



Briefing November 2012

What Might Canada's Future Exports Look Like?

At a Glance

- ◆ Rapid economic growth among Canada's trading partners will be the most critical factor affecting future Canadian export patterns, though Canada may hit capacity constraints.
- ◆ The Canada–U.S. exchange rate will remain a critical factor affecting decisions to export to the United States.
- ◆ Canadian businesses will continue to grow their exports to respond to demand in fast-growing markets.

OBJECTIVE

Canada is a small, open economy and depends crucially on global trade to generate economic growth. Unfortunately, the future growth path of the world economy is highly uncertain. The mere survival of the euro is at stake because of the sovereign debt crisis in southern eurozone countries, while the United States is also dealing with its own debt problems and sluggish economic growth. Japan continues to experience weak economic growth and deflation, although it is gradually recovering from the devastating natural disasters that took place last year.

These ongoing economic difficulties experienced by Canada's major trading partners will have an impact on future exchange rate movements and real GDP growth. If countries such as Greece, and possibly even Spain

and Italy, are eventually forced to leave the eurozone, the economic ramifications of the split could have a major effect on Canada's exports to Europe. A failure of the U.S. federal government to come to grips with its deficits and debt would lead to the Canadian dollar trading well above par vis-à-vis the U.S. dollar; this development would hurt Canada's export growth in this key market.

There is also considerable uncertainty concerning economic growth in some of Canada's major trading partners over the long term. Some economists contend that the Chinese economy will continue to expand at close to a double-digit pace, while others predict that China is on the verge of experiencing a U.S.-style housing meltdown that will drive economic growth much lower. Similarly, economic growth in the European Union over the long term is fraught with risk, given ongoing concerns about the future of the euro and aging populations.

We provide long-term forecasts of exports to 2025, based on assumptions concerning exchange rate movements and real GDP growth among Canada's major trading partners.

The purpose of this research study is to examine the potential long-term growth path for Canadian exports to our major trading partners. We provide long-term forecasts of exports by major trading partner to 2025, based on various assumptions concerning future exchange rate movements and real GDP growth among Canada's major trading partners. Moreover, we examine the sensitivity of our forecasts to changes in real GDP growth or exchange rate levels, given the heightened uncertainty regarding the future path of the global economy.

METHODOLOGY

We followed these steps to examine Canada's future export growth under different exchange rate and economic growth assumptions for our largest trading partners.

DETERMINE EXPORT DRIVERS

We used empirical methods to determine, over history, what has driven Canada's real merchandise and service exports to our largest trading partners—namely, the United States, the United Kingdom, the eurozone, China, Brazil, Mexico, Japan, and India. These countries include Canada's traditional trading partners, such as the United States and the United Kingdom, as well as emerging markets, such as China and Brazil. And while exports to the latter countries are not as large as exports to the United States, they are growing rapidly. Service exports are included in the analysis to account for the fact that these exports, which include travel to Canada, may have drivers that differ from those driving demand for merchandise exports. It is important to note that service exports comprise an increasing share of Canada's total exports. Total exports to these seven countries and the eurozone account for over 90 per cent of Canada's exports.

We statistically estimated the coefficients in standard export demand equations to assess the importance of real GDP in the destination countries and the real¹ exchange rate in determining exports. These variables are considered the main drivers of export demand because they account for changes in economic activity in the destination countries and, thus, potential demand for our exports, as well as changes in the effective prices of these goods and services. Other independent variables, including variables to account for the severe 2008–09 recession and the entry of China into the World Trade Organization (WTO), were included in some of the equations. Appendix A contains the detailed estimation results for the equations.

FORECAST GDP GROWTH, EXCHANGE RATES, AND INFLATION

To predict Canada's merchandise and service exports to the seven countries and the eurozone in 2025, we developed forecasts of real GDP growth, exchange rates, and consumer price inflation for the destination countries and the eurozone. The rationale behind the forecasts is detailed in the next section.

1 The real exchange rate tracks changes in the nominal exchange rate and in the prices of goods and services in Canada relative to those in our trading partners.

The forecasts for the exchange rates involved a two-step process. Initially, we developed forecasts for the yen, pound, real, peso, rupee, yuan, and euro against the U.S. dollar. We then converted the projections to the Canadian dollar using the Conference Board's long-term forecast for the Canadian dollar versus the greenback.

PROJECT EXPORTS UNTIL 2025

We then used the equations for determining export drivers, in combination with the forecasts of the driver variables over the forecast period (2011–25), to project Canada's merchandise and service exports to the seven countries and the eurozone up to 2025.

ASSUMPTIONS

GDP FORECASTS

Table 1 shows the forecast long-term growth for the individual countries and the eurozone. Long-term economic growth is driven mainly by issues such as demographics, investment, and productivity. While the current crisis in the global economy has resulted in economic growth far below potential, especially in the eurozone, growth should rebound once the situation in Greece and other southern European countries starts to stabilize. Our assumption is that the eurozone will survive. Obviously, there are downside risks to this outlook, and Greece may be forced to leave the eurozone. In a later section of this report, we examine Canada's exports to the eurozone under a far bleaker scenario for GDP growth.

Table 1
Economic Growth in Developing Countries
Will Be Strong
(annual growth, per cent, 2015–25)

U.S.	2.5
U.K.	2.2
EU	1.6
Japan	1.1
Brazil	4.5
China	6.5
Mexico	3.7
India	7.0

Sources: The Conference Board of Canada; Consensus Economics.

The forecasts reveal the large differences between long-term economic growth in developed countries and that in emerging countries. The differences are mainly the result of weaker population growth, aging populations, and slower productivity growth in developed economies. Most of the developing economies we looked at have young and growing populations and strong increases in productivity.

In the United States, potential output was increasing at an annual pace of around 3.5 per cent before the 2008–09 recession. During the recession, potential output growth declined to the 2.5 per cent range. While the economy will recover, potential output growth will remain in the 2.5 per cent range, mainly because of slowing labour force growth. The labour force participation rate will fall over the long term due to three factors: the female participation rate is no longer rising, the teenage participation rate has been dropping, and the aging population will lead to a greater number of retirees. The overall participation rate, which was 64 per cent in 2011, will gradually decline to 60.3 per cent by 2035.

Table 1 reveals that long-term economic growth will be higher in the United States than in the eurozone, Japan, and the United Kingdom, despite the negative effect that high debt levels will have on economic growth in the United States over the long term. The population of the United States is not aging as quickly as that of these other countries, and this factor will affect growth in the labour force. The U.S. labour force was increasing at a 1 per cent pace prior to the severe recession of 2008–09; by comparison, labour force growth was declining in Japan. The labour force has also been growing more quickly in the United States than in the United Kingdom and the eurozone, and these trends will continue over the long term. The stronger growth in the U.S. economy also reflects the fact that this economy is more dynamic and productive than those in the eurozone, Japan, and the United Kingdom.

