CHAPTER 2

# Making Connections

## The New World of Integrative Trade and Canada

### DOMINANT GLOBAL DRIVERS

From high oil prices to financial imbalances among major countries, competing and sometimes conflicting forces are buffeting the global economy. This chapter concentrates on economic transformation under globalization and on the new opportunities and challenges for Canadian business and government policy makers.

### AGING NORTH, EMERGING SOUTH

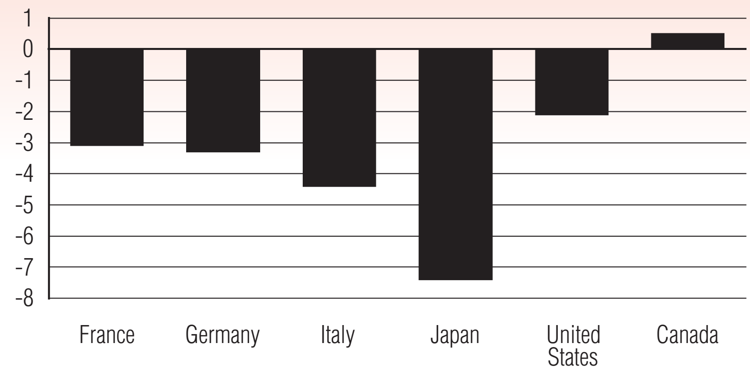
**The Aging Industrial Economies**

In much of Western Europe and Japan, economic growth potential—sustainable economic growth that does not feed inflation—has dipped to 2 per cent or lower annually.

This is a trend of global importance, driven by demographic change. Specifically, an aging population lowers the growth rate of a country's labour force as more workers retire and fewer new workers replace them. The result is a decline in long-term growth potential, barring a solution that somehow combines longer labour force attachment for existing workers, higher rates of national savings and investment, and faster productivity growth.

Chapter 3 explores at length the issue of global demographics and aging. Here, we will simply note that in major West European countries, a static population size is already slowing labour force growth and lowering potential output. The situation is similar in Japan: recent UN analysis suggests that its population could shrink by more than 20 million by 2050, to 105 million people. With a growing proportion of workers retiring and leaving the labour force, these countries will face a strong and sustained negative impact on growth potential.

**Chart 1**
Public Sector Deficits, 2005
(percentage of GDP)




Sources: The Conference Board of Canada; Consensus Economics.

Added to this are underlying economic problems in many industrialized countries. Western Europe, Japan and now the United States all have significant fiscal deficits (see Chart 1) and rising public debt. The causes include labour market rigidities, as well as protection and subsidizing of favoured sectors, such as agriculture. Other challenges are the rising pension and health-care costs of an older population, and uncertainty over the appropriate national strategy to pay for pensions. All of these problems compound the impact of an aging population on economic performance.

Real incomes and individual purchasing power are likely to remain high in Western Europe and Japan for decades to come. Still, their aging populations and structural economic problems have undeniably become a drag on economic growth. This reality has lessened the attraction of many industrialized countries as future export and investment markets.

## The Emerging Markets

Contrast this with the developing world, where sustained economic growth is leading to a fundamental shift in global economic power and political influence.

Rapid economic growth has long offered a potential advantage to developing countries such as China and Brazil. For many years, they could not seize the advantage because of generally weak and unstable macroeconomic and microeconomic policies. These created periodic financial and political crises.

**Brazil, Russia, India and China—dubbed the "BRIC" nations—have high growth potential and increasing economic clout.**

In recent years, however, many developing countries have sought to improve their economic policy frameworks. The actions of these countries have boosted their underlying growth potential and made them much more attractive places in which to do business. Trade as a share of gross domestic product (GDP) has risen, increasing competition in the domestic market. Inward foreign direct investment (FDI) has driven growth and trade. Among attractive emerging economies are countries as varied as Slovenia, Bahrain, Chile and Thailand.

Last year's *Performance and Potential* identified China and India as rising global forces. Observers group these countries with Brazil and Russia, and refer to the four as the "BRIC" nations (Brazil, Russia, India and China)[1]—emerging markets with high growth potential and increasing economic clout. (See Chart 2.) Each is at a very different stage of economic and political development, yet all four are on course for sustained growth. With their current and projected performance and their market size, they offer great trade and investment opportunities. Canada's political leaders have given priority to expanding trade relationships with the four. We will examine their emergence more closely.

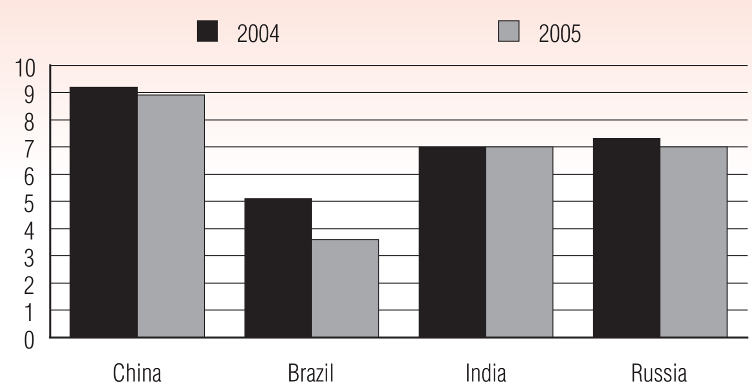
One magnet drawing exports and investors to these countries is a burgeoning middle class of consumers with disposable income. A recent study sets the bar for the middle class in emerging markets at a per capita income equivalent to US$6,000 or higher, since at this point consumers have enough discretionary income to begin purchasing durable goods and higher-value food products in quantity.[2] We have used that benchmark and related analysis here to identify the middle-class market segment in the four emerging markets.

### *China: A Spectacular Transformation*

In 1982, Deng Xiaoping famously declared, "To get rich is glorious." China took to heart the words of its pragmatic leader, and embarked on a spectacular economic transformation. After a quarter century of step-by-step market-oriented reform, China is the world's fastest-growing major economy and an emerging superpower. Since the mid-1990s, it has sustained annual real growth rates of 7 to 8 per cent or higher, with acceptable inflation rates. It has kept up this success despite the 1997 Asian crisis and the recent challenges of managing a fixed rate of exchange against the U.S. dollar. China's share of world trade doubled from 2000 to 2005, and it now exceeds 6 per cent of the total. By the measure noted above, the country's urban middle class already exceeds 200 million. By 2010 it could reach 400 million— 30 per cent of the population.

China offers tremendous opportunities as a consumer end-market. It is a source of lower-cost labour within firms' global production chains. Increasingly, it is a source of more advanced technology and production. Its growth potential will slow gradually over the coming decades as the population matures and the economy approaches the limits of its production possibility frontier. Still, estimates suggest that China will be able to sustain economic growth of around 4.5 per cent to 2025.[3]

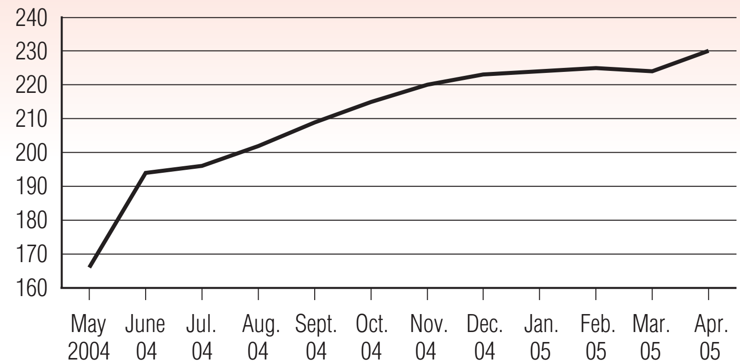
**Chart 2**
Economic Growth in BRIC Countries
(percentage change in real GDP)




Source: Consensus Economics.

China's most immediate challenge has been to find an exchange rate policy that meets domestic economic needs and responds to external political pressures. Earlier this year, the Chinese government had set the stage for this shift when it permitted seven international banks to join with two domestic banks as market-makers for foreign exchange trading. After months of urging by the U.S. government, China finally changed course in late July. The yuan now floats against a basket of currencies with an immediate appreciation of 2.1 per cent, bringing its initial value to 8.1 per U.S. dollar from 8.3. Each day, China's central bank will set an exchange rate for the yuan, and daily trading will be allowed within a 0.3 per cent range—from 7.97 to 8.22. The move should help China deal with inflationary threats fed by the massive accumulation of foreign exchange reserves resulting from the fixed exchange rate (see Chart 3), although the lack of transparency in how the policy will be implemented could be troubling.

**Chart 3**
Chinese Purchases of U.S. Treasury Securities
($US billions holdings at end of period)




Sources: Trade Information Centre (TIC), U.S. Department of Commerce.

**China's urban "middle class" already exceeds 200 million and could reach 400 million by 2010.**

### *India: Incomplete Journey to Reform*

India has moved more gradually toward emerging market status. The middle class represents less than 10 per cent of the country's population, but that translates into 90 million consumers with growing discretionary income. Annual real growth has risen from 3.5 per cent in the 1980s to 6 per cent or higher today. Two factors have fuelled the rise: internal economic liberalization and deregulation undertaken in the early 1990s, which unleashed market forces in parts of the domestic economy, and an expanding position in the global supply chain for information services. India has quickly produced some cutting-edge companies that are eager to trade and invest much more with the rest of the world.[4]

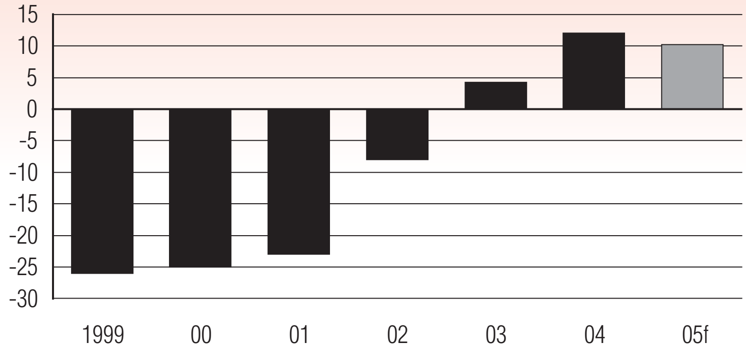
Yet the old India persists: an impoverished, overpopulated, traditional agrarian economy. Annual monsoon rains are still a very important swing factor in terms of agricultural performance and national economic growth. A good monsoon—not too heavy, not too light—can easily add 2 per cent to annual GDP growth. Economic reform has proceeded unevenly. There have been some successes: a value-added tax was introduced recently to widen the tax base and improve fiscal results, and caps on foreign investment have been eased modestly in selected sectors. But progress has been lacking on privatization, financial sector reform, labour market reform and reductions in subsidies to interest groups. Another obstacle is poor physical infrastructure.

If India ever fully opens its economy to enjoy the benefits of free trade and foreign investment, it could achieve a sustainable annual growth rate rivalling or even surpassing that of China. So long as reform remains incomplete, however, India will continue to trail its neighbour. Still, with its younger and faster-growing population, India could sustain an annual growth rate in the range of 6 per cent through 2025. Eventually, India could surpass China in terms of both population and economic growth potential.

### *Brazil: Still the Country of Tomorrow?*

Over the past 50 years, Brazil has seen many twists and turns along its economic path. Microeconomic and trade policy fluctuated, with periods of strong protectionism and cautious market opening. Macroeconomic policy varied from uneven at best to destructive at worst, triggering hyperinflation, external debt crises and sharp devaluation. Since the 1998 devaluation shock, however, Brazil has quietly striven to adopt more disciplined fiscal policies and reduce its habitual overreliance on foreign borrowing (see Chart 4), while opening up to more foreign investment.

**Chart 4**
Brazil's Current Account Balance
(US$ billions)




f = forecast
Source: Consensus Economics.

Crisis again loomed in the run-up to the 2003 presidential election: the currency rapidly fell in value and the risk premium soared on the country's foreign debt. But the fears have proved unfounded: since taking office late in 2003, President Lula has acted to promote economic stability.

Fiscal operating surpluses have grown beyond 4 per cent of GDP, real interest rates have been maintained at high levels, and confidence has been rebuilt with foreign creditors and local businesses. Brazil is quickly opening its economy through an array of bilateral and regional free trade agreements and discussion, starting in Latin America and spreading to other emerging markets. It has also introduced crucial pension and tax reforms, although the social consensus on structural reform remains fragile. Improved investor confidence has come at the expense of short-term economic growth, eroding Lula's popularity with working-class voters. Brazil's income distribution remains highly skewed. Its middle class numbers 50 million, but that is only a third of the country's population.

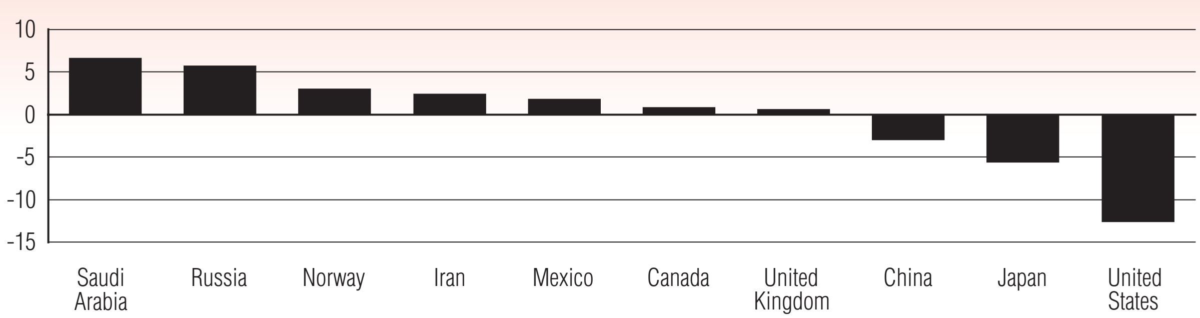
For half a century, Brazil's challenge has been to spur economic growth and, at the same time, to share the benefits of growth more widely and fairly. With continued progress on meeting that challenge, Brazil could sustain annual growth of 4 per cent through to 2025 and could finally stop being "the country of tomorrow."

