

Canadian Trade Review

A Quarterly Review of Canada's Trade Performance

Second Quarter 2003

This quarterly review reports on Canada's economic growth in the second quarter of 2003, and highlights our trade and investment performance in key sectors and markets.

Canadian Economy Contracts in Second Quarter

The impacts of SARS, mad cow disease (bovine spongiform encephalopathy or BSE) and a stronger dollar rippled through the economy in the second quarter of 2003, as Canadian economic activity contracted for the first time in six quarters. Real gross domestic product (GDP) registered a 0.3% (annualized)¹ decline. Much of the weakness came in April at the height of the SARS outbreak. The economy posted small gains in May and June.

Canada's economy had grown faster than the U.S. economy for the preceding two quarters. This quarter, in contrast, preliminary estimates indicate that U.S. GDP expanded 3.1%.

A slowdown in inventory investment held the Canadian economy back in the April to June period, as wholesalers and retailers built up inventories at a slower pace. More than half of this slowdown was due to motor vehicle inventories. On the other hand, consumer spending and business investment continued to support the economy, although at slower rates than in the previous quarter. Spending on services accounted for three quarters of the increase in consumer spending, while strong demand for housing and renovation activity drove business investment.

The export sector was hit by a series of blows (lower energy prices, soft demand in the automotive and other transportation equipment sectors, BSE, and the impact of a rising dollar) and experienced a sharp downturn, falling 17.9% in current dollar terms, compared with a slight increase the previous quarter. Imports of goods and services were off by a comparable rate, declining 16.7% for the quarter.

The current account balance also worsened in the second quarter, largely as a result of the deterioration of the trade balance.

Table 1: Canada's Economic and Trade Indicators

Percent Change at Annual Rates Second Quarter 2003 over First Quarter 2002	
Real GDP (<i>annualized</i>)	-0.3
Employment (<i>quarterly increase, level</i>)	17,000
Rate of Unemployment (<i>quarterly average</i>)	7.7
Consumer Price Index (<i>second quarter 2003 over second quarter 2002</i>)	
All Items	2.8
Core (<i>excludes food and energy</i>)	2.2
Canadian \$ in U.S. funds (<i>average for quarter, level</i>)	0.7158
Exports of Goods and Services (<i>annualized, current dollars</i>)	-17.9
Imports of Goods and Services (<i>annualized, current dollars</i>)	-16.7

Source: Statistics Canada

Job creation continued, with a net quarterly increase of some 17,000 jobs. The gains came from part-time positions, as full-time positions declined by 3,500. Despite the overall gains in employment, the average unemployment rate jumped to 7.7% from the 7.4% registered in the first quarter.

Inflation tumbled, falling to 2.8% from 4.5% the previous quarter. Likewise, core inflation dropped in the second quarter—from 3.1% to 2.2%.

The Canadian dollar appreciated 8.0% against the American dollar in the second quarter, marking the largest quarterly exchange rate shift in over a half century. The average value of the loonie for the quarter was US\$71.58.

¹ To make quarterly data comparable to annual data, the quarterly figures for trade in goods and services are adjusted for seasonality and are expressed at annual rates by raising them four times, i.e. seasonally adjusted annual rates - s.a.a.r. All figures, with the exception of investment figures, are expressed on an s.a.a.r. basis, unless otherwise noted.



Trade and Investment Highlights

Goods Exports Reach Their Lowest Level Since the End of 2001

Exports of Canadian goods and services declined 17.9% in the second quarter (Figure 1). Merchandise exports fell to their lowest level since the fourth quarter of 2001. Their 18.3% slide was accompanied by a 15.1% decline in services exports. Imports of goods and services fell 16.7%, reflecting a 17.6% decline in commodity imports and a 12.2% drop in services imports. Hit by falling energy prices, energy exports declined by more than 50% compared with the previous quarter, when energy prices were on the rise (Figure 2). Exports of agricultural products, hampered by the discovery of BSE in a single animal, declined 23.1%. Exports of automotive parts were at their lowest level since the first quarter of 2001, while exports of forestry products slumped to their lowest level in more than 10 years.

