Economic Viewpoint

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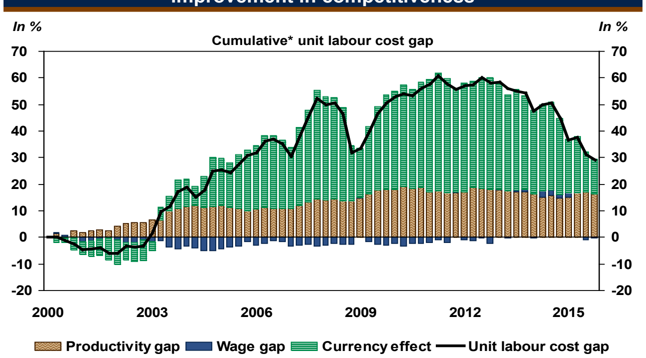
Servicing Canada's economic transition

The word "transition" often comes up in discussions of the economic environment in Canada. This will take getting used to because this transition will likely operate over several years. Taking advantage of the depreciation of the dollar, the external sector currently plays its expected role. However, in the longer term, Canada will not build on traditional sectors such as manufacturing, as was the case until the early 2000s. This being said, Canada has several comparative advantages that could make it a competitive force at a global level, in terms of exports of services. Once the indirect effects are taken into account, services play a non-negligible role in exports. However, Canada lags behind many developed countries, especially when it comes to putting high value-added services to the benefit of exports. This *Economic Viewpoint* provides a portrait of the situation. What comes clear is that in order to hope for a successful transition towards a more diversified and productive economy, the emphasis will need to be put on services.

The word "transition" often comes up in discussions of the economic environment in Canada. This will take getting used to because this transition will likely operate over several years. The story is well known: the terms of trade shock and an accommodative monetary policy have combined to cause significant currency depreciation. This currency boost has been widely counted on to revive the trade sector, whose contribution to growth was mediocre in the years preceding the shock. It occurs that the external sector has contributed positively to real GDP growth in each of the past three years. Moreover, the competitive lag Canada had accumulated against the United States during the 2000s has been greatly reduced, largely due to the currency (graph 1).

Graph 1 – The loonie's depreciation has led to some meaningful improvement in competitiveness



* Since 2000.
Sources: Statistics Canada, Bureau of Labor Statistics and Desjardins, Economic Studies

These are good news for the Canadian economy. At 1.2%, real GDP growth was certainly low in 2015, but without the contribution of the external sector, it would have been even more anemic. Consider that domestic demand grew by only 0.7% last year, weakest since 2009. This said, almost all of the export contribution of 2015 originated in exports of goods, which rose 3.7%, compared to an increase of only 0.9% for services.

CAN THIS HOLD?

The weak performance of services' exports is not without prompting some reflection about the sustainability of an economic shift to the non-energy exporting segments of the economy, absent some fundamental restructuration within these very segments. We make three observations. First, Canada is no longer the manufacturing powerhouse it once was, and it is doubtful that it will be again. While it is true that the weak dollar galvanizes the income of exporting manufacturers it also increases their import costs, particularly for machinery and equipment. Several surveys have shown that inflation in capital goods constitutes a barrier to investment in many sectors of manufacturing. Manufacturing businesses could thus be slow to expand their capacity.

Second, the decline of the Canadian manufacturing industry since the early 2000s is not only due to the appreciation of the currency during this period, but also to a large extent, to the competitive forces of globalization. Having long

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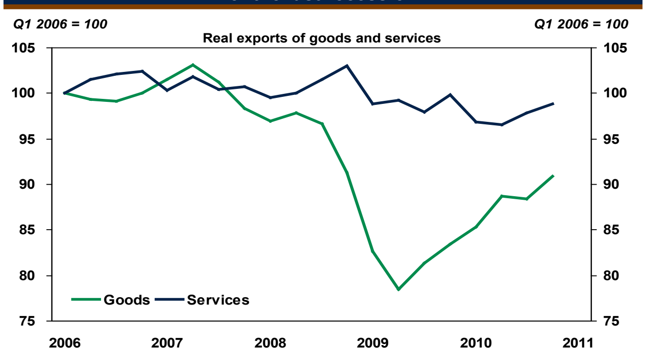
been outpaced by China in the U.S. market, Canada is now being overtaken by Mexico.[1] Manufacturing industries of emerging countries benefit from labour costs that Canada (like most developed countries) will never be able to match. It thus bears recognition that beyond the immediate benefit of the currency, several sectors tied to mass production will continue to shrink.

