## Economic News

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## January 13, 2015

## CANADA

Deteriorating terms of trade: Canada will lose its economic edge over the United States

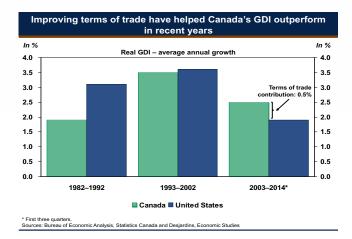
Gross domestic product (GDP) is the universally-recognized measure of economic progress but there are alternative measures of progress, some of which are more appropriate to the case of a small open economy like Canada. Real gross domestic income (GDI) is one of these metrics. In brief, the measure amounts to real GDP adjusted for the terms of trade<sup>1</sup>. The faster terms of trade improve, the faster gross domestic income, and in turn domestic purchasing power, grow.

The measure has gained some notoriety in Canada prior to the crisis, amid the run-up in oil prices, given their incidence on the terms of trade. From averaging 1.9% between 1982 and 1992, Canada's real GDI growth accelerated to an average of 3.5% between 1993 and 2002, to then decelerate to 2.5% between 2003 and 2014.

Importantly, before 2002, real GDI growth was essentially equivalent to real GDP. That is, the terms of trade contribution was nearly inexistent. From 1982 to 2002, the price of crude oil kept in a relatively tight range around US\$20 and had relatively little influence on the evolution of the terms of trade.

It then rose steadily to reach an average of US\$93 from the beginning of 2010, up until September 2014. By virtue of this effect, and with oil taking a larger portion of Canadian exports, Canada's terms of trade rose significantly, offering a non-trivial contribution to real GDI growth, to the point where it exceeded that of the United States during this period.

It follows that the deterioration in the terms of trade associated with the recent fall in oil prices will lead Canada's GDI to underperform against that of the United States,



which, as a net importer will enjoy the opposite effect. In its October *Monetary Policy Report*, the Bank of Canada (BoC) significantly revised its real GDI growth forecast lower for 2015. It is worth noting that the price of WTI (West Texas Intermediate) crude oil was at US\$82 when the BoC performed its last forecast, and that the BoC was then assuming oil prices to keep at this level through the horizon. It has instead shed over US\$35 and it would not be surprising to see the BoC further bring down its real GDI growth projection in the updated forecast it will present on January 21<sup>st</sup>.

**Implications:** Whereas the Federal Reserve looks steadfast on mid-2015 hikes, the risks posed by lower oil prices on the Canadian economy complicate the BoC's task somewhat.

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<sup>1</sup> The terms of trade are defined as the ratio of export prices to import prices.

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