OBSERVATION

TD Economics

February 1, 2012

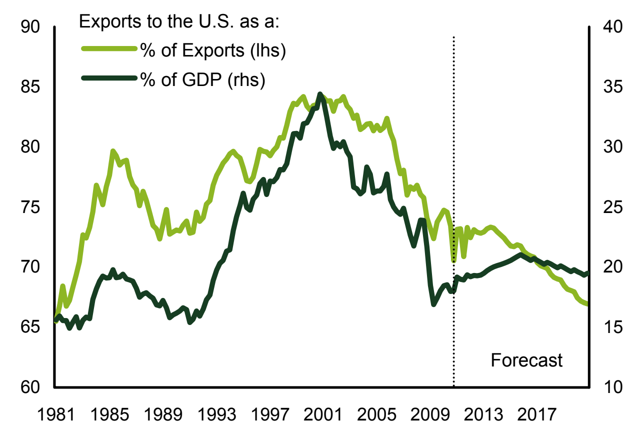
CANADA'S DECLINING RELIANCE ON THE U.S. - WHERE TO GROW FROM HERE?

Highlights

- Canada's economic reliance on the U.S. in terms of share of exports and GDP has fallen over the last decade.
- Over the next few years, a cyclical rebound in U.S. economic growth is expected to provide a boost to Canadian exports. However, over the longer haul, we expect the U.S. share of Canadian exports to continue its recent descent.
- Within the next decade, we believe that exports to the U.S. will likely account for just two-thirds of Canadian total exports, down from the peak of 85% in 2002
- Over the long term, Canada's economic prosperity will increasingly be driven by trade with other non-U.S. economies.

While the U.S. remains Canada's largest trading partner by far, Canada's economic reliance on the U.S. in terms of share of exports and GDP has fallen over the last decade (see chart 1). Strikingly, exports to the U.S. directly contributed an annual average of 0.5 percentage points to Canadian nominal GDP growth over the last decade, compared to an average annual contribution of 2.3 percentage points over the prior two decades. Over the next few years, this longer-term downtrend is likely to reverse to some extent as a cyclical rebound in U.S. economic growth provides a boost to Canadian exports. However, over the long-term, Canada's economic prosperity will increasingly be driven by trade with other non-U.S. economies. Indeed, by 2020, we project that the direct contribution of the U.S. to Canadian exports will have slipped to two thirds – down from a peak of 85% in 2002. At the same time, the direct contribution of U.S. exports to Canadian GDP will stabilize at 20%, almost half of its share ten years ago.

CHART 1: CANADA'S RELIANCE ON THE U.S.



Source: Statistics Canada, Census Bureau, Haver Analytics
F. by TD Economics as of December 2011

Factors driving Canada's shrinking reliance on U.S. exports

The declining footprint of Canadian south-bound trade can be chalked up to six culprits:

- First, since 2002, a one-third appreciation in the Canadian dollar against the U.S. greenback, in combination with rising unit labour costs, has eroded the competitiveness of Canadian made goods in the U.S. market.
- Second, the U.S. market has become more competitive. Emerging markets have been a growing source for U.S. imports. For instance, in 2003, China overtook Canada's position as the most important source of U.S. imports.

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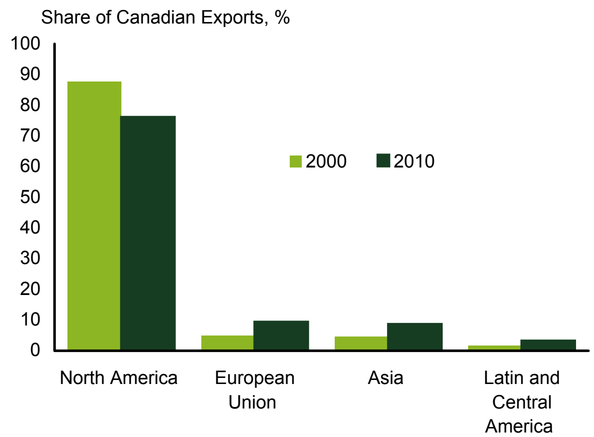
CHART 2: CANADA'S INTERNATIONAL TRADE



