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Forecast and analysis based on information/data available up to and including October 6, 2006

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EXPORT FORECAST OVERVIEW

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Global Export Forecast – Bubbles… and Beyond

1.0 Executive Summary

The current economic environment has analysts scouring the thesaurus for synonyms of slowdown. Conditions have changed very rapidly, and the tenor of economic reports has soured noticeably. In such circumstances, overreaction is inevitable. However, the obvious nervousness is not uncommon at this stage in the economic cycle. Why the rapid about-face? Four successive years of hot economic growth gradually brought the world economy to a boil. And like every pot on the boil, the world economy has generated bubbles – pockets of excessive activity that have little fundamental support. The trouble with bubbles is that they don't deflate – they burst, and very rapidly. Of key concern is the number and size of bubbles in the marketplace at present. Clearly, some have burst already, and others seem poised to burst. Of greater concern is the fallout from bursting bubbles: will they leave mere dimples on the economic landscape, or giant craters?

Been there before

We have experienced these bubbles before – excessive real estate market activity was apparent in both the US and Canadian economies both at the beginning and end of the 1980s. Concurrently, tight labour conditions in these markets brought excessive, bubble-like wage gains. A huge bubble was created in Japanese property markets in the late 1980s. And we all remember the growth of the high-tech bubble in the latter half of the 1990s.

When bubbles burst

Fallout from bursting bubbles is often dramatic. In Japan, the burst property bubble left an enormous crater, ushering in a period of economic stagnation that lasted well over a decade. Although the Japanese experience is an extreme example, other burst bubbles have had serious consequences. North American excesses presaged serious recessions in the early 1980s and early 1990s. However, not all burst bubbles leave huge craters. The high-technology implosion in 2001 had a relatively mild effect on the broader world economy. While a slowdown did ensue, recovery was swifter than most were expecting. Past experience suggests that the magnitude of burst-bubble fallout is generally related to the size of the bubble and the economic fundamentals extant at the time.

Clear and present bubble

The most obvious recent bubble is the US housing market. A shift in consumer preferences together with low interest rates ignited a new-millennium US homebuying spree that extended into the first half of 2006. Significant price gains boosted residential investment and led to speculative activity. This in turn encouraged a pace of new home construction that could not be sustained. Higher interest rates and slower economic growth helped to burst the bubble, and housing statistics have descended rapidly since mid-2006.

If contained within the sector, the descent of the housing market might well be among the milder burst bubbles of recent times. Would that it were that simple. US consumers are highly leveraged at present, and over the years have become heavily dependent on rising home equity to supplement their income. Dipping into this home equity has added roughly $250 billion to income annually in recent years, a hefty 2.5% of US consumer spending – weighty, considering that US consumer spending accounts for over 70% of US GDP, or about 15% of global GDP. Given the leading role of the US economy in the recent global boom, and the contribution of US consumer spending, outright loss of this income supplement alone could tip the world into recession.

While possible, the full effect of this scenario is unlikely. First, US consumers still have a lot of scope to draw down home equity, and prevailing trends suggest that even in the worst conditions, there would at least be a modest income supplement. Second, tight US labour markets have pushed wage growth up in recent months. This alone could add about $200 billion to income, roughly equivalent to the home equity supplement. Third, lower gasoline prices have already created over $80 billion of additional spending room, and this could well increase through 2007.

The fear factor

Bursting bubbles and the accompanying news stories have an additional effect. They make average people a bit more careful. Consumer confidence is currently riding above average, and has been remarkably stable in recent years. More recently, lower gas prices have helped consumers feel better, offsetting the effects of slowing overall growth. But like economic conditions, confidence can ebb quickly, and when confidence ebbs, consumers spend less and save more. How much more? A 2% rise in the saving rate – not uncommon when nervousness increases – could pull almost $200 billion annually away from consumption. Given current US economic conditions and past circumstances, lower consumer confidence presents a downside threat to the US outlook.

... and Beyond: Slower, but not for long

On balance, the response of the US consumer to the burst housing bubble will slow the world's economic growth engine next year. The US economy is forecast to expand by a moderate 2.2%, largely a result of weaker residential investment, a partial consumer retrenchment and softer auto production. Weakness is already colouring performance in the second half of 2006, but the slowest period will likely be the first half of 2007. However, given the global economy's underlying fundamentals, activity is expected to improve in the latter half of next year.

Global growth will follow suit. Aggregate growth will ease to 4% in 2007, the slowest pace in 4 years. However, following the 4.8% expansion in 2006, growth is much closer to the long-term trend, suggesting little further tightening in capacity pressures. Commodity prices – particularly those currently in bubble territory – are expected to fall in the coming months. Oil prices will come down significantly from recent peaks, but remain at a relatively high level, given the support prices are receiving from recent changes in market structure. Base metal prices are in for a more dramatic correction. As economic slowing initially affects pricing, speculators and pension funds are expected to head for the exits, and extra supplies hoarded by producers during the price spike will be put into use, dampening demand.

The combination of slower growth and weaker commodity prices will taint emerging market performance. The effects will vary by country: those most exposed are expected to see a widening of bond spreads, and increased volatility is likely to accompany the adjustment to more moderate conditions. Even so, emerging markets as a whole are generally expected to present good business opportunities, as collectively they are forecast to see 6.5% growth in 2007, following 7.1% this year. In addition, corporate bond spreads are generally expected to widen as slower demand increases competitive pressures, thinning out profit margins. Primary producers will feel a particularly strong pinch as selling prices decline.

Slower growth for Canadian exporters

Bubbles aren't readily observable in the Canadian economy at present. However, the fallout from the burst US housing bubble is already being felt. Lumber shipments are sinking, and sawmill closures are manifold. Merchandise exports are waning, and many prices are in retreat. Total exports are forecast to contract by 1.2% in 2007. Overall GDP growth is expected to moderate in 2007, but thanks to strength in domestic demand will still manage to reach 2.4%.

The meteoric rise in crude oil and base metal prices has propelled the Canadian dollar to new heights. Corrections to these prices are expected to remove some of the lift underneath our dollar's wings in the near term, providing some relief for exporters struggling with a 90-cent dollar, and proof that the immediate effects of bursting bubbles are not always negative.

The Bottom Line

A global slowdown is in process, triggered by weakening US performance. The slowdown is more pronounced than expected in our Spring Outlook, and the downside risks are greater. Canadian export performance is expected to be weak, and exporters should be prepared for the possibility of even slower conditions. The good news is that the slowdown will be short-lived, and as the world economy adjusts, the pressures on Canadian exporters – the high dollar, elevated input costs and slower growth – will dissipate in the near term.

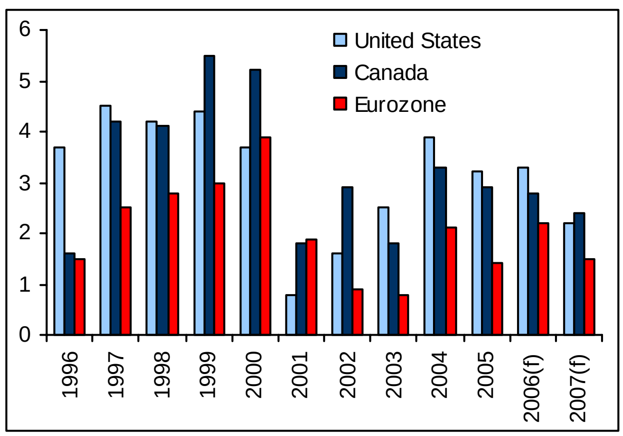
Peter Hall
Vice-President and Deputy Chief Economist

2.0 The Forecast in Context

Prospects for the global economy have become increasingly uncertain heading into 2007. One thing is becoming clear however, and that is the world economy is slowing. The global economy has been expanding above its potential for the past 4 years and this, along with historically low interest rates in many parts of the world, has allowed a number of economic and financial excesses to build – unsustainable real estate investment, rising consumer debt loads, speculative run-ups in oil and commodity markets and historically low spreads on emerging market debt quickly come to mind. As we outlined in our Spring 2006 Global Export Forecast (GEF), these excesses or “dominoes” would begin to topple before year-end. The sequence of events we envisioned last spring has been set in motion, the first of these being the correction in the US housing market.

Early signs suggest the second domino – US consumer spending – may be starting to falter as well. Moreover, the remaining dominoes in our sequence have also started to waver. Economic growth in many parts of the world has begun to slow, commodity prices are coming under downward pressure, and risk premia among corporations and developing countries are set to rise. Whenever financial excesses or “bubbles” build up, it is usually only a matter of time before they reach a breaking point. By their very nature, bubbles do not slowly compress; they almost always pop very quickly, and herein lies the danger.

Figure 1: Economic Growth Forecasts (%)



Source: IMF WEO, EDC Economics Forecast.

EDC Economics believes there will be a global slowdown in 2007, led by weaker growth in the US economy. Globally, the bubbles are beginning to break, and the high degree of integration across the world economy will spread the aftermath far and wide. At this point it is difficult to gauge how extensive the damage will be. Such uncertainty has led us to develop a second alternative downside scenario. In the 8 years that we have been producing our twice annual GEF, there was only one other time in which we thought it prudent to formulate a second forecast scenario, and that was just after 9/11 – another period characterized by a high level of uncertainty. We do not consider the current outlook as dire or uncertain as post 9/11. But a second scenario can help Canadian exporters and investors better understand the downside risks facing the Canadian and world economies in 2007.

We have assigned a 75 to 80% probability to our baseline forecast. As such, most of the analysis in this report will be centred on the basecase. Our alternative scenario has been weighted at 20 to 25% and will be discussed separately in Section 2.2, along with the implications for Canadian export markets. Our main outlook calls for US economic growth to slow to 2.2% in 2007, down from this year’s 3.3% pace. The knock-on effects will be felt around the world, with global growth forecast to pull back to 4%. Not a disaster by any means, but exporters can expect an increasingly stressful environment in 2007. A recalibration of risk perceptions will cause consumers and businesses around the world to adopt a more cautious stance when it comes to their spending and investment plans.

Our second scenario would see the US housing downturn become deeper and have a much broader impact on the US economy. US growth would fall back to 1.3% in 2007, and this would drag global growth down to around 3.3%, below its long-term potential.[1]

[1] All dollar values in this report refer to Canadian dollars unless otherwise specified.

