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Re-Energizing Canada's International Trade Strategies for Post-Recession Success

Can Compete

TRADE, INVESTMENT POLICY AND INTERNATIONAL COOPERATION

The Conference Board of Canada
Insights You Can Count On

Re-Energizing Canada's International Trade: Strategies for Post-Recession Success
by *The Conference Board of Canada*

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Preface

The global recession has had a devastating impact on Canada's international trade. As economies rebound and demand resumes, trade will pick up again. But does this mean Canada can look forward to a healthy trade outlook? This report suggests not. A tough business at the best of times, trade is likely to get a lot tougher still as firms compete for recovering markets and capital flows.

The main message of this report is that Canada's international trade cannot be taken for granted. The challenge is not simply how to survive the recession—it is how Canada can emerge from the recession better positioned for success in the global economy.

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EXECUTIVE SUMMARY

Re-Energizing Canada's International Trade

Strategies for Post-Recession Success

At a Glance

- The global recession has had a devastating impact on Canada's international trade.
- Even before the recession, Canada's trade profile for the last decade was discouraging.
- The challenge is not simply how to survive the recession—it is how Canada can emerge from the recession better positioned for success in the global economy.

The serious downturn in the U.S. and global economies has had a devastating impact on Canada's international trade. The value of Canada's exports in 2009 dropped by 14.8 per cent, and imports fell by an even steeper 15.6 per cent.

This picture can be expected to turn around as economies rebound and demand resumes. But does this mean Canada can look forward to a healthy trade outlook? This report suggests not.

Canada' trade profile going into the recession was discouraging. Real export growth had been flat since 2000, and Canada–U.S. trade integration had peaked. There was much unrealized potential in global markets, and significant underperformance in areas that are key trade drivers—notably services, innovation, and foreign direct investment (FDI).

The shape of international trade—and how we need to think about it—has also been changing profoundly. Well before the recession struck, value chains and other aspects of the ascending international business model were revolutionizing global production and the way the world does business. At the same time, the global economy has been undergoing a fundamental shift, as the engine of economic growth moves from the aging industrial economies to the major emerging economies. A tough business at the best of times, trade is likely to get a lot tougher still as firms compete for recovering markets and capital flows.

The serious downturn in the U.S. and global economies has had a devastating impact on Canada's international trade.

In short, the challenge is not simply how to survive the recession—it is how Canada can emerge from the recession better positioned for success in the global economy.

It is time to take a hard look at trade. We need to recognize where Canadian trade has been, where the world is going, and what can be done to shift gears and strengthen our position in the international marketplace. And we need to build more internationally competitive firms, stronger and more forward-looking trade policies and strategies, and a more supportive national operating environment.

The first section of this report presents a profile of Canada's international trade since 1990. Essentially, this is a conventional view of trade. The second section looks at Canada's trade future, drawing on what is known about value chains and other aspects of integrative trade, as well as trends in the global economy. The third section discusses three strategic priority areas where action by business and government—federal and provincial—would make a substantial difference.

Prepared under The Conference Board of Canada's CanCompete project, this report is a contribution to much-needed public discourse on this important subject.

Shifting Gears: Three Strategic Priority Areas

There are three strategic priority areas where action by business and governments—federal and provincial—would make a substantial difference.

STRATEGIC PRIORITY AREA ONE: MORE INTERNATIONALLY COMPETITIVE CANADIAN FIRMS

- Improve core competitiveness: Increase investment in R&D, become more innovative, and take advantage of key lower-cost imported inputs, which would also help to improve Canada's lagging productivity.
- Adopt an integrative trade mentality: Consider the advantages of foreign direct investment, value chains, trade in services, and services linked to goods.
- Rethink the U.S. market and trade diversification as a means of increasing market potential, accessing cheaper sources of inputs, as well as a strategy to protect firms against the ups and downs of the Canadian dollar vis-à-vis the U.S. dollar.
- Develop "China/emerging Asia" strategies. Canada's trade performance with this region has been subpar relative to that of other major countries.

STRATEGIC PRIORITY AREA TWO: STRONGER AND MORE FORWARD-LOOKING INTERNATIONAL TRADE POLICIES AND STRATEGIES

- Incorporate "integrative trade" more fully into the language, strategic development, and statistical measurement of international trade and business functions.
- Reinforce the competitiveness of Canadian firms in the U.S. market by reducing trade transaction costs: Accelerate the streamlining of the border, continue reducing barriers to key imported inputs, remove most or all remaining tariffs, and consider elimination of country-of-origin rules used to qualify for duty-free treatment.
- Move toward some strategic re-bilateralization of the Canada–U.S. trade relationship.
- More strategic focus on China, India, and emerging Asia.
- Realize greater trade gains from bilateral and regional agreements by concluding substantial deals with larger countries.
- Take measures to strengthen Canada's profile in the WTO (including reassessing government support for dairy supply management policies).
- Develop supporting strategies for such key trade drivers (i.e., services, innovation, and investment).

STRATEGIC PRIORITY AREA THREE: A MORE SUPPORTIVE NATIONAL OPERATING ENVIRONMENT

- Introduce greater clarity and openness regarding inward foreign direct investment, and become a more active facilitator of outward investment.
- Expedite alignment of regulatory standards to U.S. or other international standards—if necessary, unilaterally.
- Ensure the full implementation of mutual recognition of labour credentials and qualifications.
- Open the air transportation sector to cabotage. The transportation sector should be a priority sector, since it not only is an industry unto itself but also acts as an intermediary by providing service to other industries and firms across North America.
- Encourage more strategic investment in urban and transportation infrastructure to make Canada a more attractive place to invest and do business.
- Provide greater investment in knowledge and innovation.
- Retool immigration policies to give greater priority to the economic class and to meeting labour market needs.
- Rethink the future workforce, with particular attention paid to such issues as aging workers, literacy, higher education, and skills training.

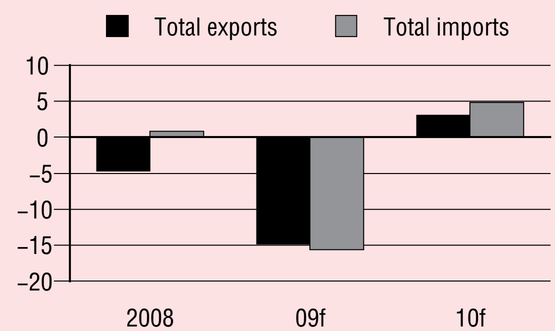
CHAPTER 1

Introduction: Time to Take a Hard Look at Trade

Chapter Summary

- The value of Canadian exports plunged 14.8 per cent in 2009, due to collapsing U.S. and global demand, as well as the drop in oil and commodity prices.
- The World Trade Organization estimates that global merchandise trade volumes declined 10 per cent in 2009, the first contraction in global trade in over 60 years.
- Canada's trade was already slowing before the recession struck—a return to our pre-recession state is no guarantee of future success.

Chart 1
Exports and Imports Declined Sharply in 2009
(percentage change)



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

The global recession took a huge toll on Canada's international trade. How bad was the damage? It was devastating. The Conference Board expects the numbers to show the value of Canadian exports plunged 14.8 per cent in 2009 (see Chart 1), due to collapsing U.S. and global demand, as well as to the drop in oil and commodity prices. (See box "Canada's Sinking International Trade.") At the same time, imports are estimated to have declined by an even steeper 15.6 per cent, in response to slow demand at home. As a result, the bottom fell out of Canada's current account balance, which shifted from a surplus position in 2008 into deep deficit. (See Chart 2.)

Is this surprising? No. Given the extent of Canada's trade with the United States, the country at the epicentre of the crisis, it was inevitable. It is also part of a phenomenon that spread across the world as businesses pulled back

Canada's Sinking International Trade

Throughout 2009, the ailing trade sector was plagued by weak global and domestic demand, a rising Canadian dollar, and continued turmoil in some of its key sectors—notably the auto and forestry sectors.

The most recent Conference Board forecast shows the value of total exports plunging by 14.8 per cent in 2009, with imports forecast to contract by an even larger 15.6 per cent. In volume terms, the forecast drop is even larger—16 per cent for exports and 17 per cent for imports. The auto sector, which accounts for nearly a quarter of merchandise exports, is responsible for much of the export decline. But the situation for the forest products and construction industry, or for manufactured and industrial goods generally, is not much better.

Because imports are falling at a faster pace than exports, the international trade sector likely ceased to be a drag on the Canadian economy in 2009. But the trade balance is forecast to decline steeply when the falloff in raw materials is factored in. The trade balance plunged from a $25.3-billion surplus in 2008 to a $25-billion deficit in 2009—a phenomenal drop of more than $50 billion. The current account will follow suit, declining from a surplus of $8.1 billion in 2008 to a deficit of $41.1 billion in 2009.

The picture is expected to improve in 2010, with exports forecast to return to modest growth of 3.1 per cent and imports a slightly higher 4.8 per cent. However, the current account deficit is expected to extend throughout the medium term, with a deficit of $7.9 billion in 2014.

Source: The Conference Board of Canada, *Canadian Outlook Economic Forecast: Autumn 2009*.

Chart 2
Current Account Balance Plunges Into Deficit
($ billions)

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

on their international value chains. The World Trade Organization (WTO) estimates that global merchandise trade volumes declined 10 per cent last year, the first contraction in global trade in over 60 years.[1] The International Monetary Fund recently forecast an even steeper 12 per cent decline.

Should Canadians be concerned? Absolutely. For a country whose economy is more trade dependent than most (in the range of about 80 per cent of GDP for total trade in 2008, compared with 28 per cent in the case of the U.S.), a deteriorating trade picture is obviously bad news.

Recent indications that trade is recovering should not be interpreted as a sign that all will be well.

To date, attention has rightly focused on mitigating the impact of the global economic downturn on trade by keeping trade flowing and markets open in the face of the risk of rising protectionism. But the top-of-mind concerns—such as mitigating the impact of "Buy America" inclinations in U.S. stimulus spending—should not overshadow the larger trade picture. Nor should recent indications that trade is recovering be interpreted as a sign that all will be well. It is a mistake to view the current implosion simply as a temporary phenomenon, a short-term blip in an otherwise healthy trade picture that will restore itself once the recession bottoms out and demand resumes. Canada's trade was already slowing before the recession struck—a return to our pre-recession state is no guarantee of future success.

The recession also struck at a time when international trade was already in tremendous flux, as a result of the rise of value chains and other aspects of the ascending international business model, and a tectonic shift in

1 In July 2009, the WTO revised its forecast of merchandise trade volumes downward from a contraction of 9 per cent to one of 10 per cent. This reflects a 14 per cent decline for developed economies and a 7 per cent decline for developing economies. See "Global Crisis Requires Global Solutions," presented by Pascal Lamay to the WTO Trade Policy Review Body in Geneva on July 13, 2009.

the global economy itself—associated with the rise of China, India, and other emerging economies. What is virtually certain is that the shape of world trade that comes out of the recession will not be the same as the one that went into the recession—there is no return to "the same old."

The challenge therefore is not simply how to weather the recession. It is how Canada can come out of the current economic shakeup much better positioned for trade success than it is now. This report addresses three central questions:

- What did Canada's international trade profile look like going into the recession?
- How are business and economic trends changing the shape of international trade and the way we need to think about it?
- What strategies will help Canada strengthen its position in the global marketplace?

This report is a contribution to much-needed public discourse on this important subject.

The Changing Face of Trade

Traditionally, trade involved relatively straightforward exchanges of goods across international borders. Some trade still takes place this way. Increasingly, however, trade takes the form of vastly more complex international economic relationships characterized by the rise of highly integrated regional and global value chains and other aspects of the ascending international business model—or what the Conference Board calls "integrative trade."[1]

Perceptions, as well as statistics and policies, have yet to fully catch up with this evolving international trade reality. (See table.) It is also more difficult to "see." However, failure to recognize the central importance of this phenomenon raises the risk of developing trade strategies based on outmoded assumptions. This makes it critical to keep one eye on what trade statistics tell us and another on the implications of evolving global business and economic trends.

Traditional Versus Integrative Trade

Traditional trade	Integrative trade
Trade mainly in goods	Trade in goods, services, and services linked to goods
Foreign markets are primarily end-users	Highly integrated value chains of exports and imports that can cross borders many times during the production process
Exports preferable to imports	Key imported inputs enhance competitiveness
Foreign direct investment (FDI) regarded as "trade substitution" to avoid trade barriers	Growing recognition of positive relationship between trade FDI–in and out
Contracting out to company down the street	Offshore outsourcing to take advantage of lower cost structures in other countries

Source: The Conference Board of Canada.

1 The term was first introduced by Glen Hodgson in "Trade in Evolution: The Emergence of Integrative Trade." See also Glen Hodgson and Anne Park Shannon, *Mission Possible: Stellar Canadian Performance in the Global Economy*

CHAPTER 2

Facing Reality: Canada's Pre-Recession Trade Picture

Chapter Summary

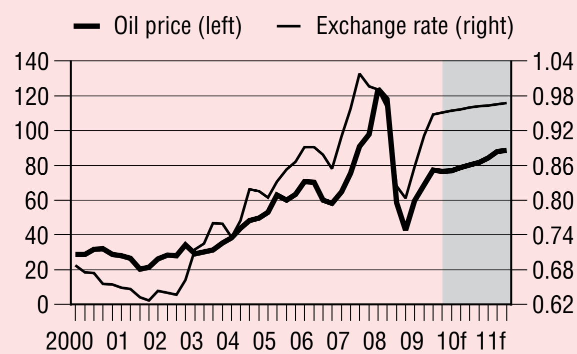
- The sharp decline in Canada's trade in 2009 took place against the backdrop of a pre-recession trade picture that has been virtually flat since 2000.
- The recession has exposed the fault lines in Canada's international trade dynamics, including shrinking exports of manufactured goods, stalled North American trade integration, unrealized potential beyond the U.S., and underperformance in such key trade drivers as services, innovation, and foreign direct investment.
- Trade is showing signs of recovery. But since post-recession trade is likely to resemble pre-recession trade, that is little cause for comfort.

Recent indications that Canada's trade may be starting to recover need to be seen in context of two things: the magnitude of the huge trade decline last year, and the backdrop of trends in Canadian trade over the past decade.

The reality is that Canada entered a new phase of international trade long before the latest economic troubles befell us. When we look at trade data, we see strong Canadian export growth during the 1990s. Growth, however, tapered off around 2000, and exports actually declined after that before resuming modest growth in mid-decade.

However, this recent growth—albeit modest—was the result of high international demand for commodities and rising oil and commodity prices. This meant that it contained a large price component, particularly during the 2007–08 period when oil prices spiked. (See Chart 3.) In other words, Canadian exports grew because these goods increased in value rather than because Canada sold more goods and services abroad.

Chart 3
In (Mostly) Lockstep: Oil Prices and Exchange Rate
(oil price, US$—left; rate, US$/C$—right)



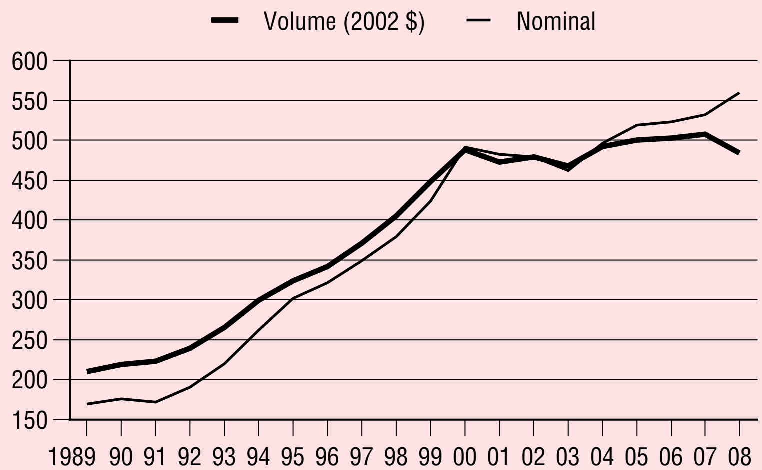
f = forecast
Sources: The Conference Board of Canada; U.S. Energy Information Administration; Statistics Canada.