***Russia: Riding High on Oil and Gas***

Russia has ridden a roller coaster since the collapse of communism in 1991. The ensuing years saw attempted coups, economic policy drift, hyperinflation, currency crises and a fire sale of state assets. The country reached rock bottom in 1998 when it defaulted on its external debt.

Vladimir Putin's ascent to the presidency represented a turning point, both economically and politically. National governance has become more consistent and predictable, but it fails to conform to Western concepts of democracy. Russia continues to struggle with the basics of modern political culture. The rule of law has not firmly taken hold. Imperial ambitions live on, as shown by the clumsy intervention in the Ukrainian presidential election. In its struggle with Muslim fundamentalism in Chechnya, Russia has again resorted to tough tactics; however, there is still fear that these will not deter further terrorist attacks.

**Chart 5**
World's Major Oil Producers and Users, 2003
(millions of barrels per day; net production)




Source: International Energy Agency (IEA).

In contrast, the economy has performed remarkably well in recent years, although it is heavily dependent on the oil and gas sector. (See Chart 5.) Russian oil and gas production has recovered to the levels of the late 1980s. Domestic energy consumption is now much lower and more efficient than in the Soviet period; as a result, the country can export two-thirds of its energy production, rivalling Saudi Arabia as the world's leading oil exporter. This strong performance has allowed the Russian economy to achieve a new annual growth baseline of around 6 per cent, and to grow even faster when global energy prices are high. But other sectors have been handicapped by the so-called Dutch Disease (see text box, "Will Canada Catch Dutch Disease?" in Chapter 5)—that is, loss of competitiveness resulting from currency appreciation driven by the energy sector. Bold words have been spoken about the need for wider reform, but action is lacking.

**Wider reform has been called for in Russia, but action is lacking. Still, Russia's prospects look much brighter today than they did in 1991 or 1998.**

Still, with steady growth and a middle class of roughly 65 million (45 per cent of the population), Russia's prospects look much brighter today than they did in 1991 or 1998. Despite an aging population, sustainable growth of 3.5 to 4.5 per cent should still be possible through 2025.

## HOW INTERNATIONAL TRADE IS CHANGING

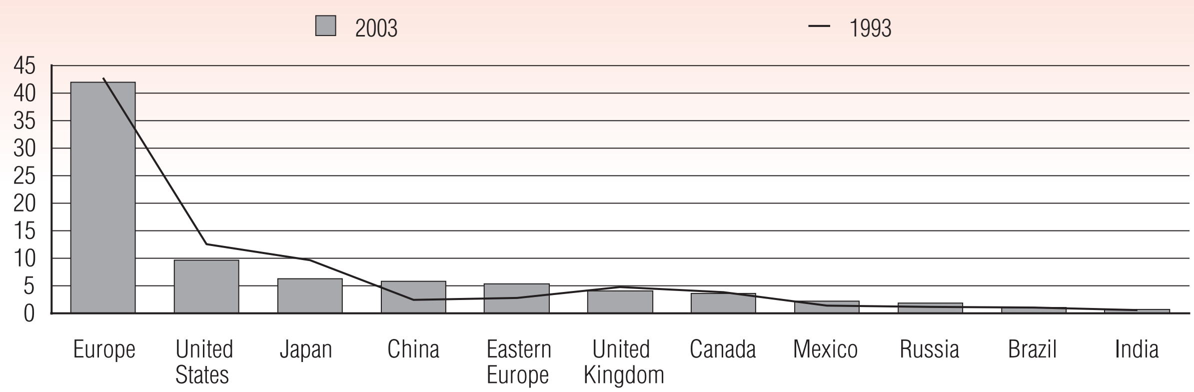
### Shifting Rankings in Global Trade

Based on data from the World Trade Organization (WTO), Chart 6 shows that the BRIC nations and other emerging markets are increasingly important in global trade. Emerging economies have lower labour costs and are adopting more open policies toward trade and investment. Their export growth has outstripped that of more mature economies. China accounted for 2.4 per cent of total world exports in 1993, compared with close to 6 per cent in 2003. Over the same period, Mexico's share of total world exports grew from 1.4 to 2.2 per cent, Russia's share rose from 1.2 to 1.8 per cent, and the share of Eastern Europe (including Russia) increased from 2.8 to 5.3 per cent. Brazil's and India's shares were effectively constant.

China, Russia and Eastern Europe increased their export share as a result of making a transition from planned, relatively closed economic systems to more open, market-based systems. Time is still needed to complete the transition, but these countries can be expected to increase their export shares further. Mexico achieved a higher share as a result of joining the North American Free Trade Agreement (NAFTA), implemented in 1994.

Chart 6 also shows a reduced role in global trade for some of the world's dominant economies. The U.S. share of world exports dropped from 12.6 to 9.6 per cent. Japan's share fell by a third, to 6.3 per cent, and other industrialized nations saw their shares drop as well.

**Chart 6**
Share of World Exports—Selected Countries
(per cent)




Sources: The Conference Board of Canada; Statistics Canada.

Canada's share of global exports declined marginally even though the country achieved much faster export growth during the 1990s under NAFTA (1994), and under the Canada–U.S. Free Trade Agreement (FTA), implemented in 1989.

**Traditional and Integrative Trade in Theory and Practice**

The economic theory behind traditional international trade is frequently described in terms of absolute and comparative advantage. Under absolute advantage, trade takes place because a good is available only in certain countries, or because a good can always be produced less expensively in one country than another. Comparative advantage is more complex; it involves countries specializing in what they do best. Even if one country can produce everything less expensively than can other countries, greater overall wealth is created if that country specializes in whatever it does the very best, which yields the best return, and then trades with other countries. Imagine a person who is not only the best lawyer, but also the best typist in town. It pays for the lawyer to focus on legal work and hire a good typist to do typing work. Specialization and trading will increase total output and welfare.

Traditional trade is generally viewed as the sale and shipment of physical goods between countries. Trade in goods is easy to define and measure, and therefore simple to understand. Trade in services has also existed since the earliest days of international trade, but its importance has often been overlooked. Even today, statistics on services trade appear significantly later than data on trade in goods. Exports and imports of goods can be easily counted at the border because they involve the physical movement of physical objects. In contrast, services trade involves the cross-border buying and selling of human behaviour and ideas. It is measured via surveys and arm's-length data collection, frequently occurring well after a transaction takes place.

In the traditional trade paradigm, foreign markets are primarily end-users of export products. Goods are sold internationally to be consumed or invested to produce other goods for domestic consumption. In the case of traditional exports, the foreign (or imported) content is usually low—less than 20 per cent. Limited attention is directed to the role of imports in production and consumption. Not surprisingly, the general public commonly sees trade issues in terms of harm caused to exports by the protectionist behaviour of another country. Occasionally, public attention turns to low-cost imports that crowd out local producers. The media will rarely focus on a producer that is hurt by restrictions on imports of intermediate or capital goods.

The pro-export bias of the traditional paradigm leads people to think that exports are good for a country and imports are bad, taking jobs away from local workers. Economists refer to this way of thinking as mercantilism. It contains a basic flaw: every export requires an import somewhere else, since international trade must ultimately balance. The mercantilist mindset creates the risk of trade protectionism, especially when economic growth declines or when a particular industry is deemed to be threatened by competition from cheaper imports. As history has shown (for example, in the circumstances surrounding the Great Depression of the 1930s), protectionism is a recipe for global economic stagnation and conflict between nations.

The term we have given to the new paradigm is "integrative trade."[1] This term better reflects current practice, capturing all elements used by firms to achieve the lowest possible cost and maximize the return for their products—exports, imports that are used to produce exports, foreign direct investment (both inward and outward), offshore outsourcing and insourcing, and sales from foreign affiliates created through foreign direct investment, notably sales of services. The growing importance of integrative trade does not imply that traditional trade is being entirely replaced; instead, it is being enhanced. Traditional trade remains important for many products in many sectors of the economy, and it creates a strong foundation for the next generation of trade opportunities by promoting greater international economic integration.

1 See Glen Hodgson, *Trade in Evolution: The Emergence of Integrative Trade* (February 2004), published at <www.edc.ca>.

**The Emergence of Integrative Trade**

The past half century has brought expanded multilateral and regional trade liberalization, along with advances in transportation and communications technology. At the same time, a number of developing countries have been integrated into the world economy. These changes have transformed global patterns of production, investment and trade. (See box, "Traditional and Integrative Trade in Theory and Practice.") Traditionally, trade involved physical goods with high domestic content, sold and shipped between buyers and sellers in different countries. Today this model has been reshaped by greater international competition for capital, technology and markets. Products are increasingly broken down into components, each of which is produced in the most advantageous location. The result has been the development of global products, distributed through global supply chains across many countries.

To a growing extent, firms rely on foreign direct investment (FDI) to build and manage the global supply chains that have emerged. Growth in FDI flows has accordingly surpassed the growth in both trade and GDP over the past two decades, with companies using FDI to construct international supply chains, develop closer contacts with their foreign customers and partners, and provide better service. The accumulated stock of global FDI nearly tripled during the 1980s and tripled again in the 1990s, attaining a level of US$8.2 trillion by 2003. (See Chart 7.) Accordingly, international trade and investment should now be seen as parts of an integrated system. Businesses generate revenues and profits not only by exporting and importing goods, but also by investing in other countries or accepting inflows of FDI to make themselves more competitive. The profits and dividends realized from FDI are subsequently transferred between countries and reinvested in even more trade, leading to greater economic growth.

**Outward FDI: Trade Substitution or Trade Creation?**

Trade and foreign direct investment have both grown explosively over the past two decades. As a result, economists have changed their view of the relationship between these two activities.

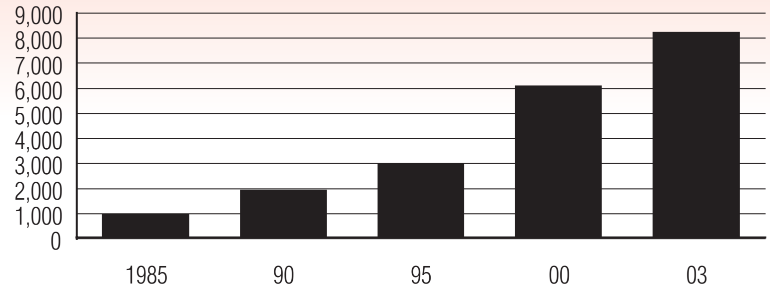
Traditionally, FDI was seen as a substitute for trade: if a firm invests in setting up affiliates in other countries, its sales from the affiliates could replace exports from its home country to the foreign markets. The substitution hurts the home country's domestic economy through a negative impact on national production and employment. More specifically, before the multilateral liberalization of trade that gained momentum in the 1960s and 1970s,[5] multinational corporations invested in other countries as a way of avoiding tariff barriers that made it difficult for them to increase export sales. By establishing branch plants abroad, they could avoid prohibitive tariffs—but export sales from their home country were likely to grow more slowly or even decline.

This branch plant phenomenon was common in Canada through most of the past century. High tariff barriers encouraged FDI, generally from American companies. The investment in Canada became a substitute for exporting manufactured products from the United States. Foreign companies also used FDI to secure access to Canada's bountiful natural resources.

**Exports and imports can no longer be treated separately. They are integral parts of the same global supply chain.**

Globalization has altered economists' view of the relationship between FDI and trade. Certainly, FDI can be a substitute for trade in certain markets, sectors and products, but it can also complement export activity. In other words, economists now see outward FDI as creating new exporting (and importing) opportunities.[6] FDI enhances a recipient country's ability to expand production in the sector where the investment is directed. More economic activity means more jobs and income gains in the recipient country. The higher incomes lift the country's ability to spend on imports. Given the trade linkages resulting from the initial investment, some of the imports will come directly from the investing country, and it will benefit indirectly from generally higher import levels in the recipient country. Often, imports from the investing country may be capital equipment or engineering services to support a particular project; this is the case especially when a developed country invests in a less developed country.

**Chart 7**
World Stock of Inward Foreign Investment
(US$ billions)




Source: United Nations Conference on Trade and Development (UNCTAD).

**Integrated Global Supply Chains**

With trade liberalization, technological change and the rise of integrative trade, the foreign or imported content of exports has increased. Firms now seek better quality and pricing for all the parts of their supply chain, whatever the source. The smooth flow of imports around the world has become crucial to the health of the global economy. Exports and imports can no longer be treated separately. They are integral parts of the same global supply chain, especially in manufacturing. In sectors such as telecommunications, aerospace, ground transportation and the automotive industry, work-in-process travels repeatedly back and forth across borders before the final output is delivered to the customer.

Global supply chains explain why close to one-third of world trade today is intra-firm trade. Multinational companies have production plants and distribution networks in various countries to take advantage of differential costs of production, resource markets and tax rates. The fragmentation of the production process requires their affiliates to engage in trade before assembling the components of a product for final sale to customers. Some intra-firm trade involves shipping final goods from assembly facilities to foreign affiliates, which then distribute the goods in the countries where they are to be consumed.

Deciding how to distribute production around the world is an extremely complex task. Corporations must determine the costs and benefits of different locations, as well as the degree of control needed over the production process. As they divide production among different countries, they must accurately assess advantages, risks and vulnerabilities. Their decisions affect the overall volume and pattern of intra-firm trade, and the extent to which external suppliers participate through outsourcing.

The rise of emerging markets has contributed to the move toward globalization and integrative trade. Even without that impetus, the shift would have occurred: international trade was already expanding and evolving in response to the proliferation of multilateral, regional and bilateral trade agreements in the 1980s and 1990s. But firms now have many more options to weigh when determining where to locate different parts of their global supply chain. China, for example, offers potential foreign investors not only low labour costs, but a growing technical workforce and improving infrastructure. Other countries, such as Vietnam, are now eager to open up their economies in order to compete with China for valuable investment dollars.