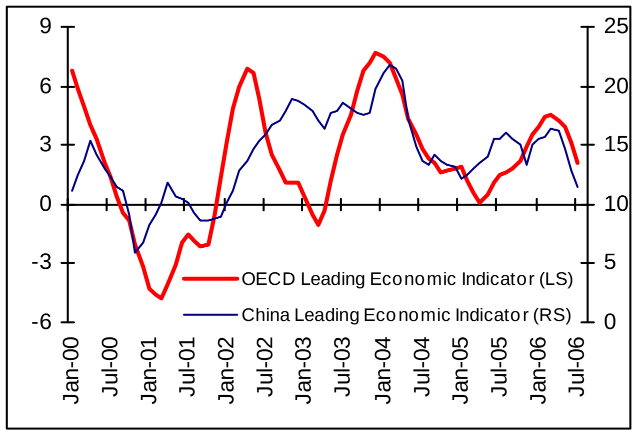
EXPORT FORECAST OVERVIEW

2.1 Forecast Synopsis – Basecase

Recent data have been painting a mixed picture of the state of the world economy. Healthy equity markets, strong global trade flows and declining energy prices have led some analysts to conclude the world economy will not undergo any meaningful slowing in 2007. In the Eurozone, much of the economic data in recent months show an economy on the mend. Indeed, Eurozone GDP growth hit a 5-year high in the second quarter of 2006 and monthly data on industrial production, trade flows and consumer spending remain upbeat.

But broader measures of economic activity around the world have clearly weakened, not least the dismal numbers coming out of the US residential construction market. Slowing US auto sales and related cutbacks in North American vehicle production will add to the overall sluggish conditions. GDP growth in most major economies is slowing and leading indicators the world over have started to trend downward, most notable the OECD composite leading index (see Figure 2). And the pace of growth in the Eurozone is expected to soften in 2007 as well – especially as the European Central Bank raises interest rates over the coming months to guard against inflation in an economy that is currently running above potential. A tightening of fiscal policy will also take away some of the Eurozone's momentum in 2007.

Figure 2: OECD and China Leading Economic Indicators point to Slower Economic Growth

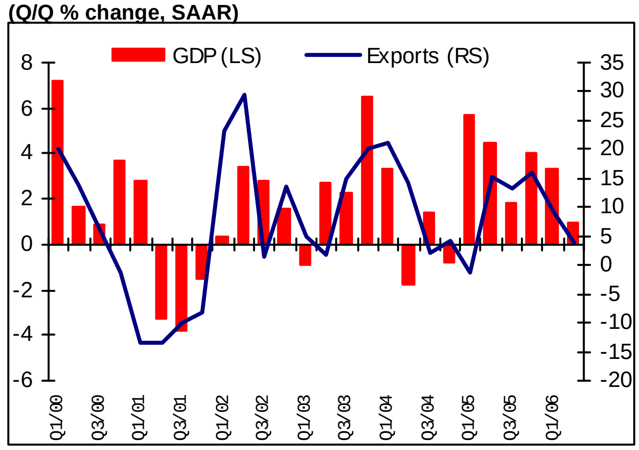


Source: OECD. Data are the trend restored CLI, annualized 6-month rate of change.

We also expect Japan to lose momentum in the final months of 2006 and through 2007. The Japanese economy slowed to a crawl in the second quarter as weakness in residential investment and exports pulled down overall growth. Japan's leading economic indicator has also been declining in recent months, suggesting a more tepid performance going forward. While Japanese labour markets have improved quite a bit over the past couple of years, growth in household spending and incomes remains sporadic and neither is showing any clear improvement. Economic growth in Hong Kong, South Korea and Taiwan slowed in the second quarter as well – three countries with tight commercial and trade linkages with Japan and China.

Over the next 12 to 18 months, the slowing US economy, which directly accounts for 21% of global output, will no doubt have a negative spillover effect across much of the world. Conditions in the developing world are already showing some early warning signs, and this includes China and Brazil among others. The latest readings show that GDP growth in Brazil has ratcheted down a notch while the composite leading indicator for China (compiled by the OECD) has started to trend lower. Investment growth in China has also come down from its heady highs while industrial production, although still strong, has come off the boil in recent months. Growth in China's money supply has pulled back as well, a good sign that credit conditions are starting

Figure 3: Japanese GDP and Export Growth Has Slowed (Q/Q % change, SAAR)



Source: Government of Japan Cabinet Office.

to tighten. For 2007, we expect growth in developing markets will slow to around 6.5% on average, compared with 7.1% this year. A decline in commodity prices introduces an additional downside for resource-dependent exporters.

Overall, global economic growth will slow to around 4% in 2007. This represents a noticeable drop from the 4.8% increase posted in 2006. The main catalyst is the slowing US economy where growth is forecast at 2.2% for 2007, down from this year's estimated 3.3% expansion. The Eurozone economy is projected to grow by 1.5% in 2007 following growth of 2.2% in 2006. Japanese growth is forecast to expand by 1.9% in 2007 after a gain of 2.7% in 2006. The pace of economic activity will slow in Canada as well – to around 2.4% in 2007 compared with this year's 2.8%.

2.1.1 Can Overseas Economies Pick Up the US Slack?

Given the outlook for slower growth in the major overseas economies, the argument that increased activity in these markets – primarily Eurozone, Japan and China – can offset weakness in the US appears shaky at best. Moreover, the high degree of integration across the global economy suggests the US downturn will spread around the world. Global trade is now equivalent to almost 60% of world GDP, up from 23% in 1970.

Likewise, cross-border investment flows have increased dramatically in the past decade, with the global stock of FDI now equivalent to almost one-quarter of world GDP. In the case of China, 55% of its exports now go to North America, Japan and Europe. On the flip side, China has become an important export market for companies in the US, Canada, Japan and Europe, not to mention all of the developing countries that are selling a significant share of their exports to China. The world economy has become a tightly woven array of trading and investment linkages – economic shocks in one part of the world inevitably re-surface somewhere else.

Table 1: Global GDP Forecast by Country (Growth)

Top Markets	% Share of World Economy (2005)	Global Outlook (growth)		
		2005	2006(f)	2007(f)
NAFTA	**24.5**	**3.2**	**3.3**	**2.2**
US	20.9	3.2	3.3	2.2
Canada	1.9	2.9	2.8	2.4
Mexico	1.8	3.0	4.3	3.0
Western Europe	**20.0**	**1.5**	**2.2**	**1.6**
United Kingdom	3.1	1.9	2.5	2.1
Eurozone	15.3	1.4	2.2	1.5
Other Western Europe	1.6	2.6	1.7	1.5
Japan	6.9	2.6	2.7	1.9
Australia & New Zealand	1.3	2.6	2.7	2.5
Asia & Pacific Total	**28.1**	**8.3**	**8.1**	**7.3**
China	13.2	10.2	10.0	9.1
India	5.9	8.5	8.5	7.1
Asian NIEs	3.5	4.4	4.8	4.0
ASEAN-4	3.5	5.1	5.0	5.0
Other East Asia & Pacific	0.6	9.3	5.8	5.5
Other South Asia	1.4	6.7	5.9	5.7
Cent. Asia and East Europe	**4.6**	**5.6**	**5.3**	**5.0**
Russia	2.6	6.4	6.5	5.5
South America	**5.2**	**4.7**	**4.7**	**4.1**
Argentina	0.9	9.2	7.5	5.2
Brazil	2.6	2.3	3.5	3.6
Central America	0.5	5.7	4.6	3.9
Middle East & North Africa	3.8	5.5	5.8	5.4
Sub-Sahara Africa	2.6	5.2	5.3	5.2
Total Global Economy	**100.0**	**4.7**	**4.8**	**4.0**

Source: EDC Economics. 2005 is actual data while 2006 and 2007 are forecast. Asian Newly Industrialized Economies (NIE) are Hong Kong, Singapore, South Korea and Taiwan. ASEAN-4 are Malaysia, Thailand, Indonesia and Philippines.

Table 2: Global GDP Forecast by Industry (% Growth)

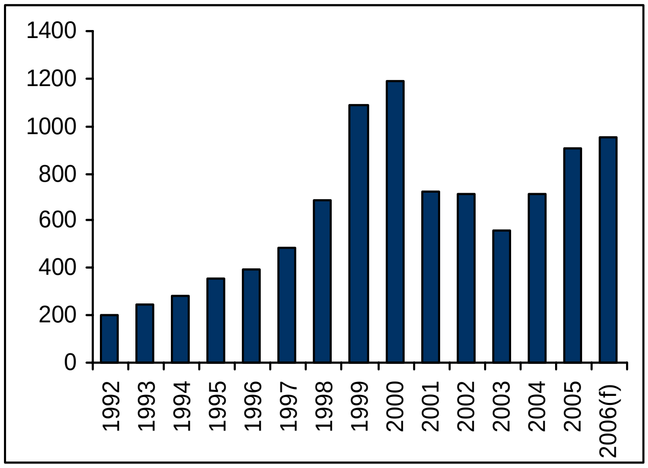
Main Sectors	% Share of World Economy (2005)	Global Outlook (% growth)		
		2005	2006(f)	2007(f)
Agri-food	6.8	3.3	3.9	3.5
Energy	5.1	3.6	4.8	4.1
Forestry	3.9	2.4	3.3	2.6
Chemicals, Plastics, Fertilizers	3.9	4.7	5.1	4.7
Ores, Metals	4.1	4.4	4.9	4.0
Other Industrial Goods	1.0	4.6	4.8	4.2
Aircraft & parts	0.4	8.2	11.6	5.9
Motor Vehicles & parts	2.1	5.6	3.8	2.5
Other Ground Transport	0.3	7.8	7.6	6.2
Telecom & equipment	2.7	17.2	7.8	6.6
Computers & parts	1.7	8.5	11.7	9.0
Other Machinery & equipment	2.4	5.6	6.3	3.8
Consumer goods	2.5	2.2	4.0	3.0
Total Goods	**37.0**	**5.0**	**5.1**	**4.2**
Transport Services	3.5	5.0	4.9	4.1
Travel Services	1.0	3.1	3.1	3.6
Financial Services	5.7	5.7	6.6	6.0
Commercial Services	52.8	4.4	4.4	3.6
Total Services	**63.0**	**4.5**	**4.6**	**3.9**
Total Global Economy	**100.0**	**4.7**	**4.8**	**4.0**

Source: EDC Economics, Global Insight. 2005 is actual data while 2006 and 2007 are forecast.

But the outlook is not all doom and gloom. Many of the structural fundamentals underlying the global economy are in good shape, and this will partially mitigate the negative impact of imploding "bubbles" in the US and elsewhere. Corporate balance sheets are healthy and equity markets remain buoyant, generating returns for investors and making it easier for companies to raise funds. And with healthy finances, corporations around the world will continue to invest in new machinery and equipment. Developing country finances are in much better shape, which will allow them to better withstand a global slowdown (and also provide continued support for all types of infrastructure investment). Global investment flows remain at high levels, supported in part by strong corporate balance sheets. But portfolio and FDI flows are likely to weaken somewhat in 2007 in response to the expected deterioration in global credit conditions.

One other positive trend that has emerged across many developing markets in recent years is the growing affluence of the middle class. Domestic consumption now accounts for a much larger share of GDP in countries such as China (42%), India (60%), Mexico (73%) and Brazil (56%); and this will help insulate them against the impact of external demand shocks. Fuel and energy prices are expected to decline in 2007, taking some pressure off consumers in developing and industrialized countries alike. Finally, the expected drop in interest rates in Canada and the US during 2007 should see growth start to regain momentum once again by end of 2007/early 2008.