Reduced imports of aircraft and parts as well as of automotive products were the main contributing factors in the decline in merchandise imports. Merchandise exports to the United States fell by 18.5%, or \$17.5 billion, in the quarter. All major markets, with the exception of "other OECD countries" (other than the U.S., the EU and Japan), experienced a decline in goods exports. Merchandise imports from the U.S. also fell substantially, down 19.5% or \$13.3 billion. Commodity imports from all other major markets—with the exception of Japan—declined.

With goods exports declining faster than imports, the merchandise trade balance narrowed \$3.9 billion in the quarter to \$59.2 billion. A \$4.2 billion decline in the merchandise trade balance with the U.S. and a \$1.2 billion reduction in the balance with Japan were only partially offset by improvements in the goods trade balance with the EU and other OECD countries.

Both Exports and Imports of Services Decline

Services exports fell 15.1% in the second quarter, primarily due to declines in travel (down 46.8% or \$2.3 billion). A number of factors contributed to the reduction in travel and travel spending, including the war in Iraq and concerns about SARS (Figure 3). Exports of transport services were also down—by 24.0% or \$928 million—as a result of reduced levels of trade. The declines were limited by increased exports of commercial services (up 9.6% or \$684 million).

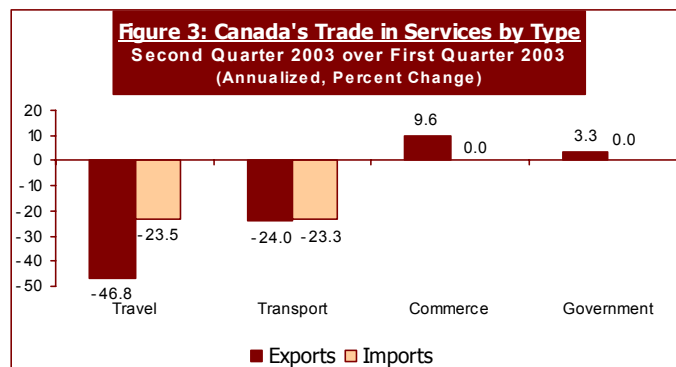
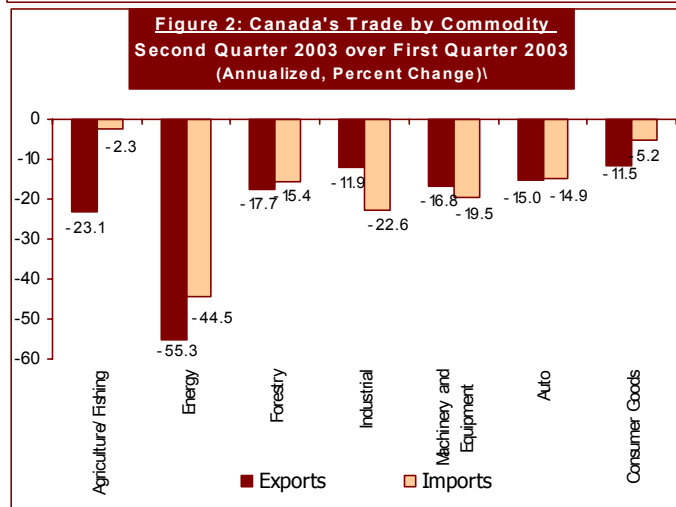
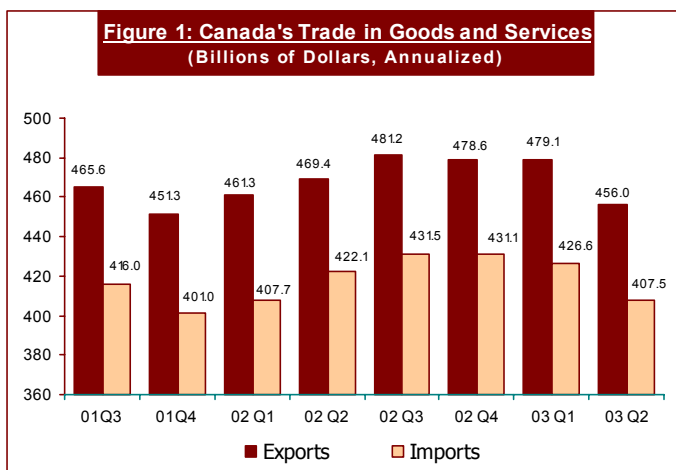
Services imports also fell in the second quarter. But at 12.2%, the decline in services imports was somewhat slower than the rate of decline in services exports. Like services exports, the declines in services imports were concentrated in travel services (down 23.5% or \$1.2 billion) and transport services (down 23.3% or \$928 million), whereas imports of commercial and government services remained at levels comparable to the previous quarter.

