

# Canadian Trade Review

## A Quarterly Review of Canada's Trade Performance

Second Quarter 2002

*This trade and investment quarterly review reports on Canada's economic growth in the second quarter of 2002, and highlights our trade and investment performance in key sectors and markets.*

## Continued Economic Growth Fuels Strong Employment Expansion in the Second Quarter

The Canadian economy continued to outpace the U.S. economy and other G7 countries during the second quarter. Canada's real gross domestic product (GDP) increased by a robust 4.3% (on an annualized basis<sup>1</sup>) in the second quarter of 2002, whereas U.S. GDP expanded by a more modest 1.1% over the quarter.

Increased business investment, strong consumer spending and the rebuilding of inventory were the main contributors to Canadian economic growth over the quarter. The economic expansion fuelled increased imports, while export growth was hampered by the slow recovery in the United States and elsewhere. Consequently, Canadian exports grew more slowly than imports.

In the first quarter, manufacturing reversed five quarters of decline in this sector, and, in the second quarter, manufacturing has registered continued growth, led by the construction and automotive sectors.

Job creation has continued, with a net increase of 134,000 jobs, and has helped to reduce the average in the unemployment rate to 7.5% from the 7.8% registered last quarter.

**Table 1: Canada's Economic and Trade Indicators**

Percent Change at Annual Rates Second Quarter 2002 over First Quarter 2002	
Real GDP ( <i>annualized</i> )	4.3
Employment ( <i>quarterly increase, level</i> )	134,000
Rate of Unemployment ( <i>quarterly average</i> )	7.5
Consumer Price Index ( <i>second quarter 2002 over second quarter 2001</i> )	
All Items	1.3
Core ( <i>excludes food and energy</i> )	2.2
Canadian \$ in U.S. funds ( <i>quarterly average, level</i> )	0.6432
Exports of Goods and Services ( <i>annualized, current dollars</i> )	9.1
Imports of Goods and Services ( <i>annualized, current dollars</i> )	12.4

Source: Statistics Canada

The Consumer Price Index (CPI) for all items increased by 1.3% in the second quarter compared to the price level recorded in the same quarter a year earlier, but was slightly down from a 1.5% increase in the previous quarter of this year. The four-quarter increase in the CPI for core items (excluding food and energy) was 2.2%, up from the 2.0% recorded for the previous quarter. Thus, inflation—the rate of change in the CPI—remained comfortably within the Bank of Canada's target range of 1% to 3%. The Canadian dollar appreciated vis-à-vis the U.S. dollar over the second quarter—from US\$0.6271 to US\$0.6432.

<sup>1</sup> To make quarterly data comparable to annual data, the quarterly figures for trade in goods and services are adjusted for seasonality and are expressed at annual rates by raising them four times, i.e. seasonally adjusted annual rates - s.a.a.r. All figures, with the exception of investment figures, are expressed on a s.a.a.r basis, unless otherwise noted.

# Trade and Investment Highlights

## Imports Expand Faster than Exports in the Second Quarter

Exports of Canadian goods and services increased by 9.1% in the second quarter, with merchandise exports expanding by 9.6% (See Figure 1 for levels.). However, imports of goods and services increased faster, at 12.4%, with imports of services rising by 12.9%.

As is evident from Figure 2, shipments of energy, autos and industrial goods experienced strong growth, while exports of consumer goods, machinery and agricultural goods declined. Imports of energy, forestry product, and autos experienced notable increases, while agricultural goods was the only sector to experience a quarterly decline in imports.

Merchandise exports expanded to all markets, with the exception of the European Union (EU), where shipments to the United Kingdom experienced a substantial decline. Imports also increased from all major markets. Merchandise imports from the EU registered particularly strong growth, despite a small drop in imports from the United Kingdom. As a result of imports expanding more rapidly than exports, the trade balance deteriorated in the second quarter. Regionally, an improvement in the trade balance with the United States was more than fully offset by declining trade balances with other major markets, in particular with the EU.