Figure 4: Global FDI Flows Expected to Lose Some Momentum (USD billion)

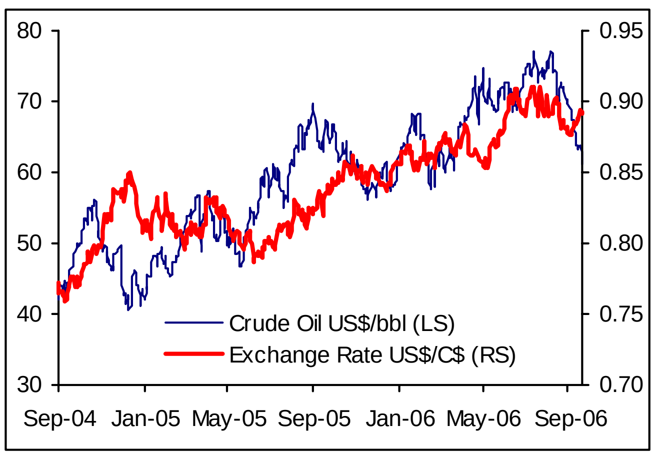


Source: UNCTAD, EDC Economics.

2.1.2 The Canadian Dollar and Interest Rate Outlook

Recent years have seen a strong relationship develop between the Canadian dollar and oil prices – so much so, that many analysts now refer to the loonie as a "petrocurrency." EDC Economics' model of the Canadian dollar shows that oil prices, non-energy commodity prices and the short-term interest rate differential vis-à-vis the United States are the main determinants of movements in the C$ exchange rate. Our forecast calls for further easing in oil and commodity prices as global growth moderates – a pattern that will allow the Canadian dollar to ratchet down to around 82 to 84 cents US by the end of 2007.

Figure 5: Oil Prices vs. the Canadian Dollar

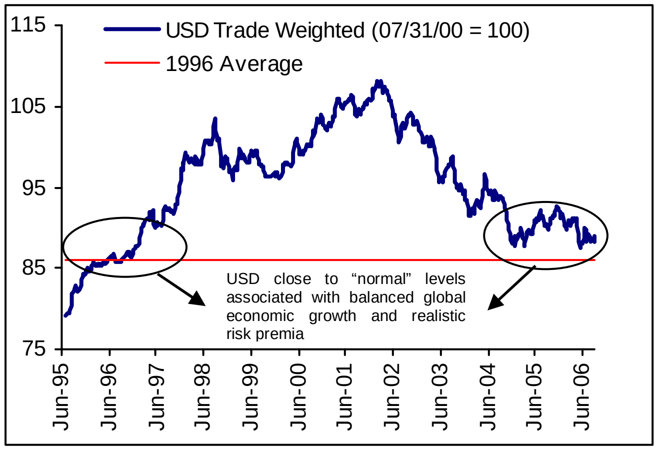


Source: Bloomberg, EDC Economics.

The loonie should receive additional help in moving lower due to the fact that the US greenback generally does better in an environment of weaker global growth, increased uncertainty and higher risk premia – the same conditions we expect for 2007. This also means currencies for most other countries, especially those in the developing world, should post modest declines in 2007. Whenever global economic conditions become uncertain and risks increase, the US dollar tends to experience a strengthening bias as investors seek the safe-haven status of US financial markets.

In response to weakening economic data, the US Fed held interest rates steady at its August 8 meeting, ending the tightening cycle. Previous rate increases of 425 basis points are now filtering through the US economy. As US economic activity loses momentum, we expect the Fed will reduce rates by 50 to 75 basis points through the course of 2007. The Bank of Canada is expected to reduce rates by a similar amount over the next 12 months. Longer-term interest rates have been fairly stable over the past couple of years, but as inflationary expectations recede and growth slows, we believe long bond yields in Canada and the US will fall by 30 to 40 basis points from current levels.

Figure 6: US Dollar – Weakness Is in the Eye of the Beholder

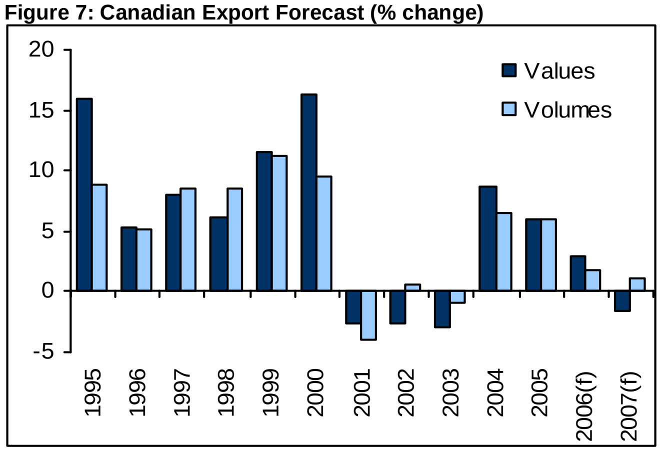


Source: Bloomberg, JP Morgan.

2.1.3 Canadian Exports and Foreign Investment Prospects

While the global slowdown we are calling for in 2007 does not appear too serious on the surface, it is of sufficient magnitude to cause a number of additional stresses for Canadian exporters and investors. Canadian firms should expect to see some downward pressure on cash flow and profit margins in 2007. Indeed, companies the world over will be competing for customers who will be scrutinizing every dollar they spend. The likelihood of lower oil and commodity prices will also impact the bottom line of resource-based companies.

Figure 7: Canadian Export Forecast (% change)



Source : Statistics Canada, EDC Economics.

Canadian export growth has been losing momentum since the beginning of 2006, and we foresee this pattern continuing through the next 12 months. Overall, the value of Canadian exports is on track to rise by 3% in 2006, compared with last year's increase of 5.4%. For 2007, we expect exports to decline by 1 to 1½%. Most of the weakness in our export outlook for next year stems from a receding price environment as oil and commodity prices decline through the year. Volume shipments (with the price effect netted out) are forecast to rise by 1% in 2007, roughly in line with this year's estimated 1 to 1½% increase. Export sales into developing markets will continue to outpace shipments to industrialized countries.

Most industries continued to grow their exports in 2006, with metals, wheat, canola, energy and rail equipment all posting double-digit gains. In the mid-tier of performers we find most agri-food sub-sectors, chemicals, plastics, telecom equipment, services and industrial machinery. Sectors reporting lower exports in 2006 include forestry, autos, regional jets, consumer goods and some sub-sectors of advanced technology. For 2007, we expect to see export growth weaken across most of Canada's major industries.

Canadian direct investment in foreign markets has been significant in recent years, and the situation has not changed in 2006. In 2005, flows of Canadian direct investment abroad (CDIA) amounted to $41.3 billion and we expect a similar result for 2006. Perhaps most striking has been the significant run-up in CDIA going into developing markets over the past 10-15 years, from an average of around $2 billion in the early 1990s to $10 to 12 billion in the past couple of years. With the global economy taking a breather in 2007, Canadian companies will probably be a little more cautious in their international investment plans when it comes to developing markets. Longer term, however, we believe CDIA in emerging markets will grow strongly.

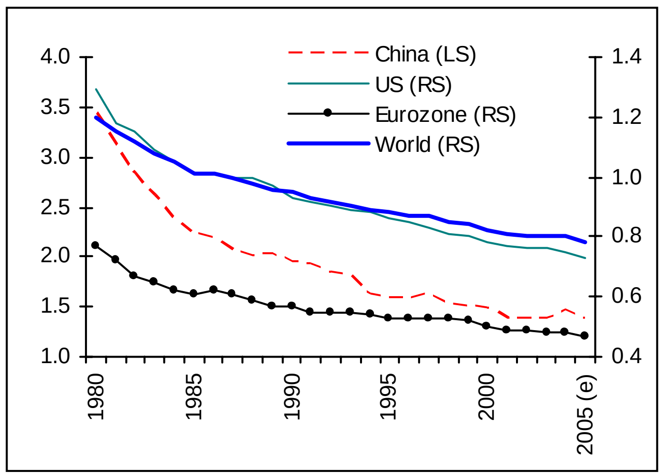
2.1.4 What About Oil and the US Trade Deficit?

Many economic forecasters have become increasingly worried over the financial outlook for US consumers, and rightfully so. Household debt as a share of disposable income continues to make new record highs (similar to the situation in Canada, Australia and the UK). Job growth has slowed while employment directly related to residential construction is already showing a small decline. With US housing markets and home values taking a turn for the worse, an important source of financial wealth and consumer spending has come under threat.

But what about other potential stresses? To be sure, oil prices and the US trade deficit will remain top of mind for many people. But in both cases, there have been encouraging developments. Supply-demand fundamentals tell us the price of oil should trend downward through the next couple of years. Indeed, as of early October 2006, oil prices had moved down significantly from a peak that nearly hit USD 80 in July. EDC Economics is forecasting WTI will average USD 55 per barrel in 2007, down from an average of around $67 in 2006. Global economic growth is slowing, crude inventories are being re-built and world production capacity is on the rise. As spare production capacity increases, the ability of producers to cover unexpected supply shocks will improve, and more importantly, reduce the fear premium that recently pushed prices to historic highs. The world economy is also becoming much more efficient in its use of energy, which means higher oil prices have a smaller impact on economic activity.

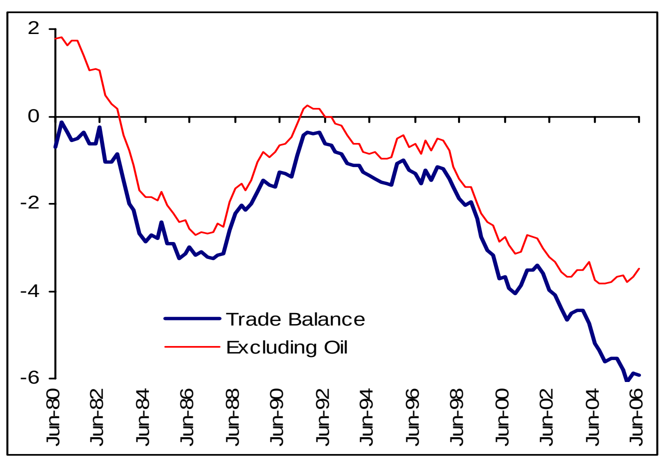
The US current account deficit increased to USD 218 billion in the second quarter of 2006, equivalent to 6.6% of US GDP. Much of the rising deficit in the past couple of years is due to higher oil prices and the resulting rise in the US import bill. In fact, once oil is removed, the deficit drops to around 3.5% of GDP – where it has been since mid-2002. With oil prices receding, we should see the overall deficit contract. In addition, a high level of intra-firm trade means the US trade deficit has a large structural component, making it much more sustainable in nature

Figure 8: The World is Becoming More Energy Efficient (Barrels of oil consumed per 1,000 USD of GDP)



Source: EIU, British Petroleum.