When trade data are adjusted for prices and moved from a nominal (value) basis to a real (volume) basis, they show that export growth has been virtually flat since 2000. And since the middle of the decade, the gap between nominal and real trade growth has also been diverging. In 2008, nominal exports grew by a remarkable 5.2 per cent, while on a real basis they declined by 4.7 per cent. (See Chart 4.)

The shift in Canada's export mix has been mirrored by a shift in the regional profile of Canadian export growth.

This price effect also helped keep our current account balance above water, as the gap between slowing exports and rising imports narrowed. The trade balance's slide into deep deficit last year did not simply spring from the recession—it is a phenomenon we have been skirting for some time.

Chart 4
Real Trade Growth Flat Since 2000
($ billions)



Sources: The Conference Board of Canada; Statistics Canada.

At the same time, a fundamental shift has been taking place in Canada's export mix. The source of export growth has moved from the traditional manufacturing sector to resources and commodities—particularly oil and gas, which pulled away as Canada's leading export sector in 2008. (See box "A Fundamental Shift in Canada's Export Mix.")

The shift in Canada's export mix has been mirrored by a shift in the regional profile of Canadian export growth. (See Chart 5.) Ontario remains the largest source of exports. But export growth has increasingly come from other regions, especially Alberta, Saskatchewan, and Newfoundland.

SHRINKING EXPORTS OF MANUFACTURED GOODS

The recent "flatness" of Canada's export performance is mainly attributable to weakness in the manufacturing export sector, which represents about 75 per cent of the total value of merchandise exports. The trend, however, is not evident across the board. The growth profile for manufactured exports is highly differentiated. (See Chart 6.) While some sectors experienced sharp declines, others registered modest to substantial growth.

This can be explained to a large extent by the differing impacts of the Canadian dollar's appreciation. Generally speaking, manufactured export growth has been higher when it involves commodities that are pegged to world and regional benchmarks (and thus tend to *set* the Canadian dollar value rather than *react* to it) than it has been in other export sectors that face the dual effect of lower prices and greater import competition. Industries that are highly export intensive are also more susceptible to the effects of dollar appreciation. This is especially true for industries that are heavily reliant on the U.S. market. (See Chart 7.)

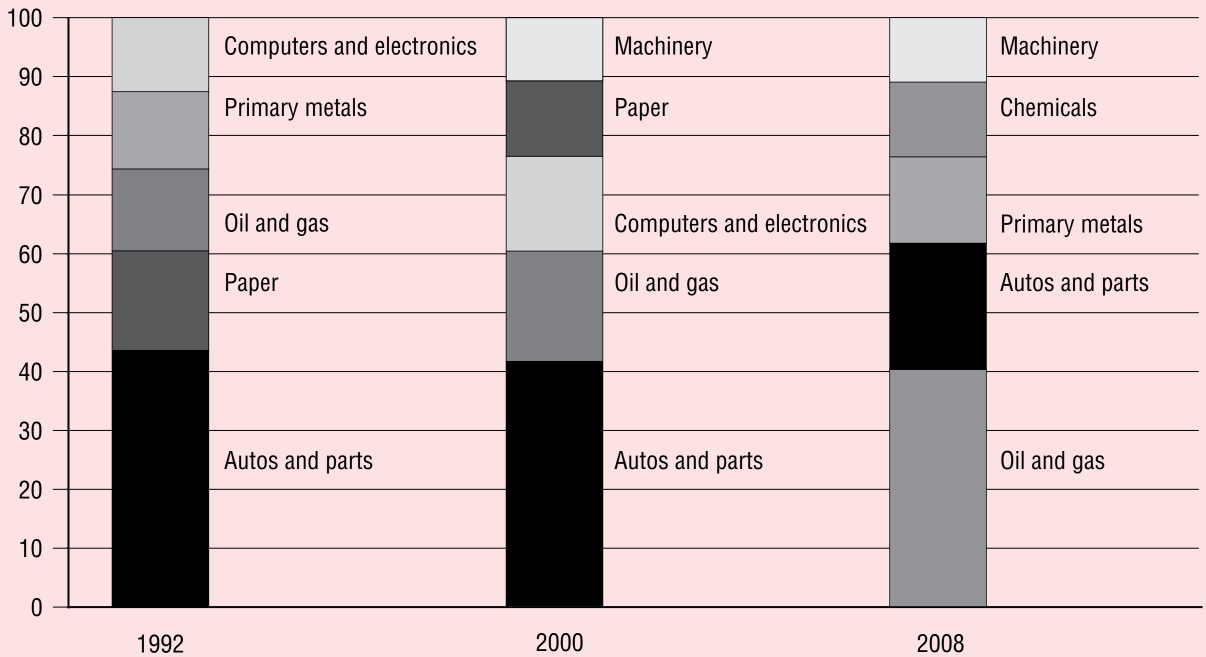
The rise of the dollar, however, does not explain everything. The steepest declines occurred in sectors that faced additional difficulties. The auto and forestry industries, for example, were also hurt as a result of their structural problems, while the clothing and furniture sectors suffered

A Fundamental Shift in Canada's Export Mix

In 1992, Canada's export profile was dominated by the auto and auto parts segment, which represented roughly three times the value of the next largest export group. By 2000, merchandise trade had expanded across the board, although the signs of decline in some sectors, notably paper and textiles, were becoming evident.

Between 2000 and 2008, overall merchandise export growth was minimal. But the trade mix changed significantly. (See chart.) Oil and gas replaced autos and auto parts at the top of the exports list as Canada went from being a net auto exporter to a net importer. Computers and electronics declined sharply following the tech bust. Paper continued to fall. And wood dropped out of the top 10.

Canada's Shifting Merchandise Export Mix
(top five exports, per cent)



Note: The top five exports represented 37 per cent of total exports in 1992, 45 per cent in 2000, and 49 per cent in 2008.
Sources: The Conference Board of Canada; Statistics Canada.

Sources: Industry Canada; The Conference Board of Canada.

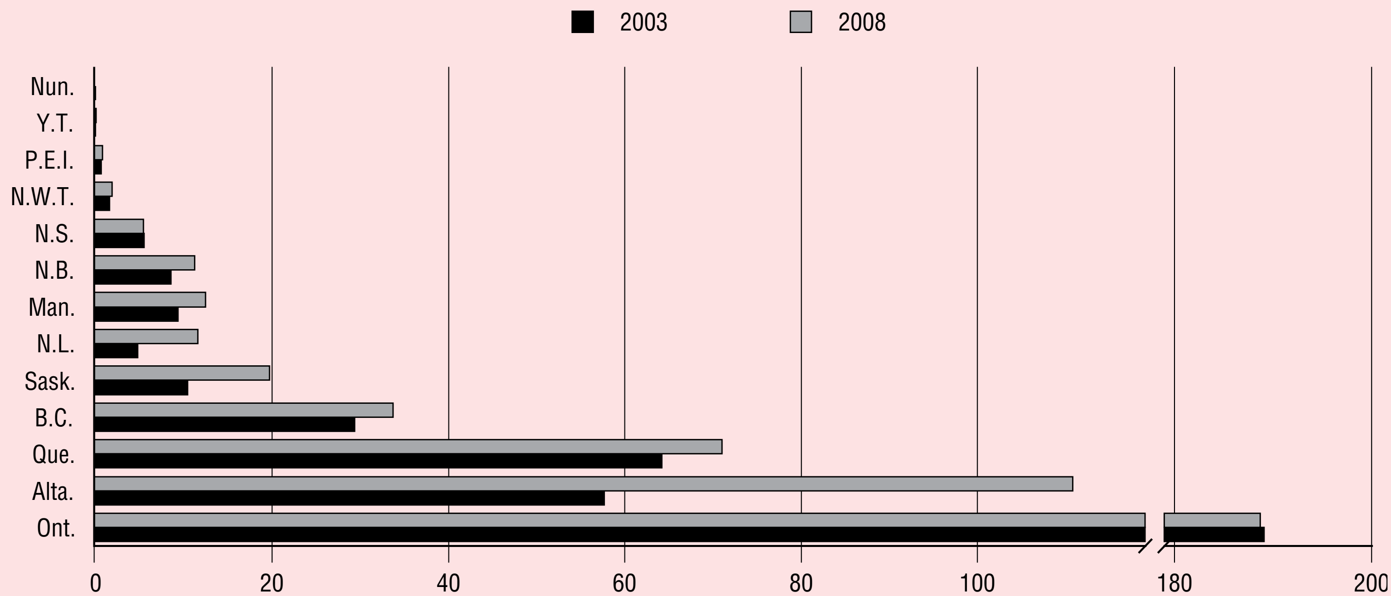
from rising low-cost competition as well as, more recently, the collapse in U.S. consumer demand that hit parts of the manufacturing export sector particularly hard.

PEAKING NORTH AMERICAN TRADE INTEGRATION

Exports to the U.S. have an even flatter profile than does Canadian trade as a whole. The value of Canada's merchandise trade with the U.S. in 2007 was close to what it was in 2000. And while it did increase slightly in 2008 due to the spike in oil prices, in volume terms exports to the U.S. were actually lower in 2008 than they were in 2000. (See Chart 8.)

While it is tempting to attribute this picture to post-9/11 security concerns and the "thickened" Canada–U.S. border, there is no evidence that this phenomenon has actually translated into reduced export volumes. Streamlining and improving the border-crossing process is critical, especially as trade volumes recover. But this

Chart 5
Canada's Shifting Regional Export Profile
($ millions)



Source: Statistics Canada.

is because the thickened border imposes additional costs on exporters—costs that could reach the point where they seriously undermine the competitiveness of future exports and influence future investment decisions. (See box "Blame the Border?")

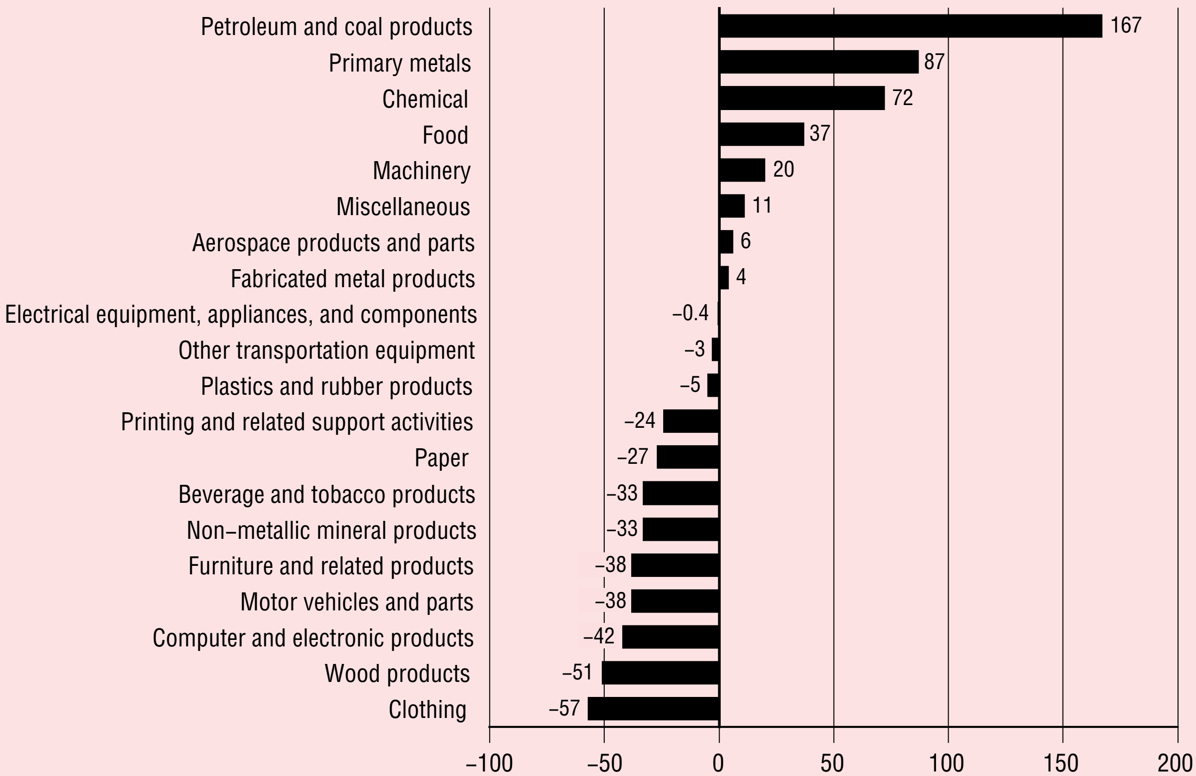
Recent trade trends don't bear out the popular vision of ever-increasing levels of Canada–U.S. trade integration.

A more compelling explanation for the decline in trade volumes is that a critical juncture was reached around the turn of the decade when the economic factors that drove trade expansion through the 1990s receded. It started with slower U.S. economic growth and the tech bust, which arrived at about the same time that parts of Canada's manufacturing sector were coming under stress, the Canadian dollar had begun its upward appreciation, and the trade-generating effect of the Canada–U.S. Free Trade Agreement (FTA) and later via the North American Free Trade Agreement (NAFTA) had largely run out of steam.

Nor does the direction of recent trade trends bear out the popular vision of ever-increasing levels of Canada–U.S. trade integration. Unquestionably, Canada and the U.S. have become more closely integrated economically over the past 20 years, particularly in certain sectors and regions. But the U.S. share of Canada's merchandise trade has fallen to 78 per cent. When services are factored in, the U.S. share of total Canadian exports is in the range of only 68 per cent. (See box "The U.S. Accounts for a Shrinking Slice of the Canadian Trade Pie.")

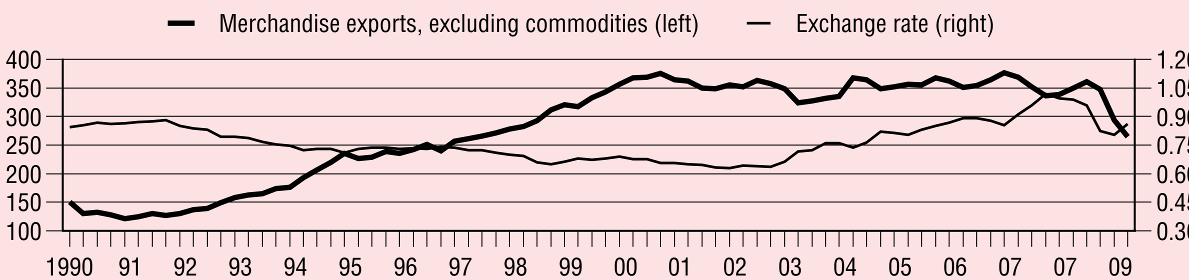
Similarly, the perception that intra-firm trade (trade that takes place between related firms operating on both sides of the border) has been increasing is somewhat misleading. The value of intra-firm trade in Canada has

Chart 6
Manufacturing Exports: What Grew, What Didn't
(percentage change, 2000 to 2008)



Sources: The Conference Board of Canada; Statistics Canada.