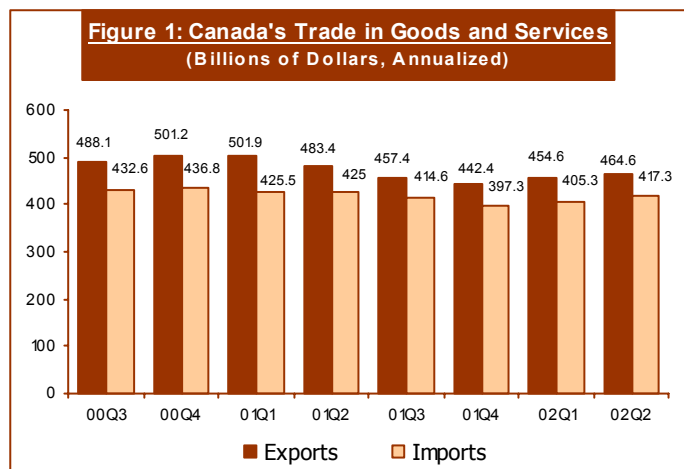
## Services Trade Deficit Worsens

In the second quarter, overall services exports increased by 5.8%—led by commercial and transport services—while travel services declined. This was, however, offset by a 12.9% increase in services imports—similarly led by commercial and transport services—that widened the services trade deficit by \$282 million to \$7.5 billion. For details by type of services, see Figure 3.

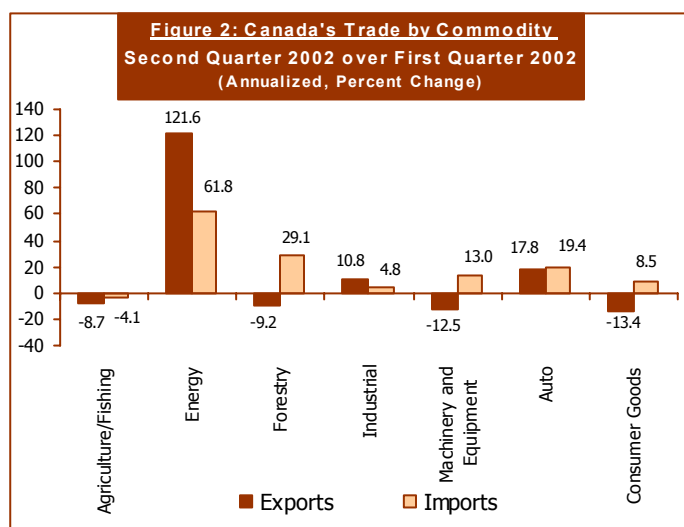
## Both Inward and Outward Foreign Direct Investment Decline

The second quarter of 2002 saw a drop in inward Foreign Direct Investment (FDI) to just over half the level recorded in the same quarter in 2001—\$7.9 billion versus \$15.2 billion. The drop in FDI was particularly pronounced in the energy and minerals sector. FDI from the United States and the United Kingdom registered steep declines, whereas FDI from Japan and the EU countries (other than the United Kingdom) registered increases.

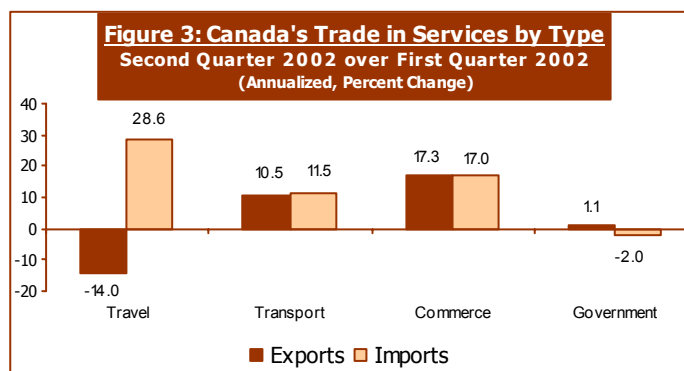
Outward Canadian Direct Investment Abroad (CDIA) also registered a substantial decline—to \$8.3 billion in the second quarter of 2002 from \$21.2 billion in the same quarter in 2001. The wood and paper sector was the only sector to register any substantial increase. CDIA to the EU increased, while CDIA to the United States and Other OECD countries recorded considerable contractions.



Source: Statistics Canada



Source: Statistics Canada



Source: Statistics Canada

## Canada Adds to Its Official International Reserves

Canada added \$1.5 billion to its official reserves of assets in the first quarter of 2002, compared to a small \$135-million reduction recorded in the same quarter in 2001.

## SERVICES SNAPSHOT

### Services GDP and Employment

The past decades have seen a broad structural shift toward services in the Canadian economy. The measured contribution of services to Canada's GDP increased to 65.3% in 1997 (the latest year for which this type of data is available) from 55% in 1961, while the corresponding figure for manufacturing fell to 18.9% from 24.1% over the same period. Agriculture, forestry, mining, and other resources-related sectors, which played a significant role in the Canadian economy throughout our history, also experienced similar declines in their relative importance.