Figure 9: US Trade Balance as a Share of GDP (%) – Non-oil Balance has Stabilized



Source: US Census Bureau, US Bureau of Economic Analysis, EDC Economics.

(see below). There is indeed still a cyclical component in the US trade deficit and the risk of further deterioration remains real. But with US economic growth expected to slow relative to overseas markets by 2007, the cyclical aspect of the US trade shortfall should ease as import demand softens.

The process of globalization means that a large share of US international trade now takes place within multinational companies (e.g. shipping goods and services between a US-based parent company and its foreign subsidiaries, or vice versa, a foreign company located in the US trading with its parent). In 2004 (the latest data available), multinational companies in the US imported USD 585 billion worth of goods and services from their operations and/or parent companies in foreign countries. At the same time, they exported USD 337 billion worth of goods and services to their operations outside the US. The net result was an intra-firm trade deficit of USD 249 billion, which accounted for 41% of the year's total trade deficit. Note that this 41% relates to trade that takes place between multinational companies and their *majority-owned* subsidiaries in foreign countries. Including levels of ownership less than the 50% associated with majority control (down to as low as 10%) pushes the percentage of the trade deficit accounted for by intra-firm trade to as high as 65%.

Table 3: US Intra-Firm Trade (Majority ownership)

Trade in millions of USD	**2004**
1. US Multinationals (goods)	
-- Exports (est.)	177,616
-- Imports (est.)	224,184
2. US Multinationals (services)	
-- Exports	64,200
-- Imports	26,000
3. Foreign Multinationals located in US (goods)	
-- Exports	73,941
-- Imports	307,111
4. Foreign Multinationals located in US (services)	
-- Exports	21,400
-- Imports	28,700
Total Intra-Firm Trade	
-- Exports	**337,157**
-- Imports	**585,995**
Intra-Firm Trade Balance (exports - imports)	**-248,838**
Total US Trade Balance	**-611,296**
Share of Intra-Firm Trade in US Trade Balance (%)	**41**

Source: US Bureau of Economic Analysis, EDC Economics.

This high level of intra-firm trade means that close to one half of the US trade deficit is internal within these companies. Such arrangements are self-sustaining, and largely self-financing. The issue of sustainability, or the need for Americans to borrow from foreigners to finance these trade deficits, does not apply in these cases. As such, the US trade deficit is much less than the annual USD 726 billion shortfall recorded for 2005. Accordingly, the US trade deficit has a large structural component and may not shrink that much, which also means the greenback does not have to fall in order to bring the US trade situation into balance. In fact, a depreciating US dollar is not likely to have a significant impact on the trade deficit, since the level of the exchange rate is not considered the most significant factor in determining intra-firm trade.

2.2 Alternative Forecast Scenario – Mild US Recession in 2007

Given the uncertainty of the economic fallout from the US housing downturn, EDC Economics has developed a downside scenario (25% probability) to assess the potential impact of a mild US recession on the global economy and on Canadian exports.

Our alternative scenario assumes a deeper US housing downturn. Home values decline and the negative wealth impact forces households to save more

Table 4: Alternative vs. Basecase Forecast – 2007

	Basecase Scenario	**Alternative Scenario**	**Alternative minus Basecase**
US GDP Growth (%)	2.2	1.3	-0.9
Canadian GDP Growth (%)	2.4	1.7	-0.7
World GDP Growth (%)	4.0	3.3	-0.7
Canadian Export Growth (%)	-1.2	-3.4	-2.2
Canada/US Exchange (C$/US$)	0.86	0.81	-0.05 cents
Bank of Canada Rate Reduction	-50 to -75 bps	-150 bps	-75 to -100 bps
US Fed Fund Rate Reduction	-50 to -75 bps	-150 bps	-75 to -100 bps
Crude Oil, WTI (USD/barrel)	55	44	-11

Source: EDC Economics.

and spend less. Under these circumstances, consumer spending contracts in early to mid-2007, resulting in two consecutive quarterly declines in US GDP. On an annual basis, our underlying assumptions result in US GDP growth of 1.3% in 2007 – not as severe as the 2001 recession but deep enough to be felt here in Canada and around the world. We estimate that global growth would pull back to 3.3% in 2007 while the Canadian economy would expand by 1.7%.

The US Federal Reserve, the Bank of Canada and other central banks respond by reducing interest rates, but the stimulative impact of these reactions takes time (monetary policy takes up to 18-24 months before the full impact on economic activity comes through). In the interim, the pace of economic activity will slow significantly. The impact will be felt to varying degrees around the world. The hardest hit will be companies and industries that rely on the US consumer and residential construction for the majority of their business. This would include lumber, building products, household furnishings, appliances, autos and consumer goods.

On a geographic basis, the first impacts would probably be seen in Mexico and Asia, particularly those countries more dependent on exporting consumer goods to the US. The next round of impacts would very quickly show up in commodity markets, in the form of lower prices for oil, metals, building materials and other basic commodities. Weakness in commodities would take a toll on developing markets that are dependent on these goods for a large share of their export earnings. Resource companies in advanced countries also end up taking a hit to their bottom lines. Higher risk premia and capital outflow would prevail across many developing countries – a situation that could be exacerbated by the large amounts of highly liquid portfolio inflows (i.e. “hot money”) attracted by these markets over the past 2 to 3 years.

Here in Canada, the impact of a US recession would be felt across the country, with exporters experiencing lower sales. Our basecase calls for a decline of 1.3% in Canadian exports during 2007. The downside scenario deepens this export contraction by an additional 2.2 percentage points, for a combined annual drop of 3.4%. To add some perspective, Canadian exports of goods and services recorded an annual decline of around 2% during each of the last two US recessions (1991 and 2001).

Much of the weakness in Canadian exports would come from lower oil and metal prices, not unlike previous economic downturns. But any drop in US and overseas demand would also show up in reduced export sales across most Canadian industries. Exporters of building products, metals, basic materials, capital equipment, autos and consumer goods would all see a decline in exports relative to the basecase. In addition, service exports would also weaken, with tourism receipts perhaps taking the biggest hit.

Given the weaker global backdrop, we assume oil and metal prices fall by 20% relative to the baseline forecast. This reduces the average price of oil for 2007 from USD 55 per barrel in the basecase to USD 44 in the alternative outlook. Running this decline through EDC Economics' Canadian dollar model reduces the Canadian dollar by 3 cents US. We estimate the pullback in non-energy commodity prices removes an additional 2 cents US. The end result is a Canadian dollar of 81 cents US (2007 average), compared with 86 cents US in the baseline projection. In terms of the impact on Canadian exports, the lower dollar partially offsets some of the drop in US and foreign demand.

Mechanical and Dynamic Impacts of the Stronger Canadian Dollar

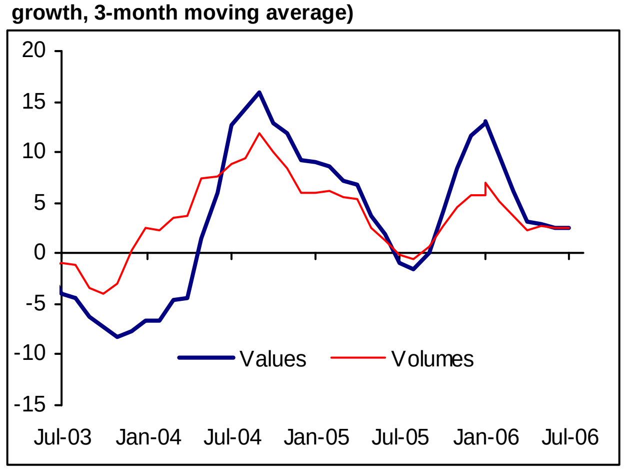
The appreciation of the Canadian dollar affects Canada's exports in two ways. The first is mechanical. As much as 70% of Canada's exports are priced in US dollars. Canadian companies receiving US dollar revenues for their exports will receive fewer Canadian dollars when converted at a higher exchange rate. So even if there is no change in physical volume shipments, the higher dollar automatically translates into lower export receipts in C$ terms.

The second impact involves a more dynamic process whereby Canada's export sales in physical volume terms are affected by the stronger loonie. For those Canadian exports that are priced in C$, the higher dollar makes these exports more expensive in foreign markets, which puts downward pressure on export sales – customers in foreign countries tend to substitute into less expensive goods and services from third-country competitors. The impact here shows up in the physical volume of Canadian export sales. However, some Canadian companies may choose to accept lower prices in order to keep their export volumes from falling; that is, companies may attempt to maintain market share at the expense of lower profit margins.

3.0 Canada's Export Outlook

Canadian export growth has been losing momentum since the beginning of 2006. Export shipments expanded by 5.4% in 2005 but growth moderated to an estimated 3% in 2006. For 2007, we expect exports will contract by 1%. Most of the weakness in our export outlook for next year stems from a receding price environment as oil and commodity prices decline through the year. Once price changes are netted out, EDC Economics expects the physical volume of exports will expand by around 1.5% in 2006, followed by a 1% increase in 2007.

Figure 10: Canadian Exports Losing Momentum (y/y growth, 3-month moving average)



Source: Statistic Canada, EDC Economics.

A drop in shipments of autos, consumer goods, regional jets, advanced technology, tourism and forestry account for the lower pace of growth in aggregate exports during 2006. A number of industries recorded double-digit export gains in 2006, including energy, metals, rail equipment, wheat and canola. Between the two extremes with export growth ranging from 3 to 4% are telecom equipment, aerospace parts, industrial machinery, chemicals, plastics and most agri-food sub-sectors.

For 2007, we expect to see an easing in export growth across most of Canada's major industries. Nevertheless, some sectors will fare better than others. Agri-food exports are forecast to rise by 3% in 2007. Fertilizer shipments are expected to increase by 8% following a languid performance in the first half of 2006. Exports of chemicals and plastics are forecast to rise by around 3% next year. After a multi-year run-up, energy exports are projected to fall by 2% in 2007 thanks to a pullback in crude oil prices. Volume shipments for energy products will continue to expand. Export receipts for ores and metals are also projected to decline in 2007, again the result of a softer price environment for commodities.

Forestry exports are expected to show further weakness in 2007, declining by 2%, which comes on top of an estimated contraction of around 8% in 2006. Excess capacity and sluggish paper demand account for much of the overall sluggishness in forestry. A cooling of the US housing market will also weigh on lumber prices and exports. Consumer goods are suffering from intense offshore competition and a strong Canadian dollar – conditions likely to keep this sector under

EXPORT FORECAST OVERVIEW

pressure through the forecast horizon. Furniture and household items have the potential to be hit particularly hard by the slump in US housing. The other major sector showing lower export sales is automotive, where exports are forecast to fall by 6% in 2007 as US auto sales pull back. In addition, Canadian auto parts producers will see export sales crimped by lower North American vehicle production.