Chart 7
Stronger Dollar Contributes to Lower Merchandise Exports
(exports, $ billions—left; exchange rate, US$/C$—right)



Sources: Statistics Canada; The Conference Board of Canada.

indeed tripled since 1990, as trade expanded. Only Japan has a higher level of intra-firm trade. But the relative significance of intra-firm trade, as reflected by its share of Canada–U.S. trade, has actually fallen—going from more than 40 per cent in 1990 to less than 30 per cent in 2006 (the last year for which data are available). Of this, over 90 per cent takes place between U.S. parent companies and their affiliates.[1]

The relative significance of intra-firm trade, as reflected by its share of Canada–U.S. trade, has actually fallen.

UNREALIZED NON-U.S. MARKET POTENTIAL

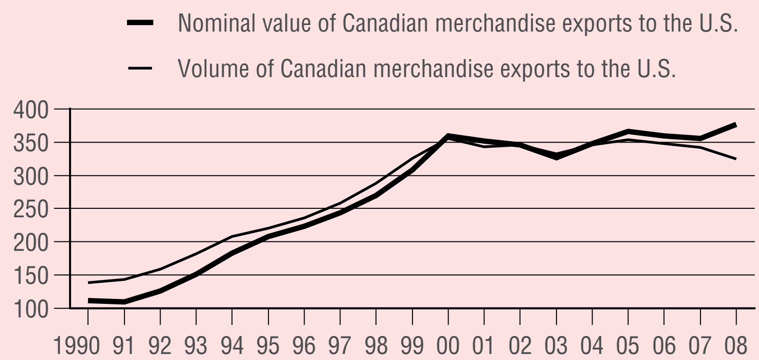
The other side of slowing Canadian trade with the U.S. equation has been the rise in trade to non-U.S. destinations, which now account for over 20 per cent of total exports of goods and close to 50 per cent of imports. (See charts 9 and 10.)

Indeed, Canada's goods exports to non-U.S. destinations are higher than official data indicate due to a statistical "undercount." While Statistics Canada has been working to reduce this, it is currently about 12 per cent—less in the case of traditional partners such as Japan and the U.K., and more with other destinations such as Asia and Latin America.[2]

1 The data is drawn from the U.S. Bureau of Economic Analysis, which covers the operations of foreign multinationals in the U.S. and U.S. multinationals abroad. See Foreign Affairs and International Trade Canada, *Canada's State of Trade and Investment Update 2009*.

2 The "undercount" arises because data on exports to the U.S. are reconciled with U.S. import data while others are not, which means the data can miss some exports, such as those through third countries. At the same time, some Canada–U.S. trade may be overvalued in terms of its contribution to the economy because goods in value chains that can cross the border several times during the course of production are assigned their full value—rather than their incremental value—each time.

Chart 8
Canada–U.S. Trade Has Peaked
($ billions)



Sources: The Conference Board of Canada; Statistics Canada.

Blame the Border?

A comprehensive analysis carried out by the Conference Board in 2007 found no evidence that the "thickening" of the Canada–U.S. border had resulted in lower export volumes during the 2001–06 period. Other factors, such as U.S. economic conditions, were found to have accounted for changes in export volumes.

The border is, however, a problem because it imposes additional costs and complexities for Canadian exporters. Some exporters have essentially eaten the costs involved in getting their goods across the border, while their competitors in the U.S. do not have to deal with those costs at all. That situation puts Canadian exporters at a major competitive disadvantage. It also makes them less efficient. In a bid to better cope in this environment, some exporters are serving the U.S. market by, for example, relocating their warehouses to the U.S. side of the border. For some businesses, "just in time" has become "just in case."

There is little evidence that these costs contributed to the considerable drop in export volumes during 2008 and 2009. The risk, however, is that they could push Canadian exporters—who are already struggling with the effects of a low U.S. dollar—to a tipping point where the total costs of doing business undermine the competitiveness of future Canadian exports. The ultimate danger is that the costs involved in crossing the border could reach a point where the advantages of locating in the far larger U.S. market outweigh the advantages of locating any parts of production in Canada. In other words, the border could influence business investment and location decisions, undermining the level playing field first achieved through the Canada–U.S. Free Trade Agreement and later via the North American Free Trade Agreement, and affecting future trade

Sources: Danielle Goldfarb, *Reaching a Tipping Point? Effects of Post-9/11 Border Security on Canada's Trade and Investment*; Michael Burt, *Tighter Border Security and Its Effect on Canadian Exports*.

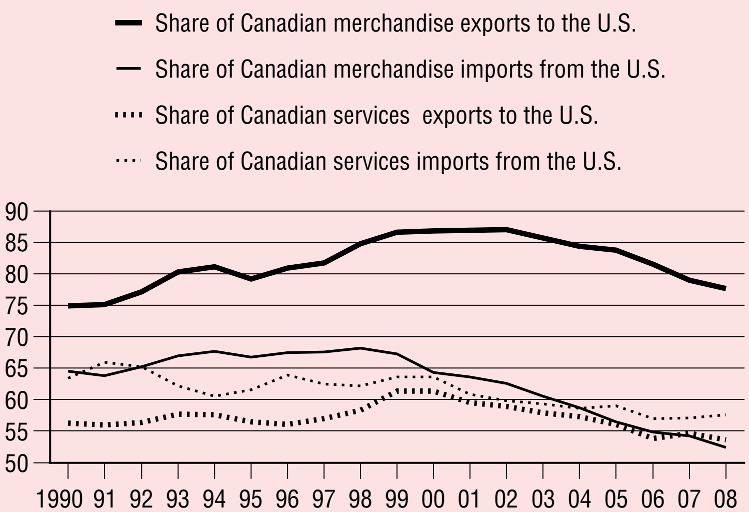
The U.S. Accounts for a Shrinking Slice of the Canadian Trade Pie

The perception of steadily increasing levels of trade integration with the United States is rooted in the 1990s, when the U.S. share of Canadian merchandise exports rose from 75 per cent to 85 per cent.

We still hear that "more than 85 per cent" of Canadian exports go to the United States. But that has not been true since 2004. (See chart.) By 2008, the share for merchandise exports had dropped to 78 per cent—just above the level in 1990. As well, these share figures apply only to exports of goods. The share of Canada's services trade with the U.S. is much lower and has also declined, falling to the 55 per cent range for both exports and imports.

At the same time, the U.S. share of Canadian merchandise imports has shown a steeper drop, falling from the 65 per cent-plus range during the 1990s to just above 50 per cent today.

Share of Canadian Trade to the U.S.
(per cent)



Source: Statistics Canada.

Sources: Statistics Canada; The Conference Board of Canada.

Trade data also reveal a pivotal shift occurring in the middle of this decade when non-U.S. destinations began accounting for Canada's merchandise export growth, thereby offsetting declines in export growth to the United States. (See Chart 11.)

International comparisons bear out the perception that Canada has been missing the global trade opportunity boat.

Canada's trade in services, about one-sixth of total trade, is also more oriented toward non-U.S. destinations than is its trade in goods. In 2008, just under half of services exports (46 per cent) went to non-U.S. destinations. The non-U.S. share of services imports was in the same range (42 per cent).

Despite these trends, Canada has not made as much of the trade opportunities beyond the U.S. as it could have. While recent double-digit growth in exports to Europe and China look impressive, they need to be kept in perspective. Canada does not rank anywhere in China's list of top 10 suppliers—a discouraging statistic. (See box "Opportunity Gap? Canada's Exports to China.") Trade with emerging economic powerhouse India remains infinitesimal. And exports to Latin America are both smaller and slower growing than those to Europe or Asia. (See Chart 12.)

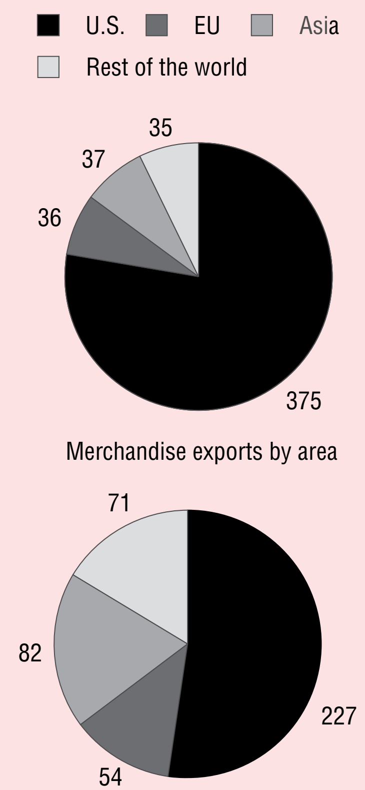
International comparisons bear out the perception that Canada has been missing the global trade opportunity boat. Data from the WTO indicate that the value of Canada's exports over the 2000–08 period grew by an average of 7.5 per cent annually, while imports were up 7.4 per cent. These gains are in the same ballpark as the gains recorded by the trade-deficit-challenged U.S. and Mexico, but are sluggish when compared with the double-digit average annual growth experienced in other regions. (See Chart 13.)

Chart 9
What Canada's Trade Looked Like in 2000
($ billions)

Merchandise imports by area

*In 2000, more than 75 per cent of ROW consisted of: Latin America, Middle East, Mexico, Africa, Australia, and the former Soviet Union.
Source: Industry Canada Trade Data Online (TDO).

Chart 10
What Canada's Trade Looked Like in 2008
($ billions)



Merchandise imports by area

*In 2008, more than 75 per cent of ROW consisted of: Mexico, Latin America, Africa, Middle East, Australia, and the former Soviet Union.
Source: Industry Canada Trade Data Online (TDO).

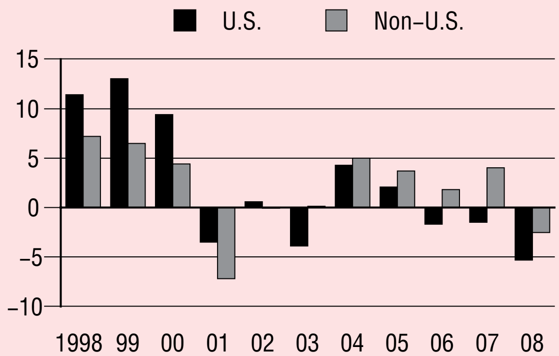
UNDERPERFORMANCE IN KEY TRADE DRIVERS

SERVICES

One puzzle is why Canada has not done better in trade in services, which has emerged as an increasingly important dimension of trade for industrialized and emerging economies. Trade in services builds wealth and is linked to the creation, production, and marketing of goods through value chains. Canada's economy, like many others, has become much more services oriented. The services sector now accounts for a substantial two-thirds of GDP and 7 out of 10 jobs. But services exports account for only about 13 per cent of Canadian exports—considerably below the 2007 world average of just under 20 per cent, a U.S. share of around 29 per cent, and an Australian share of 22 per cent. In other words, our economy has become much more services oriented, but our trade has not. (See Chart 14.)

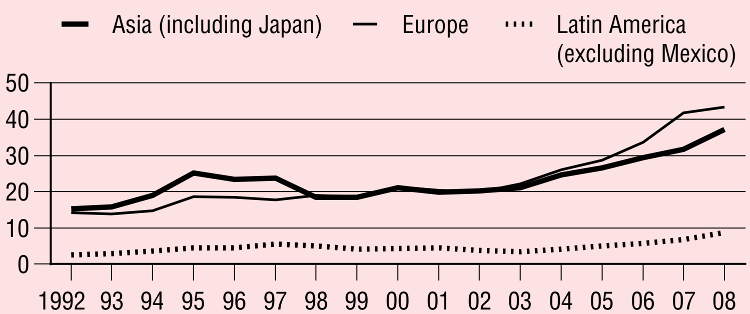
We are also a much larger importer of services than an exporter. Unlike trade in goods, which has only recently fallen into deficit, Canada has chronically run a deficit in trade in services—which is to say that we are realizing the economic benefits that flow from imports much more than those from exports. (See Chart 15.)

Chart 11
Merchandise Exports to U.S. and Non-U.S. Destinations
(percentage change)



Sources: The Conference Board of Canada; Statistics Canada.

Chart 12
Canada's Merchandise Exports, by Major Regions
($ billions)



Sources: The Conference Board of Canada; Statistics Canada.

Our services export performance is even more striking in light of the comparative advantages Canada enjoys—an entrepreneurial services sector; a population whose majority first language is the world's *lingua franca*, English; a large French-speaking minority; and an increasingly multilingual and multicultural society.

One possible explanation is that Canada has simply failed to realize opportunities inherent in services trade while others—such as Australia, which moved into providing education services in Asia with impressive results—have been quick to seize those opportunities. Another is the appreciation of the Canadian dollar, which impacts heavily on such key Canadian service exports as travel and tourism. It is also conceivable that services exports may actually be larger than we think because services trade data are based on estimates that miss potentially significant exports by smaller companies.

There is a need for better understanding of services trade and how Canada can take better advantage of it.

Whatever the case, there is a need for better understanding of services trade and how Canada can take better advantage of it—including the possibility of levering the positive reputation of our financial sector into increased trade in financial services.

INNOVATION

As with trade in services, recent growth in trade of goods has also been driven by advances in technology—in products and in relation to transportation and communications.

With strong capabilities in areas such as medical research and information and communications technology, and with its high levels of education, Canada should be well positioned to succeed in this area. We also have a growing high-technology sector, one that is significantly more export intensive than the rest of manufacturing. (See Chart 16.) But while Research In Motion's BlackBerry is a true world beater, RIM is the exception, not the rule; Canada does not currently have any other global high-tech brands.

Opportunity Gap? Canada's Exports to China

Canada's unrealized export potential in emerging economies is evident in the case of China, the world's fastest-growing economy.

On the face of it, recent Canadian export growth to China looks impressive. Merchandise exports have increased more than fourfold since 2000—slightly better than have such exports from the U.S., a major supplier to China.

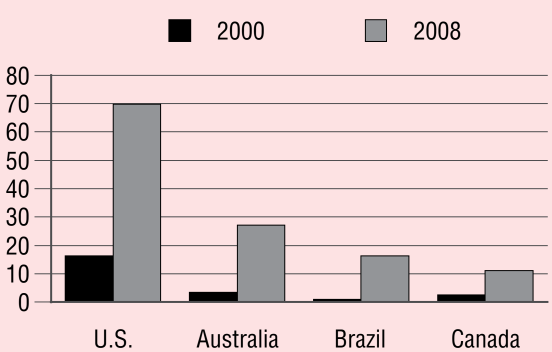
But Canada's export performance is eclipsed by that of two countries with similar capacities to take advantage of China's huge demand for resource-based and agricultural products. Australia's exports to China have grown ninefold over the same period, and Brazil has seen its exports to China expand a remarkable 16-fold. Not surprisingly, China counts Australia and Brazil among its top 10 suppliers, while Canada does not make that list. (See charts.)

Transportation, the exchange rate, the export mix, and other factors may help to explain some of the differences. But the trendlines are so stark that they raise fundamental questions about why Canada has not been doing better than it has in China.

China has also slipped a spot when it comes to being one of the top destinations for Canadian exports. In 2007, China ranked third. But in 2008, Canadian exports to Japan surged by a remarkable 20 per cent, moving Japan into third place as an export destination and pushing China down into fourth spot.