Productivity is another key factor in determining potential economic growth over the long term. Since 2000, U.S. labour productivity has been expanding by roughly 2 to 3 per cent annually, although growth dropped off sharply in 2011 as companies started to hire more workers after numerous layoffs during and after the 2008–09 recession.

The growth in U.S. labour productivity has been faster than in Japan, the United Kingdom, and the eurozone since 2000, and it will continue to expand at a faster pace over the long term.

The higher long-term growth in Brazil, India, and Mexico is a result of a younger population and a growing middle class in each country, and the fact that these countries have generally opened up their economies more to free market principles. This will result in higher productivity and potential economic growth. The labour force has expanded by over 2 per cent annually in Mexico and Brazil since 2000—much more quickly than the labour force has grown in developed countries, especially Japan. A similar trend in labour force growth has been present in India, although growth declined during the recession. Over the long term, the labour forces in these countries will continue to expand more quickly than those in the developed world, helping to generate stronger long-term economic growth.

It is interesting that China's strong growth in potential output over the long term (see Table 1) is not a result of booming growth in its labour force. Unlike the situation in other emerging markets in this analysis, growth in China's labour force has been closer to that in developed countries such as the United States, and growth will be weaker over the forecast period, in line with declining population growth and an aging population. China's population was increasing at an average annual pace of around 1 per cent in the 1990s; that growth will slow to 0.5 per cent per year over the long term. In fact, China is facing the same issue as developed countries, including Japan and Europe: its population is aging. That is partially a result of the government's one-child policy, designed to sharply slow down population growth in a country with a population of over 1.3 billion.

The main factor behind China's high potential growth over the long term is surging productivity. It has been increasing at a double-digit pace since 2000 and, while growth will slow over the long term, it will continue at a faster pace than growth in the other countries included in this analysis. China has experienced rapid gains in productivity over the past few decades, as its population

has shifted from rural areas to cities. That development has led to an increase in manufacturing jobs, which are more productive than jobs in the agriculture sector.

Long-term growth in China, estimated to be in the 6.5 per cent range, is one of the most contentious projections in this analysis, given the important role that China has in the fortunes of the global economy. Growth in China has weakened considerably from the double-digit growth that transpired throughout much of the 2000s and is currently in the 8 per cent range. The slower growth is, in part, due to the Chinese government's attempt to slow the red-hot property market in some of China's major cities. Also, as the Chinese economy matures and labour costs start to increase, the country's competitive position will weaken.

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The debate over China's economy centres on the degree to which long-term growth will decline. Some economists contend that China could be in store for a U.S.- or Japanese-style housing meltdown that would see economic growth tumble to the 3 to 4 per cent range. A housing bust would decrease bank lending, investment, and productivity growth over the long term. This factor, combined with China's sluggish population growth, would sharply reduce growth in China's potential output.

The assumption in this analysis is that China will experience a "soft landing," with economic growth in the 6.5 per cent range over the long term, as opposed to a "hard landing," where GDP growth tumbles to 3 to 4 per cent per year. While there is little doubt that housing prices are declining in many Chinese cities, a number of factors suggest that China is not about to experience a major housing market debacle. These include the following:

- ◆ One-third of homes in China are purchased with cash.
- ◆ Down payments average between 25 and 50 per cent.

- ◆ Mortgage loans comprise only 15 per cent of GDP, compared with 65 per cent in the U.S.
- ◆ Only 6 per cent of overall bank credit consists of lending to property developers.
- ◆ Banks are effectively state owned.
- ◆ Bank credit as a share of GDP is the same as it was in 2003.

The fact that the state effectively owns Chinese banks implies that the government can control bank lending and tighten or ease monetary conditions, depending on the state of the economy. This factor, combined with the relatively low level of mortgage debt for most Chinese households, suggests that the decline in property prices in China will not turn into a major setback for the economy that could harm long-term productivity and economic growth.

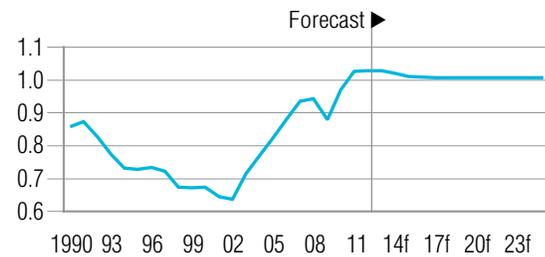
EXCHANGE RATE FORECASTS

The Canadian Dollar Versus the U.S. Dollar

Chart 1 shows that we expect the Canadian dollar to trade at or close to par with the U.S. dollar over the long term. The loonie was trading above par in the early part of this year. It subsequently depreciated as the eurozone crisis intensified and resulted in a flight to safety to the greenback. Recently, the Canadian dollar has traded well above par against the U.S. dollar, in line with rising energy prices. We contend that the loonie will continue to trade at close to par over the long term because of high commodity prices, particularly those for energy, and Canada's relatively strong fiscal position. Demand for energy from China and other emerging markets will continue over the long term, and this factor will ensure that oil prices remain well above US\$100 per barrel through 2025. Over the past decade or so, the Canadian dollar has been highly correlated with oil prices, due to the vast economic potential of Canada's oil sands in northern Alberta.

Also, the fact that inflation in Canada is expected to be lower than U.S. inflation over the long term should enable the loonie to trade close to or above par against the greenback. The Bank of Canada has a specific mandate to target inflation while the Federal Reserve does not, although recent rumblings from U.S. monetary authorities suggest that this policy could change in the future.

Chart 1
Canadian Dollar Will Keep Trading Near Par With U.S. Dollar (US\$/C\$)



f = forecast

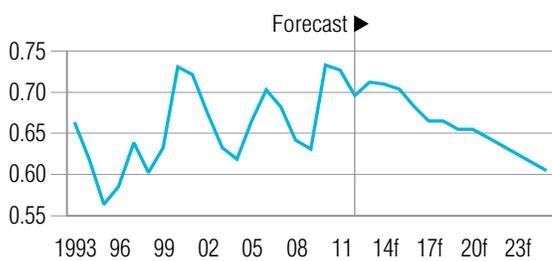
Sources: Bank of Canada; The Conference Board of Canada.

Given that the Canadian dollar has tracked oil prices closely over the past decade, the dollar could gradually appreciate above par against the greenback, as oil prices will increase over the long term. Our base case assumes that this will not transpire, as factors such as Canada's weaker productivity—in comparison with that of the United States—will persist over the forecast period, offsetting the impact of rising oil prices on the loonie. Later in this report, we look at the effect of the Canadian dollar trading well above par on Canada's exports to the United States.

