



Prospects for Post-CETA Issues for German-Canadian Trade

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With the provisional adoption of the Comprehensive Economic and Trade Agreement (CETA) in 2017, trade has improved between the EU and Canada.¹ In the following two years, Canadian exports to the EU increased by 16 percent and exports from the EU to Canada rose 24 percent. The strongest increase in trade was related to those goods subject to tariff reductions. Overall, CETA provisions were utilized for roughly half of trade, which underlies the growth.

However, the post-CETA trade experience between Germany and Canada was more mixed. Canadian exports to Germany rose by 24 percent to \$5.5 billion by the end of 2019 (26 percent for dutiable trade) – better than to the rest of the EU. On the other hand, German exports to Canada rose by only 11 percent to \$19.1 billion at the end of 2019 (dutiable imports from Germany fell by 1 percent) by the end of 2019. The utilization of CETA provisions only applied to roughly a third of German-Canadian trade, less than the EU-Canada average.²

Overall, trade between Germany and Canada is relatively small for both countries. In 2020, Canada's exports to Germany account for only 0.5 percent of German imports and German exports to Canada account for only 0.8 percent of Canadian imports. Despite Germany and Canada being G7 countries, Canada does not even rank in the top ten exporter or importer countries with Germany. So even though CETA has encouraged more trade between the two countries, Germany and Canada remain far distant customers.

The question addressed below is whether and how Canadian-German trade can improve. It will not be easy. Several economic and geo-political headwinds will make trade more difficult especially for countries not in close proximity. However, as seen with current German-Canadian trade patterns, some ample opportunities are available to improve trade especially in manufacturing and technology. Perhaps with promotion, some of these opportunities can be converted in real gains from trade.

¹ A useful review in 2020 by the Government of Canada is provided in <https://www.international.gc.ca/trade-commerce/economist-economiste/statistics-statistiques/eu-marchandise-ue.aspx?lang=eng>.

² These trends are affected in an opposite manner by exchange rate shifts. The Canadian dollar depreciated 5 percent against the Euro between April 2017 and August 2019, which is an important factor inhibiting German and EU exports to Canada while boosting exports to the Germany and the rest of the EU. See <https://www.xe.com/currencycharts/?from=CAD&to=EUR&view=5Y>.

Below, I will review prospects for German-Canadian trade in two sections. The first is to look at economic and geo-political factors that influence the future of trade between the two countries. The second is to discuss opportunities for trade, based on comparative economic and technological advantages each country enjoys.

Why is German-Canadian Trade Enhancement Challenged?

Trade agreements help reduce barriers to trade but it does not mean “taking the horse to the water will make it drink”. Several factors serve as strong headwinds towards increased trade between Germany and Canada: (i) current and future trading relations, (ii) proximity, (iii) self- sufficiency and (iv) other geopolitical factors including energy policy and national security.

(i) Current and Future Trade Agreements

No doubt Germany benefits from its trade agreement and monetary union with other European countries. Canada has benefited from deepening ties with the United States and Mexico through NAFTA. As well known, trade agreements encourage greater trade between agreeing countries but divert trade away from third parties. By lowering trade barriers between the EU and Canada, CETA is a welcome counterbalance to the concentration of trade within European and North American regions, enabling more diversification.

However, we can expect new trade agreements might undermine some of the possible gains through CETA. An American-European trade agreement would particularly be important in affecting German-Canadian trade. The US is a market ten times the size of Canada. Currently the CETA agreement provides a benefit to Canada to act as a hub-and-spoke for German trade to come Canada before goods are shipped to the United States. With an EU-U.S. trade agreement, German exporters can directly deal with United States – Canada becomes a secondary localized market given its small size.

Similarly, Canada has increased its trading relationships with Asian countries through the Comprehensive and Progressive Agreement for Trans-Pacific Partnership. As the United States has not signed the agreement, this has allowed Canada to operate at an advantageous position for Asian trade. Given the size of the Asian market and especially its demand for Canadian natural resources, trade with EU would likely focus on manufacturing and services.

(ii) Proximity

Trade studies come to one distinctive conclusion: proximity is a significant factor influencing trade patterns. Countries are more likely to trade with neighbours for transport costs but also due to similarity of institutions and cultures that make trade easier to do. It is no accident that three-quarters of Canadian trade is with the United States. Three-fifths of German trade is with the other members of the European Union (and two-thirds with all European countries).³

³ See <https://www.bmwi.de/Redaktion/EN/Publikationen/facts-about-german-foreign-trade.pdf?blob=publicationFile&v=7>.

The recent revision of NAFTA will make it more likely that Canada-U.S. trade will deepen further. In the past, the two most important Canadian exports are energy and vehicle and parts, of which over 90 percent of their trade is with the United States. NAFTA which strengthens provisions related to auto trade between the two countries, will concentrate trade with the United States.⁴

The European Union has been adopting rules to strengthen trade with its neighbours. The new “rules of origin” will be used to determine which goods can benefit from preferential treatment with lower customs duty rates, or even a zero rate, depending on the preferential tariff treatment. Countries include Iceland, Liechtenstein, Norway, Switzerland, Faroe Islands, Turkey, Egypt, Israel, Jordan, Lebanon, Palestine, Georgia, the Republic of Moldova, Ukraine, Albania, Bosnia and Herzegovina, North Macedonia, Montenegro, Serbia and Kosovo. This will further focus the mind on neighbouring jurisdictions.

