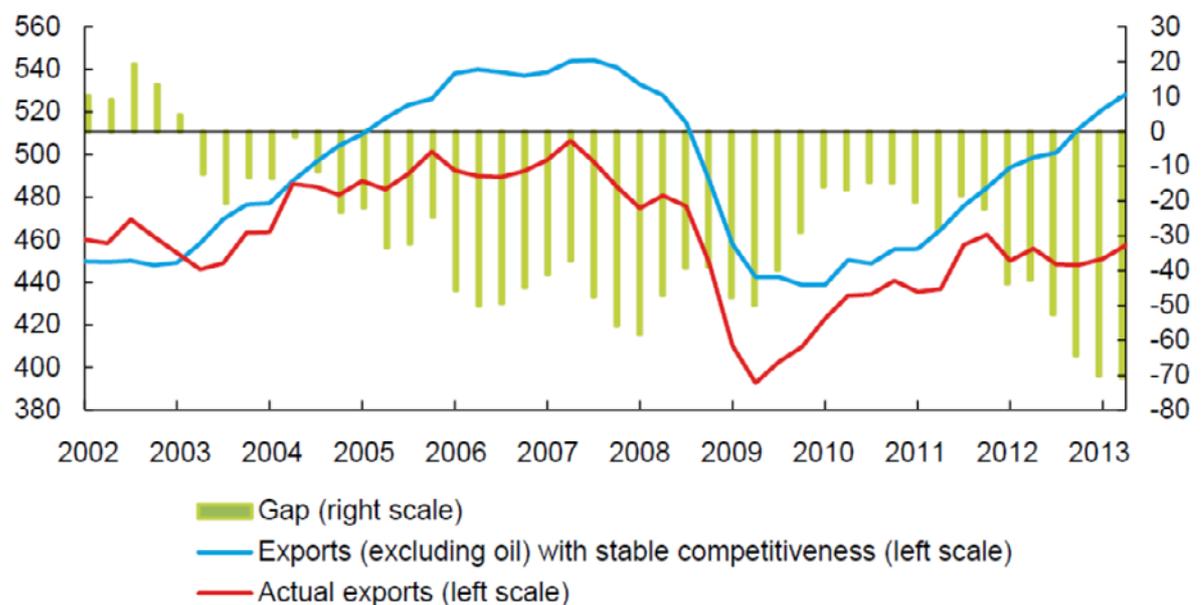
Last observation: 2013Q1

Chart 14: Lost competitiveness has reduced our exports

Chained 2007 dollars; quarterly

Can\$ billions

\$billions



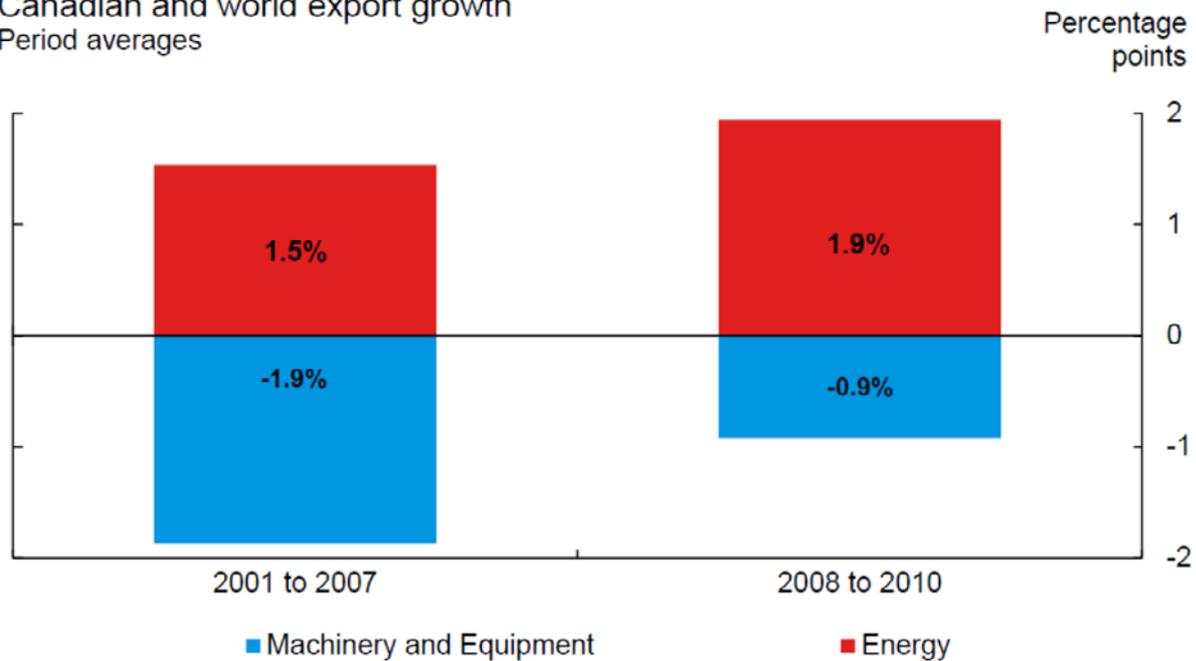
Note: The stable competitiveness calculation assumes that exports grew at the rate of the foreign activity measure since 2002Q1