The Canadian Dollar Versus the Euro and the British Pound

The euro has generally been depreciating against the Canadian dollar in the midst of the European debt crisis, just as the currency has continued to lose ground against most of the world's major currencies. (See Chart 2.) We assume that the crisis will gradually ease and that the heavily indebted countries will make progress in reforming their economies and lowering deficits and overall debt levels. While Greece may have to eventually leave the common currency, the remaining members will continue to use the euro. With the euro surviving and member countries gradually experiencing a revival in economic activity, the euro will gradually appreciate against the Canadian dollar over the long term. By 2025, the euro will trade at around €0.6 versus the loonie, appreciating from the current level of €0.75.

Chart 2
Euro Will Gradually Appreciate Against
Canadian Dollar
(€/C\$)



f = forecast

Sources: Bank of Canada; The Conference Board of Canada.

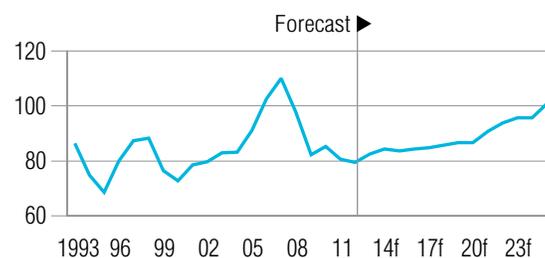
Obviously, given the precarious situation in the euro-zone, a far darker scenario could unfold that would see the euro depreciate sharply against the loonie over the long term or cease to exist at all. Our assumption is that Germany and France, the two most powerful eurozone members, will do everything within their means to ensure that the euro survives. It is important to realize that the euro was formed for political as well as economic reasons and, as a result, the forces that created the common currency will not give up easily.

The fortunes of the British pound have been tied closely to the euro recently and we assume that, as the euro strengthens against the Canadian dollar over the long term, the pound will appreciate as well.

The Canadian Dollar Versus the Japanese Yen

Interestingly, despite the recent serious problems with the Japanese economy, the yen has remained strong against the Canadian dollar. (See Chart 3.) Japan's huge debt-to-GDP ratio and its low interest rates would normally send a currency into a tailspin, but this hasn't been the case since the 2008–09 global recession. Foreign investors have viewed the yen as a safe haven, similar to the U.S. dollar, and have purchased the currency during heightened tensions in the global economy. The fact that Japan has generally run current account surpluses also offsets some of the negative news about the Japanese economy and encourages investors to purchase the currency.

Chart 3
Japanese Yen Will Start to Depreciate Against
Canadian Dollar
(¥/C\$)



f = forecast

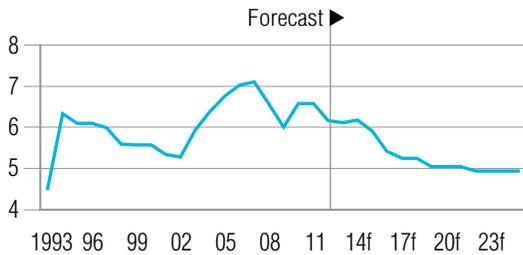
Sources: Bank of Canada; The Conference Board of Canada.

We do not expect this situation to persist over the long term. As the crisis in Europe eases, Japan will lose its appeal as a “flight to quality” currency and start to depreciate against the Canadian dollar. The Bank of Japan supports yen depreciation because it helps in the ongoing fight against deflation in the Japanese economy. Monetary authorities frequently intervene in global currency markets when the yen approaches ¥76 against the U.S. dollar. Through 2025, we expect the yen to depreciate against the Canadian dollar and reach ¥100.

The Canadian Dollar Versus the Chinese Yuan

Since 2005, the Bank of China has gradually permitted the yuan to appreciate against the U.S. dollar, and the yuan has also appreciated against the Canadian dollar. At the height of the 2008–09 recession, monetary authorities reversed course and let the yuan depreciate against the world's major currencies in order to boost Chinese exports, which faced slumping demand during the recession. Over the long term, we expect that the yuan will continue to appreciate against the Canadian dollar. (See Chart 4.) The currency will continue to face upward pressure due to the strong current account surpluses that China will run through 2025. Current account surpluses, combined with the fact that China will have to gradually change its growth model from one that favours exports and investment spending to a model more dependent on domestic demand, will ensure that the yuan appreciates. An appreciating currency encourages consumer spending, due to its moderating impact on the prices of imported goods and services. Also, the Chinese government will

Chart 4
Chinese Yuan Will Continue to Appreciate Against Canadian Dollar
(yuan/C\$)



f = forecast

Sources: Bank of Canada; The Conference Board of Canada.

remain under pressure to permit the yuan to appreciate to appease the U.S. Congress, which blames the weak value of the yuan for contributing to the chronic U.S. trade deficit with China.

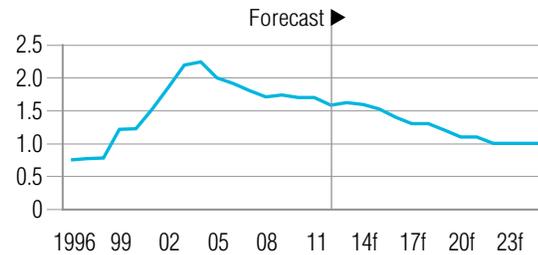
The Canadian Dollar Versus the Brazilian Real

The Canadian dollar appreciated sharply against the Brazilian currency, the real, in the late 1990s and early 2000s. Then the fortunes of the real started to change, in line with booming commodity prices and sounder macroeconomic fundamentals in the Brazilian economy. The Brazilian government has gradually put its fiscal house in order and brought inflation down to more manageable levels. Annual inflation in Brazil is expected to be around 5 per cent through 2025. In the 1980s and part of the 1990s, the difference between Canadian and Brazilian inflation rates was astronomical. Consumer prices in Canada increased by annual rates in the 4 per cent range, while Brazil experienced double- and even triple-digit inflation rates. Stable inflation has improved Brazil's prospects as a destination for foreign investment and put upward pressure on the currency. The discovery of offshore oil will also boost the fortunes of the real over the long term. We expect the real to gradually appreciate against the Canadian dollar over the forecast period. (See Chart 5.)

The Canadian Dollar Versus the Mexican Peso

The Mexican peso has generally followed the same path as the Brazilian real against the Canadian dollar. From the early 1990s until 2010, the peso depreciated against

Chart 5
Brazilian Real Will Gradually Appreciate Against Canadian Dollar
(real/C\$)



f = forecast

Sources: Bank of Canada; The Conference Board of Canada.