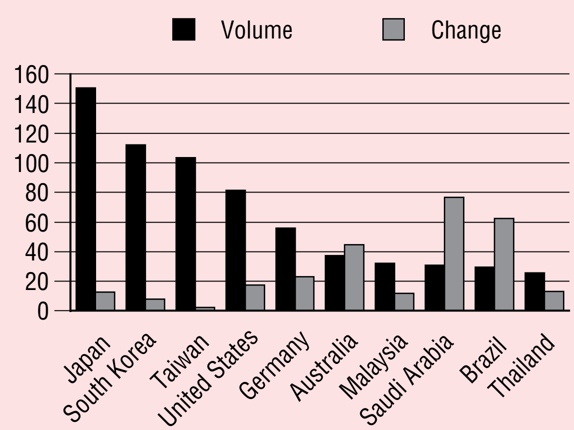
The Canada–China trade relationship has ridden increasingly on import growth. Since 2002, rising imports of electronics and consumer products from China have made it Canada's second largest source of imports next to the United States. In other words, Canada is experiencing the impact of China's remarkable economic transformation more on the import than the export side.

Export Growth to China
(US$ billions)



Source: PRC General Administration of Customs.

China's Top Ten Import Suppliers, 2008
(volume, US$ billions; percentage change, over 2007)

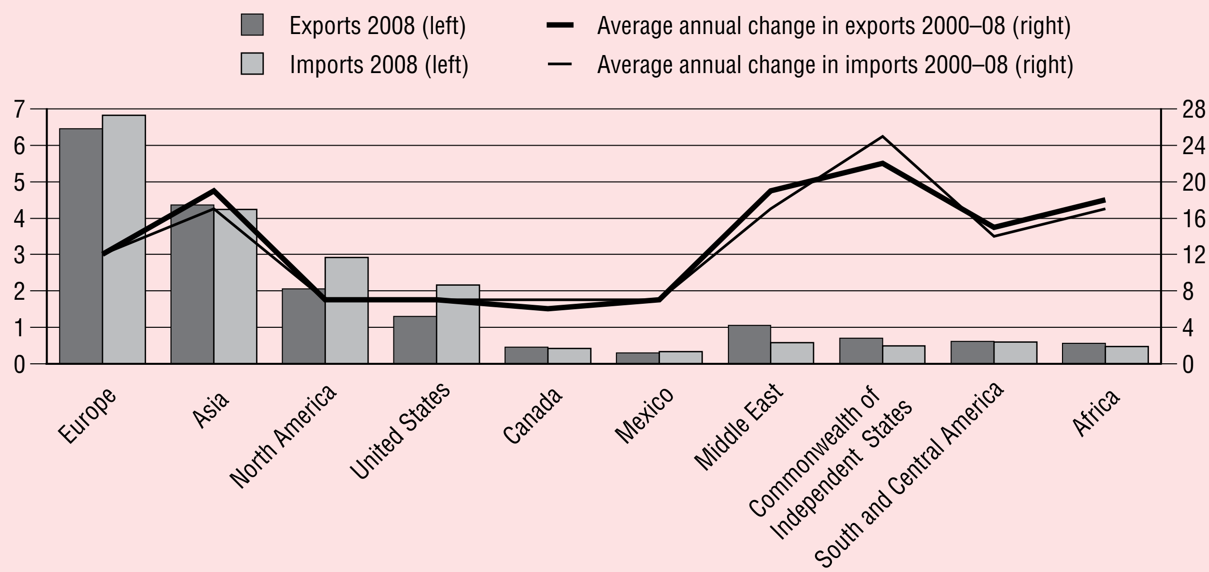


Source: PRC General Administration of Customs.

Sources: World Trade Organization; UN Comtrade.

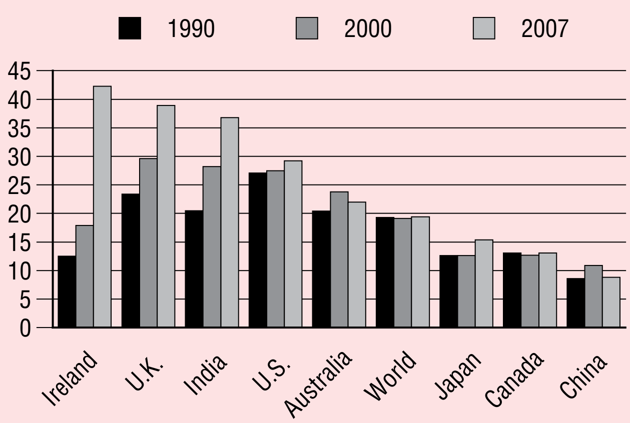
Canada's biggest innovation weaknesses are well known: inadequate research and development (R&D) by private industry, and an unimpressive track record in converting research knowledge into commercial advantage. We also do not stack up well in the broad measures of what it takes to produce truly innovative and competitive companies.

Chart 13
World Merchandise Trade by Region and Selected Country, 2008
($ trillions; percentage change)



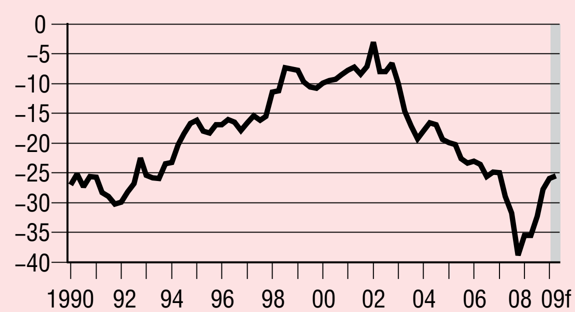
Source: World Trade Organization, *WTO Sees 9 Per Cent Global Trade Decline in 2009*.

Chart 14
Canada's Share of Services in Total Trade
(percentage of total trade in merchandise and services)



Source: United Nations Conference on Trade and Development, *UNCTAD Handbook of Statistics 2008*.

Chart 15
Services Trade in Deficit
(2002 $ billions)



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

Over the past three decades, Canada's innovation performance has rated a consistent "D" in the Conference Board's annual international rankings. (These rankings measure a country's capacity to innovate by assessing the stages of knowledge production, how that knowledge is transformed, and the market share of knowledge-based industries.) In the 2009 rankings, Canada came in 14th among the 17 industrialized countries surveyed, finishing below the U.S., Japan, and most of Europe. In fact, Canada scored higher than the 17-country average on only two indicators: scientific articles published, and the export market share of the aerospace industry.

WTO data indicate that Canada has dropped out of the ranks of the top 10 global merchandise exporters.

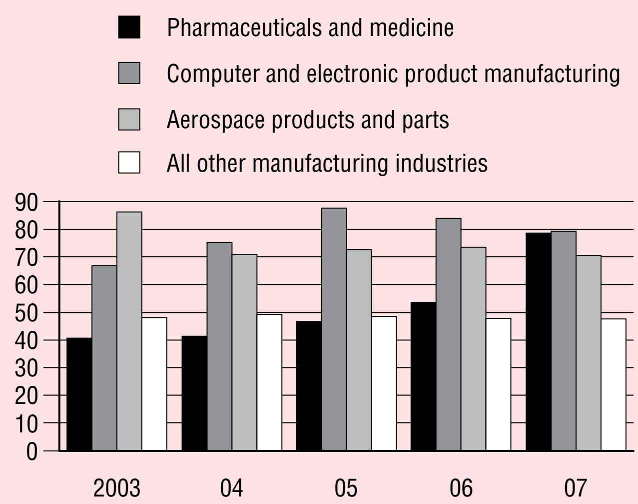
FOREIGN DIRECT INVESTMENT

Canada has also performed relatively poorly when it comes to foreign direct investment, at a time when FDI has become an increasingly sought-after means of generating wealth and stimulating trade. In the late 1990s, Canada became a net outward investor. But Canada's share of global inward FDI stock—which captures a country's relative success in taking advantage of global FDI—has fallen (see Table 1), due mainly to weak inward investment. This drop undermines our capacity to compete internationally.

Make no mistake, Canada is still a major trading nation. But we have less cause to think of ourselves as one of the most successful trading nations among the G8 or G20. According to WTO data, Canada has been steadily dropping among exporting nations and we are now out of the ranks of the top 10 global merchandise exporters. And we are nowhere near the top 10 exporters of services.

In 2006, the WTO listed Canada as the 9th largest exporter and 8th largest importer. By 2008, we had fallen to 11th in both categories—still a major trading power but out of the top 10. As a services trader we rank lower—13th place as an importer in 2008, but only 20th as an exporter. (See Table 2.) The direction is worrisome.

Chart 16
Canada's High-Tech Sector Highly Export Intensive
(exports as per cent of total shipments, 2008)



Source: Industry Canada Trade Data Online (TDO).

Table 1
Canada's Declining Share of World Inward FDI Stock
(distribution, per cent, 1980–2007)

	1980	1990	2000	2007
Developed Economies	57.0	72.7	68.9	68.8
Western Europe	13.9	19.6	18.8	23.1
United States	11.8	20.3	21.7	13.8
Canada	**7.7**	**5.8**	**3.7**	**3.4**
Developing Economies	43.0	27.2	30.0	27.9
China (including Hong Kong)	25.4	11.5	11.2	9.9
India	0.1	0.1	0.3	0.5
Latin America	5.2	5.3	7.3	6.3

Sources: UNCTAD *World Investment Report 2008*.

Table 2
Out of the Top 10: Canada's Trade Rankings
($ billions; annual percentage change)

Merchandise Trade: Leading Exporters and Importers, 2008

Rank	Exporters	Value	Share	Annual percentage change
1	Germany	1,465	9.1	11
2	China	1,428	8.9	17
3	United States	1,301	8.1	12
4	Japan	782	4.9	10
5	Netherlands	634	3.9	15
6	France	609	3.8	10
7	Italy	540	3.3	10
8	Belgium	477	3.0	10
9	Russian Federation	472	2.9	33
10	United Kingdom	458	2.8	4
11	**Canada**	**456**	**2.8**	**8**

Rank	Importers	Value	Share	Annual percentage change
1	United States	2,166	13.2	7
2	Germany	1,206	7.3	14
3	China	1,133	6.9	19
4	Japan	762	4.6	22
5	France	708	4.3	14
6	United Kingdom	632	3.8	1
7	Netherlands	574	3.5	16
8	Italy	556	3.4	10
9	Belgium	470	2.9	14
10	Korea, Republic of	435	2.7	22
11	**Canada**	**418**	**2.5**	**7**

Commercial Services: Leading Exporters and Importers, 2008

Rank	Exporters	Value	Share	Annual percentage change
1	United States	522	14.0	10
2	United Kingdom	283	7.6	2
3	Germany	235	6.3	11
4	France	153	4.1	6
5	Japan	144	3.9	13
6	Spain	143	3.8	11
7	China	137	3.7	
8	Italy	123	3.3	12
9	India	106	2.8	
10	Netherlands	102	2.7	8
20	**Canada**	**62**	**1.7**	**2**

Rank	Importers	Value	Share	Annual percentage change
1	United States	364	10.5	7
2	Germany	285	8.2	11
3	United Kingdom	199	5.7	1
4	Japan	166	4.8	11
5	China	152	4.4	
6	France	137	3.9	6
7	Italy	132	3.8	12
8	Spain	108	3.1	10
9	Ireland	103	3.0	9
10	Korea, Republic of	93	2.7	12
13	**Canada**	**84**	**2.4**	**5**

Source: Geneva: World Trade Organization.

CHAPTER 3

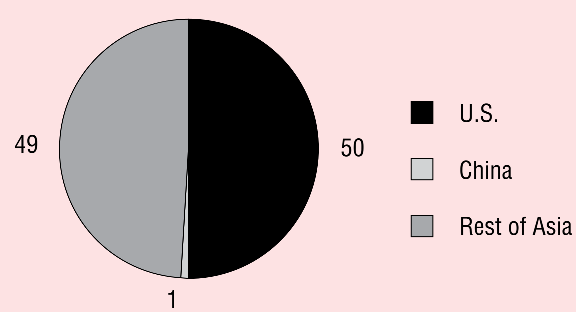
Looking Ahead: Changing How We Think About International Trade

Chapter Summary

- The global recession struck at a time when the world of international trade was already undergoing profound changes.
- The ascending international business model is changing the shape of international trade.
- At the same time, the international economic geography is changing in ways that suggest a need to rethink Canada's approaches to the United States and the rest of the world—in particular the enormous impact of China, India, and emerging Asia.
- International trade will also be shaped by the response to opportunities and risks—the impact of shifting global comparative advantage, the trade implications of transition to less carbon-intensive economies, and the future of international trade liberalization.

When an iPod assembled in China enters the United States, U.S. Customs records half its value as a U.S. import from China. This boosts the huge trade deficit with China and contributes to political backlash in the United States against China. But when California researchers took an iPod apart to determine the value of each component or service input at the location where that value was created, they found a much different story. In fact, China accounted for only 1 per cent of the iPod's value; the other 49 per cent attributed to China should, in fact, be attributed to other countries in Asia. And that remaining 50 per cent? It was created in California.[1] (See Chart 17.)

Chart 17
The Apple iPod: Where Is Value Actually Created?
(per cent)



Sources: Linden et al, "Who Captures Value?"; Goldfarb and Thériault, *Canada's "Missing" Trade With Asia.*

The iPod example graphically illustrates the misperceptions that can arise when trade is seen through the lens of conventional trade models and data. It also speaks

1 Linden et al, "Who Captures Value?"

to how the shape of international trade is changing as a result of the increasingly complex, globally integrated economic realities. Well before the recession struck, the ascending international business model was revolutionizing global production through the rise of value chains and other aspects of what the Conference Board has called "integrative trade."

At the same time, the fundamental shift taking place in global tectonic plates—as the engine of economic growth moves from the older industrial economies to the emerging economies—has been opening vast new economic and trade opportunities, while challenging traditional comparative advantage.

China, India, and Brazil will hold more global sway in the post-recession world.

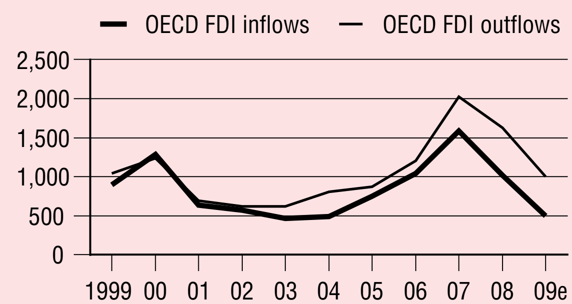
To this mix, the economic crisis of 2008 and 2009 added the uncertainties associated with a collapse in the financial flows that had powered recent trade expansion, as well as the threat of rising protectionist pressures. It also seems likely that the post-recession world will be one in which the larger emerging economies, such as China, India, and Brazil, which were less affected by the financial crisis, will hold more global sway.

It remains to be seen how the post-recession world will unfold. But we can be virtually certain that it will not be a return to "the same old." International trade is changing, and thinking, policy, and practices need to change with it.

FOREIGN DIRECT INVESTMENT—MORE CRITICAL AND MORE COMPETITIVE

Not surprisingly, the impact of the financial crisis on FDI has been enormous. Recent studies by the Organisation for Economic Co-operation and Development (OECD) suggest that if trends in the early part of 2009 continued, FDI flows into industrialized countries (which account for 80 per cent of total FDI flows) could well have collapsed by 50 per cent for the year as a whole—to $500 billion from $1 trillion in 2008, and down from a high of $1.5 trillion in 2007. About 60 per cent of the downturn is due to a collapse in cross-border mergers and acquisitions. Outward investment from industrialized countries was also on course to dip below $1 trillion in 2009, for the first time since 2005.[2] (See Chart 18.)