Third, we must keep in mind that the currency, one of the main variables favouring the export revival, is determined by financial markets. For instance, in a scenario of a sharp rise in oil prices to their levels of early 2014, a strengthening Canadian dollar would quickly eliminate the gain in competitiveness exporters have recently come to enjoy. This scenario certainly appears unlikely at present, but the recent financial market experience is testament to how volatility must not be underestimated.

SERVICES WILL NEED TO CONTRIBUTE MORE

With an economy that remains under the predicament of the weak energy prices, a shift towards sectors less vulnerable to erratic financial market variables would undoubtedly be welcome in the case of Canada. Note that compared to goods, services' exports are less volatile. This reality manifested during the last recession. While exports of goods were down 23% from their 2007 peak to the trough of 2009, the peak-to-trough decline in services was of only 6% (graph 2). The issue, one might argue, is that direct exports of services, as shown by Statistics Canada data on foreign trade, account for only 16% of nominal exports.

Graph 2 – Services' exports have better absorbed the shock of the last recession

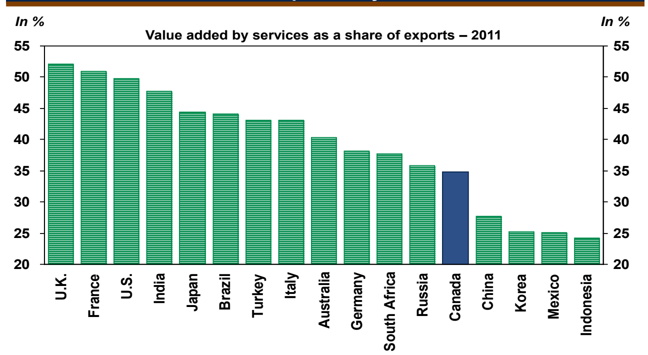


Sources: Statistics Canada and Desjardins, Economic Studies

However, this statistic tends to minimize the importance of services, since Statistics Canada data on international trade do not include the indirect contribution of services. Together with the World Trade Organization (WTO), the Organisation for Economic Cooperation and Development (OECD) has constructed a useful database on sources of value-added in exports.[2] These data reflect the services' portion of the value chain for exported products, regardless of the form taken by these exports. They reveal that as of 2011, the value added of Canadian services' industries accounted for about 35% of exports, a proportion that has been relatively stable since 1995.

The unfortunate news is that even by the concept of value added, the importance of services in Canada's exports is lower than elsewhere. For example, the value added by domestic services account for nearly 50% of U.S. exports. Even in a country like Australia, which shares some of Canada's attributes when it comes to commodity dominance in total exports, services account for 40% of export value added (graph 3).

Graph 3 – The value added of services in Canadian exports is comparatively low



Sources: Organisation for Economic Cooperation and Development, World Trade Organization and Desjardins, Economic Studies

THE IMPORTANCE OF ADVANCED SERVICES FOR THE FUTURE

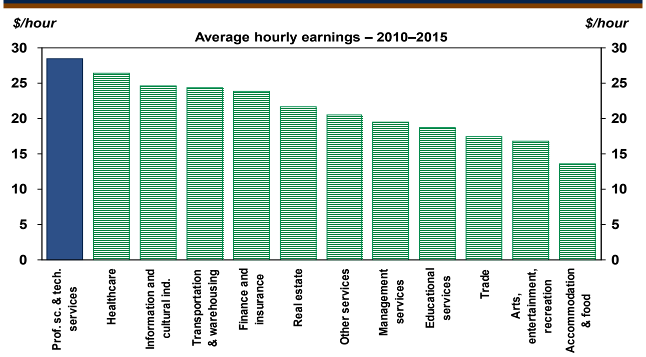
The composition of services' exports has important implications for productivity, a key determinant of long-term growth. For example, transportation services play an important role when it comes to foreign trade, but their productive footprint is rather low. Transportation generally employs a workforce with an intermediate skill level. According to the National Occupational Classification matrix, most occupations in the transport sector are level-B skill level jobs that require a college education or apprenticeship training. Productivity gains in transportation have been low in recent years. From 2005 to 2014, labour productivity growth was of only 0.2%, compared to 0.8% for the business sector as a whole.