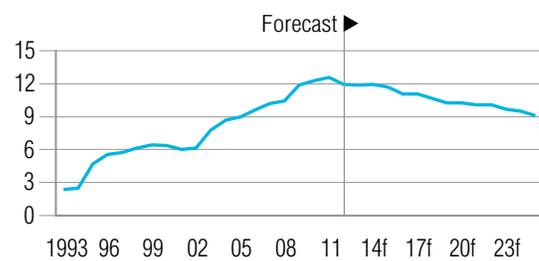
the loonie. The peso has generally been appreciating since 2011, although in recent months it has experienced some selling pressure. Over the long term, we forecast that the peso will slowly appreciate against the Canadian dollar, in line with improving macroeconomic fundamentals and stable inflation. (See Chart 6.) Also, Mexico is an oil exporter and oil prices are expected to increase over the forecast period.

The Brazilian government has gradually put its fiscal house in order, and stable inflation has improved Brazil's prospects as a destination for foreign investment.

The Canadian Dollar Versus the Indian Rupee

The rupee has been depreciating steadily against the Canadian dollar for over a decade. While the Indian economy has experienced solid economic growth for most of this period, inflows of foreign direct investment (FDI) have been declining, largely because successive governments in the country have failed to live up to their promises to loosen restrictions on FDI in key sectors of the economy, especially retail. The lack of FDI has put downward pressure on the rupee. We don't expect the rupee to reverse course and appreciate sharply against the Canadian dollar over the long term because it has proved difficult for Indian governments to implement badly needed reforms. However, some reforms will slowly

Chart 6
Mexican Peso Will Slowly Appreciate Against Canadian Dollar
 (peso/C\$)



f = forecast

Sources: Bank of Canada; The Conference Board of Canada.

move ahead and, as a result, the rupee will trade close to current levels vis-à-vis the loonie (around 50 rupees per Canadian dollar) over the forecast period.

DOES CANADA HAVE THE CAPACITY TO MEET FUTURE DEMAND IN EMERGING MARKETS?

One of the issues that will affect Canada's merchandise exports over the long term is Canadian supply constraints. If emerging markets continue to expand rapidly through 2025 and demand for Canada's raw materials soars, questions about the ability of Canada's economy to meet this demand will emerge. For instance, there are environmental and land claim issues surrounding the construction of a pipeline to Canada's west coast to supply oil to the Asia-Pacific region. Also, there are concerns about the capability of Canada's transportation infrastructure and ports to meet rising demand for raw materials.

It may take many years for Canada to build the capacity required to transport raw materials to foreign destinations. For instance, the production of mineral fuels in Canada was flat between 2002 and 2010, even though prices—especially for oil—surged over the decade. This suggests that impediments to production have hurt Canada's ability to meet global demand for this country's commodities. To account for this issue, we constrained the results from the equations to the growth in Canada's total exports from our long-term forecast, which is updated every autumn. We did this so that

export growth forecasts based on the model simulations would not reach levels by 2025 that would be unattainable, given supply-side constraints in Canada.

RESULTS

GENERAL RESULTS

With the exception of Brazil, the exchange rate is not a significant factor in explaining the changes in Canada's merchandise exports to emerging markets such as China and India. (See Table 2.) The exchange rate is a key factor in explaining Canada's exports to the United States, Japan (to a lesser extent), and the eurozone, but not in explaining exports to the United Kingdom. Given that the United States still accounts for over 75 per cent of Canada's exports, the exchange rate remains a critical factor in determining Canada's overall export performance, despite the fact that it is much less important in explaining exports to emerging markets.

The fact that the exchange rate is not a major determinant of growth in Canada's merchandise exports to most emerging markets is a result of changing patterns in Canada's global trade. In the early 2000s, Canada's exports of energy and mine products were close to 30 per cent of total merchandise exports. By 2011, this share had grown to over 50 per cent, mainly because of soaring demand for Canada's raw materials in developing countries such as China. Since many raw materials are priced in U.S. dollars, it is not surprising that the exchange rate is not a significant factor in explaining changes in Canada's merchandise exports to some developing countries. For such commodities, changes in the exchange rate have no impact on the price charged to our foreign customers and hence have no impact on our exports. The impact of changes in the exchange rate is seen only in the profits of Canadian producers. Also, China has been willing to purchase the raw materials required to keep its industrial machine growing regardless of the changes in relative prices attributable to movements in global exchange rates.

Other changes in global trade over the past few decades have also had an impact on the importance of the exchange rate in determining export flows. The rise of global supply chains, where components from many countries are used to produce manufactured products, especially automobiles,

has diminished the importance of exchange rate adjustments in explaining export flows. Components are required on tight deadlines, so changing prices resulting from exchange rate adjustments may not factor into a firm’s purchasing decisions, especially in the short term.

For all of the export equations for both merchandise and services, real GDP has the greatest influence on export flows. The analysis that follows focuses mainly on merchandise exports, since they comprise close to 90 per cent of total exports.

UNITED STATES

The exchange rate is a significant factor in explaining Canada’s merchandise exports to the United States, although it is not as important as real GDP. Chart 7 shows that from the mid-1990s to early 2000s, when the Canadian dollar was trading well below par with the greenback, merchandise exports to the United States expanded at a rapid pace. Then growth in merchandise exports stalled throughout much of the 2000s, in line with the rising value of the Canadian dollar. Export growth subsequently slumped considerably during the 2008–09 recession.

It wasn’t only the high value of the Canadian dollar that affected U.S. demand for Canada’s merchandise exports during the 2000s. There is little doubt that the high value of the Canadian dollar hurt a number of manufacturers producing wood, paper, and furniture goods. However, technological factors also played a role in weaker U.S. export demand. For instance, rising Internet use led to a drop in demand for paper products. In addition, the severe restructuring in the U.S. auto manufacturing sector attributable to the recession and the resulting collapse in demand affected demand for Canada’s automobiles irrespective of the high value of the Canadian dollar. Finally, competition from China has had a negative effect on Canada’s merchandise exports, especially in sectors such as wood manufacturing.

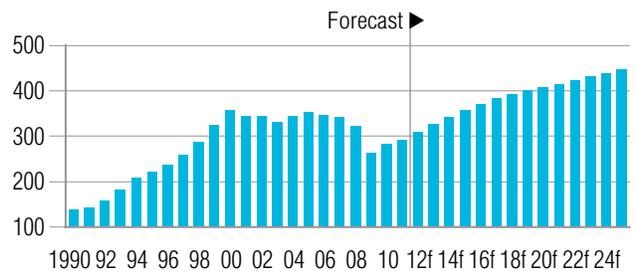
Despite all these challenges, total merchandise exports to the United States held their own through most of the 2000s. This success was due, in part, to changes in the goods sold south of the border. For example, mineral fuels, which are less sensitive to exchange rate movements,

Table 2
Effect of Exchange Rates on Canadian Exports Varies by Region and Export Type

	Merchandise	Services
Brazil	Strongly significant	Not significant
China	Not significant	Strongly significant
EU	Significant	Not significant
Japan	Significant	Not significant
Mexico	Not significant	Significant
U.K.	Not significant	Significant
U.S.	Significant	Significant
India	Not significant	Significant

Source: The Conference Board of Canada.