Chart 18
Foreign Direct Investment Flows Drying Up
(US$ billions)



e = estimate
Sources: Organisation for Economic Co-operation and Development, "International Investment Flows Collapse."

The steps being taken to restore confidence in the international financial system will help to restore flows, although how soon and to what extent remains to be seen. The post-recession trend, however, seems squarely pointed in the direction of fiercer competition for global FDI flows.

Unfortunately, Canada does not come to the post-recession FDI table from a position of strength. The attraction of our resources, aspects of our research and development environment, and the soundness of our financial sector are pluses. But our ability to attract FDI is undermined by significant shortcomings in the eyes of potential investors related to poor productivity performance, the Canadian business environment, and quality and skills issues in the workforce.[3]

2 OECD, "International Investment Flows Collapse in 2009," p. 1.

3 Rhéaume, *Open for Business?*

Our ability to deal with FDI is also complicated by a perceptual disconnect. On one hand, FDI is increasingly recognized as a critical driver of trade and wealth creation. Our economic and trade future depends on being able to attract more FDI—in and out. At the same time, there remains a historical and not fully warranted suspicion of FDI that associates it with loss of economic and political control and the so-called "hollowing out" of the Canadian corporate sector. (See box "Is Canada Being "Hollowed Out" by Foreign Takeovers? Putting M&As in Historical Perspective.") Indeed, studies suggest that foreign-controlled firms may even typically have larger plants, higher wages, higher productivity, and more frequent innovation.[4]

The trend toward more active investing by Chinese, Indian, Brazilian, and other non-traditional sources of FDI seems likely to accelerate.

While such concerns have recently abated with the contraction in financial flows, they may well re-emerge in the context of expanded merger and acquisition activity as firms reposition themselves coming out of the recession, as well as China's interest in diversifying its investments beyond the U.S., particularly in the resource sector. The trend toward more active investing by Chinese, Indian, Brazilian, and other non-traditional sources of FDI also seems likely to accelerate.

This underscores the need to move forward with the thrust of the advice of the recent federal Competition Review Panel, which underlined the importance of greater openness to foreign investment and to competition if we are to improve the competitiveness of the Canadian economy and grow more globally competitive Canadian firms.[5]

4 Baldwin and Gellatly, *Global Links: Multinationals in Canada*.

5 Competition Review Panel, *Compete to Win—Final Report*. The report, which offered 65 recommendations aimed mainly at clarifying the *Investment Canada Act* and the *Competition Act*, is consistent with The Conference Board of Canada's own recent research on corporate transformation and foreign ownership, which was provided to the Panel.

Is Canada Being "Hollowed Out" by Foreign Takeovers? Putting M&As in Historical Perspective

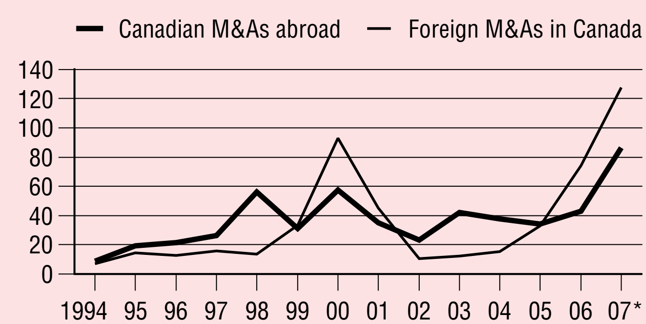
Public concerns that Canada is "up for sale" were fuelled by a series of high-profile mergers and acquisitions (M&As) in the 2006–07 period, involving such national icons as the Hudson's Bay Company, Fairmont Hotels, Inco, Falconbridge, and Alcan.

Recent Conference Board analysis shows that these takeovers are an exception to Canada's longer-term investment trend. Canadian companies have actually been more active in M&A activity abroad over the last decade and a half, than have been foreign companies in Canada. Mostly smaller in value, these takeovers attracted less attention (although they also involved some mega-deals—notably the acquisition of Reuters Group by Thomson Corp., which was the largest takeover of a foreign company in Canadian history).

Why the recent spike in large and expensive Canadian acquisitions? (See chart.) Analysis shows a strong link between M&A activity and record corporate profits in the U.S. and Canada, as well as with lower interest rates. The spike may also be part of a global phenomenon. In an era when China, India, Brazil, and others have emerged as major exporters and destinations for FDI, many companies need to expand in size in order to become more efficient and be able to compete against these lower-cost economies.

M&A activity in Canada is highly cyclical and is expected to slow over the near term due to tightening U.S. lending standards, a stronger Canadian dollar, and slower growth in U.S. corporate profitability. Given growing global competitiveness, however, the long-term trend for M&A is likely in an upward direction.

Canadian M&A Activity
($ billions)



*up to third quarter of 2007
Source: Financial Post Crosbie: Mergers & Acquisitons in Canada.

Source: Thériault and Beckman, *Trends in Foreign Direct Investment*. See also Bloom and Grant, *"Hollowing Out"—Myth and Reality*.

THE CENTRAL IMPORTANCE OF REGIONAL AND GLOBAL VALUE CHAINS

At the same time, Canadians need to come to grips with the rise of value chains and what it means for the future of international trade. Indeed, failure to understand the central importance of this phenomenon not only means missed opportunities. It also risks basing trade strategies and policies on outmoded assumptions of what modern trade is all about.[6]

The traditional concept of international trade, in which exports and imports are exchanged between one country and another, has increasingly been giving way to a much more complex global economic and trade reality.

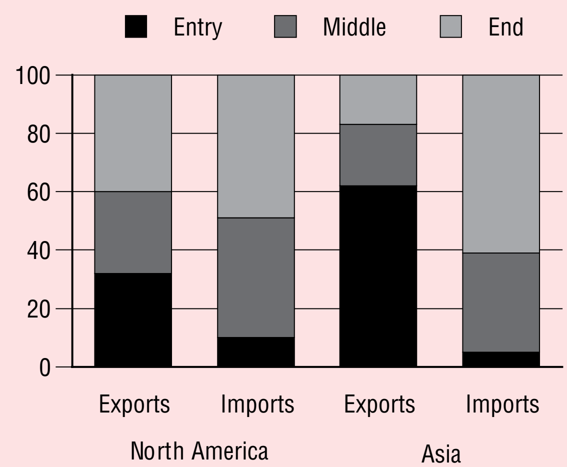
Two-way trade in more advanced inputs with Europe appears to have increased steadily.

The combination in recent years of lower trade barriers, advances in communications and transportation technology, and the rise of emerging economies has allowed business to slice the production process into smaller parts and position them around the world wherever they can achieve the lowest possible cost and maximize return. This phenomenon has revolutionized global production, giving rise to sophisticated networks of goods and services in value chains, powered by rapidly expanding FDI and other financial flows.

Of course, not all trade takes place this way. But Canada's future trade success depends on more active engagement in this ascending international business model.

How engaged are Canadian firms in the value chain phenomenon? While difficult to track statistically, Conference Board analyses suggest this has not gone very far—in contrast to the global trend. Participation by Canadian firms in the kind of mid-level production inputs that multinational corporations are sourcing around the world grew during the 1990s, while the auto and other manufacturing industries were expanding. But it has since become stuck in neutral. (See Chart 19.)

Chart 19
Goods Trade by Stage of Entry Into Importers' Supply Chains, 2006
(per cent share)



Source: Goldfarb and Chu, *Stuck in Neutral*.

Not surprisingly, Canadian firms are much more integrated into North American value chains than others, although two-way trade in more advanced inputs with Europe appears to have increased steadily and value chain engagement with Latin America, while small, also appears to be growing. At the same time, Canadian companies appear to be doing a much better job of using Asian inputs in Canadian value chains than they are of integrating into Asian value chains.[7] Although Canada is becoming significantly more engaged in this kind of global production, it appears to be more at the entry level through its resource exports.

While this picture suggests Canadian companies are not fully seizing global opportunities, it also points toward important untapped potential. A 2007 OECD study found

6 This report uses the term "value chains" rather than "supply chains." While these are similar, value chains imply a networked process involving the creation, development, production, and distribution of a product, creating value at each step. Supply chains suggest a linear production process in which parts and inputs are brought together to create a final product brought to market.

7 Beckman and Goldfarb, *Canada's Changing Role in Global Supply Chains*; Goldfarb and Chu, *Stuck in Neutral;* Hodgson, *Making Integrative Trade Real*.

that smaller companies engaged in global networks were able to expand their businesses, increase their stability, and gain exposure to new learning opportunities, technologies, and ideas.

Value chains are, of course, not for everyone. (See box "SMEs: The Benefits and Risks of Value Chain Participation.") But they need to become a more central feature of the Canadian corporate and trade policy lexicons. Firms, both large and small, should be carefully considering whether and how value chain participation fits in their corporate strategies. In particular, value chains offer important opportunities for small and medium-sized businesses, which account for a substantial portion of the Canadian economy. According to a Canadian Federation of Independent Business survey in 2004, only 15 per cent of its SME members were participating in global value chains.

SMEs: The Benefits and Risks of Value Chain Participation

A recent Conference Board survey provides insights on how SMEs perceive participation in value chains. The survey revealed significant gaps in the "reality" and the "perception" of benefits and risks associated with value chain participation between firms that have become experienced suppliers to multinational corporations versus those looking to become suppliers.

Experienced SME suppliers found that value chain participation brings increased revenues, enhanced corporate reputation, improved financial stability, expanded access to new markets, and greater economies of scale. But they were frustrated by what they regarded as excessive bureaucracy on the part of multinational corporations, difficulties in establishing trust, and the dangers of relying too heavily on a few large customers.

Would-be suppliers placed more emphasis on revenue growth, market access, productivity gains, and access to expertise and advice, while underestimating the benefits of enhanced corporate reputation. And they expected to face greater challenges in such areas as establishing trust, accessing credit, and meeting standards and certifications.

Sources: Krywulak and Kukushkin, *Small Companies, Big Connections*; Macmillan, *Canadian SMEs and Globalization*.

A MORE POSITIVE VIEW OF IMPORTS

As imported inputs assume a larger role in production, appreciation of the role of imports is changing. The role of imports in production is already high in some areas. Early in the decade, the domestic content of Canadian exports exceeded 70 per cent or 80 per cent in the case of certain resource industries (such as oil and gas) and many services exports (such as financial services and tourism). But in sectors that have become deeply integrated into the North American economy, as is the case with large parts of manufacturing, domestic content is around 50 per cent or lower. In the case of certain cars, it slipped as low as 35 per cent, meaning that Canadian production of automobiles exported to the U.S. relies as much or more on foreign inputs than it does on Canadian inputs, including labour.[8]

Value chains need to become a more central feature of the Canadian corporate and trade policy lexicons.

At the same time, the rise of value chains—which can see goods and services travel back and forth across borders many times—challenges the old mercantilist "exports good—imports bad" view of trade.

The logic of value chains is that reducing barriers to key imports can be as critical as reducing barriers to exports in determining a firm's capacity to compete effectively. Some important moves have been made in this direction. The capacity of Export Development Canada (EDC) to finance key imports has expanded.[9] And the recently announced plan to eliminate import tariffs on machinery and equipment will help to reduce costs and make Canadian business more competitive, while encouraging much-needed investment in this area.

8 Statistics Canada, *A Profile of Canadian Exporters*.

9 EDC's capacity to finance imports under its pre-shipment financing program is used by exporters to finance the upfront production costs of their export contracts. For example, EDC can finance the purchase of an imported machine tool needed by a Canadian company in order to expand production of its exports. Under its temporary powers, EDC's ability to finance working capital costs and other production costs (for domestic and export contracts) has expanded.

Sales Through Foreign Affiliates: Largely Invisible, But Enormous

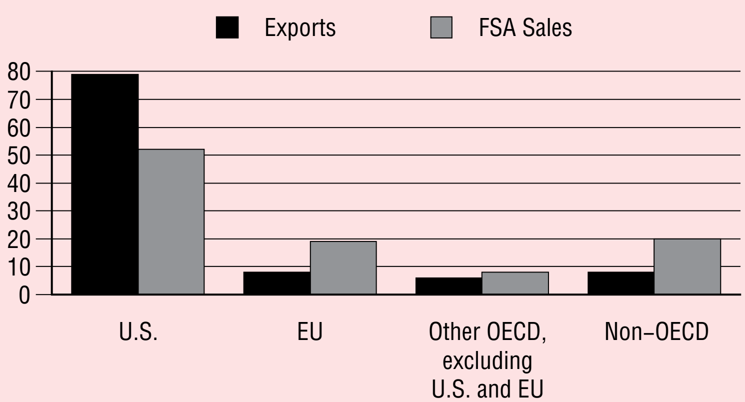
A less well-known feature of recent trade is the growing trend among Canadian firms to sell through their affiliates in other countries. These foreign affiliate sales involve products from Canada, as well as elsewhere. Estimated at over $400 billion annually, they are roughly comparable in magnitude to total Canadian exports of goods.[1]

Establishing foreign sales affiliates (FSAs) can help companies transcend trade and non-tariff barriers, as well as enjoy closer contact with their customer base. In some countries, establishing a commercial presence may be necessary to comply with local rules. India, for example, has various equity or regulatory restrictions that effectively force Canadian companies to establish joint ventures if they want to provide services to Indian clients.

What is known about FSA sales is that they are more likely to involve services than goods. They are less important for trade with the U.S. than for success in more geographically distant or difficult markets; in recent years, the U.S. share of Canadian foreign affiliate sales has fallen—from 64 per cent in 1999 to 52 per cent in 2007. On the other hand, Canada sells more in Europe than it does to Europe; in 2007, sales by Canadian foreign affiliates in the EU were more than twice the level of Canadian exports to the EU. (See chart.)

The direct benefits of these sales, in the form of dividends and profits that eventually return to Canada, are relatively minimal. But their indirect benefits, in terms of making Canadian businesses more competitive internationally and providing capital gains to shareholders, can be substantial. More needs to be understood about the implications of this way of doing international business.

Foreign Sales Affiliates Play Major Role Outside North America
(per cent of total Canadian sales abroad, 2007)



Source: Statistics Canada.

1 Statistics Canada data on FSAs cover majority-owned foreign affiliates and exclude depository institutions and foreign branches of firms, consistent with the international practice for measuring foreign affiliate trade statistics.

Source: Statistics Canada.

Consideration now needs to be given to eliminating tariffs on other key imported inputs—or simply eliminating most or all remaining tariffs across the board.

Facilitating imports can of course be a sensitive matter. But it does not imply throwing the import door wide open. Canada has a system of trade remedy rules and institutions designed to deal with injurious imports of dumped or subsidized goods, while giving Canadian producers time to adjust. Rather, the question is what purpose Canada's remaining tariffs, most of which are now small and have relatively little financial or policy impact, actually serve in the larger context of such other determinants of domestic producers' competitiveness as lower cost structures in other countries, technological superiority, quality, or access to capital.

The struggling U.S. economy will likely provide a slower market as well as a more challenging one in the future.