Exports of services will remain lacklustre in 2007, growing by around 1% – not much change from the 2% growth experienced in each of 2005 and 2006. Tourism is the main drag on overall service export receipts. The stronger Canadian dollar and higher gasoline prices certainly discouraged inbound travel from the US in the past couple of years. Lower gas prices and an easing in the Canadian dollar may provide some relief for tourism in 2007, but not enough to offset the slowing US economy and new US passport requirements. Transportation services should continue to make modest gains in line with growing trade volumes. We should see very modest export gains across most of the commercial service sub-sectors, but again, export growth will slow as the global economy loses momentum in 2007.

On average, Canadian export sales to developing countries are estimated to have increased by 12% in 2006 compared with a 3% rise for industrialized countries. Canadian exports of goods and services to the developing world are on track to reach a record $38 billion in 2006. Shipments to Russia, Mexico, India and Brazil are all showing double-digit gains so far this year. Exports to China have softened due to a drop in

Table 5: Canadian Export Forecast by Sector

Main Sectors	CAD bn (2005)	% Share of Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Agri-food	30.5	6.4	-1.5	4	5
Energy	87.6	18.5	28.0	11	-2
Forestry	43.4	9.2	-5.7	-8	-2
Chemical & Plastics	34.6	7.3	7.6	2	3
Fertilizers	4.0	0.8	29.6	-4	8
Ores and Metals	42.5	9.0	10.8	20	-7
Other Industrial Products	7.3	1.5	-4.4	-5	1
Aircraft and Parts	10.2	2.2	2.9	-4	1
Other Ground Transportation	1.9	0.4	-19.6	12	3
Telecom Equipment	6.9	1.5	13.7	4	3
Advanced Technology	14.0	3.0	5.0	-2	1
Other Machinery and Equipment	26.2	5.5	3.9	3	4
Motor Vehicles and Parts	80.9	17.1	-2.4	-5	-6
Consumer Goods	10.1	2.1	-8.1	-6	-7
Total Goods Sector	407.8	86.3	6.0	3	-2
Total Services Sector	65.0	13.7	1.7	2	1
Total Exports	**472.8**	**100.0**	**5.4**	**3**	**-1**
Memorandum					
Total Volumes		100.0	2.1	1.5	1
Total Goods (excl. energy)	320.3	67.7	1.2	1	-2
Total Goods (excl. Autos & Energy)	239.4	50.6	2.5	3	0

Source: EDC Economics. 2005 is actual data while 2006 and 2006 are forecast.

Table 6: Canadian Merchandise Export Forecast by Country

Top Markets	CAD bn (2005)	% Share of Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
NAFTA					
US	343.3	84.2	5.3	2	-2
Mexico	3.1	0.8	8.3	21	3
Western Europe					
UK	7.6	1.9	5.3	7	-1
Eurozone	13.5	3.3	10.0	12	2
Other Western Europe	3.2	0.8	17.1	12	-1
Cent. & East. Europe	1.5	0.4	30.5	24	7
Russia	0.5	0.1	40.8	19	9
Asia & Pacific					
Japan	9.0	2.2	6.5	4	0
China	6.6	1.6	9.6	2	7
Asian NIEs	5.7	1.4	10.6	9	3
ASEAN - 4	1.7	0.4	-5.8	12	2
India	1.0	0.3	27.0	23	7
Other Asia	0.8	0.2	24.3	21	8
Oceania	1.8	0.5	-3.7	16	-1
South America (ex. Brazil)	1.9	0.5	13.0	15	10
Brazil	1.1	0.3	15.7	13	1
Central America	1.4	0.3	16.7	11	6
Middle East	2.2	0.6	12.0	13	9
Africa	1.8	0.4	16.7	11	12
Total Goods Exports	**407.8**	**100.0**	**6.0**	**3**	**-2**
Total to Developing Markets	**23.7**	**5.8**	**12.6**	**12**	**7**
Total to Industrialized Countries	**383.8**	**94.1**	**5.6**	**3**	**-2**

Source: EDC Economics. 2005 is actual data while 2006 and 2007 are forecast. The Asian Newly Industrialized Economies (NIEs) are Hong Kong, Singapore, South Korea and Taiwan. ASEAN-4 are Malaysia, Thailand, Indonesia and Philippines.

aircraft, fertilizer and wheat shipments – most other sectors are posting solid gains. Although slowing, exports to emerging markets will continue to outperform the more advanced countries in 2007. Indeed, shipments to the developing world are forecast to rise by 6% in 2007 compared with an average decline of 2% for the industrialized countries.

Exports to the US will grow an estimated 2% in 2006 and decline by 2% in 2007, down from last year's 5.4% expansion. A downturn in auto and forestry exports, along with an easing in metal and oil prices, account for the slower pace in sales to the US. In contrast, Canadian exports to the UK, Eurozone and other European markets should finish 2006 with some very good gains before slipping back in 2007. Exports to Japan should rise by 4% in 2006 while a slight contraction is anticipated for 2007.

More detail on Canadian exports by industry and by country/region is provided in Section 7.

3.1 Provincial Export Outlook

Most provinces continued to post higher export sales in 2006, the exceptions being Nova Scotia, and Ontario, where overall exports are expected to show little or no growth. The strongest rates of export growth in 2006 are in those provinces where energy and mining/metals make up a larger share of the aggregate export bundle – namely, Newfoundland and Labrador, Manitoba, Saskatchewan and Alberta. While the mining and energy sectors in New Brunswick and British Columbia are also performing strongly in 2006, these provinces' exports are being held back by a slump in forestry shipments. The downturn in forestry exports is a common thread across all regions of the country.

Parts of the country that rely more heavily on manufactured goods (particularly autos and consumer goods) generally experienced slower export growth over the past couple of years. The divergence between exports of commodities and manufactured goods should narrow in 2007 as prices for energy and other resources pull back. However, autos, consumer goods and forestry are expected to continue to underperform – a situation that does not bode well for Ontario, especially when it comes to the auto sector.

Table 7: Canadian Merchandise Export Forecast by Province

Provinces	CAD bn (2005)	% Share of Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Newfoundland & Labrador*	8.1	1.9	16.7	16	11
Prince Edward Island	0.8	0.2	19.9	3	1
Nova Scotia	5.7	1.4	3.4	-5	6
New Brunswick	10.7	2.6	13.1	3	-3
Quebec	66.9	16.4	3.5	2	-1
Ontario	180.1	44.2	0.7	0	-3
Manitoba	9.7	2.4	1.5	5	1
Saskatchewan	14.0	3.4	14.4	13	0
Alberta	80.1	19.6	19.8	9	-1
British Columbia	34.1	8.4	10.0	2	-3
Total Goods Exports*	**407.8**	**100.0**	**6.0**	**3**	**-2**

Source: EDC Economics. 2005 is actual data while 2006 and 2007 are forecast. NL includes EDC estimate for crude oil exports (*not included in national total from Statistics Canada).

International exports for **Newfoundland and Labrador** are expected to rise 16% in 2006 and 11% in 2007 on strength in energy and iron ore shipments. Seafood exports are down in 2006 but a modest recovery is anticipated for 2007. After a strong showing in 2005, **Prince Edward Island's** exports should rise by a more modest 3% in 2006, led by the agri-food sector. Next year will see the Island's export growth slip back to around 1% as agricultural exports are expected to hold steady at 2006 levels.

Nova Scotia exports are forecasted to fall 5% this year before rising 6% in 2007. Much of the volatilty relates to significantly scaled back newsprint production this year and an ensuing increase in output next year. Although there was weakness in energy, agri-food and auto parts during 2006, there were some key areas of strength in sectors like aerospace. The Nova Scotia outlook for 2007 is generally more favourable for most export sectors. Following two consecutive years of double-digit growth, **New Brunswick** exports have lost some momentum in 2006, rising by 3% on the year. Exports are expected to decline by 3% in 2007, mostly reflecting the expected movement in oil prices and refined petroleum products, and the decline in exports of wood products to the US.

Quebec's exports are expected to advance 2% in 2006, about half of last year's pace. While most sectors will post weaker results this year, Quebec's ailing forestry and consumer goods industries will be the main drag on headline growth. Prospects for 2007 are equally downbeat with exports forecast to show a small decline due to a drop in lumber shipments, a fall in metal prices, sluggish demand for regional jets, and difficulties in the furniture and textile industries. Several of **Ontario's** main export industries remained under pressure in 2006. Declines in the province's exports of automotive, forestry and consumer products have offset gains in agri-food, chemicals, metals, industrial machinery and aerospace. Ontario export sales are forecast to drop by 3% in 2007 as languid demand for autos and forestry products are joined by a decline in prices for some of the province's main commodity exports (metals, lumber).

After falling below the national average in 2005, **Manitoba's** export growth is expected to accelerate to 5% in 2006, almost double the overall Canadian figure. The rebound will come on the back of returning agri-food and industrial goods exports, as well as continued strength in energy sales. Strong growth in the province's main export sectors this year, however, will give way to weaker momentum next year, as export sales level off in 2007. **Saskatchewan's** exports have maintained the pace in 2006, rising an estimated 13% after having grown by 14.4% in 2005. Growth will continue to be led by energy, uranium and agri-food exports. We expect Saskatchewan's export sales will level off in 2007 as lower export receipts for energy and forestry are offset by growth in agri-food and industrial goods (mainly fertilizers and uranium).

A boost in energy sales will lift **Alberta's** total exports by 9% in 2006. Gains in agri-food (cattle), industrial goods (rubber, chemicals) and capital equipment are adding to this year's upturn in exports. Export receipts are projected to ease back by 1% in 2007 as lower oil and commodity prices reduce overall export earnings. We expect further growth for Alberta's agri-food and industrial machinery exports in 2007. Exports from **British Columbia** lost momentum in 2006 with overall growth slipping back to around 2% compared with 10% in 2005. Sluggishness in forestry, electricity and some seafood products account for much of this year's slowdown. BC's export receipts are forecast to drop by 3% in 2007 due mainly to lower commodity prices and continued weakness in forestry. The province's industrial machinery and advanced technology exporters put in a good performance in 2006 but slower growth is expected for these products in 2007 as global demand pulls back.

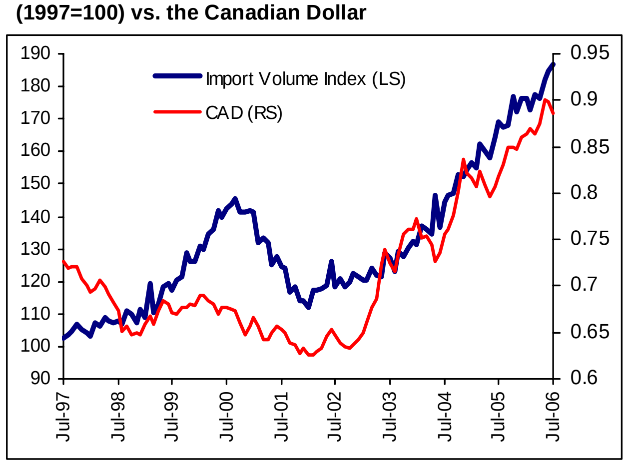
A comprehensive export outlook by province is provided in Section 8.