Because services exports declined at a somewhat more rapid rate than services imports, the services trade balance widened slightly to \$10.7 billion in the second quarter from \$10.6 billion in the previous quarter.

Inward Investment Flows Exceed Outward Flows

Canadian direct investment abroad (CDIA) was \$2.8 billion in the second quarter of 2003—down from the \$8.7 billion recorded in the second quarter in 2002. All sectors experienced a downturn in CDIA, with the exception of a small increase for the service & retail sector. Declines were particularly pronounced in the energy and finance & insurance sectors. Regionally, the declines were concentrated in the EU (down \$5.0 billion) and non-OECD countries (down \$0.7 billion). CDIA into the U.S. was down only marginally.

Foreign direct investment (FDI) flows into Canada amounted to \$5.1 billion in the second quarter of 2003—down from \$7.3 billion in the same quarter a year earlier. Most of the decrease in FDI flows occurred in the energy (down \$1.4 billion) and service & retail (down \$1.0 billion) sectors, while the machinery & transport sector registered a \$0.8 billion increase.



Source: Statistics Canada

The reductions stemmed primarily from declines in FDI from the EU (down \$1.4 billion), the U.S. (down \$0.4 billion) and Japan (down \$0.3 billion). Overall, inward flows exceeded outward flows by \$2.3 billion in the second quarter, a reversal of the situation in the same quarter the previous year when CDIA exceeded FDI by \$1.4 billion.

Canada Draws Down on Its Official International Reserves

Canada reduced its official reserves of assets in the second quarter of 2003 by \$0.2 billion, compared with a \$1.5 billion increase in the same quarter in 2002.

Economic Changes in U.S. Regions Between 1989 and 2001

Canada shares geographical proximity, a largely integrated production system and a comprehensive free trade agreement with the United States. These factors, coupled with strong U.S. demand for Canadian exports, have worked in favour of Canada selling relatively more and more of its output to the United States. However, U.S. demand for Canadian products differs from region to region and has been evolving over time. For example, an earlier feature article in the *Review* (Third Quarter, 2002) showed that increasing shares of Canadian exports were going to the U.S. West and South, at the expense of exports to the Northeast and Midwest. Regional and state disparities in economic growth and prosperity might be one explanation for these shifting trade patterns.

This special feature analyzes economic changes in U.S. regions between 1989 and 2001, the latest year for which data on gross state product (GSP) are available.¹ Table 1 provides an overview of the average annual growth rates in GSP, arranged by subregional and regional classifications. For the United States as a whole, GDP grew at an annual average rate of 3.0% over the period.

The data in Table 1 reveal considerable differences in growth rates over the past decade or so, even at the subregional level. For example, the state with the highest growth rate (6.0%) over 1989-2001 was Nevada, in the Far West subregion. Alaska, in the same subregion, experienced the lowest rate of growth. GSP in Alaska was actually shrinking by an average 1.1% over the period.

If we use a standard of ± 2 percentage points from the national average growth rate to designate well performing and poor performing states, then well performing states would include Nevada, Oregon, Arizona, Idaho, New Mexico,

Colorado and Utah, while poor performing states would be restricted to the District of Columbia, Hawaii and, of course, Alaska.

The remainder of this special feature will concentrate on the regional and subregional levels to complement the findings published in the earlier *Review* article.

Average Annual Growth by Region

Of the four principal, or macro, U.S. regions, real regional state product² was led by the South and the West, which at 3.6% and 3.4%, respectively, registered growth rates exceeding the national average (Table 1). On the other hand, the rates for

Table 1: Average Annual Growth in Real Gross State Product (chain index 1996=100), 1989-2001