A SLOWER AND MORE CHALLENGING U.S. MARKET

The financial crisis that has battered Canada's trade provides a stark reminder that North American trade integration cannot shield Canada from the larger U.S. and global economic realities. While the severe recession in the U.S. appears to be winding down, the recovery will continue to be hampered by weak labour markets and ongoing structural problems—notably the trillion-dollar deficit, which spells higher interest rates, higher taxes, and/or a return to inflation. The likelihood is that, for the foreseeable future, the struggling U.S. economy will provide a slower market as well as a more challenging one, as European, Asian, Latin American, and other competitors vie to recapture recovering U.S. demand.

In other words, the conditions that led to booming trade during the 1990s—a stronger U.S. economy, a depreciating exchange rate, a substantial reduction in trade barriers—are unlikely to reassert themselves in the foreseeable future. Meanwhile, Canada's cost advantage in the U.S. is eroding with dollar appreciation and the thickened border, while others are making inroads into the U.S. market, and protectionist sentiment is on the rise in the U.S., as evidenced by the recent "Buy America" issue. Nor are there any "big fixes" in sight that are likely to substantially turn this potent mix around.

This underscores the critical importance of reinforcing Canada's competitive position in the U.S., beginning with (but not limited to) improving the border. Research suggests that the biggest trade gains will come from the harmonization or mutual recognition of regulatory standards and the reduction or elimination of remaining tariff barriers.[10]

North American trade integration has not turned out quite as some envisaged at the time NAFTA was signed.

As U.S. business takes advantage of the lower U.S. dollar to export to the rest of the world, we need to think of the U.S. not only as a huge consumer end market but also in terms of participation in value chains. In other words, exporting to the U.S. will continue to depend on U.S. demand. But it can also be a way of taking advantage of demand in other markets as the U.S. seeks to improve its export position and shore up its serious trade imbalance.

At the same time, the "NAFTA optic" also needs some revisiting. North American trade integration has not turned out quite as some envisaged at the time NAFTA was signed. While intra-regional trade has grown, North American trade integration remains much more of a hub-and-spoke phenomenon than a triangle. (See box "North American Trade Integration: More Hub-and-Spoke Than Triangle.") NAFTA also has a much different profile in Canada, where it has become shorthand for the Canada–U.S. relationship itself, than in the United States, where it is associated with immigration issues, job losses, the drug trade, and other troublesome issues with Mexico.

10 See, for example, Hart and Dymond, "Navigating New Trade Routes: The Rise of Value Chains."

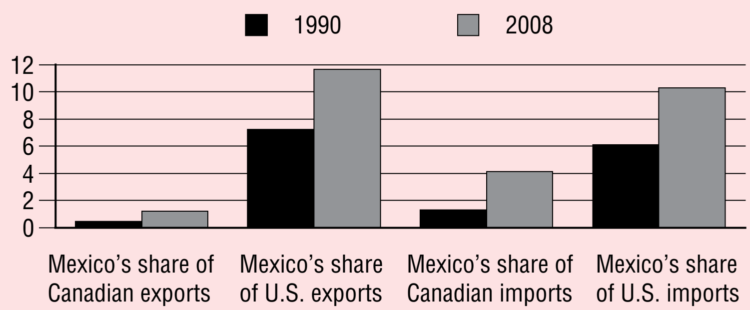
North American Trade Integration: More Hub-and-Spoke Than Triangle

Since 1990, Mexico's share of both Canadian and U.S. merchandise exports and imports has risen steadily. As might be expected, Mexico accounts for a smaller share of Canadian trade than U.S. trade—1 per cent versus close to 12 per cent for exports and 4 per cent versus 10 per cent for imports. Mexico is also more important to the U.S. as an export market than as a source of imports, while for Canada it is the reverse.

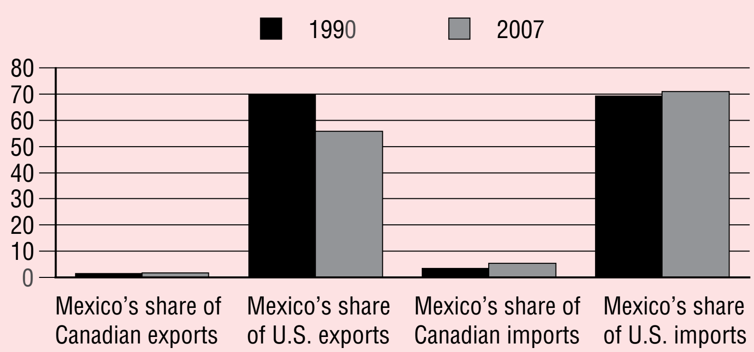
The most notable trend is that the U.S. share of Mexico's exports has, like Canada's, been declining. Indeed, the U.S. is now a relatively smaller export market for Mexico than it was before NAFTA. Otherwise, the shape of Mexico's trade with both Canada and the U.S. looks remarkably the same as it did in 1990 (except for a slight increase in Canada's share of Mexico's imports).

In other words, in relative terms, Canada and Mexico are small but increasingly significant merchandise trade partners for each other, mainly on the import side. The U.S. continues to represent a huge, though declining, export market for both. It is also a relatively flat (in Mexico's case) and relatively declining (in Canada's case) source of imports.

Mexico's Share of Canadian and U.S. Exports and Imports
(per cent)



Canadian and U.S. Share of Mexico's Imports and Exports
(per cent)



Sources: Industry Canada Trade Data Online (TDO); UNCTAD; The Conference Board of Canada.

This argues for some strategic "re-bilateralization" of the Canada–U.S. trade relationship. That is, more of Canada's interests should be pursued with the U.S. directly, involving Mexico only where this can be expected to deliver particular dividends.[11]

GROWING TRADE DIVERSIFICATION BEYOND THE U.S.

For reasons of sheer size and geographic proximity alone, the U.S. obviously remains Canada's most critical trade relationship. But the time has come to stop thinking of the rest of the world as secondary to our U.S. interests. Nor are U.S. and non-U.S. markets mutually exclusive; in the world of value chains and shifting comparative advantage, it is imperative to focus on both.

There is some evidence that Canadian firms were slowly diversifying beyond the U.S. prior to the recession

The view that Canada's interests lie in having most or all of its trade eggs in the U.S. basket is challenged by recent trends that indicate Canada–U.S trade integration has peaked, and that trade growth is increasingly coming from opportunities in other markets.

There is also some corroborating evidence that Canadian firms were slowly diversifying beyond the U.S. prior to the recession (see box "Canadian Exporters: A Modest Pre-Recession Shift Beyond the U.S.")—a trend that can be expected to continue as firms recalibrate their strategies in the wake of the recession and seek to mitigate perceived risks in the U.S. market.

This is not to suggest that Canadian firms should necessarily be moving away from the U.S. market. Indeed, some studies have suggested that firms that focus on the North American market will tend to be better performers

11 Busch, *The Perfect (Anti-Trade) Storm?*

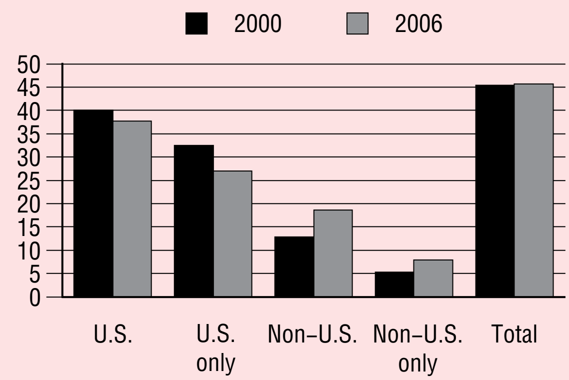
Canadian Exporters: A Modest Pre-Recession Shift Beyond the U.S.

The pre-recession trend toward greater diversification of Canada's trade beyond the U.S. was, not surprisingly, accompanied by a modest pre-recession shift in the number of Canadian firms exporting beyond the United States.

According to Statistics Canada, the total number of "exporting establishments," which are heavily oriented toward the United States, remained flat between 2000 and 2006. But the number of those exporting exclusively to the U.S. declined modestly (from 71.7 per cent to less than 60 per cent), while the number of those exporting to non-U.S destinations, or both, almost doubled. By 2006, 41 per cent of exporters sold merchandise to countries other than the United States.

Almost one-quarter of exporters shipped goods to both the U.S. and abroad, generating almost half (45.7 per cent) of all merchandise exports.

Canadian Exporters Looking More to Non-U.S. Markets
(exporting establishments, 000s)



Source: Statistics Canada, *A Profile of Canadian Exporters*, p. 23.

Source: Statistics Canada, *A Profile of Canadian Exporters: 1993 to 2006*. This survey is derived from the Exporter Registry which tracks "exporting establishments," defined as those that exported commodities valued at $30,000 or more in at least one year from 1993 to 2006. The Registry covers trade in domestically produced merchandise, but not trade in services, although a services-producing establishment exporting goods would be included.

than those that focus more globally.[12] But more attention needs to be paid to where underlying international trade and economic trends are leading.

In particular, trade strategies will need to adjust to the profound shift taking place in global tectonic plates, as the engine of growth moves from older industrialized economies toward the BRIC (Brazil, Russia, India, and China) and other emerging economies. (See Chart 20.)

Emerging economies have rapidly growing populations and improving economic policy frameworks.

This phenomenon, driven mainly by demographics, is already evident in Japan and Europe, where economic growth was slowing prior to the recession. In contrast, emerging economies have the advantage of rapidly growing populations and improving economic policy frameworks that boost their underlying growth potential and make them increasingly important global economic players and trade partners.

Industrial economies will continue to be important markets, as evident in the recent growth of Canadian exports to Europe and Japan. But in the longer run, slowing industrial economies spell lower future opportunities for Canada

12 Rugman and Li, "Are There Global or Regional Supply Chains?"

The Huge U.S. Fiscal Deficit: How Dangerous Is It?

Is the sheer magnitude of the U.S. fiscal deficit—now over US$1 trillion—likely to undermine the U.S., and indeed the world, economy?

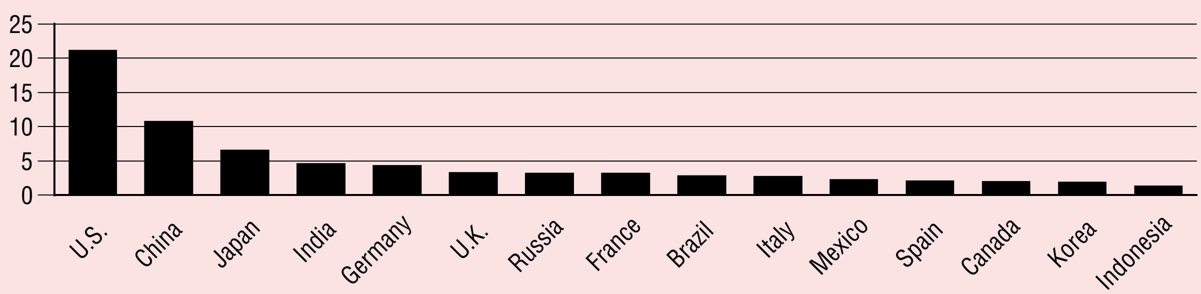
This scenario could occur if central banks in China, Japan, and other countries in East Asia, as well as some of the major Middle East oil-exporting countries, decide to unload their massive holdings of U.S. government bonds due to a lack of confidence in the U.S. government's determination to reduce the size of the deficit. In this event, the U.S. dollar would depreciate dramatically and U.S. interest rates would soar, thereby destabilizing the world economy.

The Conference Board's current outlook assumes this will not take place because, while central banks in the Asia-Pacific region and elsewhere will diversify their reserve holdings away from the U.S. dollar and into currencies such as the euro and the pound, they will still have an incentive to continue to invest in U.S. assets. Purchases of U.S. dollars help to keep domestic currencies from appreciating sharply and hurting competitiveness of exports. Also, buying U.S. bonds helps keep U.S. interest rates low, while enabling the U.S. economy to recover faster.

While central banks will diversify their holdings of foreign exchange over the forecast period, it is assumed that these actions will not lead to a dollar rout. Notwithstanding China's proposal for a new world reserve currency, it is also assumed that the U.S. dollar will remain the reserve currency, and that the world's most important commodities will also continue to be quoted in dollars.

Source: The Conference Board of Canada, *Canadian Outlook Long-Term Economic Forecast 2009*.

Chart 20
The World's Leading Economies, 2007
(percentage share of world GDP, US$ at PPP)



Source: International Monetary Fund, "World Economic Outlook Database."

U.S. Economy Slowly Turning the Corner

The U.S. economy is making the adjustment from recession to recovery. The U.S. government's latest estimates suggest real GDP expanded at an annualized pace of 5.7 per cent in the fourth quarter on the heels of an increase of 2.2 per cent growth in the third quarter. For the entire 2009, real GDP is expected to post a drop of 2.4 per cent before rebounding and expanding by 2.8 per cent in 2010. The recovery in 2010 will be weaker than the growth that generally accompanies economic recoveries from deep recessions, due to ongoing weakness in consumer spending.

The recovery is mainly a result of unprecedented monetary and fiscal support for the economy. The Federal Reserve has taken aggressive actions including cutting interest rates to close to zero and engaging in quantitative easing. These factors, combined with the bank stress tests that the Obama administration initiated earlier in the year, have stabilized the financial system as evidenced by the fact that inter-bank lending rates have returned to normal levels and credit spreads between bonds and ultra-safe U.S. Treasuries have narrowed sharply in recent months. While some credit markets remain fragile and many smaller banks throughout the country will likely not survive, credit is flowing much better than the situation a year ago.

Fiscal policy measures have also helped turn the economy around. Unemployed workers and local and state governments would have had to cut back to an even greater degree if not for the timely support garnered from fiscal stimulus policies. The housing tax credit was responsible for boosting home sales by more than 400,000 over the summer months, while close to 700,000 cars were sold thanks to the popular "cash for clunkers" program. Lower taxes—both for consumers and for businesses—have also helped boost spending.

Naturally, there is a price tag for the huge spending measures required to turn the economy around. The federal deficit is expected to hit $1.1 trillion in 2009 and remain close to the $1 trillion mark in 2010. These deficits will have to be addressed at some point over the next few years, but the economy remains in too fragile a state for policy makers to take immediate steps to tackle the problem. It is important to note that, while nobody likes trillion-dollar deficits, the alternative would have been far worse. The failure to respond to the collapse in business and consumer confidence and spending as well as foreign trade would have resulted in far greater job losses than the 7.2 million positions that have already been shed since the recession hit. We could be looking at an unemployment rate approaching 12 per cent were it not for the dramatic intervention in the economy by the federal government.

The main question going forward is what direction the economy takes after the fiscal stimulus begins to fade. Interest rates are already close to zero, leaving little room for monetary authorities to stimulate the economy to an even greater degree than has already transpired. Future growth will therefore depend primarily on household spending, which has been constrained by the ongoing deterioration in labour markets. The economy continues to lose jobs, albeit at a much slower pace compared with last winter. Given that job creation will likely not return to positive territory until sometime in 2010, consumer spending will remain sluggish, thereby restraining the pace of economic growth in 2010. The weak state of the job market implies that the federal government will have to provide more assistance for laid-off workers about to lose their unemployment benefits. Also, Washington will have to provide more help to state governments contending with gaping holes in their budgets.

Sources: Beckman, *U.S. Outlook: Autumn 2009;* Bureau of Economic Analysis, *Gross Domestic Product: Fourth Quarter 2009*.

with most of its traditional trade partners. (See box "Is the Financial Crisis Accelerating the Shift in Global Growth From Industrial to Emerging Economies?") And just as emerging business and economic trends drove us toward greater regional trade integration in the 1980s and early 1990s, they are now leading us in other directions.