Chart 7
Merchandise Exports From Canada to the U.S. Will Rise Gradually
(constant C\$ billions)



f = forecast

Sources: Industry Canada; The Conference Board of Canada.

have become Canada’s largest export to the United States. (See Table 3.) In addition, some Canadian exporters with high initial profit margins were able to take a cut in margins, rather than raising their selling price, to maintain market share. The penetration of Chinese imports into the U.S. market increased competitive pressures, keeping some Canadian exporters from reflecting the rising value of the dollar in their selling prices.

Table 3
Mineral Fuels Now Top Canadian Merchandise Exports to U.S.

Rank	2000	2011
1	Motor vehicles	Mineral fuels
2	Mineral fuels	Motor vehicles
3	Machinery	Machinery
4	Electrical	Plastics
5	Wood	Electrical

Source: Industry Canada.

While Canada's merchandise exports to the United States will expand by close to 2 per cent per year over the forecast period, the share of our exports to the U.S. will decline from 74 per cent in 2010 to 68 per cent by 2025. This trend has been under way for a few decades, due to the growth in Canada's merchandise exports to emerging markets.

The statistics reveal some risks in the outlook for Canada's merchandise exports to the United States. They are very sensitive to real GDP growth, as a 1 per cent decrease in U.S. real GDP results in a roughly 2 per cent decline in growth in merchandise exports. If the United States fails to solve its fiscal problems and real GDP growth slumps below our assumption of 2.5 per cent per year over the long term, merchandise exports will expand at a weaker pace than is currently anticipated.

While the growth in merchandise exports is not as sensitive to the exchange rate as it is to GDP (a 1 per cent appreciation in the Canadian dollar leads to a 0.4 per cent drop in merchandise exports), the exchange rate still represents a risk going forward. The current analysis assumes that the Canadian dollar will trade at par over the forecast period. However, the loonie could appreciate well above par if, for instance, world oil prices rise higher or large U.S. deficits persist and weaken the U.S. dollar considerably over the forecast period. Such a development would have a negative impact on the growth in merchandise exports to the United States. In the next

section, we examine the way Canada's merchandise exports to the U.S. could change if the loonie appreciates above our base case assumption over the long term.

The share of service exports will decline slightly between 2010 and 2025 (51 per cent compared with 52 per cent in 2010). Service exports to the United States are not as sensitive to the exchange rate or GDP as merchandise exports are.

U.S. Alternative Scenario

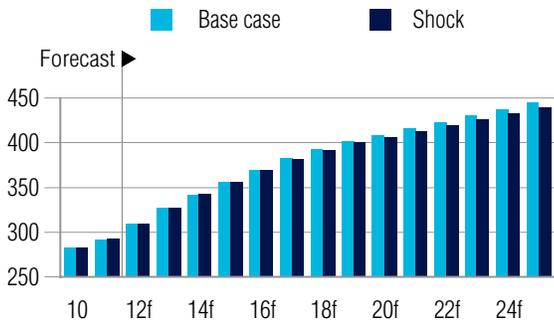
Our base case assumes that the Canadian dollar will trade at par against the U.S. dollar over the long term. However, if the prices of oil and other commodities increase at a faster pace than is currently expected, the Canadian dollar could trade well above par through 2025, especially given the vast potential of Canada's oil sands. Also, a failure on the part of the U.S. government to solve its deficit and debt problems over the long term could lead investors to shun U.S. assets, and this development could put upward pressure on the loonie. In this scenario, we assume that the Canadian dollar will gradually appreciate to US\$1.15 by 2025.

Not surprisingly, Chart 8 reveals that real merchandise exports to the United States would be weaker if the Canadian dollar appreciated. In fact, by 2025, real merchandise exports would be \$5.6 billion less than the base case. The higher price of Canadian exports in the United States due to a more highly valued loonie would lower demand, especially for manufactured goods that have to compete for market share with goods made by U.S. and global suppliers.

UNITED KINGDOM

Chart 9 shows that merchandise exports to the United Kingdom surged in the early to mid-2000s, despite the fact that the U.K. economy recorded modest growth in the 2 per cent range. The driving force behind the solid growth in merchandise exports during this period was surging exports of gold and, to a lesser extent, diamonds. Table 4 reveals that Canada's exports of these minerals were not in the top five in 2000 but have subsequently become the largest merchandise exports to the United Kingdom.

Chart 8
Alternate Scenario: Stronger Canadian Dollar Would Weaken Merchandise Exports to U.S.
(constant C\$ billions)



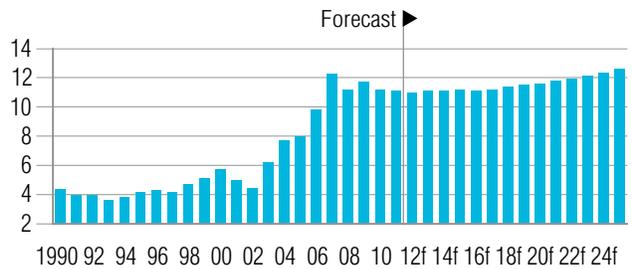
f = forecast
Sources: Industry Canada; The Conference Board of Canada.

The price of gold has surged over the past decade, and this development is reflected in the trade flows from Canada to the United Kingdom. London is a major clearinghouse for gold delivered to other countries in the region. We do not expect this trend to continue over the long term, and the U.K.’s relatively weak GDP growth through 2025 implies that the share of Canada’s merchandise exports to this country will decline from 2.9 per cent to 1.9 per cent by 2025 (the shares in Chart 10 exclude the U.S. and other countries for purposes of illustration) and average annual growth will be virtually flat. The exchange rate is not a significant factor in explaining Canada’s trade with the United Kingdom and, consequently, the assumed depreciation of the Canadian dollar against the pound over the long term will not boost merchandise exports.

EUROZONE

Merchandise exports from Canada to the eurozone are expected to expand at a modest pace over the long term. (See Chart 11.) While real GDP growth will remain fairly weak (1.6 per cent per year through 2025), the exchange rate has a modest but significant impact on Canada’s merchandise exports to the eurozone. Our statistical results suggest that a 1 per cent depreciation of the Canadian dollar against the euro results in a 0.4 to 0.5 per cent increase in exports. Since it is assumed that the Canadian dollar will depreciate against the euro over the long term, thereby stimulating

Chart 9
Canada’s Merchandise Exports to U.K. Will Be Flat
(constant C\$ billions)



f = forecast
Sources: Industry Canada; The Conference Board of Canada.

Table 4
Top Five Merchandise Exports From Canada to the U.K.