**With the move towards globalization and integrative trade, firms now have many more options to weigh when determining where to locate different parts of their global supply chain.**

## CANADA'S STANDING IN THE WORLD TODAY—AND TOMORROW

How has Canada been affected by demographic change and the growing prominence of integrative trade and global supply chains? In this section, we use economic and financial indicators to analyze Canada's ranking in the world economy, and we investigate the changing patterns of Canada's international trade over the past 15 years. We also examine trends in Canada's inbound and outbound FDI, as well as recent developments in sales involving Canadian companies and foreign affiliates.

### HOW CANADA RANKS IN THE WORLD ECONOMY

#### Slipping Share and Status

Since the second half of the past century, Canada has had an important place in the global economy. As a founding member of the International Monetary Fund (IMF), the World Bank and the General Agreement on Tariffs and Trade (GATT), we have always enjoyed high standing in these entities. From the outset, Canada has been represented and involved at senior levels in policy questions, as well as in financial and lending issues.

**Over the decades, Canada and other individual countries have seen their share of the global economy slowly decline.**

Canada's standing in the IMF and the World Bank serves as an indicator of our international economic status over the past five or six decades. A country's IMF quota and World Bank share broadly reflect its share of global GDP and its involvement in international trade. Canada's capital share and voting power in these organizations is significant. Our IMF quota is 2.99 per cent—the same as China's, placing us seventh in the world. Over the decades, however, Canada has seen its shares and voting power slowly decrease as new members joined the two organizations, and as our actual shares of the global economy and international trade were recalculated.

In capital share and voting power, developing countries are generally under-represented at the IMF and the World Bank. Shares are only partially realigned with each increase in capital or financial resources, and developing-country users of IMF and World Bank credit cannot act as a financial backstop for themselves. Canada and other industrialized countries thus have shares that reflect their past standing in the global economy, not where the world is now or where it is headed.

By the measure of nominal GDP at current (April 2005) exchange rates, Canada places ninth in the world, at 2.39 per cent. (See Chart 8.) We have the smallest economy among the Group of Seven (G7),[7] and we also rank behind China and Spain. Of the BRIC economies, only China outranks Canada in share of global GDP at current market exchange rates. But market-based exchange rates fluctuate and can distort comparisons between countries. For example, the euro has appreciated against the Canadian dollar over the past three years, thereby boosting Spain's share of nominal global GDP beyond the share of Canada.

For international comparisons and country rankings, purchasing power parity (PPP) is a more stable measure. PPP provides the conversion rates at which a comparable basket of goods and services would be the same price in all countries—in other words, the conversion rates at which purchasing power is equalized. PPP represents the long-term equilibrium for a country's exchange rate within the world economy. In many respects, it provides a preview of the country's future international economic status. There are various estimates of PPP—*The Economist*, for instance, has its Big Mac Index, based on the price of a McDonald's hamburger—but they generally produce comparable results.

**The trend is unmistakable: the North's share of global GDP is declining and the South's share is rising.**

Using PPP conversion rates, Canada's share of global GDP slips to less than 2 per cent, and its global ranking slides from ninth to 11th place. But all the other G7 countries also see their GDP shares fall by a third or more by the measure of PPP. For example, the U.S. share of global GDP declines from 29 to 21 per cent, and that of Japan from 11.5 to 7 per cent.

The share of global GDP jumps for all the BRIC economies, as does their global ranking, when PPP conversion rates are applied. In the case of China and India, each country's share of global GDP triples. China's leaps from around 4 per cent to over 13 per cent, and its ranking leaps from eighth to second. India's share increases from 1.7 per cent to 6 per cent, advancing it from 11th to fourth place in the global rankings. Brazil and Russia each see their share of global GDP increase by a full percentage point. Russia moves up to ninth and Brazil to 10th place in the global rankings, leaving Canada behind in 11th place.

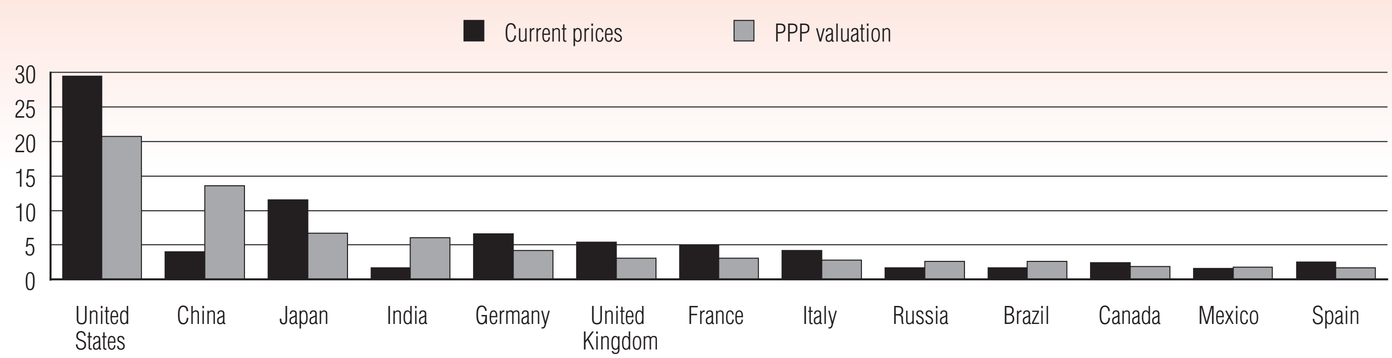
There is no guarantee that PPP estimates and actual market-determined exchange rates will eventually converge. However, the trend is unmistakable: the North's share of global GDP is declining and the South's share is rising. With an aging population and slowing rates of annual economic growth potential, Canada will find it hard to avoid falling further in the global rankings.

Two observations can be drawn from this situation. First, Canada will have an increasingly difficult time justifying its claim to G7 membership in the years ahead. But second, we are not the only member of the G7 to see a change in global status. Under PPP rates, China's share of global GDP exceeds that of Japan and every other G7 member except the United States. Powerful forces are clearly at play in the global economy, and they will change the distribution of economic power in coming decades.

**Status in International Finance**

Another measure of status is the use of a country's currency as a means of exchange or as a store of value. By far, the bulk of world trade is denominated in U.S. dollars, although the euro is taking on increasing

**Chart 8**
Country Shares of Global GDP: Current Exchange Rates vs. PPP
(per cent)




Source: International Monetary Fund.

importance. As Table 1 shows, these two currencies are the dominant reserve currencies, with the U.S. dollar representing about 64 per cent of identified global reserves and the euro nearly 20 per cent. The yen is also a major reserve currency, since Japan is a leading trade partner for many countries. Finally, since London remains the world's financial hub, the British pound continues to be an important reserve currency.

In contrast, foreign demand for Canadian dollars is negligible. The amount of Canadian currency held by most countries is not sufficient to be reported separately. Our own analysis of Canadian liabilities indicates that the United States is the largest holder of Canadian currency, followed by the United Kingdom.[8] In both cases, the Canadian content of these countries' reserves is marginal compared to that of first-tier reserve currencies. In short, the Canadian dollar is at best a second-tier currency in international trade and finance.

**Table 1**
Composition of World Foreign Exchange Holdings
(percentage as of year end, 2003)

| Currency | All countries | Industrial countries | Developing countries |
|---|---|---|---|
| U.S. dollar | 63.8 | 70.8 | 59.3 |
| Euro | 19.7 | 20.9 | 18.9 |
| Japanese yen | 4.8 | 4.0 | 5.2 |
| U.K. pound sterling | 4.4 | 1.7 | 6.2 |
| Swiss franc | 0.4 | 0.2 | 0.6 |
| Unspecified currencies | 6.8 | 2.3 | 9.8 |

Sources: International Monetary Fund, AR of Executive Board for fiscal year ended April 30, 2004.

In terms of equity market capitalization, Canada actually performs better than on some of the other measures we have discussed: it currently ranks sixth in the world, ahead of Italy among the G7 countries. How long it can maintain that ranking, however, is open to question, given the rapid expansion of equity markets in the BRIC countries. China, India and Russia have each shown spectacular growth in equity market capitalization over the past decade, and they will soon overtake Canada within the global rankings.

A peculiarity of Canada's equity markets is the small scale of Canadian firms. Only the United States and India have more listed companies than Canada—an indication that the Canadian economy is heavily dependent on firms that are small and medium-sized in the global arena. (See Table 2.)

The performance of the mining sector is a notable exception to Canada's slowly declining status in international equity finance. Here the country is a world leader. There is much that we can learn from the sector's performance. (See box, "The Mining Sector Equity Market—A Model to Replicate?")

**Table 2**
Global Equity Market Capitalization

| | Value (US$ billion) | | Companies (number) | |
|---|---|---|---|---|
| Country | 1990 | 2004 | 1990 | 2004 |
| Brazil | 16,400 | 330,347 | 581 | 357 |
| Canada | 242,000 | 893,950 | 1,144 | 3,578 |
| China | 2,030 | 639,765 | 14 | 1,384 |
| France | 314,000 | 1,355,643 | 578 | 723 |
| Germany | 355,000 | 1,079,026 | 413 | 684 |
| India | 38,600 | 387,851 | 2,435 | 4,730 |
| Italy | 149,000 | 614,842 | 220 | 271 |
| Japan | 2,920,000 | 3,040,665 | 2,071 | 3,116 |
| Russia | 244 | 267,957 | 13 | 215 |
| United Kingdom | 849,000 | 2,412,434 | 1,701 | 2,311 |
| United States | 3,060,000 | 14,266,266 | 6,599 | 5,295 |

Source: World Bank Group, *World Development Indicators 2005* (March 2005).

### A Choice Ahead for Canada

Canada's status within the global economy is slowly slipping. Canada's share of global GDP is not seventh in the world, either at current exchange rates or on the basis of more stable and long-term PPP exchange rates. Foreign demand for Canadian currency as a means of exchange and store of value is negligible. Our equity market presence is still substantial, but it is at risk of decline in relative terms. Only the mining sector equity market offers some hope for success, with a strategic approach to capital market growth, based on niche specialization.

In striking contrast is the performance of China, India and the other BRIC nations. Their rise is increasing pressure for a reordering of international economic relations. Canada must continue to press to take on an expanded role for the G20 or a comparable group.

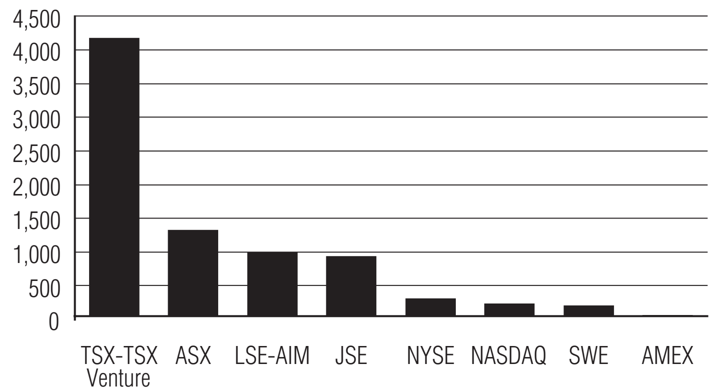
**The Mining Sector Equity Market—A Model to Replicate?**

Canada's mining and mineral sector (MMS) is a global leader in equity. The Toronto Stock Exchange and the TSX Venture Exchange lead in listing mining companies—over 1,100 firms valued at about US$120 billion. TSX mining companies raised US$4.2 billion in 2004, the largest amount raised on any exchange in the world. (See Chart, "Global Comparison of Mining Equity Financings, 2004.")

Canada's abundant mineral wealth is but one factor in this strong performance. Several others are involved:

- **Superior access to capital**. The TSX Venture Exchange has unique, innovative listing mechanisms and a track record of successful junior mining incubation.[1] Mining and mineral companies listed in Canada are eligible for inclusion in the globally recognized Standard & Poor's and TSX indexes, as well as specialized mining indexes. In addition, historical trading volumes show a liquid secondary market for mining securities.

Global Comparison of Mining Equity Financings, 2004
(US $ millions)




Source: Gamah International (December, 2004, Preliminary data compiled by TSX Group.

- **Global reach**. Of Canada's goods-producing industries, the mining and mineral sector has the largest stock of outward foreign direct investment. Canadian equity markets help to finance international mining and mineral projects with significant country risk as well as product or sectoral risk, notably working with many developing countries. As of January 2005, a third of the 7,900 mineral projects held by public Canadian companies were outside North America; 780 were in South America alone.

- **Supportive regulation and infrastructure**. Canadian securities laws and exchange standards—particularly mining disclosure requirements unique to Canada[2]—were designed to inspire investor confidence in the MMS capital market. Over 50 per cent of the world's public mining companies are listed in Canada, and the country has one of the finest and strongest scientific and technical infrastructures related to the minerals and metals industries.

- **Innovative policy measures**. In October 2000, the Government of Canada introduced a temporary 15–per cent federal Investment Tax Credit for Exploration for flow-through share investors. This stimulated investment in mineral exploration in Canada, as is shown by the change in levels of Canadian exploration expenditures, from $600 million in 2001 to more than $900 million in 2004.

Can other industries learn from this success story? To follow a similar path, other sectors must have or develop a comparable core competency, combined with global aspirations. Needed as well is joint action by industry, government and financial institutions—specifically, to replicate the TSX Venture Exchange incubation process in some form. The challenge remains to be met.

1 For example, the Capital Pool Company program is very popular with junior oil and mining firms in Canada. The program allows entrepreneurs to raise capital quickly, with relatively inexpensive listing fees.