One is toward improving the comfort level for firms in moving beyond the "tried and true" of the huge U.S. market next door. Another lies in re-orienting trade diversification strategies beyond the vision of hemispheric free trade with Latin America, which has not, generally speaking, lived up to its billing. In 2008, Latin America represented only 1.8 per cent of Canada's merchandise exports and 3.2 per cent of imports—about where they were in 1990, and similar to Canada's trade profile with Mexico. The Latin American relationship is lighter on trade and heavier on investment. Meanwhile, Latin America is diversifying its trade toward Asia.

At the same time, the current strategy of negotiating bilateral and regional trade agreements with smaller, mainly Latin American, countries—while presumably helpful to some companies—has not had much impact

Is the Financial Crisis Accelerating the Shift in Global Growth From Industrial to Emerging Economies?

The financial crisis, while created by different factors, appears to be echoing—and quite possibly accelerating—the shift in growth away from the traditional economic powers and toward the emerging economies. Europe has fallen into a sharp and prolonged recession (at least in some countries), due in part to the disastrous effects of property bubbles in the U.K., Spain, and Ireland, and to tight credit conditions in Eastern Europe. Many countries in Western Europe ship a significant portion of their exports to Eastern Europe. Germany, for example, ships 17.8 per cent of its exports to Eastern Europe, while Italy sends 15.7 per cent of its total exports. Japan was also in the grip of a major recession, largely the result of weakness in its export sector due to lower demand from its principal markets—the U.S. and China.

Emerging economies, in contrast, have generally not recorded recession-like conditions. Latin America has been hurt by tumbling commodity prices and real GDP is expected to post a drop of 2.4 per cent in 2009 in the wake of solid growth of 4.2 per cent in 2008. And emerging Asia, while hit by the collapse of demand in the industrialized countries, appears to be emerging relatively unscathed.

China is forecast to post growth of 8.3 per cent for 2009—down from its spectacular double-digit growth of a few years ago but still impressive—due largely to massive domestic stimulus spending. India is expected to register 6.1 per cent growth, down from 6.7 per cent in 2008.

Source: The Conference Board of Canada.

Chart 21
Real GDP: China Leads the Pack
(percentage change, annualized)

Source: Consensus Economics.

on the trade bottom line. Canada needs more substantive trade deals with larger economies. (See box “Needed: More Substantial Trade Deals With Larger Economies.”)

In particular, Canadians need to come to grips with the impact of China, India, and emerging Asia, and what it means for trade. Asia’s export-dependent economies were hit hard by the global economic downturn, but they are now leading the global recovery (see Chart 21), thanks to a financial sector that was less vulnerable to the global crisis, massive economic stimulus packages, and the easing of credit. This fuels speculation that the most important aspect of the shift in global economic tectonic plates could well turn out to be from the industrialized world to Asia.

Indeed, the BRIC concept that has characterized the emerging economies discussion is becoming outdated, as Asia pulls ahead of the global pack. Recent growth forecasts suggest that the GDP growth gap between the industrialized world and Asia is widening. Emerging Asia as a whole is expected to grow by at least 5 per cent in 2009, while the G7 economies contract by 3.5 per cent—an enormous gap.

Canadians need to come to grips with the impact of China, India, and emerging Asia, and what it means for trade.

In Asia, real GDP growth of 5.2 per cent is anticipated in 2010, well above the 3 per cent growth anticipated for the entire global economy this year. While the collapse in export demand hurt this part of the world during the recession, domestic demand offset, to a certain extent, the downturn in exports. The Chinese economy will lead the way in Asia with anticipated growth of 9.6 per cent in 2010. However, other countries in the region will also experience solid growth including India, Indonesia and

South Korea. The Japanese economy will continue to lag behind other countries in the region with meager growth of 1.5 per cent in 2010. The ongoing difficulties in dealing with deflation will hurt the economy's prospects over the near term.

There is, of course, some risk that underlying economic and social problems in China and India will at some point prick the Asian growth balloon. But the key ingredients of Asian success—rapid productivity growth, relatively open markets, a high savings rate, and, in the case of

Needed: More Substantial Trade Deals With Larger Economies

Efforts to expand Canada's trade through bilateral and regional free trade deals have largely echoed the U.S. pattern by focusing on smaller Latin American and Middle Eastern countries. To put this in perspective, Canada's trade with Colombia is about the same size as South Dakota's trade with the Latin American country.

Aside from NAFTA, five such agreements are currently in force, of which three (Costa Rica, Peru, and EFTA[1]) were negotiated since 2000. Others are either signed but not yet in force, still in the negotiation pipeline, or stalled. (See table.)

What is less clear is why, unlike the U.S., Canada has not been able to conclude negotiations with larger and more consequential Asian economies, such as Singapore and South Korea. Or why, unlike Australia, Canada has not negotiated agreements with China and Japan, its second- and third-largest trading partners respectively.

The recent shift toward negotiating more ambitious agreements with larger economies (such as the recent commencement of negotiations with the EU and a potential economic arrangement with India) is encouraging, as is a possible trade agreement within the Asia-Pacific Economic Cooperation (APEC) group, of which Canada is a member.

To achieve significant trade gains, however, such deals need to include significant commitments on the part of both Canada and other countries, some of which are not easily forthcoming. The EU, for example, is seeking greater access into Canada for its exports of alcoholic beverages and cheese before it will agree to open up more of its markets to Canada. Such access, however, could be politically difficult for Canada to grant.

Canada's Bilateral and Regional Trade Agreements

	Latin America	Asia	Other
In force	◆ NAFTA (Canada, U.S., Mexico) (1994) ◆ Chile (1997) ◆ Costa Rica (2002) ◆ Peru (2009)		◆ Israel (1997) ◆ European Free Trade Association (Norway, Switzerland, Iceland, Liechtenstein) (2009)
Signed	◆ Colombia (2008)		◆ Jordan (2009)
Pending	◆ Panama ◆ Andean Community (Bolivia, Colombia, Ecuador, Peru) ◆ CARICOM (Caribbean countries) ◆ Dominican Republic ◆ Central America Four (Honduras, El Salvador, Guatemala, Nicaragua) ◆ Free Trade Agreement of the Americas (FTAA)	◆ Korea ◆ Singapore ◆ India	◆ Morocco ◆ European Union

Sources: Foreign Affairs and International Trade Canada; World Trade Organization data base on regional trade agreements.

1 The free trade agreement between Canada and the European Free Trade Association (EFTA) countries of Iceland, Liechtenstein, Norway, and Switzerland took effect on July 1, 2009.

China and India, huge domestic markets—are strong assets. It is also worth recalling how, contrary to most predictions, Asian economies managed to rebound quickly following their own financial crisis in 1997.

Canada is a latecomer to the China/Asia table. Our presence in the region pales in comparison with that of the U.S., Europe, Australia, or even Brazil. But Canadian firms—whether they are exporters or importers, or are simply seeking to survive—urgently need strategies for dealing with Asian countries as markets for goods and services, partners in value chains, a growing source of imports, and increasingly important global investors.

Canadian firms—whether engaged in trade or not—need to figure out what the rise of Asia means for them.

Classic trade enhancement strategies—such as more trade agreements, trade commissioners, trade offices, and trade visits—on their own are unlikely to make a significant difference. The underlying problem is that China and emerging Asia have yet to fully register on the Canadian mental map. To the extent they have, the image is clouded by a perception that it is a more complex place to do business, or by concerns about product safety, environmental degradation, and human rights. The view is also confused by suggestions that China's rise is either likely to be short-lived or at odds with U.S. (and by extension Canadian) interests—neither of which is well founded.

Nor is it all about China. It is also about the other rising economic giant, India, as well as other industrial economies in the region such as Japan, South Korea, and Singapore, and rising stars like Vietnam and the countries of Southeast Asia, all of which are increasingly interlinked through value chains and investment. These countries will also become increasingly important economic players, as China's growth inevitably cools and it moves up its own value chain into higher and higher levels of production. (See box "Can China Compete?")

Can China Compete?

Given China's remarkable success, the question may seem absurd. However, according to a survey of 66 multinational companies by global consulting firm Booz & Company, 54 per cent of respondents indicated that China was becoming less competitive with other low-cost producers mainly because of higher labour costs. Twenty per cent said they planned to move production to other countries, such as Vietnam and India.

History suggests this is not surprising. After many decades of rapid growth, increasing business costs and rising standards of living in the so-called Asian Tigers—South Korea, Singapore, Taiwan, and Hong Kong—resulted in an exodus of low-cost production to China.

Now the tables are turning again as China's population matures, costs rise, other lower-cost economies come on stream, and China turns to producing higher value-added products, including cars and high-technology equipment. Government-directed efforts to clean up the country's manufacturing sector by improving quality and safety will expedite this process, as will tighter environmental and labour laws and other regulatory reforms, which will force many marginal low-end manufacturers out of business.

These changes are coming quickly. Within the next few decades, Chinese manufacturing could closely mirror Japan's production of sophisticated, high value-added goods and services and—like Japan's and Korea's—increasingly challenge Canadian manufacturing.

Source: Beckman, *World Outlook, Spring 2009*.

In short, Canadian firms—whether engaged in trade or not—need to figure out what the rise of China/Asia means for them, and then get on with the business of realizing opportunities and adjusting to its inevitable impact.

SHIFTING GLOBAL COMPARATIVE ADVANTAGE

Shifts in global comparative advantage are nothing new. But this time the industrialization process is telescoped—not gradual in the manner of previous rising stars such as Japan or South Korea. China is already an auto exporter and has a space program. Brazil challenges Canada in the Asian resource markets and also on aircraft.

Reality Check: How Regional Is International Trade?

International trade is becoming more regionalized—but not perhaps as much as we may think. Europe trades more within itself than with any other region. (See table.) WTO data indicates that 75 per cent of Europe's merchandise trade in 2007 was intra-regional, reflecting strong trade integration within the EU, including the economies of Central and Eastern Europe.

The comparable figure for North America, where the share of trade that takes place within the region has declined somewhat, was just over 50 per cent. Asia, where both intra- and inter-regional trade has been growing rapidly, is in the same range.

Intra-regional trade in South and Central America, while increasing, was considerably lower (24 per cent); its exports have remained more oriented to North America (30 per cent) and Europe (21 per cent), and increasingly to Asia (16 per cent).

Intra-regional trade among the Commonwealth of Independent States (CIS) was in the same range (20 per cent). CIS exports are more oriented to Europe (56 per cent). Intra-regional trade in the Middle East is lower still (12 per cent). The region's exports are oriented to Asia (52 per cent). In Africa, intra-regional trade is less than 10 per cent. Africa exports mainly to Europe (39 per cent), North America (21 per cent), and increasingly to Asia (19 per cent).

Intra-Regional Shares of Merchandise Trade, 2007
($ billions)

Total trade	Share of regional trade flows in each region's total merchandise exports							
		Europe	Asia	North America	Middle East	CIS*	South and Central America	Africa
5,772	Europe	**73.5**	7.9	7.9	2.6	3.3	1.4	2.6
3,800	Asia	18.8	**49.7**	19.9	4.0	2.1	2.4	2.4
1,854	North America	17.7	19.0	**51.3**	2.7	0.7	7.0	1.5
760	Middle East	14.3	52.3	11.0	**12.3**	0.6	0.6	3.6
510	CIS*	56.3	11.7	4.6	3.2	**20.2**	1.2	1.3
499	South and Central America	21.2	16.1	30.3	1.8	1.3	**24.4**	2.7
424	Africa	39.5	19.1	21.7	12.3	0.2	3.4	**9.5**

*Commonwealth of Independent States
Note: Bold numbers indicate trade within own region.
Source: WTO data base, 2007.

Source: WTO data base.

Canada's natural comparative advantage in the resource area makes it an obvious beneficiary of this phenomenon, as the exploding needs of emerging economies for energy, resources, and agricultural products, coupled with high use in industrialized countries, spell continued solid demand and prices for the foreseeable future. Resources, however, are far from a seller's market. Brazil, Russia, and the Middle East, as well as some Southeast Asian and African economies, have the advantage of lower costs and, in some cases, more accessible products—and they are becoming increasingly serious competitors in many areas. Others, notably China, are increasingly influential as price setters.

At the same time, export sectors without much comparative advantage apart from Canada's proximity to the U.S., will increasingly need to rely on such firm-specific advantages as quality and innovation in order to compete, especially as emerging economies move into higher and higher levels of industrialization.

Either way, future opportunity for Canadian business lies in becoming more competitive by investing in greater efficiency, securing positions in value chains, developing niche markets, and moving into higher and higher levels of innovation-based production. The risk to that scenario comes from the temptation to slide backward into rear-guard action with protective barriers and costly bailouts that can only make Canadian firms and the Canadian economy increasingly less competitive and delay the inevitable adjustment process.

TRANSITION TO A LESS CARBON-INTENSIVE ECONOMY

Canada's trade competitiveness will also be determined by how business and governments respond to the issue of climate change and the transition over time to a less carbon-intensive economy.

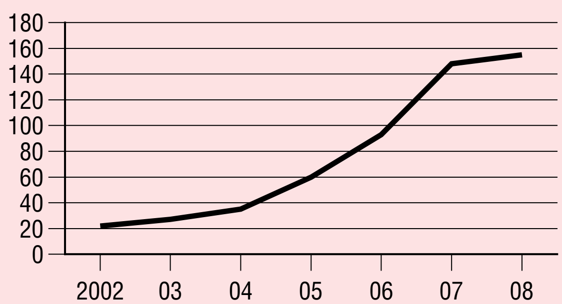
Clean technology is the only sector where global venture capital is expected to increase over the next three years.

Assuming regulations mandating substantial reductions to greenhouse gas emissions are implemented, demand for Canadian oil and gas is still likely to be sustained for at least the next decade, as will domestic demand for foreign direct investment to develop reserves and transport them to market. This suggests that the shift in Canada's trade profile toward stronger reliance on exported oil and gas therefore seems likely to be sustained for the foreseeable future, although U.S. environmental concerns about the oil sands could constrain future growth.

As well, as a Conference Board report—due to be released in 2010—documents,[13] the stars seem to be aligning for more climate-friendly trade as we witness carbon policy shifts in most industrialized countries, environmental problems in major emerging economies that call for greater economy/energy efficiency, and increasing energy and water costs.

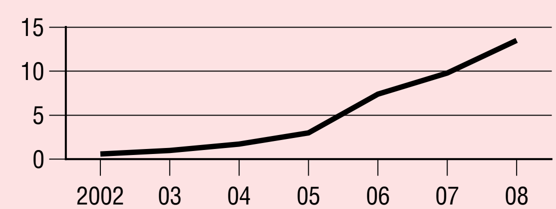
At the same time, public and private financing for cleaner and more efficient energy sources have been growing rapidly. Some US$500 billion, or 15 per cent of the total global stimulus, has been allocated by national governments worldwide to "climate-friendly" activities. (See charts 22 and 23.) Clean technology is the only sector where global venture capital is expected to increase over the next three years.

Chart 22
Rapid Growth in New Global Financing for "Clean" Energy
(US$ billions)



Sources: New Energy Finance; The Conference Board of Canada.

Chart 23
Rapid Growth in Clean Energy Venture Capital/Private Equity
(US$ billions)



Sources: New Energy Finance; The Conference Board of Canada.