Rank	2000	2011
1	Electrical	Gold and diamonds
2	Machinery	Chemicals
3	Aircraft	Nickel
4	Nickel	Machinery
5	Ores	Electrical

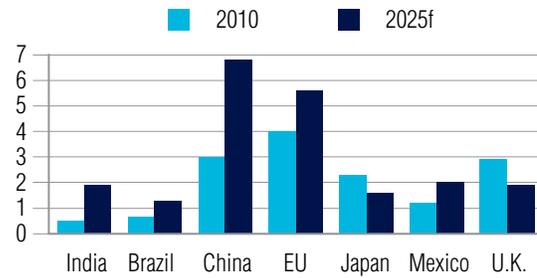
Source: Industry Canada.

export demand, the share of Canada’s merchandise exports to the eurozone will increase from 4.0 to 5.6 per cent by 2025. (See Chart 10.) Merchandise exports from Canada to this destination will increase at an annual average pace of around 5 per cent over the long term. The potential Canada–EU free trade agreement, which is currently being negotiated, could also have a positive effect on trade over the long term.

EU Alternative Scenario

Obviously, given the huge uncertainty surrounding the future of the euro, there are huge downside risks to the outlook for exports from Canada to the eurozone. A less-optimistic outcome in this region could easily result in a sharp appreciation of the Canadian dollar against the euro and anemic export growth over the long term.

Chart 10
Share of Canada's Merchandise Exports to Different Regions Will Vary
(percentage share of total)

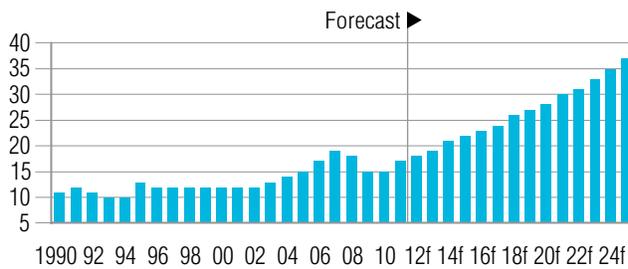


f = forecast
Sources: Industry Canada; The Conference Board of Canada.

In our base case analysis, we assume that real GDP in the EU will expand at an annual average rate of 1.6 per cent over the long term. Given the major problems that the eurozone is currently dealing with, it is not difficult to envision a far bleaker scenario in which near-recessionary conditions exist in the debt-plagued EU countries—including Greece, Italy, Portugal, and Spain—for an extended period. This unwelcome development would also drag down growth in some of the stronger EU countries, such as Germany and Finland, as a result of weaker export demand.

In this gloomy scenario, we assume that real GDP growth will average only 0.6 per cent per year through 2025. Chart 12 shows that weaker demand for Canadian merchandise exports attributable to a more pessimistic economic outlook in the EU would reduce exports by \$4.2 billion by 2025 in comparison with the base case.

Chart 11
Merchandise Exports From Canada to EU Will Expand Modestly
(constant C\$ billions)

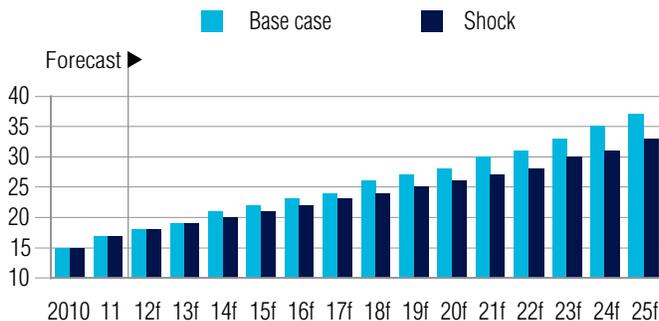


f = forecast
Sources: Industry Canada; The Conference Board of Canada.

JAPAN

The Japanese yen has generally appreciated against the Canadian dollar for the past decade, but this has not greatly increased demand for Canada's merchandise exports. (See Chart 13.) While the yen/dollar exchange rate has a modest impact on trade between the two countries, our statistical analysis shows that its positive impact on exports has been offset by Japan's sluggish real GDP growth, as this country has been in a two-decade-long battle against deflation and its detrimental impact on economic growth. Given that the Japanese economy will expand by a meagre 1.1 per cent per year over the long term, Canada's merchandise exports to this destination will stagnate through 2025 and Japan's share of Canadian merchandise exports will drop from 2.3 to 1.6 per cent by the end of the forecast period. (See Chart 10.)

Chart 12
Alternate Scenario: Slow GDP Growth Would Weaken Canadian Merchandise Exports to EU
(constant C\$ billions)



f = forecast
Sources: Industry Canada; The Conference Board of Canada.

CHINA

Chart 14 reveals that Canada's merchandise exports to China soared from under \$3 billion in 1990 to close to \$15 billion by 2011. They are projected to hit the \$45-billion mark by 2025, based on the assumptions concerning China's future GDP growth. This represents an average annual growth rate of close to 8 per cent over the long term. The yuan/dollar exchange rate is not a significant factor in explaining growth in Canada's merchandise exports to China. Canada's top five merchandise

exports to China in 2011 were all raw materials, which are less sensitive to changes in the exchange rate. (See Table 5.) In 2000, motor vehicles and machinery exports from Canada were among the top five exports, but China’s voracious demand for raw materials has altered the mix, as has China’s increased domestic auto production.

Canada continues to export electrical, paper, and machinery products to Brazil that are affected by changes in relative prices between the two countries.

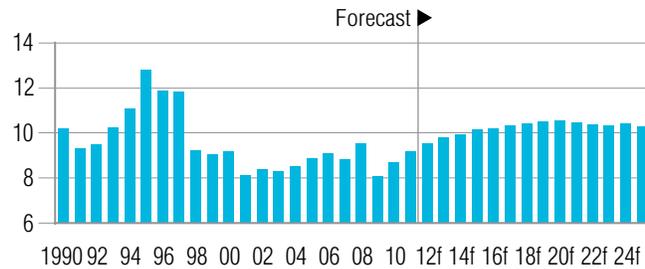
By 2025, China’s share of Canadian merchandise exports will increase to 6.8 per cent from 3.0 per cent. (See Chart 10.) While this is an impressive increase, there are some risks attached to this outlook. Canada’s merchandise exports are sensitive to China’s real GDP growth, as a 1 per cent increase in GDP leads to a 1 per cent increase in export demand. This suggests that, if China’s economy fails to expand by 6.5 per cent annually over the forecast period and instead experiences a “hard landing,” exports from Canada will not expand at the fast clip expected in this analysis. Alternatively, if the Chinese economy manages to keep expanding by 8 to 10 per cent annually and demand for Canada’s raw materials continues to soar over the forecast period, questions about Canada’s ability to supply Chinese demand over the long term, given the supply side constraints, will emerge.