The structural shift toward a services-based economy looks even more pronounced, if one looks at the changing employment pattern over time—the share of services in total Canadian employment rose significantly to 74.8% in 2000 from 54.6% in 1961. During much of the 20th Century, manufacturing was the largest employer of all major industrial groups, but its leading position had been surpassed by business services (which include computer, accounting, legal, advertising, architectural and engineering services) by the late 1960s. Further, since 1990, retail and wholesale trade combined have employed more workers than manufacturing.

The transformation of the Canadian economy from a resource- and manufacturing-based economy into a

services-based one has meant many changes in the Canadian labour market. One distinguishing feature of the current structural shift is the importance of knowledge and education for success. Services are, on balance, more knowledge-intensive than other sectors; therefore, they employ proportionately more well-educated workers than other industries. Workers with post-secondary training accounted for 19.7% of total services employment in 1998, compared to an 8.7% share for manufacturing, a 7.1% share for agriculture and a 5.2% share for construction.

The gains in educational attainment have translated into better earnings or higher standards of living for some groups of people, particularly for those in the knowledge-intensive services sectors. Financial, legal, advertising, health care, computer software and engineering services are among the top-paid industries. On average, a full-time worker with some graduate training earns almost two and half times more than a high school graduate or a dropout.

### Trade and Investment in Services

The expansion of Canada's international trade and investment in services is an integral part of the broad-based adjustment toward a knowledge-based services economy that is currently under way in Canada. To provide a comprehensive picture of Canada's international transactions in services, the

following overview uses statistics on all four modes of services trade as set out in the General Agreement for Trade in Services (GATS): cross-border trade, consumption abroad, commercial presence and movement of natural persons. This overview establishes that Canada's services trade is already more significant than commonly thought.

Canada's cross-border exports of services totalled \$56.6 billion in 2001 (Consumption by foreigners in Canada amounted to \$16.7 billion, while cross-border exports and services suppliers in foreign countries were responsible for the remaining \$39.9 billion.). At the same time, Canada imported \$65 billion of services (Consumption abroad totalled \$18 billion, while payments for cross-border imports and for foreign services suppliers were \$47 billion.) (See Table 1.).

Over the past decade, Canada's cross-border exports and imports of services have risen at a steady pace. As a share of GDP, Canada's services exports rose to 5.2% in 2001, from 3.4% in 1989-1992 and 4.4% in 1993-1996. Services imports have also expanded faster than GDP; however, the expansion has been more moderate—from 4.9% in 1989-1992 to 5.8% in 1993-1996 and easing to 6.0% in 2001.

The United States remains Canada's principal trading partner in services. Services exports to the United States accounted for 59.2% of Canada's total services exports in 2001 (compared to 85% for goods), up modestly from

**Table 1: Canada's Cross-border Trade and Commercial Presence in Services, 1990-2001**

	Exports (million)		Annual Growth (%)	Imports (million)		Annual Growth (%)	Balances (million)	
	1990	2001		1990	2001		1990	2001
<b>Total Cross-border Trade</b>	<b>22,381</b>	<b>56,612</b>	<b>8.8</b>	<b>33,018</b>	<b>64,994</b>	<b>6.4</b>	<b>-10,637</b>	<b>-8,382</b>
Travel	7,398	16,682	7.7	12,757	17,998	3.2	-5,359	-1,316
Health-related	68	96	3.2	278	352	2.2	-210	-256
Education-related	769	1,128	3.5	339	818	8.3	430	310
Transportation	4,920	10,523	7.2	6,746	14,209	7.0	-1,826	-3,686
Commercial Services	9,061	27,963	10.8	12,554	32,002	8.9	-3,493	-4,039
Government Services	1,003	1,444	3.4	962	785	-1.8	41	659
Affiliate Sales*	N/A	68,039	N/A	106,311	170,656	4.4		

Source: Statistics Canada, *Canada's International Trade in Services*, Catalogue no. 67-203-XPB, 2002, Colleen Cardillo, *Foreign Affiliate Trade Statistics – 1999 How Goods and Services are Delivered in International Markets*, Statistics Canada Working Paper 11F0027 No. 004, and special data requests from Statistics Canada.

Note: \* Affiliate Sales (exports) refer to sales made abroad by foreign affiliates of Canadian firms; the latest available data for this category were collected in 1999. Affiliate sales (imports) refer to sales made by Canadian affiliates of foreign-owned firms in Canada; the latest available data for this category were collected in 1997.