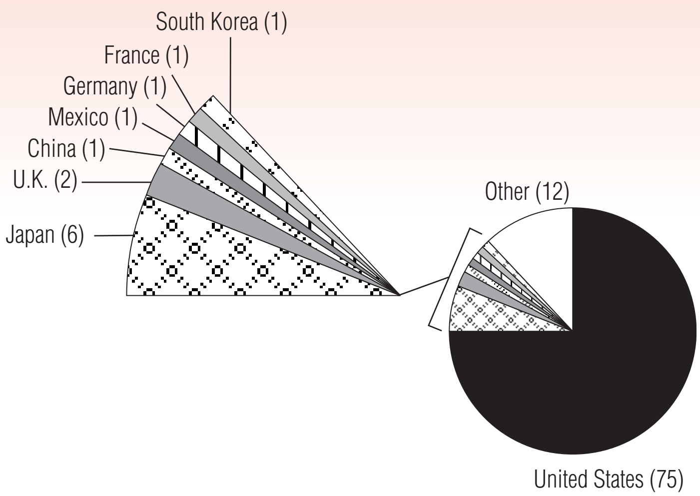
2 The TSX enforces news release disclosure guidelines for exploration and mining companies. In 2001, the Canadian Securities Administrators published National Instrument 43-101, a rule governing standards of disclosure for those companies.

## TRENDS IN CANADIAN TRADE

### Analysis by Country and Content

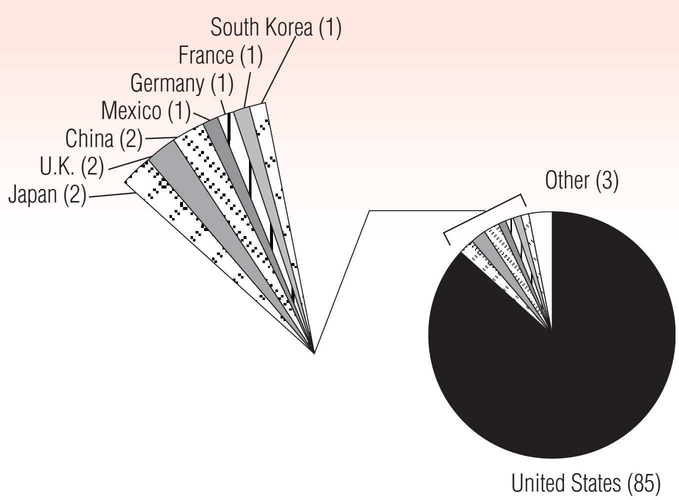
The United States continues to be the primary destination for Canada's exports, as well as the primary source of our imports. Since the FTA came into effect in 1989, Canada has become steadily more dependent on exporting goods and services south of the border, and trade as a share of our GDP has grown significantly (total trade now makes up 73 per cent of our GDP, up from 51 per cent in 1990). In 2004, total Canadian exports to the United States were worth $348.2 billion (current dollars). Our next most important market was Japan, which received a mere $8.5 billion worth of Canadian exports. Some 85 per cent of Canada's exports went to the U.S. market in 2004, up from 75 per cent in 1990. (See charts 9 and 10.)

**Chart 9**
Canada's Exports by Country, 1990
(per cent; share of total exports)




Sources: The Conference Board of Canada; Statistics Canada.

**Chart 10**
Canada's Exports by Country, 2004
(per cent; share of total exports)




Sources: The Conference Board of Canada; Statistics Canada.

Ranking behind the United States and Japan as destinations for Canadian exports in 2004 were the United Kingdom and China: each received about 2 per cent of total Canadian exports.

Close to 25 per cent of Canada's exports to the United States are motor vehicles, followed by mineral fuels, machinery and mechanical appliances. (See Chart 11.) Mineral fuels accounted for 19 per cent of total exports in 2004, compared with 11 per cent in 1990—although this increase mainly reflects higher oil prices in recent years.

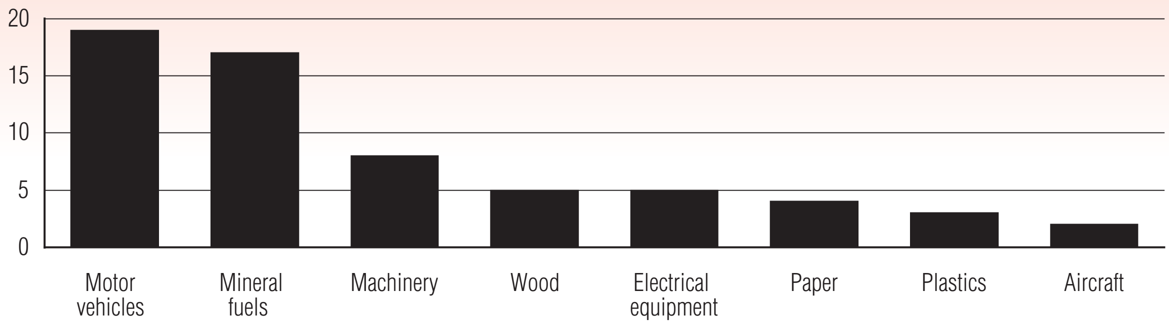
**The United States continues to be the primary destination for Canada's exports, as well as the primary source of our imports.**

The United States is also Canada's major source of imports, although this lead is diminishing. Close to two-thirds of Canada's imports originated from the United States in 1990; by 2004, this share had fallen to 59 per cent. (See charts 12 and 13.) In 1990, Canada's second-largest source of imports was Japan, followed by the United Kingdom. By 2004, Japan had dropped to fourth place and the United Kingdom to fifth, behind China and Mexico.

Motor vehicles, as well as machinery and mechanical and electrical equipment, make up nearly half of Canada's total imports. This share has been stable since 1990.

Canada's trading relationship with the United States far outweighs all our other trade relationships. Still, we have seen steady growth in our trade with emerging markets such as China, Mexico and India. Canada's total exports to China rose from $1.7 billion in 1990 to $6.6 billion in 2004, a 287 per cent increase. The share of our exports going to the Chinese market doubled

**Chart 11**
Canada's Exports by Products, 2004
(per cent; share of top 25 export products)




Source: IEA.

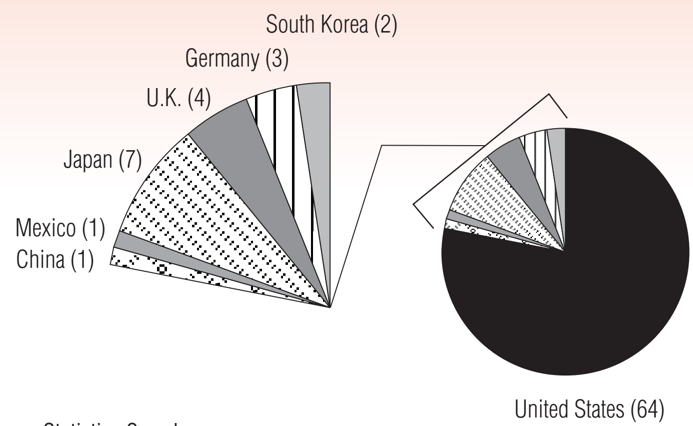
over that period, to 2 per cent of our total exports. Reflecting the impact of NAFTA, Canadian exports to Mexico grew by 353 per cent, to $3 billion in 2004. Canada's exports to India grew by 173 per cent from 1990 to 2004, although they remained low in current dollar terms, at $875 million.

While exports to key emerging markets have taken off, Canada's trade with some of its more traditional markets has either stagnated or declined. Japan's share of total Canadian exports dropped from 6 per cent in 1990 to 2 per cent by 2004, while the U.K. share remained stable at 2 per cent. The decline in exports to Japan appears to reflect reduced demand for Canadian goods as a result of repeated recessions in Japan during the 1990s, plus the change in exchange rates over the last 15 years.

Most industrialized countries' shares of imports to Canada have dropped markedly from 1990 levels. The U.S. share has gradually declined, while Japan's share of total imports to Canada fell from 7 to 4 per cent. The share of imports from the United Kingdom dropped from 4 to 3 per cent; France's share declined from 2 to 1 per cent.

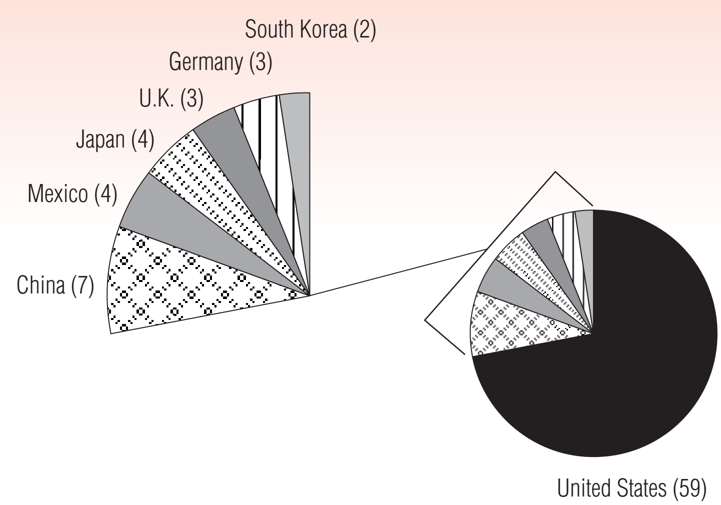
Canadian imports from emerging markets have taken off since 1990, with Canadian consumers and producers taking advantage of these countries' lower labour costs. China is now Canada's second-largest source of imports, with the total value rising from $1.4 billion in 1990 to $24.1 billion by 2004—an increase of more than 1,500 per cent! In the same period, imports increased by 666 per cent from Mexico, 594 per cent from India, 220 per cent from

**Chart 12**
Canada's Imports by Country, 1990
(per cent; share of top 10 importing countries)




Source: Statistics Canada.

**Chart 13**
Canada's Imports by Country, 2004
(per cent; share of top 10 importing countries)




Source: Statistics Canada.

Russia, and 197 per cent from Brazil. (Despite this growth, neither Russia nor Brazil ranks among Canada's top 10 import sources.)

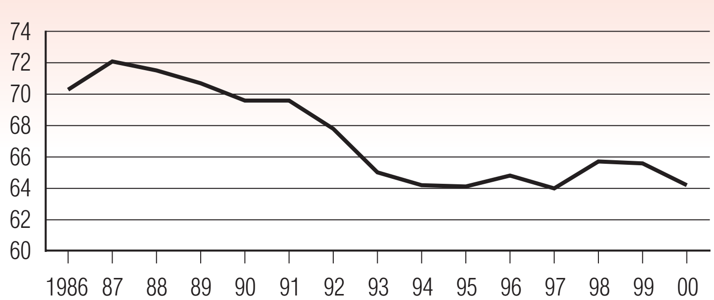
The United States still dominates Canada's import market overall, although Canadian imports from the United States no doubt incorporate more and more offshore content, from countries such as India and China. We expect Canadian trade with emerging markets to continue to increase significantly over the next two decades, with a material impact on the Canadian economy.

**Canada and Global Supply Chains**

Canada's trade over the past two decades also reflects the growing importance of global supply chains. With exports and imports becoming increasingly interconnected, the domestic content of Canadian exports has fallen. (See Chart 14.) From sector to sector, there is considerable variation in Canadian content of exports and overall production. In general, domestic content is highest (above 80 per cent) for the primary, agricultural and services sectors, where it is more difficult to disaggregate production across international boundaries. Canadian content is lower for exports of manufactured goods (60 per cent or less) because manufacturing activity can more easily be standardized and adapted to global supply chains.

The average Canadian content of exports has declined from around 70 per cent in 1990—a year after implementation of the FTA—to 64 per cent in 1999, a level at which it appears to have stabilized. Most of the drop during the 1990s is attributable to the declining domestic content of exported manufactured goods. Examples include standardized manufactured exports such as washing machines, dryers and dishwashers, as well as complex goods such as integrated circuits; their Canadian content has declined as manufacturers have restructured operations and located more of their supply chains in foreign markets to reduce costs and remain competitive. In the automotive sector, Canadian content is generally below 40 per cent, and it can even dip toward 30 per cent for some finished vehicles. Trends are similar in other highly complex manufacturing sectors, such as aerospace and ground transportation. Canadian content remains substantial, but these goods and related services are truly multinational.

**Chart 14**
Domestic Content of Canadian Exports
(per cent)




Source: Export Development Canada.

**Foreign Direct Investment: The Canadian Experience**

With completion of the Kennedy, Tokyo and Uruguay trade rounds and the resulting increase in trade liberalization (see endnote 6), foreign direct investment surged starting in the 1980s. Multinational corporations have extended their supply chains globally, working with partners in foreign countries to optimize their competitiveness.

For their part, Canadian companies have become increasingly reliant on FDI, both inward and outward. To build global supply chains linking together their production processes, Canadian companies have invested record amounts abroad; at the same time, foreign investment has sharply increased in Canada. In 1990, Canada's inbound FDI stock represented 19 per cent of nominal GDP; by 2004, the share had increased to 28 per cent. Over the same period, outbound FDI stock grew from 14 to 34 per cent of GDP. But despite the growth, Canada's global share of inward and outward FDI has fallen since 1990 as other countries have engaged in foreign investment at an even faster rate.

Taking advantage of opportunities opened up by the FTA and the end of the branch plant economy, Canadian firms set to work building their own global networks. Over the past 15 years, Canada has shifted from being a net inward investor to a net outward investor. In 1990, the stock of inward FDI was $131 billion, while outward FDI was $98 billion. In 1997, the stock of outward FDI surpassed inward FDI. By 2004, inward FDI stood at $366 billion, while outward FDI had soared to $445 billion. (See Chart 15.)

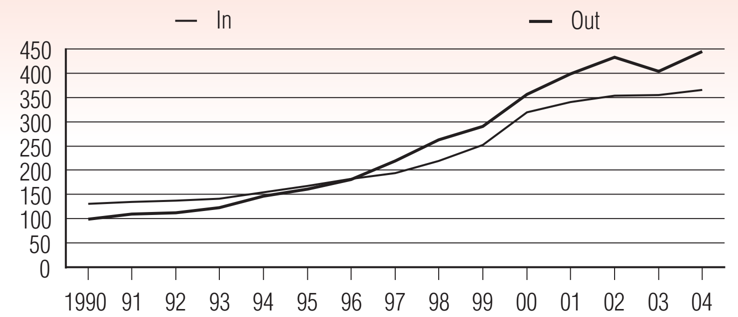
Consistent with increased North American economic integration, the United States dominates both inward and outward flows of Canadian FDI. In 2004, 65 per cent of inward FDI flows originated from the United States, and 44 per cent of outward FDI flows were destined for the U.S. market.

