Is Canada's economy really dependent on global trade?

KEVIN CARMICHAEL

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Currency traders love the monthly import and export data, which provide an excellent guide of how much demand exists for dollars, euros, yen, francs and the like.

But for anyone seeking a more precise understanding of the dynamics of international trade, the data compiled by customs agents are about as about as relevant to a modern economy as carbon paper.

The reason: supply chains. Virtually nothing is produced entirely within a single border anymore. Companies outsource everything from components to packaging. That means a good can cross a border several times on its way to becoming a final product. Each time, it's value increases. That value is what the customs agent enters in his or her computer. But that inflates the actual contribution of that good to a country's economy.

It is relatively early days, but some economists are trying to develop a more useful measure of international trade. Among them is the Conference Board of Canada, which Thursday released the first of three reports based on what it calls "value-added trade." The report should be required reading in Ottawa. Its conclusions challenge much of what we think we know about the nature of Canada's economy.

Conference Board economist Maxim Armstrong explains the concept this way: "Conventional trade measures record the value of a good or service when it crosses the border. In contrast, value-added trade measures would record only the amount by which a good or service has increased in value while passing through a specific country."

This is no easy thing. There are no items branded "Made 40 per cent in the USA, 30 per cent in Canada, and 30 per cent in China." The Global Trade and Analysis Project at Purdue University has created a database of input-output tables for the global economy. Input-output tables track the flow of goods and services as they pass through the value chain from raw materials to finished products. This data is compared with conventional trade data to estimate the import content of exports. The difference is the actual value derived in a particular country. (Mr. Armstrong recommends reading "Who Produces for Whom in the World Economy" for a thorough understanding of the concept, although his own explanation in the Conference Board paper is very lucid.)

Any interpretation of the Conference Board's results must be tempered by the limitations of the GTAP database, which is only current to 2004. The world has changed a lot since then. Still, in Mr. Armstrong's hands, the outline those data create of the Canadian economy is remarkably different from the one we think we know.

Canada is often described as a "small open economy" that is highly dependent on the vagaries of international trade. According to the Conference Board's value-added analysis, that may not be so.

The value of trade shrinks for all countries when measured in value-added terms. But for Canada, the difference is more pronounced because it is one of the world's bigger users of supply chains. Measured conventionally, trade represents 35 per cent of Canada's gross domestic product, 17th among the world's 30 largest trading nations, according to the Conference Board. Measured on a value-added basis, that figure drop to 24 per cent of GDP, which drops Canada's rank to 20th. That's hardly the measure of an economy dependent on trade. Mr. Armstrong offers that as an explanation for why Canada withstood the global recession better than many expected it would.

Canada’s reliance on trade with the U.S. is diminished in the Conference Board study. The U.S. remains Canada’s biggest trade partner, but it accounts for 62 per cent of exports, compared with 69 per cent when using conventional data.

The value-added method also puts a stronger emphasis on services because it attempts to break out what went into the unit value captured in customs data. The Conference Board report estimates that services account for 40 per cent of Canadian trade when measured on a value-added basis, compared with 16 per cent when calculated using traditional methods.

“A clear understanding of trade patterns is necessary to make informed political and business decisions,” Mr. Armstrong writes.

The Conference Board findings reinforce the Harper government’s push for a free-trade agreement with the European Union that emphasizes services. But they also call into question whether a stronger U.S. economy is all that’s keeping Canada from stronger economic growth. If Canada is only the world’s No. 20 trader, then it might be more reliant on domestic demand than we realize. Something for Finance Minister Jim Flaherty to consider as prepares for his next budget.