Chart 15 shows that China’s share of Canadian services exports increases over the forecast period. Part of this gain reflects increased travel from China to Canada because, as Chinese wealth increases and more people move into the middle class, international travel to destinations such as Canada will grow.

BRAZIL

An appreciating Brazilian real, combined with strong real GDP growth over the forecast period, means merchandise exports will grow at an annual average pace of between 8 and 9 per cent through 2025. Canada continues to export electrical, paper, and machinery products to Brazil that are affected by changes in relative prices between the two countries (the exchange rate is significant in the

Chart 13
Merchandise Exports From Canada to Japan Will Stagnate
(constant C\$ billions)



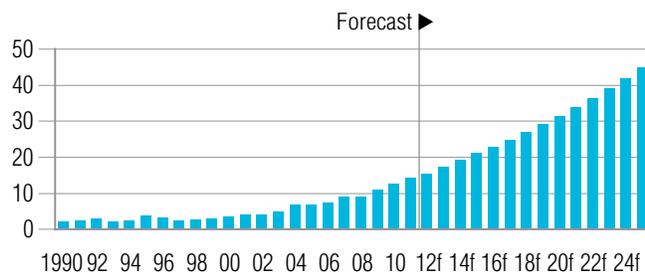
f = forecast
Sources: Industry Canada; The Conference Board of Canada.

Table 5
Raw Materials Comprise Canada’s Top Five Merchandise Exports to China

Rank	2000	2011
1	Pulp	Pulp
2	Motor vehicles	Ores
3	Fertilizers	Wood
4	Oil seeds	Mineral fuels
5	Machinery	Oil seeds

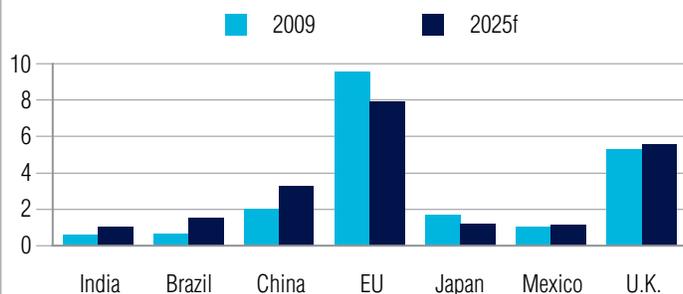
Source: Industry Canada.

Chart 14
Merchandise Exports From Canada to China Will Keep Soaring
(constant C\$ billions)



f = forecast
Sources: Industry Canada; The Conference Board of Canada.

Chart 15
Share of Canada's Services Exports to Different Regions Will Vary
(percentage share of total)



f = forecast

Sources: Industry Canada; The Conference Board of Canada.

Brazil equation). Brazil's share of Canada's merchandise exports will grow from 0.63 per cent in 2010 to 1.3 per cent by 2025. (See Chart 10.) Similar to the results for China, Brazil's share of Canadian service exports will also increase solidly by 2025, in part because Brazil's middle class is expanding rapidly, a development that will result in growing international travel to countries such as Canada. (See Chart 15.)

MEXICO

Merchandise exports to Mexico will increase by 4 to 5 per cent annually over the forecast period—less than those to China, Brazil, and India—and Mexico's share of Canada's merchandise exports will increase to 2.0 per cent from 1.2 per cent by 2025. (See Chart 10.) Canada exports a variety of both raw materials and manufactured goods to Mexico, and the composition of exports has not changed significantly since 2000. The Canada/peso exchange rate has little effect on merchandise exports, partly due to Canada's involvement in North American global supply chains, especially in auto production, that tend to offset the impact of the exchange rate on trade flows.

INDIA

Canada mainly exports agricultural commodities and raw materials to India. As in China, future export demand will depend on India's real GDP growth, as the exchange rate is not a significant factor in explaining export trends. The strong growth in the Indian economy over the long term (7 per cent per year) will cause India's share of

Canada's merchandise exports to increase from 0.5 per cent in 2010 to 1.9 per cent by 2025. (See Chart 10.) Annual growth will average around 10 per cent over the long term.

CONCLUSION

The exchange rate is a significant factor in explaining growth in Canada's merchandise exports to the United States. Given that the United States still accounts for over 70 per cent of Canada's exports, the exchange rate will remain a critical factor in determining Canada's overall export performance over the forecast period.

The exchange rate is also a factor in determining growth in exports to some emerging markets. However, growth in real GDP in the destination countries will be the main factor driving growth in Canada's merchandise and service exports to these destinations. The increase in the volume of Canada's exports of raw materials—especially mineral fuels to emerging markets such as China—accounts for the relatively minor role that the exchange rate plays in our analysis of exports to some of our trading partners. Most raw materials are priced in U.S. dollars and are thus unaffected by movements in the Canadian dollar. Moreover, the strong demand in China for raw materials to fuel its domestic and export-oriented industrial growth seems insensitive to price changes.

While Canada's share of both merchandise and service exports to the United States will decline by 2025, the U.S. will remain Canada's largest export market by a considerable margin. In fact, despite the high value of the Canadian dollar, merchandise exports will continue to expand at a modest pace (annual average growth of close to 2 per cent through 2025). This is attributable to the fact that the U.S. economy will record modest growth over the forecast period, especially in comparison with the eurozone and Japan. Also, mineral fuels have become Canada's top export to the United States and demand for these raw materials is not closely linked to changes in the Canadian dollar. The supply of mineral fuels to the United States is expected to increase over the forecast period as production from the oil sands expands.

The sensitivity of merchandise exports to changes in U.S. real GDP poses a risk for Canada going forward if the United States fails to solve its debt and deficit issues and the economy fails to expand at potential over the long term. Also, while exports are not as sensitive to changes in the Canada/U.S. exchange rate as they are to changes in real GDP, if the loonie soars well above par—which could happen, if energy prices increase more quickly than expected through 2025—Canada’s real exports of non-energy goods could be at risk. Our alternative scenario reveals that real merchandise exports would be \$5.6 billion lower if the Canadian dollar appreciates to US\$1.15 by 2025.

Growth in merchandise exports from Canada to Japan will either be flat or decline over the long term, while growth in exports to the United Kingdom will be less than 2 per cent per year. These trends mainly reflect anemic economic growth, especially in Japan. The U.K. results are also a result of our assumption that gold prices will not continue to surge as they have over the past decade or so. Consequently, growth in merchandise

exports to the United Kingdom over the long term will mainly reflect weak gains in that trading partner’s potential output.