Source: Statistics Canada

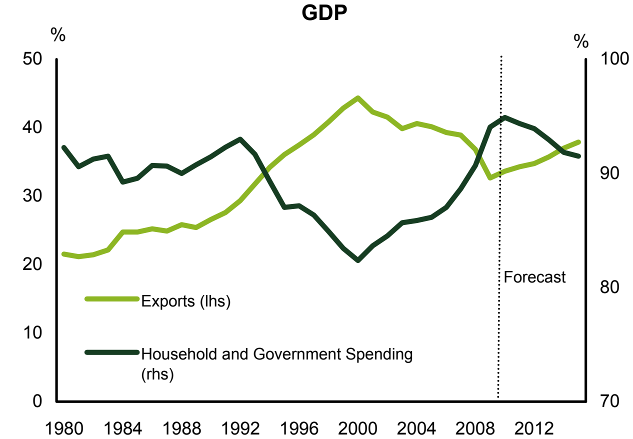
Meanwhile, the U.S. has signed a number of Free Trade agreements and U.S. manufacturers have responded to these pressures by lowering costs and becoming more competitive.

- Third, the 1990s marked a boom period for Canadian exports following the signing of the North American Free Trade Agreement. However, the 2000s not only witnessed diminishing returns to the trade agreement but a thickening in the Canada-U.S. border following 9/11.
- Fourth, more recently, the 2008/2009 recession took a large bite out of U.S. demand for Canadian imports, particularly for automotive and machinery and equipment products.
- Fifth, at the same time, Canadian exporters began to set their sights on the European Union and rapidly-growing emerging markets, which presented new opportunities especially for the nation's resource exporters. While export shares to these regions remain relatively small, this conceals the rapid annual average growth rates that have been recorded. While exports to the U.S. are down 14% from the peak in 2002, Canadian exports to China have more than doubled and exports to Europe are up 83%.
- Sixth, the declining share of U.S. exports in Canadian nominal GDP partly reflects the impact of a rapidly expanding denominator. For one, GDP has been driven up over the past decade by strong gains in commodity prices. In addition, low interest rates and a boom in Canadian government spending have spurred outsized growth in domestic spending, thus making U.S. exports look smaller in the overall count.

Shift to persist over the long term

In the short-term, we expect a slight bounce back in Canada's economic reliance on the U.S. as the economy records a cyclical rebound in economic growth and Canada's fatigued domestic sector records markedly slower growth. However, over the longer haul, we anticipate that the U.S. share of Canadian exports will continue its recent descent. This is because many of the factors cited above are structural in nature. Notably, the high Canadian dollar and the increased competitiveness in the U.S. marketplace are likely to continue to weigh on the success of Canadian exporters in the U.S. market. At the same time, exporters will continue to expand trade ties to non-U.S. markets. With respect to trade diversification away from the U.S., the ball has already been set in motion. Since 2009, Canadian officials have signed or brought into force six free trade agreements and are currently negotiating 14 free trade agreements. The largest trade agreement currently under negotiation is one with the European Union, with talks expected to conclude in 2012. Moreover, over the longer term, more and more of global demand will increasingly be driven by emerging markets, which should reap benefits for the Canadian export sector. Indeed, over the next 10 years, annual U.S. real GDP growth is expected to average 2-2.5%, compared to rates of 6-7% in emerging markets. On the plus side, efforts to secure a perimeter agreement between Canada and the U.S. could help to improve trade flows between the two countries, albeit unlikely enough to reverse the downward trend.

CHART 3: COMPOSITION OF CANADIAN REAL GDP



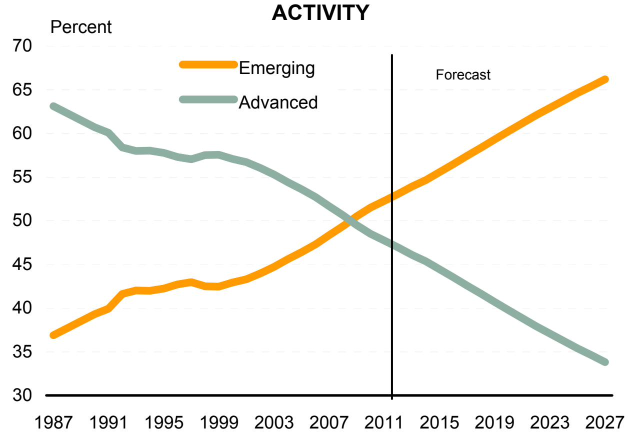
Source: Statistics Canada. Haver Analytics . F. by TD Economics as of December 2011