3.2 Assessing the Impact of the Higher Dollar

Canadian exports have come under pressure over the course of 2006, and much of this has been due to the rising loonie. Since dipping below 62 US cents in January 2002, the Canadian dollar has appreciated by 35% to reach 88 to 89 US cents as of early October 2006. We estimate that 70% of Canadian exports are priced in US dollars. Canadian companies receiving US dollar revenues for their exports are now earning fewer Canadian dollars when converted at the higher exchange rate. Even for those firms selling goods and services in Canadian dollar prices, the rising exchange rate makes their products more expensive in foreign markets, potentially reducing their competitive advantage.

Dealing with the higher dollar has been extremely difficult for some companies and industries – manufacturing, forestry and tourism quickly come to mind. Things could have been much worse however, had it not been for actions taken by exporters to help offset the dollar's run-up. Widespread cost

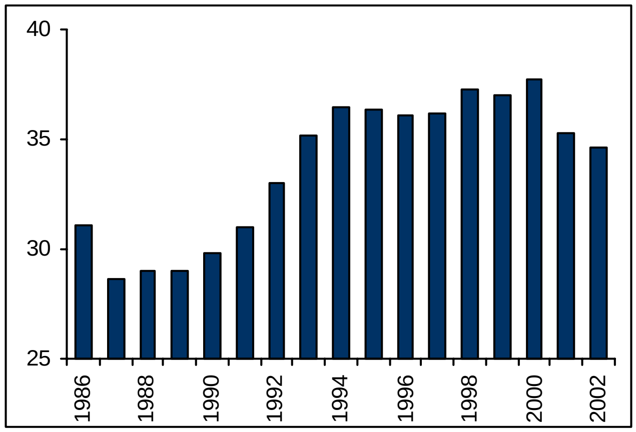
Figure 11: Imports of Machinery and Equipment (1997=100) vs. the Canadian Dollar



Source: Statistics Canada, Bloomberg.

cutting and new investments in machinery and technology have enabled Canada's export sector to remain competitive. Growth in machinery and equipment (M&E) investment during 2005 was the strongest since the Y2K-led surge in 2000. Indeed, investment in machinery and equipment among Canadian firms increased by 10.5% in 2005 to reach $106.2 billion (in price-adjusted terms), and manufacturers accounted for about one-fifth of this amount. These investments have started to pay off. Labour productivity for Canadian manufacturing increased by 5.4% in 2005 compared with 2.1% for the broader economy. There was some easing in productivity growth in the first half of 2006, but we believe productivity growth will recover as firms continue to invest in new capital equipment. To be sure, spending on capital goods increased a further 8.8% (annualized) in the first half of 2006. Most of the M&E installed in Canada is imported from the US. The higher Canadian dollar means these goods are now being brought into the country at a lower cost.

Figure 12: Import Content in CDN Manufacturing Exports (%) – Companies Import a Large Share of Their Inputs

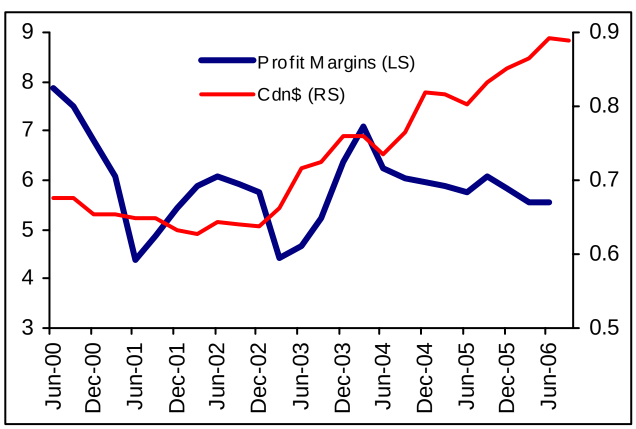


Source: Statistics Canada, EDC Economics.

Several external factors have also supported Canadian exports through the past 3 years. Perhaps most important is stronger US and overseas demand, which has partially offset the negative impact of the dollar's appreciation. At the company level, rising foreign demand translates into higher utilization of the firm's productive assets. This increase in utilization boosts overall productivity, which lowers the average cost per unit of output (explaining why profit margins were rising even as the CAD increased from 62 US cents to the low 80 US cent range). However, with manufacturing output and export growth slipping this year, we have seen a gradual decline in average capacity utilization rates across the manufacturing sector. This may explain some of the pullback in productivity during the first half of 2006, as well as some of the drop in manufacturing profit margins. If the Canadian dollar remains strong at the same time that foreign demand is weakening, the small contraction we are currently forecasting for exports in 2007 could become even larger, leading to further downward pressure on capacity utilization and profit margins.

Another factor supporting Canadian exports is related to increasing globalization. Canadian companies now import a much larger share of the inputs used in their production processes. The import content used to make Canadian exports has been growing steadily and now averages around 35%, and in many manufacturing industries the ratio is 50% or more. A higher dollar means Canadian exporters are importing these inputs at a lower cost, which helps to maintain cost competitiveness.

Figure 13: Profit Margins for Canadian Manufacturers under Pressure from Stronger C$ and Higher Input Costs (Quarterly margins, %)



Source: Statistics Canada and Bloomberg.

As already noted, average profit margins across Canadian manufacturing have come under pressure during the past year in response to the rising dollar and higher input costs. Manufacturing profit margins in the second quarter of 2006 averaged 5.5% – just a little below the 5.8% average of the past 5 years (and around 6% for the past 20 years). This does not appear too serious, but the aggregate number masks a mixed performance among the many sub-sectors of manufacturing. Margins for the petroleum refining industry, primary metals production and chemicals have held up very well through the second quarter of 2006. Likewise, average margins among computer equipment, electronics and auto parts producers have also been fairly steady (these sectors all have high import content in their production process). Electrical equipment and appliances have also experienced some improvement in profit margins (another industry which uses a high ratio of imported inputs). Alcohol and tobacco profits also remain strong – not the least surprising. On the downside, pulp and paper companies have seen a significant compression in their bottom line. Clothing, textiles and furniture manufacturers are also struggling to stay in positive territory.

Over the course of 2007, we may see some relief for Canadian manufacturers on the cost front. The Canadian dollar is forecast to gradually depreciate (by around 5 to 6%) through the next 12 months while lower oil and commodity prices should reduce input costs. However, changes in US and overseas demand generally have a bigger impact on Canadian exports. A stronger-than-expected economic slowdown in 2007 could very well eclipse any cost savings resulting from a lower Canadian dollar and declining commodity prices.

4.0 The Bottom Line

After 4 years of growing above potential, the world economy has shown resiliency against a number of headwinds. As 2006 winds down however, a slowdown is emerging, led by a slump in the US housing market. Global economic growth is forecast to slow to around 4% in 2007, down from about 4.8% in 2006. This may not seem all that bad on the surface, but the deceleration will make for a riskier and more stressful operating environment in 2007. Canadian companies should be prepared to see their export sales and profit margins come under further pressure through the coming year. Increased risk perceptions will certainly make foreign customers more cautious in their spending and expansion plans. We believe most of the risk is on the downside, and the high level of uncertainty has led us to develop an alternative downside scenario – in which the US economy goes into a mild recession during 2007, pulling global growth down to around 3.3%. We have assigned a 20 to 25% probability to this alternative scenario.

In the baseline forecast, as economic growth slows in the United States and Canada, both the US Federal Reserve and the Bank of Canada are likely to reduce interest rates. Monetary authorities in other major economies (e.g. Eurozone, China, India) are expected to tighten monetary policy further in the months ahead but should adopt a neutral stance once the global slowdown gets a firmer grip on their domestic economies. We have to keep in mind that the global economy still has several factors working in its favour – including stronger corporate and emerging market balance sheets, healthy cross-border investment flows, and improved labour markets in several key countries – which should partially mitigate the downturn in economic activity.

Canadian export sales are on track to rise by 3% in 2006, down from the pace of the past couple of years. The outlook for 2007 calls for further deterioration, with export receipts forecast to fall by 1%. Much of this is due to a weaker pricing environment for energy and metals, but most major industries will see export sales lose momentum nonetheless. The main drag on export growth through the next 12 to 18 months will be weakness in the automotive, forestry and consumer good sectors. Canadian exports to developing countries will continue to grow much stronger compared with export sales into the industrialized markets.

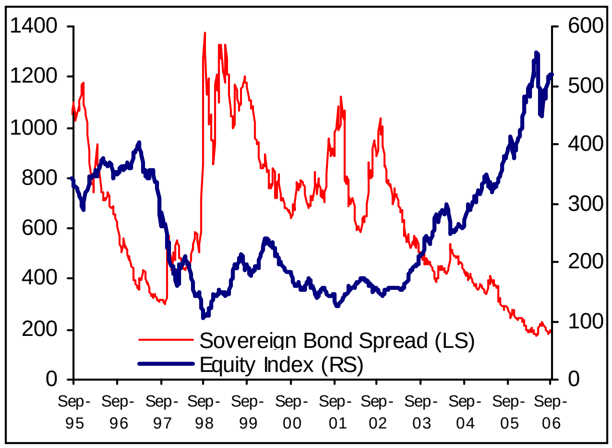
5.0 Developing Markets Overview

5.1 Developing Markets Summary Outlook – A More Challenging Environment in 2007

Developing market economies will be entering 2007 on an increasingly uncertain economic footing, after several years of solid economic growth. Recent indicators, especially those coming out of the US, have been worrisome. Indeed, the global domino effect outlined in our Spring 2006 Global Export Forecast is starting to make its way through the world economy. The housing slowdown we are currently witnessing in the US is starting to have an impact elsewhere, especially in the export-dependent nations of East Asia where the pace of growth in exports and industrial output has started to slow. With growth set to slow in the world's major economies, including the US, Eurozone, Japan and China, it is only a matter of time before developing countries begin to slow as well. The US, Eurozone, Japan and China comprise the largest export markets for much of the developing world, and any slowdown in these countries will soften growth elsewhere.

To be sure, increased integration of the global economy does pose a greater risk that falling dominoes could spread more quickly and be more far-reaching than would have occurred in the past. Rising trade penetration has made the global business cycle more synchronous across individual economies. For example, trade penetration (i.e. exports plus imports as a share of GDP) for the world economy increased from 23% in 1970 to an estimated 57% in 2005. Likewise, cross-border investment flows have increased dramatically in the past decade with the global stock of FDI now equivalent to almost one-quarter of world GDP. And most emerging markets have seen a similar increase in their integration into the global economy, meaning any downturn in the major industrialized markets will certainly spread to the developing world.

Figure 14: Rising Equities and Narrowing Bond Spreads Point to Lower Developing Market Risk



Source: Bloomberg.