13 Danielle Goldfarb's report, tentatively titled *The Global Market for Climate-Friendly Technologies: Canada's Chance to Clean Up*, will examine the extent to which Canada is adopting global climate-friendly technologies and its areas of comparative advantage in selling such technologies. See also Thomson and Bloom, *Turning Green Into Gold*.

The key question is, to what extent will Canadians become technology makers or technology takers in the potentially enormous expansion of economic and trade opportunities that flow from this phenomenon?

The risk lies in the scope for "green protectionism"—that is, measures taken for narrow protectionist reasons dressed in the guise of legitimate environmental goals. The international trade system is likely to increasingly find itself grappling with this challenge.

UNCERTAIN FUTURE TRADE LIBERALIZATION

Meanwhile, we may also need to face up to a view of international trade expansion that is less agreement-led than in the past, and relies more on the underlying competitiveness of Canadian businesses and the Canadian economy.

The massive expansion of international trade that took place over the past 40 years owes much to successive rounds of multilateral trade liberalization—which lowered trade barriers, opened markets, and improved efficiency by exposing businesses to greater competition.

More trade agreements do not translate into significantly more trade unless they involve substantive changes that are taken up by business.

The question now is whether the momentum of multilateral trade liberalization can be sustained, or whether the world community will fall back into a more protectionist mode. Predictions, made at the beginning of the recession, of the world falling into 1930s-style protectionism have not come to pass—perhaps in part because the world is now much more interconnected through value chains and other links, making protectionism more self-defeating. Nonetheless, protectionist actions have been growing, putting an onus on keeping current trade channels open.

Nothing would send a better signal than the successful conclusion of another round of multilateral trade negotiations. But as the stalled Doha round of WTO trade talks indicates, the process of multilateral trade negotiation has itself become more difficult. While many formal trade barriers have come down, the remaining issues are fraught with political peril (e.g., agriculture) or are more technically complex (e.g., services and intellectual property). As well, the WTO has grown steadily—there are now 153 members—making the world trade body more unwieldy than at its outset 15 years ago. This does not make the WTO less important. But it is conceivable its focus may swing increasingly toward its equally important role as a keeper of global trade rules and arbiter of trade disputes.

We may also need to face up to a view of international trade expansion that is less agreement-led than in the past.

At the same time, the perception that the focus of trade liberalization has shifted from the multilateral to regional and bilateral levels bears scrutiny. The number of regional and bilateral trade agreements certainly proliferated as Doha stalled. What is less clear is the extent to which these are actually generating trade expansion. A significant downside of such agreements has been the "spaghetti" or "noodle" bowl of overlapping and complex trade rules that can have the effect of increasing business transaction costs, thus offsetting the value of negotiated lower entry. A recent Asian Development Bank (ADB) survey, for example, found that while the number of such agreements exploded in the region over the past decade, the business utilization rate remained low.

Trade agreements—multilateral, regional, or bilateral—can certainly deliver trade gains. And Canada has no choice other than to pursue them actively. But more trade agreements do not translate into significantly more trade unless they involve substantive changes that are taken up by business.

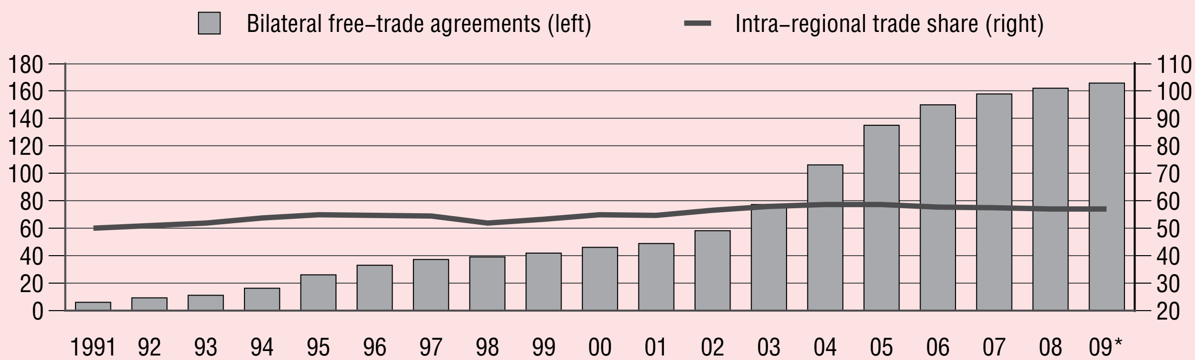
Trade Gains From Bilateral and Regional Trade Agreements: Reality or Illusion?

While rising trade within Asia has been a major factor in recent global trade growth, regional and bilateral trade agreements do not appear to have played a critical role in this phenomenon. A recent study by the Asian Development Bank indicates that while inter-Asian trade deals rose from 42 in 1999 to a startling 166 by June 2009, with another 62 under negotiation, the share of Asian trade that takes place within the region remained flat. (See chart.)

The main explanation appears to be low private sector take-up. A 2007–08 survey of exporters in Japan, South Korea, Singapore, and Thailand found that a relatively small number of exporters—22 per cent—actually took advantage of such agreements. One reason was that the so-called "noodle bowl" of complicated and overlapping rules imposes substantial certification and labelling costs. Given these costs and complexities, many businesses decide it is just not worth the effort.

Formal trade barriers in the region were also already relatively low in some cases, which made the benefit of further small reductions tiny—particularly relative to other growth factors in the region.

Bilateral Free Trade Agreements in Asia: A Limited Impact
(number of agreements; trade share, per cent)



*as of June 2009
Source: Asian Development Bank.

Source: Kawai and Wignaraja, *Tangled Up in Trade?*

CHAPTER 4

Shifting Gears: Strengthening Canada's Position in the Global Marketplace

Chapter Summary

- A tough business at the best of times, international trade is likely to get tougher as firms vie for recovering investment and markets.
- Canada needs to shift gears and strengthen its position in the international marketplace: internationally competitive Canadian firms, stronger and more forward-looking international trade policy and strategies, and a more supportive national operating environment are key.
- The biggest challenge facing Canadians is complacency—doing "well enough" is no longer "good enough."

International trade has been a struggle in these challenging times. But trade is a remarkably tough business to succeed at even in the best of times. And things are about to get tougher as businesses vie for recovering investment and markets, and as upward pressure on the Canadian dollar resumes.

As a country, we have taken comfort in being sheltered by Canada–U.S. trade integration without recognizing that this does not give us immunity from larger economic dynamics, and without taking sufficient advantage of opportunities associated with value chains, services, investment, and other features of modern global business. And we have counted on trade promotion and trade agreements to expand trade without doing enough to build what it takes to develop enough truly competitive Canadian businesses and a truly competitive national economy.

We can't risk complacency, that "doing well enough" is "good enough," when evidence points to the contrary.

We can coast in the hope that the U.S. and global recovery will see us through. Or we can recognize, as successful trade players seem to, that standing still is a recipe for slipping backward and that we must take the steps needed to strengthen Canada's competitive position in the global marketplace.

What we cannot risk is complacency, a sense that "doing well enough" is "good enough," when the evidence increasingly points to the contrary.

This means shifting gears. The following are three strategic priority areas where enhanced action by business and governments—federal and provincial—would make a substantial difference.

STRATEGIC PRIORITY AREA ONE: MORE INTERNATIONALLY COMPETITIVE CANADIAN FIRMS

Canada's trade future ultimately rests with firms that will now be assessing their outlooks in light of the recession and developments in the U.S. and around the globe.

While one size obviously does not fit all, firms should be considering where international trade and investment fit in their corporate strategies and how they can use it to improve their core competitiveness.

In particular it is important to think about how the shape of international trade is changing as a result of the rise of value chains and other aspects of the ascending international business model, as well as the rise of China and other emerging economies, and shifting global comparative advantage.

KEY DIRECTIONS

- Improve core competitiveness: Increase investment in R&D, become more innovative, and take advantage of key lower-cost imported inputs.
- Adopt an integrative trade mentality: Consider the advantages of foreign direct investment, value chains, trade in services, and services linked to goods.
- Rethink the U.S. market and trade diversification.
- Develop a China/emerging Asia strategy.

STRATEGIC PRIORITY AREA TWO: STRONGER AND MORE FORWARD-LOOKING INTERNATIONAL TRADE POLICIES AND STRATEGIES

Canada has some clear trade strengths. But it is also up against some exceptionally hard-nosed and well-armed competitors. The U.S., the EU countries, and Australia all have strong national trade policy arsenals. So, increasingly, do China and such other leading emerging economies as Brazil and India. Canada needs the same.

Recent trade and economic trends suggest that Canada's trade policy needs to move in three directions. First, Canada needs to come to grips with how value chains, foreign direct investment, and other aspects of the ascending international business model are changing the shape of international trade. Second, it needs to recognize the impact of U.S. and global economic trends by adopting a more explicit two-track approach that involves a reinforced focus on the United States coupled with a more rigorous and expanded focus on the rest of the world, especially China and emerging Asia. And third, Canada needs to strengthen its profile in the evolving World Trade Organization, where it has become increasingly caught up in defending Canada's supply management system in the agricultural sector.

Firms should consider where international trade and investment fit in their corporate strategies and how they can be used to improve their core competitiveness.

As well, the line between international trade policy and domestic policy is blurring, as trade issues shift increasingly toward such areas as non-tariff barriers, subsidies, and intellectual property. In particular, Canada needs strategies that will strengthen the competitiveness of Canadian business and lever Canadian advantages in areas of potential trade growth—areas such as financial and other services, innovative and green technologies, and value chains.

KEY DIRECTIONS

- Incorporate "integrative trade" more fully into the language, strategic development, and statistical measurement of international trade.
- Reinforce the competitiveness of Canadian firms in the U.S. market by reducing trade transaction costs: accelerate the streamlining of the border, continue reducing barriers to key imported inputs, and remove most or all remaining tariffs; expedite harmonization or mutual recognition of regulations.
- Move toward some strategic rebilateralization of the Canada–U.S. trade relationship.
- Focus on China and emerging Asia.
- Realize greater trade gains from bilateral and regional agreements by concluding substantial deals with larger countries.

- Take measures to strengthen Canada's profile in the WTO (including reassessing government support for dairy supply management policies).
- Develop supporting strategies for such key trade drivers as investment, innovation, and services.

STRATEGIC PRIORITY AREA THREE: A MORE SUPPORTIVE NATIONAL OPERATING ENVIRONMENT

At the same time, no trade strategies are likely to be successful without improvements in the underlying competitiveness of the Canadian economy. One direction lies in removing those things in the Canadian economy that impede the emergence and retention of competitive Canadian businesses. In addition to providing greater clarity and openness toward foreign investment in Canada (as recommended by the recent Competition Review Panel), we also need to remove those things that we know discourage foreign investors—things like Canada's poor productivity performance compared with the U.S., interprovincial barriers that limit economies of scale, the slow pace of adoption of new technologies, the vast web of complex and time-consuming regulatory requirements, the state of physical infrastructure in and between cities, the thickening of the border, and quality and skills issues in the workforce.

No trade strategies are likely to be successful without improvements in the Canadian economy's underlying competitiveness.

Recent steps by governments to move toward the creation of a more unified Canadian market are helpful. These include reduction of some interprovincial trade barriers, mutual recognition by provinces of credentials and qualifications, continued efforts to establish a single national securities regulator, as well as more internationally competitive tax rates and greater tax harmonization. But the process needs to be expedited and become more attuned to the need to enhance Canada's international competitiveness. For example, the effort to achieve greater regulatory harmonization within Canada is useful. But to serve Canada's international competitiveness needs, it should be more oriented toward harmonization with U.S. or other international standards through mutual recognition or other measures—if necessary, unilaterally.

While Canada is among the most open economies in the world, it could also use a good dose of enhanced competition. From a trade point of view, priority should be placed on eliminating non-tariff barriers in the transportation sector by opening up the North American and other transportation markets to cabotage. ("Cabotage rights" refer to the right of a company in one country to operate in the other as well. In aviation, this would allow a Canadian carrier to fly passengers between two U.S. points along its route.) Because transportation is both an industry in itself as well as a service provider to others, efficiency gains are multiplied across many sectors.

Although Canada is one of the most open economies in the world, it could use a good dose of enhanced competition.

At the same time, in addition to removing barriers, more emphasis needs to be placed on the building blocks required to develop a Canadian economy that is better able to compete effectively in the global economy. This calls for action on a number of fronts: much greater investment in Canada's aging urban and transportation infrastructure, development of a culture of innovation, and retooling immigration policies to place more emphasis on attracting entrepreneurial talent and labour market needs. Much more attention will also need to be paid to Canada's aging workforce and to fostering the kind of highly educated, skilled, and internationally literate workforce the future economy will require.

KEY DIRECTIONS

- Introduce greater clarity and openness regarding inward foreign direct investment, and become a more active facilitator of outward investment.
- Expedite alignment of regulatory standards to U.S. or other international standards—if necessary, unilaterally.
- Ensure the full implementation of mutual recognition of labour credentials and qualifications.
- Open the air transportation sector to cabotage.

- Encourage more strategic investment in urban and transportation infrastructure.
- Provide greater investment in knowledge and innovation.
- Retool immigration policies to give greater priority to the economic class and to meeting labour market needs.
- Rethink the future workforce with particular attention paid to such issues as aging workers, literacy, higher education, and skills training.

If New Zealand Can Do It . . .

New Zealand is a major dairy exporter that has just negotiated progressive duty-free entry into China's growing dairy market. Could Canada do something similar? Not as things stand. Canada's supply-managed dairy industry is barely competitive in the international marketplace. Exports account for a mere 5 per cent of Canadian dairy receipts. With the exceptions of milk protein and yogurt, all the major export categories—milk, butter, cheese—have fallen considerably from their 2001 values.

The dairy sector is a particular, but nonetheless telling, example of how lack of industrial competition at home thwarts realization of opportunity abroad. Dairy farmers benefit hugely from a system of domestic price setting that has risen steadily—indirectly providing an average of $175,000 in extra income per farm per year. These prices are effectively subsidized by Canadian processors, which raises their production costs, as well as by Canadian consumers who pay much more for dairy products than they would in other countries.

This system, which the WTO has ruled an export subsidy, seriously undermines the ability of the industry to take advantage of international opportunities, including growing demand in emerging markets. At the same time, lack of competition at home discourages the kind of efficiency and innovation that would enhance its international competitiveness.

In the meantime, defending dairy supply management has become a primary focus for Canada at the WTO, thus undermining Canada's ability to expand markets for more outward-oriented Canadian agricultural producers, as well as for other goods and services.

Source: Goldfarb, *Making Milk*.

CONCLUSION

International trade is not simply about exports and imports—it is about how Canada earns its living in the global economy, which ultimately affects the livelihood of each and every Canadian.

The main message of this report is that Canada's international trade cannot be taken for granted. Global trade can be expected to rebound as the recovery takes hold and demand resumes. But recovery does not necessarily spell future trade success for Canada.

International trade isn't only about exports and imports—it's about how Canada earns its living in the global economy.

To improve Canada's trade future, firms and governments (federal and provincial) need to do two things. The first is to better recognize the central importance of value chains and other aspects of the ascending international business model, the fundamental shifts taking place in the global economy, and why future success depends on thinking differently about trade than in the past. The other is to bite the bullet and do what it takes to become more truly competitive at a time when trade is becoming both more challenging and more critical.

What we cannot afford to do is rest on outdated perceptions of international trade that interfere with our ability to seize the trade and economic opportunities that are vital to the future of Canadian firms and the Canadian economy.

APPENDIX A

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