Table 1: Canada's Reliance on Trade							
	Canadian Exports to the U.S.			Canadian Exports to Non-U.S. Countries			Total Canadian Exports
	% of Total Exports	% of GDP	% Contribution to GDP Growth	% of Total Exports	% of GDP	% Contribution to GDP Growth	Total Exports as a % of GDP
2000 peak	84.2	34.4	5.8	15.7	6.4	0.6	40.8
2011	72.6	19.1	2.0	27.4	7.2	1.1	26.3
2015	71.7	21.0	1.3	28.3	8.3	0.8	29.2
2020	66.9	19.4	0.6	33.1	9.6	0.8	29.0

Source: Statistics Canada, Haver Analytics, F. by TD Economics as of January 2012

Table 1 includes long-term projections of Canada's direct reliance on trade with the U.S. and non-U.S. destinations. Our U.S. economic forecast is consistent with Canadian exports to the U.S. growing by an average of 7.5% over 2012 to 2015 and then decelerating to a more modest pace of 3.5% thereafter. Meanwhile, exports to other countries are expected to grow by a stronger 8% per year over the next decade, which is largely consistent with the growth rate experienced in the past. Growth in exports to other non-U.S. economies could prove stronger given the scope of the potential free trade agreements in place. A joint study by the European Commission and the Government of Canada estimated that once signed and sealed, the European Free Trade Agreement alone may increase Canadian exports to Europe by 20% by 2014. Based on these projections, the share of Canadian exports destined to the U.S. is expected to fall below 70% by 2020. A combination of slowing U.S. demand and less trade reliance on the U.S. implies that the economic contribution from U.S. exports will likely fall back to an average of 0.7 percentage points by 2020, a third of the contribution at the height of the Canada-U.S. trade relationship during the 1980's and 1990's. In contrast, the economic contribution from non-U.S. exports will average 0.8%, up from an average of 0.3% per year over the last three decades. The rising importance of emerging market demand will keep the share of exports in overall Canadian GDP at a healthy 30% over the long-term forecast.

CHART 4: SHARE OF GLOBAL ECONOMIC ACTIVITY



Forecast by TD Economics as at December 2011
Source: IMF, TD Economics

Implications

Make no mistake – Canada's economic well being remains closely tied to developments in the U.S. economy. However, the world economy is fundamentally shifting. Whereas emerging markets were one-third of global demand two decades ago, they are now over 50% of global output, with that share expected to increase to two-thirds over the next two decades. This changing pattern in global demand will impact Canadian export opportunities. Canada's economic prosperity will increasingly be driven by international events outside of North America. This means that businesses will need to pay attention to global currencies other than the U.S. greenback. Canadian policy makers will have to continue to strengthen trade ties with non-U.S. economies.

Table 2: Canadian Composition of Exports by Region in 2010 % of Total Exports to Each Region							
	Resouces		Manufacturing				Utilities
	Total Resources	Non-Energy Resources	Total Manufacturing	Machinery And Equipment	Transport Equipment	Other manufact uring	Total
Asia	42	17	55	5	2	48	3
European Union	45	6	54	6	11	36	1
Latin America	34	18	64	13	11	40	2
North America	28	2	67	5	19	44	5
All Countries	30	5	65	5	16	44	4

Source: Statistics Canada

In addition, the changing world order will likely create a sectoral shift in the Canadian economy. Exports to the U.S. are predominately higher value added manufactured goods such as automotives and machinery and equipment, whereas exports to emerging economies are more heavily made up of resources (see table 2). Indeed, Canada's competitive advantage lies in the resource sector since the economy is rich in resources. As such, commodities are on track to become even more important drivers of Canadian economic growth, likely at the expense of manufactured goods.

The shifting world order will also likely bring many challenges for Canadian exporters. While demand from other non-U.S. economies has ramped up over the last decade, Canadian exports in volumes terms have not increased since 1999. In part, the weakness in real exports can likely be chalked up to Canada's poor productivity performance eroding competitiveness in global markets. Looking forward, Canadian businesses are going to have to become more cost competitive in order to compete on the global stage.

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