As with trade in goods, however, Canada has seen growth in FDI in both directions with emerging markets. For example, in 1990 there was virtually no Canadian FDI, either inward or outward, with China. The stock of Canada's FDI in Mexico reached $2.8 billion in 2004, compared with only $245 million in 1990. (See Chart 16.) Similarly, the stock of Canada's FDI in Brazil increased from $1.7 billion in 1990 to $6.4 billion by 2004. The stock of Canada's FDI in China grew to $647 million by 2004, while China's FDI stock in Canada increased to $220 million (admittedly, the figures remain low). Inward FDI from emerging markets such as Brazil, Mexico and India remains minimal, but the pace of FDI from some of these countries has quickened in recent years as their businesses have become increasingly integrated into the world economy.

By sector, manufacturing is Canada's largest recipient of inward investment dollars, with a stock of $157.1 billion in 2004. (See Chart 17.) Ranking next as recipients of inward FDI are mining, and oil and gas, followed by the finance and chemical sectors. Canada's outward FDI goes mainly to the finance and insurance sector in foreign countries. In 2004, outward FDI stock in this sector stood at slightly more than $153.7 billion—ahead of manufacturing, with a stock of about $107 billion. The outward stock of FDI in finance and insurance has grown by close to 70 per cent since 1999; Canada became a net outward investor in the mid-1990s, primarily because of FDI in financial services.

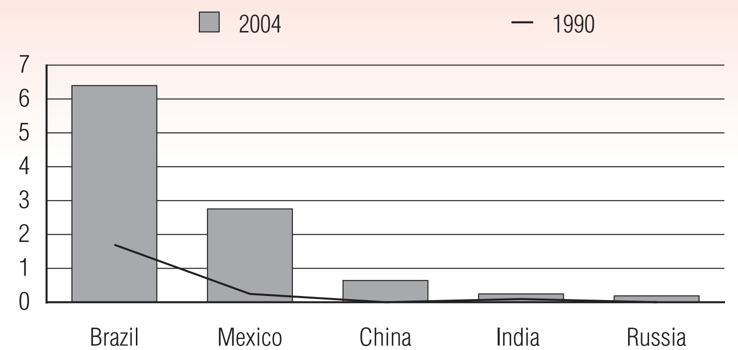
The Canadian economy has benefited from the growth in both inward and outward FDI. Inbound FDI creates jobs, and it boosts trade and domestic capacity. FDI into Canada can increase profits for the investing foreign company, with the expectation that the profits will eventually be repatriated. While the benefits of outward FDI may be less well understood by the Canadian public, the Canadian economy is reaping the rewards of investing in foreign markets. FDI from Canada to

**Chart 15**
Canada's Stock of FDI—Inbound and Outbound
(billions of current $)



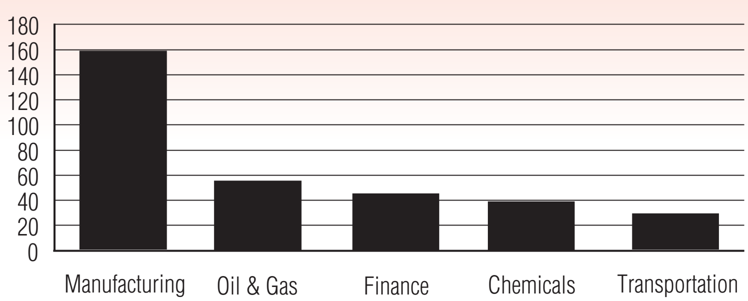

Source: Statistics Canada.

**Chart 16**
Canada's Outbound FDI by Selected Countries
($ billions; stock)




Sources: The Conference Board of Canada; Statistics Canada.

**Chart 17**
Canada's Inbound FDI by Industry, 2004
($ billions; stock)




Source: Statistics Canada.

another country generates investment and jobs in the recipient country. This increases profits for the Canadian company, and, more importantly, it raises export volumes from Canada. The impact of trade creation is especially significant when the recipient is a developing country.

**Outward FDI and Trade Creation: The Evidence**

We earlier noted that economists have changed their views on the relationship between FDI and trade: they now see FDI as complementing export growth. In an analysis of this relationship, the Organisation for Economic Co-operation and Development (OECD) concluded that, on average, each dollar of outward FDI generated double that amount in additional exports from the originating country to the recipient. FDI strengthens commercial links between the originating country and the recipient, thereby expanding exports. Moreover, FDI can stimulate intra-firm trade in both directions. The OECD study found that the trade multiplier was stronger when the recipient was a developing country rather than a mature economy: FDI to a developing country could boost trade for the investing country by three to six times the amount of the original investment.[9]

**Economists have changed their views on the relationship between FDI and trade: they now see FDI as complementing export growth.**

Export Development Canada (EDC) has conducted research on the FDI-export multiplier for Canada. Its research concluded that flows of FDI from Canada to the United States and other mature economies led to follow-on export sales of about 60 per cent of the initial investment, or a multiplier of 0.6. On the basis of the OECD analysis, EDC established a multiplier of 2.0 for FDI flows from Canada to developing countries, with the benefits spread over a number of years; that is, follow-on export sales from the investing country amounted to twice the initial investment. The export multiplier for developing countries is higher because of less efficient resource allocation in these markets; accordingly, increased foreign investment has the potential to stimulate faster trade growth.[10]

These findings suggest various ways to examine the link between outward Canadian FDI and exports. A correlation analysis we undertook tested the relationship between outward Canadian FDI and exports to a few select countries for the years 1990 to 2004. The results (see Table 3) showed a strong positive correlation (0.95) between total exports and outward FDI; this is consistent with the consensus view in the economic literature that outward Canadian FDI would contribute to stronger demand for Canadian goods and services in recipient countries.

On a country basis, the correlation between outbound FDI and exports was strongest for the United States, at 0.97. Given the close integration between the two economies, this is not surprising. Also strong was the correlation for Mexico (0.83), Canada's other NAFTA partner, and for China (0.73). Correlation results for India, Russia and Brazil were positive but progressively weaker.

In counterpoint, the correlation coefficient for Japan was negative (–0.21), indicating that outward Canadian FDI to Japan might act as a substitute for higher Canadian exports to the Japanese market. FDI to Japan from Canada started to surge in 1999, when exports to Japan began to decline. Trade barriers have made it difficult for Canadian businesses to increase exports to Japan, perhaps necessitating FDI to penetrate the Japanese market. Of course, other factors not captured by the correlation analysis could explain the weaker Japanese demand for Canadian exports—for instance, the country's weak growth through much of the 1990s, plus its focus on intra-Asian trade.

**Table 3**
Correlation Between Outward Canadian FDI and Exports

| | |
|---|---|
| Total Canadian Trade | 0.95 |
| Exports to the United States | 0.97 |
| Exports to Mexico | 0.83 |
| Exports to China | 0.73 |
| Exports to Japan | –0.21 |

Sources: The Conference Board of Canada; Statistics Canada.

As the Japanese example shows, numerous factors affect foreign demand for Canadian products and services, including real GDP growth, exchange rate movements, and absolute and comparative advantage. The FDI-export correlation analysis considers none of these factors. Nevertheless, the analysis reveals a close statistical relationship between outward FDI and exports in the U.S., Mexican and Chinese markets. These findings are consistent with the view that outward FDI and exports are, in fact, complementary in some of Canada's key export markets.

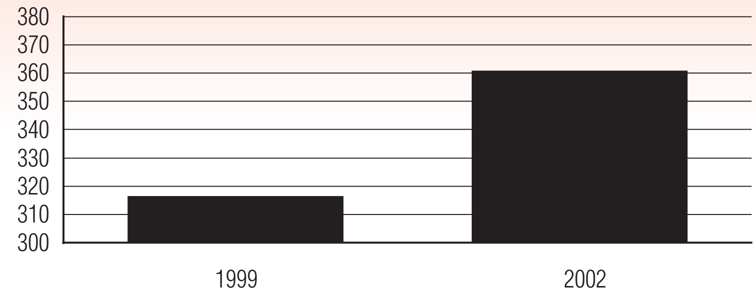
**Sales from Canadian Foreign Affiliates**

Another result of the surge in outward Canadian FDI has been increased sales from Canadian foreign affiliates. The sales have been measured only recently by Statistics Canada, using detailed data for the years 1999 to 2002 exclusively. In addition, the data capture gross, not net, sales; in other words, exports from Canada to affiliates are not subtracted, with the result that not all of these affiliate sales are incremental. Nonetheless, the numbers show that goods and services sales from Canadian foreign affiliates reached $360 billion in 2002—a figure comparable to total Canadian goods exports in that year—and they increased by 14 per cent over the four-year period. (See Chart 18.) In essence, these massive sales create a new dimension of the Canadian economy beyond our borders.

**One result of the surge in outward Canadian FDI has been increased sales from Canadian foreign affiliates.**

Sales from manufacturing companies accounted for close to 50 per cent of the total. However, services make up almost 40 per cent of total sales from foreign affiliates, and such sales of services are nearly triple the level of Canadian services exports. Services sales from Canadian-owned foreign affiliates increased strongly from 1999 to 2002, rising by 17 per cent. Services sales are also more likely to be incremental, since it is hard to export and then sell services. To a growing extent, Canadian businesses in the services industry are using sales from their foreign affiliates, not exports, to meet the needs of their foreign clients.

**Chart 18**
Canada's Foreign Affiliate Sales
(current $ millions)




Source: Statistics Canada.

The General Agreement on Trade in Services (GATS) identifies **four modes of trade in services** (below, "supplier" refers to the country offering the service, and "consumer" refers to the country that purchases the service):

**Mode 1**—Cross-border supply: A service is supplied from a supplier's country of residence to a consumer's country of residence.

**Mode 2**—Consumption abroad: A service is supplied through the movement of a consumer to a supplier's country of residence.

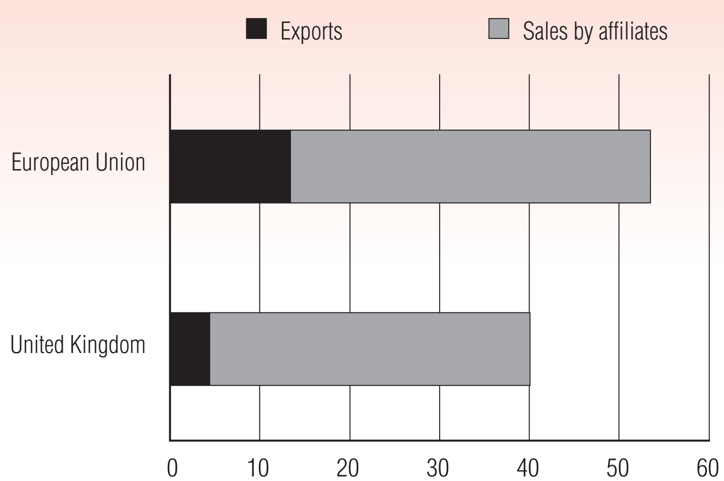
**Mode 3**—Commercial presence: A service is supplied through the movement of a commercial organization to a consumer's country of residence.

**Mode 4**—Presence of a natural person: A service is supplied through the movement of a natural person—that is, an individual who does not reside in the country and who is a national of another country—to a consumer's country of residence.

What explains the remarkably high sales from Canadian foreign affiliates generally, and particularly their sales of services? Partly at play are traditional trade factors. Facing barriers to entry into a foreign market or the need to comply with regulatory standards, Canadian businesses turn to foreign investment as a way of gaining access to that market and serving it. But the sales are also consistent with the integrative trade concept. To ensure that they meet customer expectations, service providers require close contact with their clients—and foreign affiliates provide that proximity. In addition, sales from affiliates are a crucial component of a company's global supply and distribution system. A developer of specialized telecommunications software, for instance, may need foreign affiliates not only to sell its product but also to provide installation advice and follow-up service.

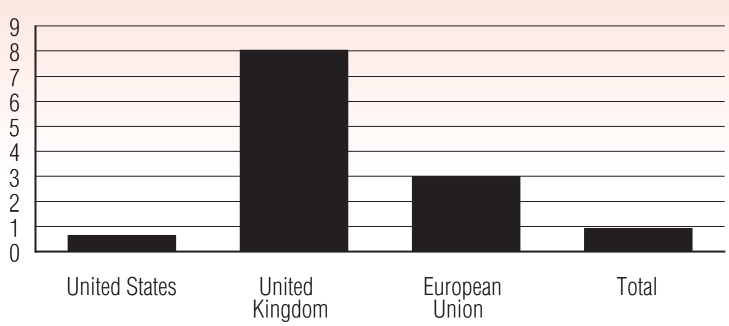
In any foreign market, sales from foreign affiliates should be treated as a key part of total Canadian business sales. Within the limitations of the data, total Canadian business sales—the sum of exports and foreign affiliate sales—can be determined for certain key markets: the United States, the United Kingdom and the European Union. Foreign affiliate sales generate the bulk of Canadian business revenue in the U.K. and EU markets. (See Chart 19.) In fact, sales from affiliates in the United Kingdom are eight times higher than Canadian exports to that country, which declined from 1999 to 2002. In contrast, foreign affiliate sales in the U.S. market are substantial, amounting to $222 billion in 2002, but that figure is much smaller than the value of Canadian exports to the United States. (See Chart 20.)

**Chart 19**
Canadian Business Revenues with the U.K. and EU, 2002
(current $ billions)




Source: Statistics Canada.

**Chart 20**
Canada's Foreign Affiliate Sales vs. Exports, 2002
(ratio; foreign sales versus exports)




Source: Statistics Canada.