[1] Desjardins, Economic Studies, *Economic News*, "Canada's share in U.S. imports shrinks", February 17, 2016, www.desjardins.com/ressources/pdf/nf160217-e.pdf?resVer=1455724733000.

[2] Database Trade in Value Added (TiVA).

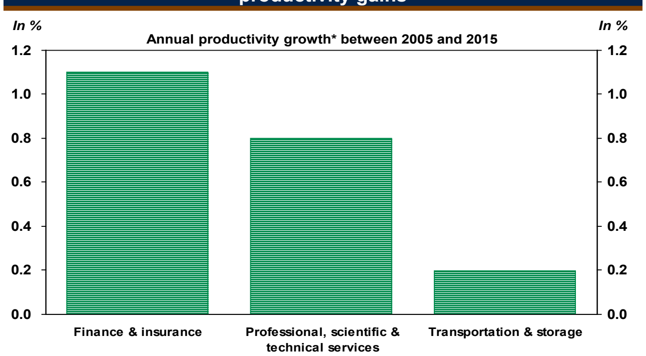
By contrast, high-value-added services are more readily found on the side of intellectual property, research and development, finance, or business strategy. The workforce skill is usually level-A (university degree). The salaries of workers who perform these functions tend to be above average. For instance, hourly earnings in professional, scientific and technical are the highest among private services (graph 4). Moreover, productivity growth has been faster in areas such as finance and professional services (graph 5).

Graph 4 – Wages are higher in professional services



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 5 – Commercial services generate superior productivity gains

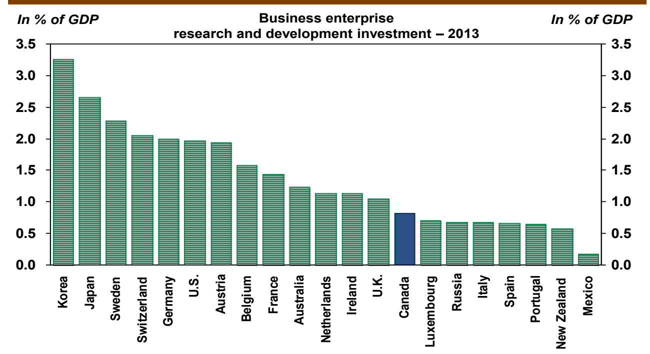


* Compounded rate.
Sources: Statistics Canada and Desjardins, Economic Studies

The commercial services' sector includes many of these advanced activities, and the relatively low footprint of this sector in Canadian exports, (see box on page 4), is a concern. It offers the suggestion that Canada is somewhat less dynamic than many countries when it comes to exporting its expertise abroad, whether directly or indirectly.

This can certainly not be blamed on a lack of resources. The Canadian workforce is among the most skilled in the world. Canada consistently ranks among the top five countries in terms of educational attainment. Three Canadian universities rank among the world's top 50.[3] Yet, these impressive strengths struggle to percolate to innovation and productivity gains. In particular, Canada has a pervasive lag in research and development at the enterprise level (graph 6). It goes without saying that improvements in these areas will be crucial in order to hope for some enhancement in the contribution of services to the trade sector, and more generally, to a more balanced, productive and resilient economy.

Graph 6 – Canadian firms less dynamic when it comes to research and development



Sources: Organisation for Economic Cooperation and Development and Desjardins, Economic Studies

CONCLUSION

Having long been comfortably enjoying the tailwinds of profitable natural resource extraction and a debt-fuelled real estate frenzy, the Canadian economy has reached a crossroads. However its comparative advantages no longer reside in the mass production of goods. Textbook industry lifecycle theory stipulates that when a manufacturing industry evolves to a more mature stage, competition heightens, pricing power erodes and profitability is determined by cost management. In this sense, with labour costs that are in some cases a fraction of those in Canada, manufacturers of emerging countries shall continue to increase their share of world manufacturing output.

