Canada Competitive? Trade Flow Says "No"

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We raised the issue of the net outflow of foreign direct investment from Canada as a competitiveness warning signal three weeks ago in *Focus*. This week, we look at the other side of the balance of payments ledger—trade flows.

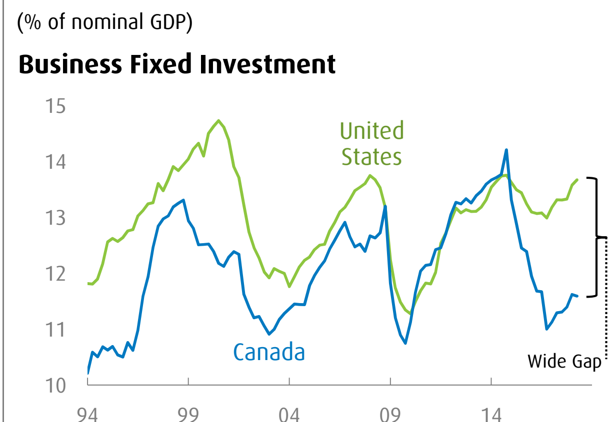
Almost from the moment that U.S. tax reforms were approved late last year, concerns over Canada's ability to attract capital and talent were raised, compounded by the lingering uncertainty over the fate of NAFTA. Those concerns have only been ramped up further by the studied absence of a meaningful response in this year's round of Canadian government budgets—which were heavy on new spending, but feather-light on tax relief—and by the rising drama on the NAFTA front, as well as by the deepening uncertainty on pipeline access for domestic oil production. Even before these latest developments could weigh in, foreign direct investment witnessed a record net outflow last year of more than $70 billion, and further outflows so far in 2018. More broadly, domestic business investment remains soggy, as total non-residential capital spending was just 11.6% of nominal GDP in the first half of 2018, compared with a U.S. reading of 13.6% *(Chart 1)*.

In turn, the still-sluggish business investment landscape means that Canada's productive capacity is growing slowly, dampening the country's medium-term growth potential. The Bank of Canada nudged up its view on potential GDP earlier this year (to a mid-point of 1.8% over the next three years), and noted some rebound in capital spending. But the upgrade in potential growth speaks more to faster-than-expected population growth rather than better productivity. (The 1.4% population rise in the four quarters to mid-2018 was the fastest since 1991.) In fact, labour productivity has slowed to just 0.2% y/y in the most recent four quarters, a big cooldown from last year's near-2% advance, and even below the five-year trend of just over 1% annual growth *(Chart 2)*.

One way in which that lack of productive capacity is showing up in real time is the underlying deterioration in Canada's merchandise trade flows. Even with some narrowing in recent months, the deficit is on track to hit roughly $25 billion again this year on a 12-month tally (or just over 1% of GDP), little-changed from last year. This persistent gap is despite the fact that: a) U.S. auto sales remain close to all-time highs; b) U.S. spending growth overall has strengthened considerably and can be deemed close to the top of the cycle; c) the Canadian dollar is still at competitive levels of under 77 cents; and, d) WTI oil prices have recovered to above long-run averages at around $70.

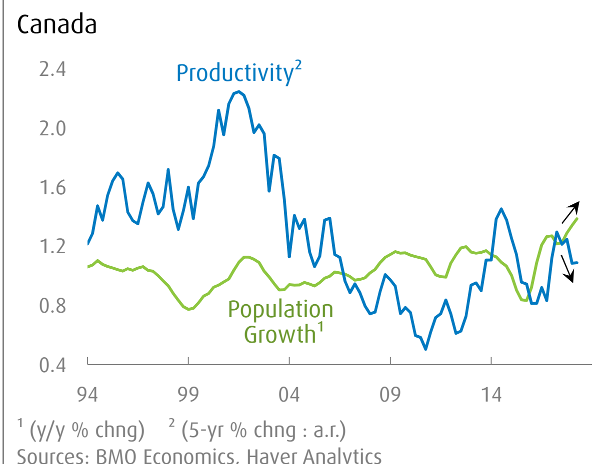
Over the past three years, Canadian merchandise export volumes have managed to rise at less than a 1% annual rate, even amid a thriving global economy and a reasonably valued currency. And, it's not like this sluggish performance is a one-time wonder—the annualized gain in export volumes over the past decade is barely

Chart 1
Mind the Investment Gap



Sources: BMO Economics, Haver Analytics

Chart 2
More People, Modest Productivity



[1] (y/y % chng) [2] (5-yr % chng : a.r.)
Sources: BMO Economics, Haver Analytics

above a paltry 1% pace. Meantime, imports are on wheels, headed for a 5% rise this year, keeping the trade gap close to a record-wide level *(Chart 3)*.

One of the more extreme examples of what's driving this wedge between fast-growing imports and crawling exports can be found in autos. Over the past two years, Canadian auto exports (vehicles and parts) have dropped 5%, while imports of such have risen 7% in real terms. Put another way, for the first time in decades, Canada is now producing fewer finished vehicles than its consumers purchase. That's despite the fact that Canadian auto sales have dipped slightly this year, following a lengthy upswing from the recession's depths. As a result, Canada is now running an auto trade deficit of $25 billion when parts are also factored in, alone roughly accounting for the entire trade imbalance. To put that in some perspective, Canada historically ran moderate auto trade surpluses for decades, until the balance tipped in 2006 *(Chart 4)*.