Various factors account for the dominant role of exports in generating Canadian business revenue in the U.S. market. Simple geography matters: given the shorter physical distance to the U.S. market, plus the similar time zones, it is easier to serve the United States via exports. Many decades of trade growth within North America have built a strong base: two-way trade accelerated in the first decade after implementation of the FTA, leading to more integrated production systems in manufacturing. Canada does not have a similar free trade agreement with Europe, and Canadian firms seeking to sell to European clients face relative trade barriers. Many have responded by deciding to operate as European companies, with sales from affiliates. In doing so, they are leaping the relative trade barrier around Europe, just as American companies jumped over Canadian trade barriers to establish branch plants in Canada prior to the FTA.

Still another factor is customer service. Last are socio-political considerations, such as historical ties and common language; these may account for the exceptionally high level of foreign affiliate sales in the U.K. market.

By a traditional measure such as the national accounts, sales from foreign affiliates have minimal direct impact on the Canadian economy. The direct benefits are captured only as dividends and profits that eventually return to Canada. But the indirect benefits are likely to be enormous: they make Canadian businesses more competitive internationally, spur their growth and add to profitability. This indirect impact multiplies the contribution of sales from foreign affiliates to Canada's economy.

## STRUCTURAL CHANGES IN CANADA'S TRADE

In the previous section, we noted that Canada's trade over the past two decades reflects the increased importance of global supply chains. The domestic content of Canadian exports has declined as exports and imports have become ever more interconnected. In this section, we take the analysis a step further by examining how Canada fits into global supply chains. To do this, we compare the components of Canada's exports and imports over the years 1990 to 2004. We then develop a scenario for how trade between Canada and China could unfold in the next 20 years.

## HOW CANADA FITS INTO GLOBAL SUPPLY CHAINS

Canada's trade with emerging markets is increasing, the Canadian content of exports is declining, and both inward and outward FDI are growing explosively. These developments show that the Canadian economy has become closely tied to the rise of global supply chains and integrative trade. Here, we examine how Canada fits into global supply chains and how other countries fit into Canada's supply chains.

We took Canadian exports to and imports from 10 different countries and regions and broke them down into three categories: raw products, intermediate goods and finished goods. (We excluded services because of data limitations.) We chose the time frame 1990 to 2004, starting shortly after implementation of the Free Trade Agreement and continuing to the most recent year for which data were available. We assigned each product to a category on the basis of where a particular good would fit into another country's supply chain—that is, from the importer's perspective, not (as is traditionally done) from the exporter's perspective. A product such as a steel plate, for example, was treated as a raw material since it comes into use at the beginning of the manufacturing process.[11]

**The Canadian economy has become closely tied to the rise of global supply chains and integrative trade.**

The changing composition of Canadian exports indicates how Canada fits into other countries' supply chains. If Canada has continued to export primarily raw materials to a particular country over the period examined, this implies that Canada has a comparative advantage in exporting unprocessed products with little value added. A shift toward exports of intermediate products implies that Canada has developed a comparative advantage in delivering goods with more value added to other countries, and that trade integration is increasing. An increased export share for finished goods might also represent a move to higher value-added production. However, the value-added of finished goods varies considerably, with the result that expanded exports of finished goods cannot be treated as automatically signifying a move toward greater value-added integration.[12]

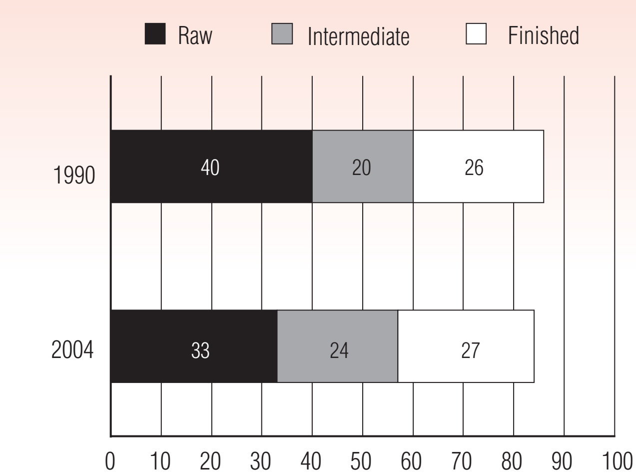
In the world of integrative trade, goods may be repeatedly shipped back and forth across borders before completion of the final product. A rising proportion of intermediate goods and, in some instances, finished goods indicates that Canada is more firmly tied into global supply chains for countries and regions around the world.

**When our trade is evaluated from the importer's perspective, the Canadian economy has become more integrated into the global system.**

### Results for Aggregate Canadian Trade

Historically, Canada has been a heavy exporter of raw materials such as oil, minerals and lumber, and that image is strong internationally. The reality today is somewhat different: under our classification method based on point of entry into other supply chains, only about one-third of Canada's exports in 2004 were raw goods. (See Chart 21.) The share of raw materials in overall exports has declined, from 40 per cent in 1990 to 33 per cent today; the share of intermediate goods has risen from 20 to 24 per cent, and the share of finished goods has increased from 26 to 27 per cent.

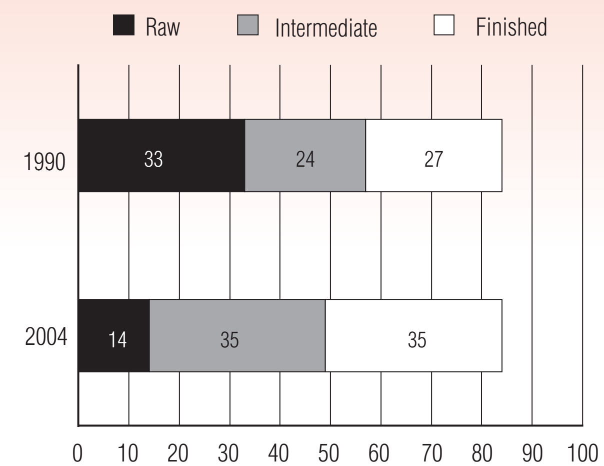
**Chart 21**
Composition of Canadian Exports, Importer's Perspective
(per cent)




Note: Bars do not add to 100 per cent as only the top 25 export categories for each year have been used.
Source: Statistics Canada.

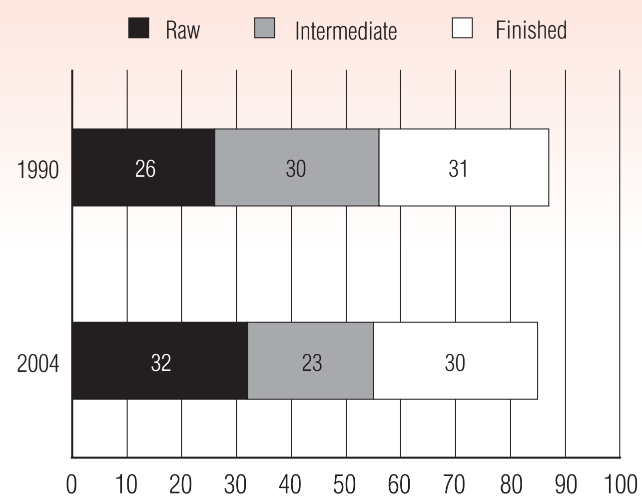
In terms of the changing shares of Canadian imports, or how other countries fit into Canada's supply chain, it is not surprising that only 14 per cent of imports were classified as raw products in 2004. (See Chart 22.) With an abundant supply of a wide variety of natural resources, Canada is not heavily dependent on obtaining raw materials from foreign markets. Instead, 70 per cent of the country's imports are either finished or intermediate goods (35 per cent each).[13] More than one-third of imports were intermediate goods in 2004, showing that Canadian manufacturers are making extensive use of imported machinery, electrical equipment and auto parts to assemble final products in Canadian plants.

**Chart 22**
Composition of Canadian Imports, Importer's Perspective
(per cent)




Note: Bars do not add to 100 per cent as only the top 25 export categories for each year have been used.
Source: Statistics Canada.

**Chart 23**
Composition of Canadian Exports to the United States, Importer's Perspective
(per cent)




Note: Bars do not add to 100 per cent as only the top 25 export categories for each year have been used.
Source: Statistics Canada.

### Significant Country Trends

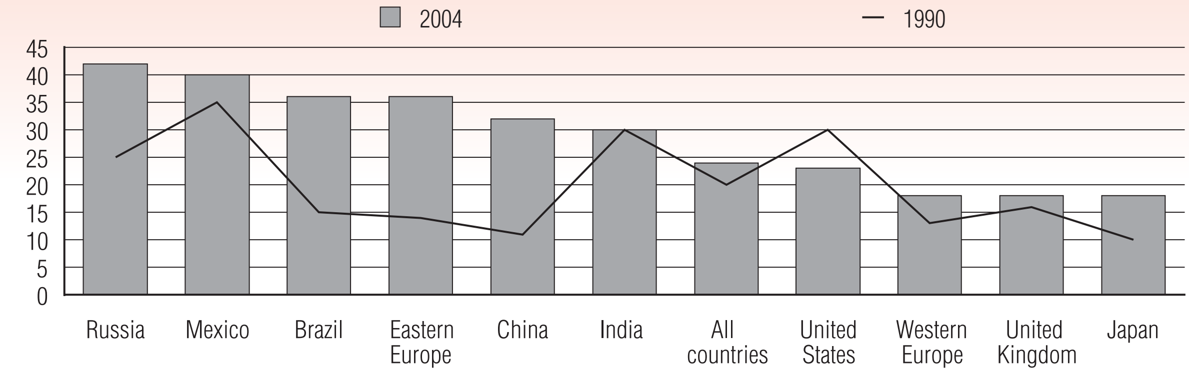
The heavy U.S. dominance of Canadian trade can hide some interesting developments at the country level. For the United States, our analysis shows that greater North American economic integration is occurring principally through significant increases in trade volumes. The share of Canadian exports of raw products to the U.S. market has actually increased since 1990 (rising from 26 to 32 per cent; see Chart 23) as a result of higher energy prices and growing U.S. reliance on Canadian energy exports; in contrast, the share of intermediate goods has declined from 30 to 23 per cent.

Canadian trade with Mexico shows no meaningful trend in the share composition for exports or imports, and therefore we have limited evidence of increased integration. It appears that both Mexico and Canada have achieved stronger integration with the U.S. economy under NAFTA, but not necessarily with each other.

Within the BRIC economies, Canadian exports are generally moving steadily up the value chain. (See Chart 24.) Nominal levels of trade are still relatively low, but in nearly all cases, Canadian export shares for intermediate goods rose substantially from 1990 to 2004. The share of raw material exports to China dropped from 60 to 49 per cent, while the share of intermediate goods increased from 11 to 32 per cent. For Brazil, the raw materials share dropped sharply, from 50 to below 20 per cent, while the share of Canadian intermediate goods exports increased from 15 to 36 per cent. The share of Canadian raw material exports to Russia fell from 44 to only 8 per cent in 2004, while intermediate and finished goods now represent 88 per cent of major export categories, compared with 54 per cent in 1990. The shares for India changed little.

The story for Canadian imports is slightly different. The BRICs are each moving in a different direction as exporters to Canada, in accordance with such factors as relative labour costs and stages of domestic economic development. The bulk of Canadian imports from China

**Chart 24**
Intermediate Goods as Share of Canadian Exports, Importer's Perspective
(per cent; by importing country)




Source: The Conference Board of Canada; Statistics Canada.

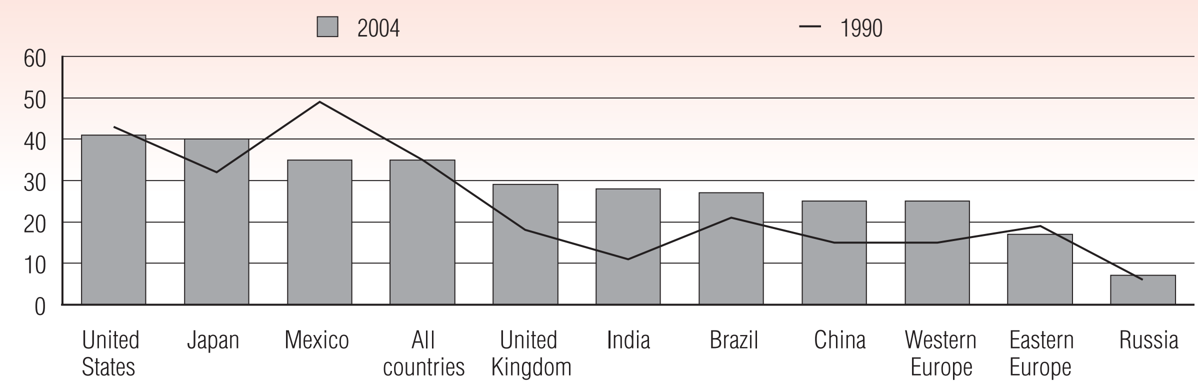
remained finished goods (68 per cent in 1990, 63 per cent in 2004), but the intermediate goods share grew from 15 to 25 per cent by 2004 (see Chart 25), indicating a closer fit for China into Canadian supply chains. For India, two-thirds of Canadian imports in 1990 were finished goods such as textiles and apparel, but by 2004 the finished goods share had fallen to 43 per cent; the share of intermediate goods had almost tripled, however, from 11 to 28 per cent.

In contrast, Brazil increased its share of raw-material exports to Canada from 23 to 40 per cent, while its finished-goods share declined from close to 50 per cent in 1990 to 23 per cent in 2004. This may indicate that Brazilian labour has slowly been priced out of the consumer goods market. The bulk of Canadian imports from Russia remained raw materials, at around 80 per cent in both 1990 and 2004.

## THE IMPACT OF CHINA ON CANADA'S TRADE IN 2025

Finally, let us peer into the future and develop a plausible scenario for the composition of Canada's trade in 2025 if Chinese exports and imports continue to grow at a healthy pace. The pace will undoubtedly slow as the Chinese economy matures and becomes more efficient, and as real labour costs rise. Even so, China is likely to be an increasingly important part of Canada's total trade.

**Chart 25**
Intermediate Goods as Share of Canadian Imports, Importer's Perspective
(by exporting country)




Source: The Conference Board of Canada; Statistics Canada.