Sources: Statistics Canada and Bank of Canada calculations

Last observation: 2013Q2

Chart 15: Strong energy exports compensated for weakness in exports of other goods

Selected contributions of product structure effect to the difference between Canadian and world export growth
 Period averages

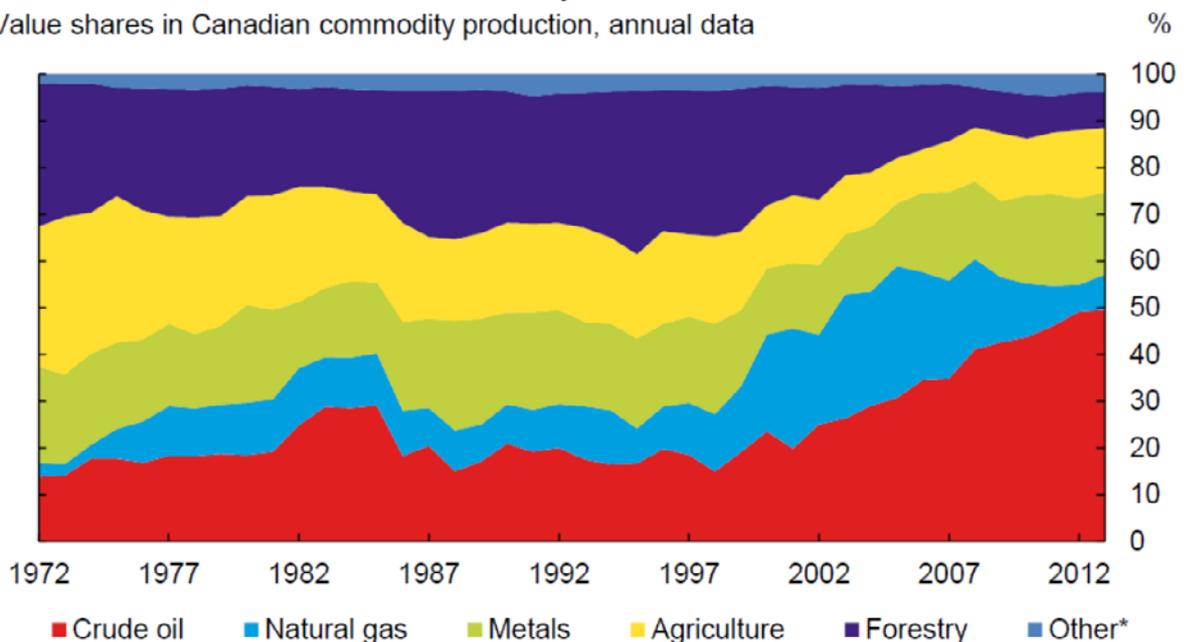


Sources: UN Comtrade and Bank of Canada calculations

Last observation: 2010

Chart 16: Oil is now Canada's most important goods commodity

2013 Fisher BCPI - nominal commodity shares
 Value shares in Canadian commodity production, annual data



*Defined as the aggregation of fisheries products and coal.
 Source: Bank of Canada

Last observation: 2013

Chart 17: Exports of Canadian services remained stable

Index, 2000Q1=100; chained 2007 dollars

