

I. MERCHANDISE TRADE

Overview

Since the downturn in the global economy in early 2000, recovery world-wide has been patchy, uneven, and, until very recently, has failed to gather significant momentum. Fiscal and monetary policy world-wide has become increasingly accommodative, but this has been counterbalanced by persistent "headwinds" to recovery; these include the macroeconomic imbalances that built up during the boom-period of the late 1990s in the U.S., the sharp decline in world equity prices from early 2000, structural problems in the euro area, the continued fallout from a general asset price collapse in Japan, weakness in several emerging market economies, and more recently, the persistence of heightened geopolitical tensions. While Canada has fared relatively well over this period, its heightened exposure to international markets made it particularly vulnerable to a series of shocks that affected output destined for foreign markets and, consequently, dampened economic activity over 2003.

The strong global economic growth experienced over the late 1990s relied heavily on strong and continued domestic demand in the U.S., which was reflected in a sizeable and growing U.S. current account deficit, bolstered by large-scale capital inflows which generated significant US dollar appreciation. Such was the reliance on the U.S. as a driver, or locomotive, of global growth in recent years that the rest of the international economy has not been able to grow at or above trend growth (See Box A for a discussion on Canada-US business cycle synchronization).

However, the strong U.S. domestic demand growth over the late 1990s involved "excessive exuberance" regarding economic prospects, leading firms to over-invest and consumers to over-spend. This, in turn, was reflected in and further driven by over-valuation of equity prices. On top of these economic imbalances, rising geopolitical tensions early this decade provided a further drag on global economic growth. The situation with regard to Iraq raised uncertainty, with the effect of depressing consumer and business confidence, causing further declines in equity prices and resulting in substantial risk *premia* in oil prices through the latter part of 2002 and into 2003.

Throughout this period, monetary policy was highly accommodative, with Canadian, U.S., and most other countries interest rates falling to recent-historical lows. Likewise, fiscal policy has also contributed to economic growth through a series of tax-lightening measures, particularly in the United States but also, to some extent, in Europe and Japan.

After the sub-par economic growth of the past three years, strong signs of improvement in the international economic environment became more evident through the latter part of 2003. This is most apparent in the US, where the recovery picked up momentum over the first three quarters and locked the gains in place with a strong fourth quarter showing for GDP growth, and in Japan where, after a decade-long period of stagnation, growth has picked up. The improved performance of Japan is being assisted by robust growth in other Asian economies, most especially China, which registered a 9.1 per cent rate of growth in 2003. Economic activity in the euro area remained torpid, however, as Germany in particular continued to drag on Europe's economic health.

Inflation in most economies in 2003 was fairly stable. This was the reflection of, on the one hand, sharp increases in energy prices that were exerting inflationary pressures in the short-term and, on the other, the persistence of subdued economic growth and weak labour markets dampening inflation and inflationary expectations. Nonetheless, the rate of inflation in services remained high throughout the year in most countries, resulting in inflation rates of over 2 per cent. The main exception to these developments was Japan, where deflation remained embedded in the economy, although oil price developments slowed the annual rate of decline in consumer prices in that country.

The pick-up in global economic activity is still at a preliminary stage, and the strength and particularly the durability of the recovery remain uncertain. The long-standing imbalances are still present in the US, in particular the large current account and fiscal deficits, which could have a disruptive effect on future exchange rates and international developments in the months ahead.

The Canadian macro situation in 2003

While during much of the downturn early in the decade, Canada had managed rather successfully to lean into these headwinds, all this changed in 2003 as a series of international events, many beyond its control, spilled over into Canada and negatively affected Canadian trade performance and economic activity over the course of 2003.