**Canadian Exports to China**

After a lull in the late 1990s and early 2000s, Canada's real exports to China have shot up over the past few years, climbing by 17 per cent in 2003 and a remarkable 36 per cent in 2004. The rise reflected strong growth in the Chinese economy, stimulating demand for all that Canada produces: raw materials, intermediate goods and finished goods. As we have seen, the share of Canadian raw materials feeding into China's supply chain has actually fallen over the past to se15 years, to about 50 per cent of total Canadian exports to China, while the intermediate goods share has risen from 11 to 32 per cent. (See Chart 24.)

**Real import growth from China is currently in the range of 20 to 30 per cent annually, but over the long term it can be expected to slow, reaching 4 per cent by 2025.**

Over the long term, Canadian exports to China cannot keep up the dramatic increase of the past two years, nor can imports from China keep growing at the same torrid pace. China's economy has been expanding at a real annual growth rate of around 8 per cent in recent years. As it matures, as its population ages, and as real labour costs increase, China will see its underlying growth potential decline slowly over the long term. Other countries with even lower labour costs, such as Vietnam, will slowly steal market share from China, which will gradually focus on higher–value added production. Our scenario therefore assumes that China's real annual GDP growth will steadily decelerate, from 8 per cent in 2006 to 6 per cent by 2013 and 4.5 per cent by 2025. This assumption is consistent with the conclusions of other analysts.

Slower Chinese growth will moderate growth in demand for Canadian goods. Nevertheless, some factors should ensure that Canada's exports continue to grow strongly throughout the forecast period. We earlier calculated a highly positive correlation coefficient between Canadian FDI to China and export growth; this should translate into strong Chinese demand for Canadian exports, provided Canada sustains its growth in outward FDI to China. As we noted earlier, analysis by EDC indicated that every dollar of outward investment from Canada to a developing market, such as China, would generate additional exports worth double that amount.[14] EDC is now using its analysis to estimate benefits to Canada from outward Canadian FDI to emerging markets.

Further, now that the yuan will be permitted to appreciate over the forecast period, Canadian goods and services should become more price-competitive, and demand for Canadian exports should increase in the Chinese market. For these reasons, we have assumed that real Canadian export growth to China will slow only gradually from the 12 to 13 per cent range, down to around 7 per cent by 2025.

On the basis of these assumptions, Canada's real exports to China would be $46.7 billion by 2025, up from $6.2 billion in 2004—an increase of more than 600 per cent. The Conference Board's latest long-term economic forecast projects total real exports of about $900 billion for Canada in 2025, assuming that Canada's real exports to China grow at the same rate as total exports to all countries. If we adjust the baseline forecast to include the higher level of real exports to China ($46.7 billion by 2025), real exports to all countries in 2025 would increase by about $35 billion. The extra $35 billion would obviously expand employment and output in Canada. Moreover, Canada has increased its share of intermediate exports to China since 1990, and this trend is likely to continue.

**To ensure a long-term trade relationship with China, Canadian businesses and governments will need to be fully engaged in the Chinese market.**

Still, an extra $35 billion in exports to China would represent less than 4 per cent of Canada's total real exports by 2025. In contrast, real exports from Canada to the United States will be $720 billion by 2025—an increase of more than $350 billion—if Canadian exports to the United States grow by an average of 4 per cent annually over the next 20 years. This is a clear indication of how dominant the U.S. market has been and will continue to be in Canada's export trade.

**Canadian Imports from China**

In 1990, imports from China were around 1 per cent of total imports to Canada. By 2004, the share had increased to close to 6 per cent, and China had become Canada's second-largest source of imports, ranking behind the United States. Real imports from China soared by 30 per cent in 2004 alone; this reflected Canadians' increasing purchases of inexpensive apparel, toys and electrical equipment from China, as well as a growing share of intermediate goods. As already noted, China has increased its penetration of Canada's import market at the expense of more traditional sources, such as the United States and Japan. Chinese goods are also increasingly integrated into Canadian supply chains: the share of intermediate goods imports has grown from 15 per cent in 1990 to 25 per cent today. (See Chart 25.)

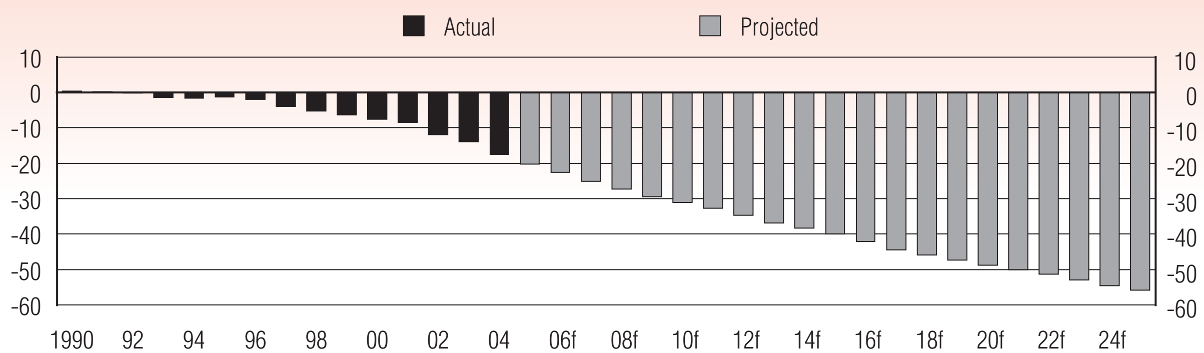
**The BRICs are exciting prospects for faster trade and investment growth, but it appears that trade and investment ties with the U.S. will ultimately matter most for Canada.**

Real import growth from China is currently in the range of 20 to 30 per cent annually, but over the long term it can be expected to slow, reaching 8 per cent per year by 2008 and 4 per cent by the end of the forecast period. As China shifts to producing higher–value added goods, Canada will turn more to other emerging markets with lower real labour costs for standardized consumer products such as apparel and toys. Market saturation for goods from China will lead to weaker growth in standardized consumer imports to Canada; people require only so many T-shirts. In addition, the appreciation of the yuan against the Canadian dollar over the forecast period will make Chinese imports more expensive in Canada, thereby reducing relative demand. As a result of all these factors, Chinese import growth will remain strong compared with growth from traditional industrial markets, but the double-digit rates will not be maintained over the next two decades.

An increase in China's Canadian import market share to nearly 10 per cent by 2025 would have important implications for Canada's economy. Imports from Canada's traditional markets, such as the United States and the United Kingdom, would continue to lose market share as a result of substitution from China. East–West trade would become an ever-more prominent feature of Canada's international trade patterns. More pressure would be placed on Canada's trade infrastructure, especially West Coast ports and Western railways, as well as highway transportation. Infrastructure improvements would be required for all modes of transportation to handle the ever-rising volumes of import traffic from the Asia–Pacific region.

Another, more political constraint would be the size of the bilateral trade balance between China and Canada. In 2004, Canada's trade deficit with China stood at $17.4 billion (current dollars). Relative to the size of our economy, Canada's trade deficit with China is as large as that of the United States with China (US$162 billion in 2004, current dollars), but it has attracted little media attention as a potential problem for Canadian business. And unlike in the United States, our trade deficit with China so far has not had political repercussions or sparked demands for trade sanctions. The explanation may be that Canada has always been more open and trade-dependent than the United States.

**Chart 26**
Canada's Projected Trade Balance with China
($ billions)




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

Canadians in general may understand better than Americans the negative repercussions of trade wars. Canada has also benefited from a significant trade surplus with the United States for some years now, so we are hardly in a position to complain about bilateral trade imbalances with China.

On the basis of our assumptions for exports and imports, Canada's trade deficit with China would rise to close to $56 billion by 2025. (See Chart 26.) However, as the trade deficit continues to increase, businesses, union leaders and politicians may start to demand action to reduce the pace of growth in Chinese imports in order to protect jobs in Canada. This may create a de facto political ceiling for the size of the bilateral trade deficit with China, even if comparative advantage and investment patterns indicate that the relationship is not out of alignment with Canadian economic interests. To help ensure a sustainable long-term trade relationship with China, Canadian businesses and governments will need to be engaged fully in the Chinese market. All the necessary facets of trade and economic policy, as well as all the available trade development instruments, will need to be in place and used to maximum effect so that every possible opportunity is exploited.

**Canadian trade and investment policies, actions and instruments should be designed to facilitate all the elements of integrative trade.**

## IMPLICATIONS FOR CANADA

### CANADA'S ROLE IN THE INTERNATIONAL ECONOMIC AND FINANCIAL SYSTEM

Much as the G7 wants to believe that it will be the dominant guiding force in international economic and financial policy over the coming decades, the game is quickly changing. Together, demographics and underlying economic policies are bringing about a fundamental shift in global economic status and power. If PPP conversion rates are used as a proxy for longer-term currency-market equilibrium, China immediately leaps to second place after the United States among world economies. India rises to fourth, after Japan. All the preceding analysis supports the view that this is the shape of things to come.

Similarly, much as we in Canada want to see our country as a central player in the G7, the hard data suggest that our global status is in decline. By the same yardstick of PPP, Canada now ranks 11th in the world economy, behind all the BRICs as well as the other G7 members.

Consequently, Canada's longer-term interests may in fact lie in becoming a central part of a wider circle of influence—such as a G20 that includes the major emerging markets. When he was federal finance minister, Paul Martin encouraged an expanded role for the G20. We believe that this should be a long-term priority for Canada, even if current geopolitical circumstances do not necessarily support the formal and permanent establishment of such a group. In the meantime, Canada should make use of its G7 status to put on the table key issues, such as global imbalances. Doing so would serve our own interests and those of the wider global economy.

Further, we should understand that the Canadian dollar is seldom used to denominate international business transactions, nor is it being held by many countries or private organizations as a store of value. National pride should not be threatened by our currency's absence from the top tier of global currencies; this is simply a reflection of our global status.

At the same time, Canada has the potential for carving out additional high-value niches in the international financial system, and specifically in equity markets. Our country's success in equities in the mining sector shows that it is possible to exercise specialized financial market leadership, given the right circumstances. Can we create the conditions to make that happen?

### CANADIAN TRADE AND INVESTMENT POLICY

The BRIC emerging markets are important for Canada's future trade growth and diversification. They are fundamentally altering the structure of the global economy, including the competitive space within North America. Canadian firms cannot afford to ignore them. But despite the attractive growth potential of these markets, it would be a mistake to view the BRICs primarily as an alternative to Canada's existing heavy concentration on the U.S. market. Even with the potential gains from enhanced trade with the BRICs, our trade and investment relationship with the United States will remain Canada's top international economic priority over the next two decades, simply because of the reality of North American integration. Canadian policy-makers and business leaders must act accordingly.

Moreover, Canadian trade today is more complex than ever before. It has entered a new phase, called integrative trade, which captures all the elements used by firms to achieve the lowest possible cost and maximize the return for their products: exports, imports used to create exports, foreign direct investment (both inward and outward), outsourcing into and out of Canada, and sales from foreign affiliates created through FDI. Canada's international trade and investment policy needs to reflect and capture all of these elements, while continuing to support the traditional trade model that has underpinned Canadian economic development for nearly three centuries.

A number of implications for Canada flow from the preceding analysis. They can best be grouped under two headings: the geographic focus of Canadian trade, and the appropriate agenda for trade and investment policy in the new integrative trade paradigm.

### Geographic Focus

On an ongoing basis, Canada will need to strike the right balance in the geographic orientation of its trade and investment policy. It must continue pursuing the growth opportunities offered by the BRICs and other high-potential emerging markets, but at the same time it must foster its core trade relationship with the United States. For decades, many Canadians have searched for a trade alternative to the United States in the hopes of diversifying ties to the world economy and making the country less dependent on one dominant partner. But the gravitational tug of deepening North American economic integration is pulling Canada ever closer toward its southern neighbour. The BRICs are exciting prospects for faster trade and investment growth, but it appears to us that trade and investment ties with the United States will ultimately matter the most for Canada. Relationships with emerging markets must be seen from the perspective that Canada is an integral part of the North American economy.

Canada must continue to explore ways of broadening and deepening the economic relationship with the United States, even as we seek to seize the burgeoning

**The Latest Chapter in the Ongoing Softwood Lumber Dispute Chills Relations with the United States**

Canada–U.S. trade relations took on a hostile tone in August 2005 when the United States announced it would ignore the North American Free Trade Agreement (NAFTA) ruling on softwood lumber in Canada's favour. The ruling confirmed the outcome of an earlier NAFTA panel, which found that Canadian exports of softwood lumber did not hurt U.S. producers, so there was no justification for applying countervailing duties to Canadian exports.

The U.S. decision to ignore these findings and continue to collect duties outraged Canadian policy-makers and pundits. Prominent national commentators proclaimed NAFTA dead. Angry citizens wrote letters calling for retaliation. Some pundits even called on Canada to abandon NAFTA and rely on defending our interests at the World Trade Organization (WTO).

But the subsequent WTO interim ruling found that the United States complied with international law when it imposed billions of dollars in duties on Canadian softwood exports. Without the WTO's blessing, Canadian trade sanctions against the United States could be illegal.

Clearly, Canada's long-standing desire to be spared from the impact of U.S. trade remedy laws remains as elusive a goal as ever. The matter needs to be put in perspective, however. Trade friction over lumber dates back to before Confederation. While the United States has been alleging unfair Canadian subsidies and imposing countervailing duties and other punitive measures for more than two decades, the unfair subsidy claim is only one dimension of a complex issue.

Trade policy is a combination and balance of economics, technical points of law, and domestic interests, and hence is intensely political. The U.S. Congress is responsible for trade policy, and while it periodically delegates its authority to the president, it always reserves the right to approve or reject the result. Congress has jealously guarded its sovereignty over trade matters and with it, its ability to serve domestic constituencies. In Canada, tweaking Uncle Sam's nose is sometimes a national necessity, and it always makes good political theatre. Special interests and protectionism are part and parcel of trade relations, on both sides of the border.