Through the next 12 to 18 months, growth in the developing world will become increasingly impaired by a slowing US and world economy. In addition, tighter monetary policy across key emerging markets will increasingly come into play. Indeed, monetary policy has already been tightened in a number of emerging markets due to concerns of unsustainably strong growth and rising inflation (e.g. China, India, Turkey, Indonesia, Malaysia, Thailand, Argentina, Chile and the oil-rich Persian Gulf countries to name a few). There remains a risk that inflation will continue to gain momentum in these countries, forcing central banks to continue tightening monetary policy.

While the latest developments suggest economic growth will slow through the coming year, EDC Economics is not expecting a situation akin to previous downturns, when emerging markets tended to undergo very difficult transitions typified by significant declines in economic growth, rising interest rates, weaker currencies and substantially higher risk premia. One only has to look back to 1991–92 and again to 1997–98 to see how hard developing markets can get hit when the global business cycle takes a turn for the worse. Such a dire outcome is not likely this time around, as most developing economies have seen significant improvement in their external and domestic finances. Many countries have taken advantage of lower interest rates in recent years to pay down debt or to refinance on more favourable terms. Some governments are also issuing debt denominated in their own local currencies – a sign that capital markets in these countries are becoming more sophisticated. Most indicators (such as debt to GDP, fiscal balances, debt service ratios, forex reserves, etc.) continue to show improvement. All this to say, developing countries are in much better shape to withstand a global slowdown. Still, their characterization as "emerging markets" means they will nevertheless be more affected relative to their industrialized counterparts.

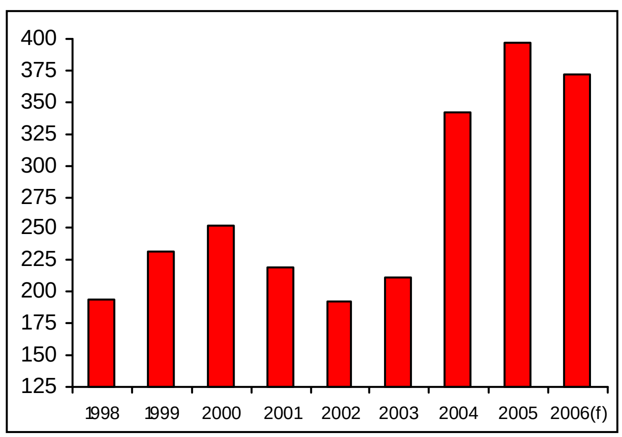
Table 8: Canadian Exports to Developing Markets (C$ mn)

	2004	2005	% Change	% of total to Developing Markets
Central & Eastern Europe	1,529.0	2,032.4	32.9	9.3
Russia	364.0	512.4	40.8	2.4
Middle East	2,665.6	3,101.1	16.3	14.3
Africa	1,235.8	1,409.1	14.0	6.5
Asia	9,957.5	10,760.0	8.1	49.5
China	6,041.5	6,620.0	9.6	30.5
India	811.4	1,030.8	27.0	4.7
South America	2,605.7	2,973.0	14.1	13.7
Argentina	118.7	154.6	30.2	0.7
Brazil	917.2	1,060.8	15.7	4.9
Central America	1,219.8	1,424.1	17.3	6.7
Mexico	2,871.3	3,110.4	8.3	14.3
Total Goods	**21,256.0**	**23,684.0**	**11.4**	**66.9**
Total Services (est.)	**12,228.0**	**11,700.0**	**-4.6**	**33.1**

Source: Statistics Canada, EDC Economics. Data refer to domestic exports.

We expect growth in the developing world will slow from around 7.1% in 2006 to around 6.5% in 2007 – not a disaster by any means but still enough to cause a number of economic and financial stresses to surface over the next 12 to 18 months. With global economic growth losing momentum, the conditions that supported improvements in credit quality have started to dissipate. In particular, profit growth in most countries is already starting to slow. Corporate bond spreads have begun to widen while bond spreads in emerging markets are not likely to show any more improvement at this point in the cycle. As global growth moderates and the business environment becomes increasingly uncertain, risk premia in the developing world will move higher. Things to watch for in this type of environment include increased business insolvencies, rising fiscal deficits and greater volatility in financial markets.

Figure 15: Global FDI Inflows to Developing Markets (USD bn)



Source: UNCTAD, EDC Economics.

The currency and equity market volatility seen this past summer across many developing economies is a reminder that international investors are still quite skittish when it comes to emerging markets. In May and June of this year, a series of unexpectedly weak US economic data led to a rout in emerging market equities and currencies – an indication of the large amounts of highly liquid money that can quickly flee these countries at the first sign of trouble. There is no doubt the finances of emerging countries are in much better shape than just a few years ago and therefore better able to withstand external shocks. But the events of the past summer remind us that many of these nations are still highly exposed to the vagaries of the international economy. Canadian exporters and investors should be prepared for a more challenging and volatile environment in 2007.

Regional Growth Summary

Growth throughout developing Asia will lose some momentum over the course of 2007, but the region as a whole will continue to outperform the rest of the developing world. Regional activity will remain focused on the Chinese market. India is also expected to record solid growth, adding to the region's relative strength. This part of the world is expected to post economic growth of around 7.5% in 2006 followed by 6.5% growth in 2007. Prospects for Central and Eastern Europe remain generally positive over the longer term, due in large part to the continuing process of EU Accession and the resulting convergence that is supporting increased economic activity. But as with other developing countries, the pace of economic activity across Central and Eastern Europe will ratchet down in 2007.

Table 9: Stock of Canadian Direct Investment to Developing Markets (C$ mn)

	2004	2005	% Change	% of total to Developing Markets (2005)
Central & Eastern Europe	**9,595**	**8,400**	**-12.5**	**17.3**
Russia	*178*	*188*	*5.6*	*0.4*
Middle East	**400**	**450**	**12.5**	**0.9**
Africa	**3,252**	**3,035**	**-6.7**	**6.2**
Asia	**9,318**	**11,600**	**24.5**	**23.8**
China	*1,003*	*1,017*	*1.4*	*2.1*
India	*217*	*204*	*-6.0*	*0.4*
South America	**20,207**	**21,468**	**6.2**	**44.1**
Brazil	*6,984*	*8,018*	*14.8*	*16.5*
Chile	*5,447*	*5,673*	*4.1*	*11.7*
Argentina	*4,783*	*4,621*	*-3.4*	*9.5*
Central America *	**500**	**600**	**20.0**	**1.2**
Mexico	**2,580**	**3,142**	**21.8**	**6.5**
Total FDI in Dev. Markets	**45,850**	**48,660**	**6.1**	**100.0**

Source: Statistics Canada, EDC Economics.
* Excludes Bahamas, Barbados, Bermuda & the Cayman Islands

The economies of Latin America remained strong in 2006, although the pace of growth was down slightly from the past couple of years. Economic growth in Latin America is expected to average around 4.5% in 2006 with a more significant pullback to 3.9% projected for 2007. The region's non-energy commodity producers (namely Argentina, Chile and Peru) are at increased risk from a possible downturn in global commodity markets during 2007.

The Middle East and North Africa have been experiencing an unprecedented macroeconomic boom due to large petrodollar revenues, which have been re-invested across the region. Over the short term, the Middle East and North Africa are expected to grow faster than the rest of the world, with GDP growth in the range of 5.5 to 6% this year and possibly 5.0 to 5.5% in 2007. Sub-Saharan African oil producers have also been benefiting from record high oil prices. At the same time, firmer prices for non-energy commodities (e.g. gold, industrial metals), donor support and increasingly generous debt relief will support economic growth throughout much of the region. However, much of Africa is exposed to a global slowdown and the resulting impact on commodity demand and prices.

Canadian export and investment opportunities

Canadian exports of goods and services to the developing world are expected to reach a record $38 billion in 2006, continuing several years of solid growth. In 2005, exports were up 6%, led by higher shipments of merchandise goods (+12.6%) while exports of services were down almost 5%. EDC Economics is forecasting another solid gain for Canadian merchandise exports to emerging markets in 2006 (+12%) while service receipts are again expected to come in on the soft side (-2 to -3%). For 2007, we expect growth in exports of goods and services will slow to around 5 to 6%. For the past couple of years, more than 70% of the export industries tracked by EDC Economics have shown stronger growth in sales to developing markets than to industrialized countries, and this pattern is forecast to continue in 2007.

Canadian producers of chemicals, plastics, processed food, aerospace, telecom equipment and industrial machinery have benefited from rising demand in emerging markets during the past couple of years – a trend expected to continue through the next 2 to 3 years, albeit at a slower pace of growth. While commodities, agriculture and resource-based goods account for a large share of Canadian exports to Asia, recent years have seen growing demand for a wide range of capital and consumer goods, and this has continued through 2006. Likewise, shipments of industrial machinery and high-tech equipment to Latin America, Eastern Europe and the Middle East have made impressive gains this year.

From a global perspective, foreign direct investment (FDI) inflows to developing markets have increased dramatically in recent years as companies and investors look to take advantage of growth opportunities in these markets. Moreover, efforts geared toward enhancing competitiveness have led many companies to move some of their production and sourcing to offshore locations – an ongoing trend that will continue to support direct investment into developing economies. FDI flows into developing countries amounted to an estimated USD 360 billion in 2005 – a record high and 17% above the previous year's total inflow of USD 308 billion (also a record at the time).

Canadian companies have been participating in this trend. The flow of Canadian direct investment into developing economies surpassed $13 billion in 2005, compared with an annual average of $2 to $3 billion in the early 1990s. Emerging markets accounted for more than 30% of outbound Canadian FDI flows last year, the highest share recorded in recent years.[2] Data for the first half of 2006 show a decline in Canadian FDI flows to developing economies. Most of the drop was seen in the first quarter and stems from a sale of assets by Canadian firms in emerging markets. The stronger loonie has also reduced the value of foreign assets when measured in Canadian dollar terms. By the second quarter of 2006, outflows had started to pick up again. At the end of 2005, Canadians owned $50 billion worth of capital assets (i.e. stock) in developing countries, an increase of 7.2% over 2004 (this result was constrained by the 7% appreciation in the value of the Canadian dollar during 2005).[3] Compared to a decade ago, the stock of Canadian direct investment abroad has increased by an estimated threefold.

As governments in developing countries continue to ease restrictions on foreign investment, we can expect investment opportunities for Canadian companies to broaden over the next 2 to 3 years. Areas of note include financial services, education services, communications, transportation infrastructure, and mining and energy projects. Although such opportunities may be harder to come by through the next 12 to 18 months in light of tougher economic conditions, the longer-term prospects for such investments in developing economies remain quite promising. Another area of concern has been the recent nationalization of energy and resources in several developing economies, particularly in South America.

5.2 Developing Market Outlook in Detail

5.2.1 Middle East and North Africa

The Middle East and North Africa (MENA) countries have been experiencing an unprecedented macroeconomic boom due to large petrodollar revenues, which have been re-invested across the region. Over the short term, the Middle East and North Africa are expected to grow faster than the rest of the world, with GDP growth in the range of 5.5 to 6% this year and possibly 5.0 to 5.5% next year. This reflects sustained high oil prices and government spending, which will support private consumption and investment.