	<i>Average Annual Growth</i> 1989-2001	<i>Difference from National Average</i>		<i>Average Annual Growth</i> 1989-2001	<i>Difference from National Average</i>
UNITED STATES of AMERICA	3.0%	N/A	SOUTH REGION	3.6%	0.6%
NORTHEAST REGION	2.3%	-0.7%	<i>Southeast Subregion</i>		
<i>New England Subregion</i>			Alabama (AL)	2.6%	-0.4%
Connecticut (CT)	2.2%	-0.8%	Arkansas (AR)	3.2%	0.2%
Maine (ME)	1.6%	-1.4%	Florida (FL)	3.4%	0.4%
Massachusetts (MA)	2.7%	-0.3%	Georgia (GA)	4.4%	1.4%
New Hampshire (NH)	3.9%	0.9%	Kentucky (KY)	3.0%	0.0%
Rhode Island (RI)	2.2%	-0.8%	Louisiana (LA)	1.5%	-1.5%
Vermont (VT)	2.5%	-0.5%	Mississippi (MS)	2.7%	-0.3%
<i>Mideast Subregion</i>			North Carolina (NC)	3.5%	0.5%
Delaware (DE)	3.2%	0.2%	South Carolina (SC)	3.1%	0.1%
District of Columbia (DC)	0.9%	-2.1%	Tennessee (TN)	3.5%	0.5%
Maryland (MD)	2.1%	-0.9%	Virginia (VA)	2.8%	-0.2%
New Jersey (NJ)	2.3%	-0.7%	West Virginia (WV)	1.8%	-1.2%
New York (NY)	2.2%	-0.8%	<i>Southwest Subregion</i>		
Pennsylvania (PA)	2.2%	-0.8%	Arizona (AZ)	5.8%	2.8%
MIDWEST REGION	2.8%	-0.2%	New Mexico (NM)	5.5%	2.5%
<i>Great Lakes Subregion</i>			Oklahoma (OK)	2.3%	-0.7%
Illinois (IL)	2.9%	-0.1%	Texas (TX)	4.2%	1.2%
Indiana (IN)	2.9%	-0.1%	WEST REGION	3.4%	0.4%
Michigan (MI)	2.2%	-0.8%	<i>Rocky Mountain Subregion</i>		
Ohio (OH)	2.4%	-0.6%	Colorado (CO)	5.4%	2.4%
Wisconsin (WI)	3.3%	0.3%	Idaho (ID)	5.5%	2.5%
<i>Plains Subregion</i>			Montana (MT)	2.6%	-0.4%
Iowa (IA)	2.9%	-0.1%	Utah (UT)	5.3%	2.3%
Kansas (KS)	2.7%	-0.3%	Wyoming (WY)	2.5%	-0.5%
Minnesota (MN)	3.5%	0.5%	<i>Far West Subregion</i>		
Missouri (MO)	2.5%	-0.5%	Alaska (AK)	-1.1%	-4.1%
Nebraska (NE)	3.1%	0.1%	California (CA)	2.9%	-0.1%
North Dakota (ND)	2.8%	-0.2%	Hawaii (HI)	0.8%	-2.2%
South Dakota (SD)	4.0%	1.0%	Nevada (NV)	6.0%	3.0%
			Oregon (OR)	5.8%	2.8%
			Washington (WA)	3.9%	0.9%

Source: Real gross state product (GSP), Bureau of Economic Analysis, U.S. Department of Commerce, May 2003

1 All data are from the U.S. Bureau of Economic Analysis and refer to real GSP (i.e. nominal GSP deflated by a chained price index with 1996 = 100). Gross state product is similar to the concept of state gross domestic product on the income side except that it does not incorporate income and compensation paid to military and government personnel stationed outside the country.

2 The sum of individual real gross state products.

the Midwest (2.8%) and the Northeast (2.3%) trailed behind the national average.

Within the South, growth was led by the Southwest subregion, which includes the states of Arizona and New Mexico. The Southeast subregion also managed growth in excess of the national average.

At 5.0%, the Rocky Mountain subregion recorded the strongest rate of growth of all subregions over the 1989-2001 period. This subregion includes the fast growing states of Idaho, Colorado and Utah. The Far West subregion comprises the other half of the U.S. West. This subregion contains the most diverse states in terms of GSP growth because it includes Alaska (actually shrinking) and Hawaii (below the national average) as well as Nevada (the fastest growing) and Oregon (tied for second fastest state GSP growth). This subregion managed a 3.1% rate of growth over the period under review.

The Great Lakes subregion and the Plains subregion make up the U.S. Midwest. The Plains subregion managed growth at the national average, led by South Dakota and Minnesota. Growth in the Great Lakes subregion came in below the national average, as only Wisconsin managed growth above 3.0%.