Abandoning NAFTA is not in Canada's best interests. Rather than tearing up the rule book, we need to redouble our efforts at moral suasion to convince the United States to play fair and square. The so-called "new diplomacy" approach—direct advocacy with members of Congress and with the U.S. public to make the case that free trade is in their best interest—has proven itself over the past two decades.

Canada must continue to resist American invitations to come back to the negotiating table immediately. Brokering a managed trade deal now—in the midst of a stalemate—would be perceived as a sign of weakness, and we would forego future opportunities for trade-offs.

At the same time, we need to be realistic. While a trade war would hurt both partners, the smaller contender is always the bigger loser. While Canadians may be angry and indignant, let's not make that an excuse for being naive or misguided. The best that any U.S. trade partner can hope for is a limit to Congress's protectionist tendencies in response to special-interest groups. Ultimately, we will have to reach a settlement, and we may well find that our best option is to impose an export tax on lumber, which would be better than the United States imposing its levy. That way, the money stays in Canada. Moreover, tariffs are always more efficient than quantitative restrictions.

Beyond this particular dispute, we must continue to strengthen the design and application of the trade rules by working both sides of the street—multilaterally through the WTO and regionally with our NAFTA partners—to negotiate and secure our access to the U.S. market. The U.S. Ambassador to Canada has recently pointed out some of our more restrictive trade policies (regarding dairy products and culture). While these are tough and sensitive issues for Canadians, we need to recognize that liberalizing trade brings mutual benefit. A trade war would move us in the opposite direction. We might not only lose our heads but our shirts as well.

**What Next for Canadian Trade Policy?**

NAFTA is by now a fully implemented trade agreement, and after a decade it is beginning to show its age. Canada has seen limited growth in its exports to the United States over the past five years. Specific factors—from slower economic growth to currency realignment—invariably influence trade flows between partners, but the minimal recent growth is striking when compared with the spectacular growth in Canada–U.S. trade during the mid- to late 1990s.

Moreover, as shown elsewhere in this chapter, NAFTA has produced surprisingly little bilateral trade integration between Canada and each of its NAFTA partners, as measured by changes in the share of intermediate goods trade. We are on a plateau in our most important trading relationship.

What could be done to kick-start the trade growth engine for Canada? Three tracks could be pursued, in combination or separately. Multilateral trade liberalization remains the optimal way to improve Canadian access to all markets, including the United States. However, the WTO Doha Round keeps hitting resistance, and the planned WTO ministerial meeting may not break the logjam.

A second track would be expanded regional free trade. Though the talks on free trade in the Americas are also stalled, a number of bilateral negotiations continue among various Latin American countries and with the United States. NAFTA itself could be deepened and strengthened, but none of the partners have shown any inclination to reopen the agreement. Canada may be reluctant to do so because we know the United States will put sensitive items on the table that were not in the original agreement (for example, cultural industries). The alternative approach has been to "go around" NAFTA by having the three partners work on items mainly related to trade facilitation, but without formally reopening the agreement itself.

A third track would be to actively pursue free trade with other major bilateral or regional partners, either via umbrella agreements or in specific areas such as foreign investment protection and trade facilitation. The European Union and China are the most important prospects, but all parties must be ready and willing to bargain. Canada has its own sacred cows (including shipbuilding, dairy products and culture) that could stand in the way. Finally, the current political climate in Canada—a minority government, adversarial behaviour among the parties and a looming election—does not create the conditions for a bold stroke on trade.

The most likely near-term outcome of all these factors is that Canada will drift along passively, hoping that some external force will appear and create momentum for expanded free trade and improved foreign market access.

opportunities afforded by the BRICs and other high-growth emerging markets. The recent political commitment to strengthen North American linkages through the Security and Prosperity Partnership is simply one more step in a long journey toward deeper and more efficient economic linkages between Canada and the United States. It would be foolish and short-sighted not to sustain the momentum of that journey. (See text boxes, "The Latest Chapter in the Ongoing Softwood Lumber Dispute Chills Relations with the United States" and "What Next for Canadian Trade Policy?")

Multilateral trade liberalization still holds the greatest promise for widespread economic gains through enhanced global market access and discipline. Canada must once again show its long-standing commitment to multilateral trade liberalization as it participates in the Doha Development Round of trade negotiations. Through the World Trade Organization (WTO) and its predecessors, for almost 50 years Canada has used multilateral negotiation as the principal instrument for expanding access to the U.S. market. The past two decades have seen the adoption of a more diversified approach, with Canada engaging in bilateral and regional as well as multilateral negotiations. Despite this, the WTO will remain central to Canada's strategy for liberalizing trade. Complex issues such as trade in agriculture can be addressed only with the broad-based participation of all key players. Even with their participation, real progress is by no means certain in the Doha Round: the issues may be too complex, the negotiating positions too deeply entrenched—hence the need for diversification and flexibility on the part of Canada.

**Canada needs to pay immediate and particular attention to trade facilitation—that is, practical steps to make customs clearances faster, cheaper and more secure.**

Even as multilateral negotiations remain the cornerstone of Canadian trade policy, the country should actively seek regional and bilateral opportunities to liberalize trade with the key emerging markets. The opportunities should be chosen according to their potential for rapid and sizable trade and investment growth. China inevitably appears at the top of the list, even though a bilateral free trade agreement would be unrealistic until a much more extensive foundation has been laid for policy engagement.

With multilateral, regional and bilateral dimensions, the trade policy agenda is highly complex. But this is the reality Canada must face to fully serve and advance its economic interests.

### A Comprehensive, Appropriate Trade and Investment Policy Agenda

As for the scope of Canada's trade and investment policy agenda, promoting exports remains important but is only one aspect. Canadian trade and investment policies, actions and instruments should be designed to facilitate all the elements of integrative trade. These policies, actions or instruments include the following:

*Facilitate imports used to create exports.* Imports are far more important today in Canada's supply chains, including growing imports from emerging markets such as China and India, because they can reduce production input prices without sacrificing quality, and therefore make Canadian businesses more internationally competitive. Restrictions on imports were originally designed to protect domestic industry from supposedly unfair competition. That regime now needs rethinking to ensure that it does not impede critical imports. Indeed, there may be a case for positive steps to facilitate certain key imports—for instance, through improved access to credit—to ensure that Canadian firms can compete on a level playing field with businesses from abroad.

*Attract foreign direct investment.* Foreign investment is a key aspect of trade today. Last year's *Performance and Potential* set out a comprehensive agenda for improving Canada's competitiveness in promoting our country as a destination for foreign direct investment. The agenda included a wide array of actions: increasing post-secondary completion, improving workforce skills, investing in physical infrastructure, reducing various taxes on business, streamlining and easing the burden of regulations, improving the commercialization of innovative technologies, and enhancing international market access. The agenda remains equally valid today, and even more urgent to implement.

*Expedite passage of goods,* principally at the U.S. border but also at all frontiers. This means making continuous efforts to achieve smarter borders in order to facilitate Canadian trade and ensure a smooth linkage with U.S. supply chains and consumers—without compromising our national security or that of the United States. In this connection, Canada needs to pay immediate and particular attention to trade facilitation—that is, practical steps to make customs clearances faster, cheaper and more secure. This is obviously most critical at the Canada–U.S. border. Given the integrated nature of the North American economy, Canada's attractiveness as a site for investment depends on the ability to expeditiously move goods across the border in both directions.

Trade facilitation is on the agenda of the Doha Development Round, particularly the rules and obligations governing trans-shipments. Canada should work for progress in these negotiations, but it should also seek practical trade-facilitating steps in other forums, notably the Security and Prosperity Partnership of North America. At the same time, increased investment is needed in physical infrastructure and information technology to prevent delays at the Canada–U.S. border, which impede investment in Canada.

**The Canadian public should be helped to understand that outbound FDI as well as inward FDI are vital for future trade and wealth creation in Canada.**

*Facilitate outward Canadian investment.* The economic literature and statistical evidence support the view that outbound FDI is largely trade-creating. For emerging markets in particular, two dollars or more of additional trade may be generated for every dollar of Canadian outward FDI in those markets. There is therefore a strong case for giving higher priority to outbound investment within Canadian trade policy.

Canada should give top priority to investment protection agreements that improve Canadian investors' access to foreign markets, and the Canadian public should be helped to understand that outbound FDI as well as inward FDI are vital for future trade and wealth creation in Canada. Multilateral negotiations on investment protection have stalled since the failure of the proposed OECD Multilateral Agreement on Investment and the refusal of key developing countries to proceed with negotiations through the WTO. For the present, Canada has no alternative but to pursue investment protection bilaterally or regionally, but we should continue to press for multilateral discussions.

If Canadian businesses (particularly small and medium-sized enterprises [SMEs]) are to secure FDI for Canada and take advantage of outward investment opportunities, the country must strengthen the institutions that can help to facilitate FDI in both directions, particularly Investment Canada and Export Development Canada, as well as the policy instruments available to them. Only then will the Canadian economy reap the maximum economic benefits from FDI.

**SMEs could benefit from more enlightened trade policy that acknowledges the business and economic value of foreign affiliate sales.**

*Expand trade in services.* Services now comprise 70 per cent of Canadian GDP and 60 per cent of global FDI flows, so there would be strong synergy between the FDI agenda we have outlined and an enhanced focus on trade in services. International trade in services will continue to be undervalued until a greater effort is made to capture timely data that help to explain current developments, including services exports, imports and (increasingly) sales from foreign affiliates. Canada should adopt and implement a national strategy in specific services trade sectors, such as business processes and financial services. With such a strategy, our country can begin to capture its fair share of the rapidly growing global market.

*Recognize sales from Canadian foreign affiliates.* Such sales are another way to reach foreign customers, and they can be critical to individual business success. In some markets—for instance, the United Kingdom—sales from Canadian foreign affiliates dwarf Canadian exports and are clearly the preferred way to do business, surmounting trade barriers or tapping into global supply chains. Small and medium-sized enterprises play a prominent role in the Canadian economy, but they may lack the balance-sheet size and in-house expertise needed to establish successful foreign affiliates. SMEs could particularly benefit from more enlightened trade policy that acknowledges the business and economic value of foreign affiliate sales, and that actively supports such sales. Again, better data would improve our understanding of the phenomenon.

### The Final Say

Governments may put in place the best policy framework imaginable to expand and enhance trade and investment opportunities. Ultimately, however, it is up to the thousands of individual Canadian businesses to decide where and how to trade and invest, according to where they think they can earn profits for their shareholders. Canadian businesses will decide whether our trade should be more diversified geographically, whether exporting is preferable to establishing a foreign affiliate for customers abroad, and whether imports from an emerging market should replace traditional local suppliers. They have the final say. This is a reality that the government must not forget.

1 See Dominic Wilson and Roopa Purushothaman, *Dreaming with BRICS: The Path to 2050*, Goldman Sachs Global Economics Paper No. 99, October 2003.

2 Benjamin Senauer and Linda Goetz, *The Growing Middle Class in Developing Countries and the Market for High-Value Food Products*, Prepared for Economic Research Service, U.S. Department of Agriculture, February 2003.

3 See Wilson and Purushothaman.

4 For an excellent discussion of India's rise to prominence in the global economy, see Thomas Friedman's latest book, *The World Is Flat* (New York: Farrar, Straus and Giroux, 2005).

5 The 1947 General Agreement on Tariffs and Trade (GATT) led to a series of global negotiations seeking to reduce trade barriers. The most important negotiations were the Kennedy, Tokyo and Uruguay rounds. The Kennedy Round (1964–67) cut tariffs and reached an anti-dumping agreement. The Tokyo Round (1973–79) further reduced customs duties and established optional codes limiting non-tariff barriers. The Uruguay Round (1986–94) reached agreements on, among other things, better market access for tropical products and a dispute settlement system. This round also laid the groundwork for creation of the WTO, which came into being in 1995.

6 See the research summary provided in Lionel Fontagné, *Foreign Direct Investment and International Trade: Complements or Substitutes*, STI Working Paper 1999/3, October 1999: OECD Directorate for Science, Technology and Industry.

7 The G7 nations—Canada, France, Germany, Italy, Japan, the United Kingdom and the United States—meet regularly at senior levels to discuss global macroeconomic performance and coordinate policy. Russia's regular but at times awkward inclusion expands the group to the G8.

8 Based on an analysis of Canadian liabilities, as reported by Statistics Canada, CANSIM II database, 2004.

9 See Fontagné.

10 See two EDC reports: Stephen Poloz, *The Benefits of International Trade and Investment Facilitation*, June 2002; and Glen Hodgson and Todd Evans, *The Quiet Creator of Canadian Wealth: Foreign Direct Investment*, September 2003.

11 The example of a steel plate highlights the difference between what is normally thought of as a raw material and an intermediate or finished good. If a steel plate is manufactured in Canada and used in the production process in this country, it would be classified as an intermediate good because some work is required to convert raw steel into a steel plate. However, in this

analysis we are looking at the steel plate from the perspective of the user. Since Chinese producers take the steel plate and use it at the earliest stage of production to help build a car, the plate is a raw material from the Chinese perspective. Similarly, motor vehicles and parts would normally be thought of as finished goods. However, if a Chinese manufacturer takes a car bumper manufactured in Canada and uses it to assemble an auto, the bumper is an intermediate good from the Chinese perspective. In this analysis, we took great care to classify Canadian exports and imports according to how the end user utilized the trade product. The classification system developed by the Conference Board to divide exports and imports into raw, intermediate and finished goods is available on request.

12 Assembly may not add much value added, particularly in activities that are not labour intensive. To accurately assess the value added of a finished good requires a detailed analysis of input-output tables, which indicate the number of inputs required to produce that good. Such an analysis is beyond our scope here, but it would be a fruitful area for future research.

13 The country percentages in the accompanying charts do not add up to 100 per cent because only the top 25 export and import categories were considered in this analysis for the different countries. This was done to eliminate the large number of product categories that are not significant in terms of Canada's overall trade.

14 See Poloz.