The share of merchandise exports from Canada to developing countries will increase over the forecast period if economic growth in these countries continues at a solid pace. Merchandise exports are sensitive to real GDP growth and if growth in the Chinese economy, for instance, slows down to the 3 to 4 per cent range annually over the long term, growth in merchandise exports would slow down sharply from the expected annual growth of 7 to 8 per cent through 2025. Canada’s share of service exports to emerging markets will grow over the forecast period. This gain is, in part, due to the growing middle class in countries such as China and Brazil and the resulting increase in international travel to destinations such as Canada.

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APPENDIX A

Estimation Methodology and Results

Canadian merchandise and service export equations were constructed to identify variables that affect Canadian export volumes to eight important trading partners: the United States, the euro-zone, the United Kingdom, China, Japan, Mexico, Brazil, and India. For each country, we developed and estimated merchandise and service export equations.

As a starting point, we applied the following framework to each merchandise and service export equation:

$$XK_{\langle \text{foreign country} \rangle}_t = \beta_0 \times C + \beta_1 \times GDPK_{\langle \text{foreign country} \rangle}_t + \beta_2 \times RPFX_{\langle \text{foreign country} \rangle}_t + \beta_3 \times Trend_t + \beta_4 \times DREC09_t$$

The betas (β_0, \dots) represent the estimated coefficients and, hence, measure the impact of the independent variable on real export volumes (merchandise or services) to a foreign country, $XK_{\langle \text{foreign country} \rangle}$. $GDPK_{\langle \text{foreign country} \rangle}$ represents the real gross domestic product of the foreign country expressed in local currencies, while $RPFX_{\langle \text{foreign country} \rangle}$ represents the real exchange between Canada and the foreign country, with the exchange rate expressed as the price of the trading partner's currency in Canadian dollars.¹ Hence, the

estimated coefficients of both these components are expected to be positive. $DREC09$ represents a dummy variable to take into account the 2009 recession. C represents a constant and $Trend$ represents a time trend. Auto-regressive terms were added to many equations to correct for autocorrelation. Lastly, the subscript t represents time. For developed countries, both merchandise and service exports were estimated using logarithms. For the emerging economies (Brazil, China, and India), level estimations were used, as the volume of merchandise trade over the past several years has taken off sharply and would have skewed the elasticity estimates that result from a logarithmic form.

Trade data by country are available from Industry Canada and Statistics Canada.² The data were available on an annual basis, with most time series starting in 1990. At the time of this study, historical merchandise export data were available from 1990 to 2010, and services export data were available from 1990 to 2009. Exchange rate data did not go as far back for all countries. For example, the euro was created only in 1999, and a proxy was used to cover the years preceding its creation. Furthermore, exchange rate data for China, India, and Mexico are available only from 1993 onwards, and data for Brazil go back to 1996 only.

1 The real exchange rate measures purchasing power in Canada relative to that in our trading partners. It is calculated as the nominal exchange rate adjusted by the different rates of inflation in Canada and in our trading partners. For example, inflation may be higher in some of our trading partners, but if the nominal exchange rates depreciate at the same rate, then the relative purchasing power (real exchange rate) remains unchanged.

2 Merchandise trade data are available from Industry Canada at www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/Home. Information on trade in services by country is published by Statistics Canada at www.statcan.gc.ca/daily-quotidien/111014/dq111014f-eng.htm.

Additional variables were created and tested to account for some special factors. For instance, China joined the WTO at the end of 2001, which no doubt changed the scope of world trade. Entering the global scene as a low-cost producer, China has managed to capture a growing share of foreign export markets over the past several years. Indeed, China's penetration into the world trading system has likely cut into the volume of Canadian exports to other countries, particularly the U.S. To take into account the fact that China has become a bigger player on the global front, a trend variable was created and included in the U.S. merchandise export equation.

The merchandise export profile for the U.K. differed from those for the other regions because a sharp surge in exports from 2003 to 2010 distorted estimation results. We tested the U.K. merchandise export equation for structural breaks, and a Chow breakpoint test helped us determine that there was a break point in 2003. A surge in exports of precious metals and stones (particularly gold) underpinned the spike in merchandise trade activity from 2003 onward. To help correct the problem of nominal growth in this category of exports—precious metals and stones grew to account for over 60 per cent of Canadian exports to the U.K. by 2010—a weighted merchandise export deflator was generated for the U.K. Trade-weighted deflators were also created and tested for other countries, based on the weighted average of the top five two-digit products exported to each country. However, estimation results suggested that using the overall Canadian merchandise export deflator produced better estimation results.

A system of equations was also created to test whether merchandise exports could be used as explanatory variables in the services export equations. The system was used to identify potential links between goods exports and services exports. For example, in theory, transportation services should be closely linked to merchandise exports. However, because detailed data on services sector exports by country are not available, results were not significant and the system of equations was not used.

Export equations were estimated using ordinary least squares. Explanatory variables were retained if they were statistically significant and if the sign on the estimated coefficients was correct. Furthermore, some variables were estimated using lagged values, to capture more prolonged effects. To achieve the best fit, statistically insignificant variables were dropped from the estimation. The following tables present the elasticity estimates attributed to our variables of interest—that is, real GDP and the real exchange rate. The elasticity estimates reported are simply defined as the percentage change in exports associated with a 1 per cent change in the value of real GDP or the real exchange rate. For example, for Brazil, a 1 per cent appreciation in the value of the real will result in a 0.555 per cent increase in Canadian merchandise exports to that country. Similarly, if real GDP in Brazil increases by 1 per cent, our merchandise exports to Brazil should increase by 0.862 per cent. (See Table 1.)

Table 1
Key Elasticity Estimates for Merchandise Exports

	Real GDP	Real exchange rate
Brazil	0.862	0.555
China	1.001	–
Eurozone	1.024	0.519
India	1.492	–
Japan	0.822	0.382
Mexico	1.002	0.054
U.K.	1.228	0.029
U.S.	2.175	0.462

Source: The Conference Board of Canada.

Estimation results show that both merchandise and services exports were most responsive to changes in real GDP for all the countries examined. The real exchange rate is also important, but not for all of our trading partners. Among developing countries, merchandise export estimation results suggest the exchange rate was significant only for Brazil. For China and India, the exchange rate was not statistically significant. For services, the

exchange rate was statistically significant for China and India, but not for Brazil. Among the developed countries, merchandise export estimates showed the exchange rate was statistically significant for the eurozone, Japan, and the U.S., but not for Mexico and the United Kingdom. On the services side, estimation results suggest that the exchange rate does significantly influence trade with the United States and the United Kingdom. (See Table 2.)

Table 2
Key Elasticity Estimates for Services Exports

	Real GDP	Real exchange rate
Brazil	3.805	–
China	0.898	0.197
Eurozone	0.970	–
India	0.892	0.201
Japan	0.529	–
Mexico	1.109	–
U.K.	1.092	0.623
U.S.	1.055	0.631

Source: The Conference Board of Canada.

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