The Northeast was the slowest growing of the four macro regions, at an average 2.3% over 1989-2001. Average growth in both the New England subregion and the Mideast subregion came in below the national average at 2.5% and 2.2%, respectively. Slower growth was widespread among the states of this region, as only New Hampshire (3.9%) and Delaware (3.2%) managed to expand at rates above the national average.

Shift Share Analysis of Regional Growth

Shift share analysis has been used to examine sources of regional economic change over the 1989 to 2001 period. This methodology gives a description of regional economic change that is attributable to growth in the national economy, the industrial mix of the region and the competitiveness of the local industries. The results are shown in Table 2.

The national share component measures the regional economic change that could have occurred if the region had grown at the same rate as the national economy. It is expected that if the nation as a whole is growing, this growth will have a positive influence on the local area (a rising tide lifts all boats).

The industrial mix component measures the share of regional economic change that can be attributed to the regional industry mix and thus reflects the degree to which the region specializes in industries that are fast or slow growing nationally. In other words, if a region contains a relatively large share of industries that are growing fast nationally, then it will experience a positive industry mix effect.

Finally, the third component measures the change in a particular industry in the region due to the difference between the industry's regional growth rate (or rate of decline) and the industry's national growth rate. Some regions and some industries generally grow faster than others, even during times of overall prosperity. This is usually attributed to some local comparative advantage. Thus, the regional share component indicates growth or decline in industries due to the region's competitive position in a given industry.

A comparison of the national share between regions places all regions and subregions on an equal footing. Thus, the substantive regional differences are to be found in the other two components. The industry mixes of the New England and Great Lakes subregions show strong positive results, indicating that their regional industrial composition is tilted toward particularly fast growing industries. This observation also holds true (but is less pronounced) for the Plains, Mideast and Far West subregions. Overall, with the exception of the U.S. South, the industrial mixes of the Midwest, Northeast and West regions have contributed positively to real state product growth over 1989-2001.

On the other hand, the competitive or regional component of the Northeast and Midwest regions and their corresponding subregions are all negative, meaning that their competitive positions have deteriorated relative to the national average and have acted as a drag on total regional growth. Conversely, the competitive positions of the West and South, especially the Rocky Mountain and Southwest subregions, have improved against the national average, boosting regional growth.

In sum, the slower expanding Northeast and Midwest benefit from an advantage in their industrial mixes (i.e. they both contain a larger share of faster growing industries than the national average), but these advantages were more than offset by declines in their competitive positions (regional share components) over the 1989-2001 period.

For example, the U.S. auto industry—traditionally centred in the Midwest region—has experienced regional diversification, as new manufacturing plants (particularly those of non-U.S. manufacturers) have increasingly located in the U.S. South. Similarly, key components of the U.S. electronics industry have largely been concentrated in the South and West regions (e.g. Silicon Valley and the Austin hi-tech hub). Such shifts to the South and West in the distribution of U.S. economic activity likely explain the shift in the pattern of Canadian exports to the United States.

Table 2: Shift Share Analysis of Growth in Real Regional Gross State Product

	National Share	Industry Mix	Regional Share	Total Growth 1989-2001
UNITED STATES of AMERICA				42.8%
NORTHEAST REGION	42.9%	1.2%	-12.7%	31.5%
New England Subregion	42.9%	4.1%	-11.3%	35.7%
Mideast Subregion	42.9%	0.4%	-13.1%	30.2%
MIDWEST REGION	43.0%	3.0%	-7.1%	38.9%
Great Lakes Subregion	43.1%	3.4%	-9.0%	37.5%
Plains Subregion	42.9%	1.9%	-2.4%	42.4%
SOUTH REGION	43.0%	-1.5%	11.9%	53.5%
Southeast Subregion	42.9%	-1.7%	6.4%	47.6%
Southwest Subregion	43.4%	-1.0%	24.3%	66.7%
WEST REGION	43.1%	0.2%	6.8%	50.1%
Rocky Mountain Subregion	43.1%	-0.9%	36.8%	79.0%
Far West Subregion	43.1%	0.3%	2.6%	46.0%

Source: Real gross state product (GSP), Bureau of Economic Analysis, U.S. Department of Commerce, May 2003