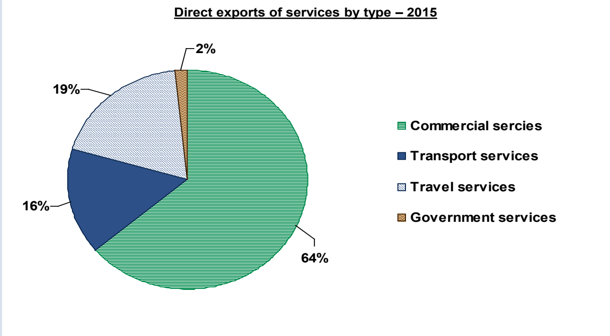
To be successful and sustained, the transition of the Canadian economy will need to operate through the channels of exports for which Canada has better comparative advantages. The quality of the labour pool, geographic and cultural proximity to a large market such as the United States, are just some of the Canadian advantages that will never be easily replicated by emerging countries. Services' industries, especially high value added advanced services, are a cornerstone in unlocking the full potential from such comparative advantages, but it does require

[3] As ranked by Times Higher Education, www.timeshighereducation.com/world-university-rankings/2016/world-ranking#!/page/0/length/25/country/91/sort_by/rank_label/sort_order/asc/cols/rank_only.

What services does Canada export?

According to Statistics Canada, commercial services account for nearly two thirds of the services that Canada exports directly (graph A). Although this is a fairly diversified sector of activity, the three largest categories of commercial services' exports, in order of importance, are management services, financial services and computer and information services. These three sectors account for over 45% of directly exported commercial services. For these firms, the networks of subsidiaries play an important role. About half of the exports of commercial services is carried out through subsidiaries abroad. Financial institutions are a prominent example, with several Canadian banks increasing their presence abroad recently, particularly in the United States. Travel and transportation services are the other two main categories of direct services' exports.

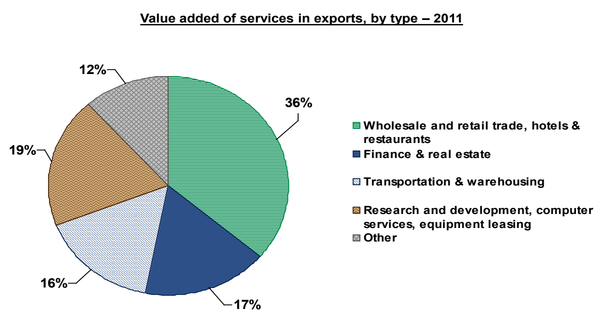
Graph A – Commercial services account for the vast majority of services directly exported



Sources: Statistics Canada and Desjardins, Economic Studies

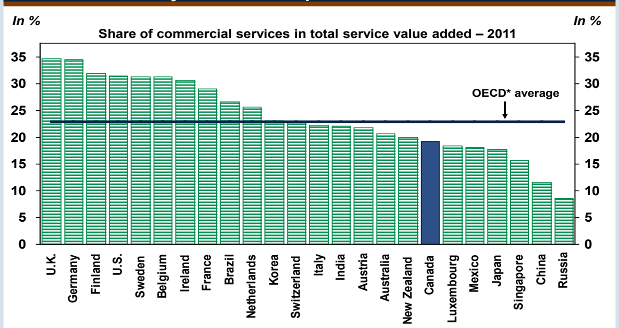
The picture changes when the concept of value added is introduced, to incorporate the indirect effects. According to the statistics of the OECD-WTO TiVA database, the contribution of services is much more diversified across different categories. In particular, the wholesale and retail trade sectors account for a value added of 36% in exports, while commercial services account for only 19% (graph B). In this regard, we note that Canada is in an unenviable position. Commercial services occupy a significantly lower share in terms of value added of services' exports compared to the average of OECD countries (graph C). As we discuss farther, commercial services encapsulate the high-value added activities that play a crucial role in innovation and productivity.

Graph B – Value added of services in exports



Sources: Statistics Canada and Desjardins, Economic Studies

Graph C – Commercial services occupy a small share of the value added by services compared to other countries



* Organisation for Economic Cooperation and Development and Desjardins.
Sources: Organisation for Economic Cooperation and Development, World Trade Organization and Desjardins, Economic Studies

that Canadian companies double down on their efforts to address persistent delays in innovation and productivity. It is not only the successful reorientation of the economy that relies on it, but also long-term growth. Let us not forget that with the population aging affecting the majority of developed countries, it is the productivity growth track record that will delineate the performing economies and the lagging ones.

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