(iii) Self-sufficiency and Supply Chain Risks

The pandemic has laid bare the risks involved with global supply chains with labour and supply shortages at home and abroad impacting the delivery of goods. The need for medical equipment and vaccines, food and other necessities have put “self-sufficiency” on the front burner of trade policy. Businesses are therefore re-evaluating risks to supply chains to encourage domestication of supply or at least reducing risks in the supply chain. This is particularly exemplified by the computer chip shortages that particularly impacts the auto industry, which is an important component of trade in both Canada and Germany.

Self-sufficiency will therefore serve as a counterweight to trade. Trade is still attractive in reducing consumer prices and increasing employment in export industries. However, the concern over secure supplies creates a focus on domestic industrial capacity rather than external trade. In Germany, greater focus is already being paid to localized supply chains with foreign investment serving as a substitute to developing foreign markets closer to the consumer. This will depress exports as exporting businesses prefer to set up shop elsewhere through outbound investments.⁵ Even the agreement to impose a minimum corporate tax on foreign affiliate income could put German and Canadian outbound investment at a competitive disadvantage compared to local investments, depending on how the agreement is implemented.

(iv) Other Geopolitical and Economic Factors

Trade may become increasingly regionalized for geo-political reasons. With Chinese-U.S. trade and security disputes, regional blocs could well play a more important role in future trading relations in part for security reasons. Canada will become increasingly tied to U.S. and EU markets while Germany is focused on Europe and North America.

⁴ Despite the potential deepening of Canada-U.S. trade under the new USMCA agreement, American protectionism has been rising that could push Canada seek more trade diversification.

⁵ See Wall Street Journal, November 9, 2021: https://www.wsj.com/articles/germany-economy-lagging-behind-europe-supply-chain-11636383954?mod=Searchresults_pos4&page=1.

Similarly, increased concern over workers displaced by global trade and inequality is leading to greater use of policies to protect industries from import competition. The recently passed U.S. infrastructure bill contains America First provisions to increase domestic production. German parties are negotiating policies that would turn Germany to reduce dependency on foreign demand including increased public investment, higher wages and streamlining planning procedures.

The development of carbon tariffs to protect domestic industries from import competition from countries with less effective carbon policies (such as China and India) could also reduce interest in trade. In this sense, both Canada and Germany have stricter policies including pricing reducing the necessity for trade-interfering carbon tariffs.

On top of these trends, aging in society will result in less labour supply available to the two economies but also globally. In the coming years, international labour markets will become more competitive, wage pressures will increase and saving propensity will decline as workers retire. This will push businesses to adopt labour saving technologies such as Artificial Intelligence as a response to a rising wage-capital price ratio. Real interest rates will also likely rise as investment grows for this reason as well as transformation of energy systems.

What Opportunities Lie Ahead?

Despite these headwinds, Canada and Germany could benefit from greater trade. The economic concept of comparative advantage is still relevant in that countries can both increase their standard of living by specializing in production where they have comparative advantage. Further, much trade is now done through related party sales – along with sales comes the transfer of technological and managerial expertise that can improve productivity.

The table below provides a list of the primary products traded between Germany and Canada. While Canada's strength remains with resource-related primary and manufacturing industries (agriculture, forestry, fishing and mining, oil/gas), it should be noted that Canada has been exporting non-resource products such as gas turbines, aircraft and chemicals, not just resource-related products like iron ore and precious metal scraps.

Top Five Products traded between Germany and Canada 2019 (Shares of trade in Parentheses)

German Exports to Canada	Canadian Exports to Germany
Autos, trucks and parts (22.7%)	Gas Turbines (9.4%)
Machinery (excluding Gas Turbines (16.9%))	Aircraft (8.0%)
Medical and pharmaceutical (15.9%)	Iron Ore (7.9%)
Gas Turbines (5.5%)	Precious Metal Scraps (7.2%)
Aircraft (3.3%)	Chemical (6.5%)

Source: OEC (some categories added together)

Canada's most important comparative advantage is in the development resources of which mining dominates for Germany. Given increased significance of mining material in energy in the coming years, mining materials could be of significance to German companies including some nickel and cobalt. German demand for natural gas from Russia could be replaced by Canadian LNG for some time. Canadian-German agricultural trade including fertilizers could also provide new opportunities.

German exports to Canada have been dominated by manufacturing industries, particularly autos, medical equipment and supplies and machinery. Germany has long enjoyed advantages in advanced manufacturing and specialized machinery which is its dominant source of trade with Canada. Greater digitization of industrial practices will drive new technological developments in the future. Canada also has good opportunities in advanced manufacturing and clean energy including hydrogen.

While the headwinds enunciated earlier impede trade, it will be up to public and private sectors to promote German-Canadian trade. Canadian and German academic institutions already have good relations (to declare my conflict, I am research fellow of CESIFO in Munich). Team Canada and Team Germany visits help focus the mind on trading relations. Further removal of barriers to trade would also promote more trade with Germany including reformed WTO rules.

However, for both countries to improve trade each other, they will need to pay attention to competitiveness. German goods will not compete in Canadian markets if they are too expensive. Similarly, Canadian trade with Germany will not broaden if Canadian goods are not cost-competitive.

Germany has found in recent years that some of its competitiveness is being eroded by high energy prices and slow processes to build infrastructure. It has largely benefited from its monetary union with the rest of Europe due its competitiveness in the past. However, since 2018, industrial production has underperformed with post-pandemic production still below 2019 levels (unlike Italy for example).

Canada has also seen its competitiveness undermined in recent years. Its labour productivity has slowed by half since 2015 to 0.5 percent per year. Real non-residential investment has also declined and, relative to GDP, fallen back to levels not seen since the 1990s during a period of low economic per capita growth.

With disruptions laying ahead such as international trade disputes and energy transformation, countries will need a new economic agenda to improve productivity and competitiveness.

Trade doesn't magically happen.