We would also bring up an uncomfortable fact on the bilateral balance side. While President Trump rails about the U.S. trade imbalance with China, Canada is no shrinking violet on that front—Canada's deficit with China was $1.5 billion in July, as imports from that country jumped 8.8% y/y. That lifted the 12-month cumulative imbalance to a $19.2 billion gap, with that country alone accounting for three-quarters of Canada's overall deficit. Exports to China have managed to rise a solid 13.8% y/y, rebounding from rail bottlenecks earlier this year arising from the harsh winter. But the underlying deterioration in the bilateral imbalance has been mostly relentless for the past five years *(Chart 5)*.

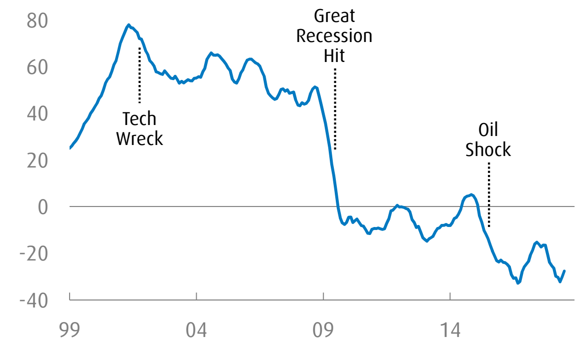
For the near-term outlook on the economy, the trade imbalance doesn't make a huge dent in the growth forecast. We were already expecting a modest drag from net exports in Q3, after some rare support in Q2. And, the fact that the latest deterioration is mostly driven by a decent import gain suggests that domestic demand is still doing fine. We remain comfortable with our call of 2.0% GDP growth for 2018, and 1.9% for next year. **But the longer-term issue is the persistent trade gap even at a time of booming global growth, a competitive loonie, and solid commodity prices.** When these benign conditions change—as they so inevitably will at some point—Canada's competitiveness challenge may be truly exposed. And this is only looking at the merchandise component of trade—we haven't even addressed the ongoing deficits in services and investment income, which leave the broader current account deficit stuck above $60 billion, or close to 3% of GDP—a wider gap than the comparable U.S. current account deficit *(Chart 6)*.

The Bank of Canada itself has become a bit more vocal on the competitiveness concerns, with Senior Deputy Governor Wilkins specifically calling out these *"challenges"* in a recent speech. We

Chart 3
Trade: A Series of Unfortunate Events

Canada (C$ blns : 12-mnth m.s.)

Merchandise Trade Balance



Sources: BMO Economics, Haver Analytics

Chart 4
Auto Trade: Reverse Gear

Canada (C$ blns : 12-mnth m.s.)

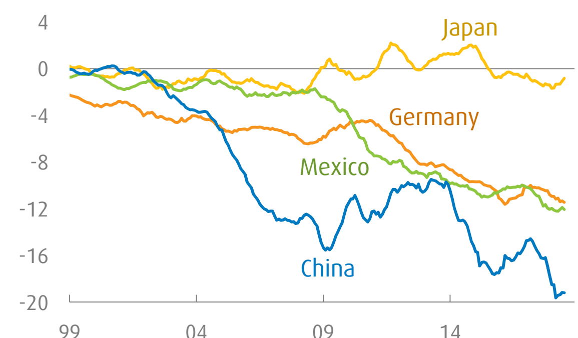
Trade Balance — Motor Vehicles and Parts

Sources: BMO Economics, Haver Analytics

Chart 5
Where the Wide Gaps Are

Canada ($ blns : 12-mnth m.s.)

Bilateral Trade Balances



Sources: BMO Economics, Haver Analytics

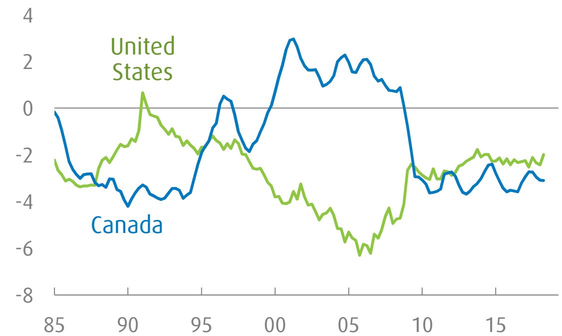
will end with a quote from that speech, as it nicely sums up a key issue facing the Canadian economy:

"It is important to recognize that the challenges facing Canadian exporters are not only about NAFTA and tariffs. Concerns about weak business investment, firms building new capacity outside our borders, and declining market shares existed long before the current trade tensions emerged. Competitiveness issues have been hampering Canadian businesses for some time, even while foreign demand has been growing.

"Market share in the United States for Canada's non-energy goods has, in fact, been declining over the past 15 years. The effect has been particularly acute in the manufacturing sector. This trend has meant a much lower share of employment for most manufacturing industries, including automotive and parts and clothing. Regardless of what transpires on the trade policy front, the Bank will still need to better understand the competitiveness issues to assess the extent to which Canada has permanently lost market share and export capacity." ("An Update on Canada's Economic Resilience", Carolyn Wilkins, September 6, 2018.)

Bottom Line: Canada's trade struggles pre-date NAFTA concerns, and will not be fixed by a deal, nor by a weaker currency alone. The competitive challenges cloud the longer-term outlook for the Canadian dollar; while the currency would benefit temporarily from the relief of a new trade deal with the U.S., we suspect the glow would fade relatively quickly.

Chart 6
North American Current Account Cousins



Sources: BMO Economics, Haver Analytics

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