**Table 2: Canada's Trade in Commercial Services, 1990-2001**

	Exports (\$million)		Annual Growth (%)	Imports (million)		Annual Growth (%)
	1990	2001		1990	2001	
<b>Commercial Services Total</b>	<b>9,061</b>	<b>27,963</b>	<b>10.8</b>	<b>12,554</b>	<b>32,002</b>	<b>8.9</b>
Communications	1,220	1,870	4.0	1,210	1,977	4.6
Construction	52	299	17.2	35	144	13.7
Insurance	1,957	3,067	4.2	2,238	4,462	6.5
Financial Services	490	2,349	15.3	733	2,568	12.1
Computer and Information	546	2,231	13.7	344	1,367	13.4
Royalty and Licence Fees	173	2,318	26.6	1,941	5,380	9.7
Non-financial Commissions	306	659	7.2	341	589	5.1
Equipment Rentals	197	267	2.8	308	689	7.6
Management	849	3,177	12.7	1,419	4,803	11.7
Advertising	124	303	8.5	211	450	7.1
Research and Development	700	3,234	14.9	483	1,395	10.1
Architectural and Engineering	549	2,589	15.1	439	1,818	13.8
Miscellaneous Business	1,392	3,488	8.7	2,018	4,027	6.5
Audio-visual	348	1,929	16.8	709	2,159	10.7
Personal	157	183	1.4	123	175	3.3

Source: Statistics Canada, *Canada's International Trade in Services*, Catalogue no. 67-203-XPB, 2002

56.1% in 1990; however, the share of U.S. imports in Canada's total services imports dropped to 61.8% from 63.4% over the same period. The share of EU imports declined both as a source and as a destination of Canada's services trade over the 1990-2001 period. On the other hand, the relative importance of other countries in Canada's services trade has increased over the same period.

The commercial services sector has established by far the largest share and the fastest growth in Canada's services trade. In 2001, they accounted for 49.4% of exports of services and 49.2% of imports. Commercial services include many knowledge-intensive sectors. As shown in Table 2, the fastest growth has been recorded in knowledge-intensive commercial services, particularly in royalties and licence fees, audio-visual, financial services, research and development, architectural and engineering, as well as computer and information services.

Nevertheless, during the 1990s, the pace of growth of Canada's cross-border trade in services has lagged behind merchandise trade. Accordingly, the share of services in Canada's goods and services trade fell to 12.0% in 2001 for exports, and to 15.6% for imports, from the recent peaks of 13.6%, and 19.8%, respectively, in 1991.

What has just been described is, however, an incomplete picture of services trade. Due to their very nature (The provision of many services requires that the service provider is proximate to the consumer for practical and regulatory reasons.), many services are delivered through affiliates set up in foreign countries, so that the services can be sold directly to foreign customers; thus, cross-border activity is not required. In 1999, Canada's cross-border exports in services totalled \$53 billion, while sales by foreign affiliates of Canadian services firms amounted to \$124 billion, more than twice the amount of cross-border services exports. With respect to services imports, in 1997, Canadians purchased \$170.7 billion worth of services directly from affiliates of foreign firms established in Canada, more than three times the amount of cross-border services imports (\$52.6 billion) in the same year. This demonstrates that commercial presence is actually, by far, the preferred mode for services trade. Thus, the usual measures of cross-border trade in services from the balance-of-payments' sources vastly underestimates the scope and depth of Canada's services transactions with foreign countries. Further, the dominance of commercial presence in delivery of services abroad underscores the importance of attracting direct investment to develop Canada's

knowledge-based services economy. It also suggests that, unlike tariffs in goods trade, the centrepieces of services trade policy (and certainly the focus in the currently ongoing World Trade Organization services negotiations) are the right to establish foreign affiliates abroad and the assurance of fair treatment to foreign affiliates to enable their smooth operation in foreign countries.

## Conclusion

Despite numerous regulatory trade barriers in services in many parts of the world, Canada's services trade has reached a more significant level than commonly thought. Services that are involved in the production and distribution of knowledge-intensive products, in particular, have registered rapid growth in both cross-border trade and affiliate sales.

Trade economists have always argued that, although trade is not expected to have a permanent impact on the level of employment over the longer term—ultimately, it is macroeconomics rather than trade policy that is responsible for maintaining full employment—it will likely have a strong influence on the structure of output and employment. Increased trade in knowledge-intensive services has had, and will continue to have, a significant impact on the structure of the Canadian economy, resulting in faster growth of output and employment in these services sectors, which will help to create many high-paid and high-quality jobs in Canada.

In the coming decades, Canada faces a challenge to maintain and improve its standard of living in an increasingly competitive global environment. Developing Canada's specialization in knowledge-based services and creating many high-paid, high-quality jobs in services is a valid approach to achieve this challenge. Liberalizing services trade and investment is clearly an important policy instrument to achieve this end and is a key objective of negotiations now under way in Geneva, as well as in various regional initiatives involving Canada.