Table 10: Canadian Merchandise Exports to the Middle East & North Africa by Sector (2004-2005)

Top 5 Sectors	2004 (CAD mn)	2005 (CAD mn)	Growth (2004/2005)
Other Machinery	248.7	307.4	23.6
Aircraft & parts	187.6	275.7	47.0
Newsprint, other paper	200.5	248.2	23.8
Wheat Farming	405.8	244.9	-39.7
Computer, electronic equip.	180.8	240.4	33.0
Total	**2,762.1**	**3,087.8**	**11.8**

Source: Statistics Canada, EDC Economics.

[2] FDI **flows** refer to the amount of money invested in any given year while the **stock** is the cumulative value of all past and current investment flows (much like water flowing into a sink where the accumulated water is the stock).

[3] Note that Statistics Canada reports the stock of Canadian direct investment abroad for developing countries at $110 billion in 2005. But this includes some $60 billion in Barbados, Bermuda and the Cayman Islands, which is mostly composed of offshore financial investments by Canadian banks and insurance companies – hardly the type of investment that comes to mind when one thinks of developing markets. The Statistics Canada definition also includes Singapore and South Korea, which by most economic measures cannot be considered developing countries.

DEVELOPING MARKETS OVERVIEW

For the past three decades, petrodollars have been recycled through workers' remittances, cross-border capital flows and Official Development Assistance (through, for example, the Saudi Fund for Development at the IMF[4]). Much investment has gone into the Western world, but such flows have been perceived as increasingly insecure since 9/11. Petrodollars have been invested in large-scale Gulf State projects and in countries with lesser oil resources (e.g. Jordan and Egypt) and in projects in North African countries. A large number of workers in the Gulf Co-operation Council (GCC)[5] come from the Mashreq countries (Egypt, Jordan, Lebanon, Syria and the Palestinian territory) and result in large workers' remittances back to these countries.[6]

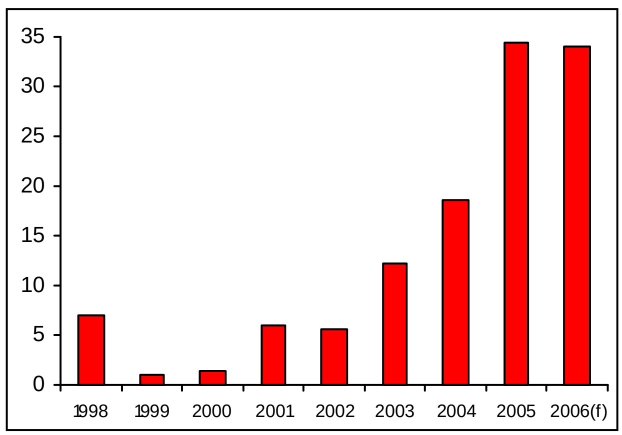
Table 11: Canadian Merchandise Exports to the Middle East & North Africa by Country (2004-2005)

Top 5 Markets	2004 (CAD mn)	2005 (CAD Mn)	Growth (2004/2005)
United Arab Emirates	357.8	511.7	43.0
Israel	345.0	396.7	15.0
Saudi Arabia	562.6	395.1	-29.8
Egypt	193.4	303.0	56.7
Iran	206.2	256.1	24.2
All others	1,097.1	1,225.2	11.7
Total	**2,762.1**	**3,087.8**	**11.8**

Source: Statistics Canada, EDC Economics.

The region is benefiting from unprecedented macroeconomic growth that far exceeds the oil booms of the 1973-74 and 1979-81 periods. But the region is still facing numerous challenges. The absence of economic integration is resulting in a duplication of resources and the economic return from some projects remains questionable (especially in the financial sector, tourism and real estate). Projects often reflect the thirst for "grandeur" (the biggest and the greatest) more so than the principles associated with a commercially viable project. The scale and quantity of new projects have led to local shortages of labour, materials and equipment. A region that had not long ago forced migrant workers to leave, has once more become dependent on migrant labour. There are shortages of experienced contractors, skilled labour, specialized equipment, raw materials (such as cement) and pressures on local utilities. Costs of construction have been climbing and profit margins have been narrowing. For example, Abu Dhabi and Qatar have forecast that power and water requirements will have to double before the end of the decade. This means for example that the GCC countries will have to invest some USD 20 billion in power generation by 2010 and USD 120 billion in desalination in the next decade.

Figure 16: Global FDI Inflows to the Middle East (USD bn)



Source: UNCTAD, EDC Economics.

It is estimated that the total value of projects planned or already underway now exceeds the USD 1 trillion mark, of which USD 250 billion was announced in the first quarter of 2006. Of the total for the region, the Gulf Co-operation Council accounts for USD 880 billion and new project outlays are projected to expand by 50% in 2006. Saudi Arabia has plans for USD 1 trillion in new projects throughout the GCC by 2011.

Real GDP growth for the GCC in 2006 and 2007 is expected to be in the area of 7% a year, reflecting growth in both the hydrocarbon and non-hydrocarbon

[4] The Saudi Fund for Development (SFD) Special Account was established at the request of the Saudi government to provide supplementary financing in association with loans under the Poverty Reduction and Growth Facility (PRGF).

[5] The GCC includes Saudi Arabia, United Arab Emirates, Kuwait, Oman, Qatar and Bahrain.

[6] A large number of workers from these countries are also from South Asia – India, Pakistan, and Bangladesh.

sectors. This follows a rapid economic expansion of about 6% per year over the past few years. Total GDP for the GCC is projected to near USD 800 billion in 2007. Indeed, the GCC economies are now larger than the Netherlands and rank as the world's 16th largest economy, while per capita GDP is expected to rise from USD 19,600 in 2006 to USD 20,600 in 2007. At current oil prices, GCC exports could reach USD 45 billion in 2007, equivalent to the combined exports of Brazil, India, Poland and Turkey. About 80% of GCC export earnings come from oil and gas. GCC total imports amount to about USD 165 billion. Thus, the GCC could record a total current account surplus of almost USD 230 billion (32% of GDP) in both 2006 and 2007.

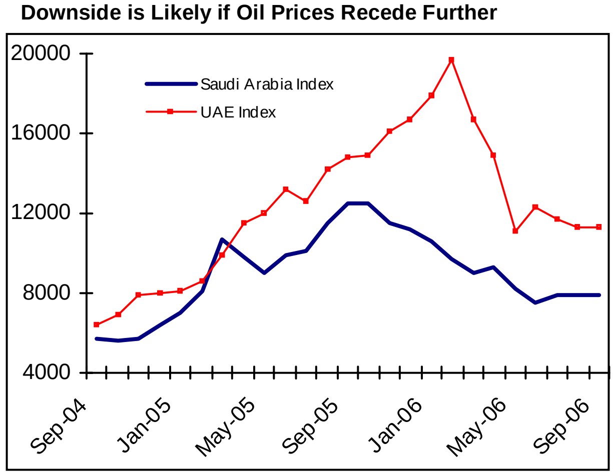
In 2005, the GCC accounted for 22% of global oil production, around 40% of crude oil exports and a similar proportion of proven hydrocarbon reserves. Although government spending rose by 18% last year, the GCC still recorded a combined fiscal surplus of 22% of GDP. Moreover, total external debt jumped by 30% to USD 125 billion in 2005, but remains manageable at 20% of total GDP. Nevertheless, the rise in new debt reflects the accumulation from borrowing abroad by domestic corporations (public sector enterprises).

Cumulative oil windfalls have led to fast growing net foreign assets, which have been estimated by the Institute of International Finance (IIF) at USD 1.1 trillion in 2005. The GCC countries have been saving only a small portion in foreign exchange reserves – currently at roughly USD 70 billion, which is equivalent on average to 3 months of import cover. Enormous amounts of capital have flowed into GCC large scale projects, real estate and stock markets. GCC stock markets remain volatile even after the sharp correction earlier this year. High domestic liquidity has been a major factor behind volatility in financial markets, but the region has also seen large capital inflows resulting from speculation by foreign investors.

Countries such as Bahrain and Oman, which are facing a shorter oil life and/or aging oil fields, have been investing in recovery techniques for improving extraction from older fields. There has been an increase in manufactured hydrocarbon products, such as refined petroleum, liquefied gas and petrochemicals. The region has demonstrated a growing interest in financial services, aluminum (energy intensive) and tourism. Overall company profitability should remain strong. Tourist receipts and workers' remittances will remain important for countries like Jordan and Egypt.

Issues Facing Individual MENA Countries

Figure 17: Middle East Stock Markets have Declined – Further Downside is Likely if Oil Prices Recede Further



Source: Bloomberg.

Saudi Arabia is on track for a third year of robust economic conditions with growth of 6.5% expected for 2006 – in line with the pace experienced in the past couple of years. The country is taking advantage of strong oil prices to embark on a development plan to accelerate growth and boost living standards. The Kingdom's imports of goods and services will total about USD 110 billion in 2006. The current trend shows that the dynamism of the economy could lead to imports goods and services reaching USD 210 billion within 5 years while exports could be in the area of USD 270 billion (assuming oil prices remain around 50-55 USD per barrel). Saudi Arabia is aiming at increasing oil capacity to 12.5 million barrels per day (b/d) by 2009 while maintaining 1.5 to 2 million b/d in spare capacity. Outside of the energy sector, the country has been planning a series of mega-projects, such as the USD 6.7 billion Knowledge Economic City and the USD 8 billion Prince Abdulaziz bin Mosaed Economic City after the launch of the USD 27 billion King Abdullah City. These cities form part of six Special Economic Zones

(SEZ) to be developed by the end of 2006. The SEZ are expected to focus on tourism, fishing, agriculture, energy and aluminum. Infrastructure should be of the highest quality, but bureaucratic delays are liable to create problems for investors.

The United Arab Emirates (UAE) are experiencing an unprecedented macroeconomic boom. It is the most vibrant economy among the GCC countries and is expected to grow strongly in 2006 and 2007, with a GDP growth rate of 7 to 8% a year. Dubai and Abu Dhabi have embarked on a second wave of large-scale investment projects in services, manufacturing and heavier industrial projects that offer a wide range of opportunities for investors. Abu Dhabi has made a renewed push to develop its gas reserves. Meanwhile, Dubai, which has relatively smaller oil reserves, has shown its commitment to use its petrodollars to transform and secure the future of its economy as mainly a "prime tourism resort" and research centre. A series of mega projects is included in the second wave of the development of Dubai; and these have included the Biotech city, the Sports city, the Festival city, Dubai Waterfront, Dubai Jebel Ali airport, Dubai's Business Bay and Palm City. Dubai has been "shopping" worldwide for the latest technology and the best expertise in all fields to make it happen. The UAE has been recording large budgetary and external account surpluses during 2004 and 2005, and the outlook for 2006 and 2007 is even more promising.

Kuwait needs major investments in new fields to increase, if not sustain, its current oil output of 2.5 million b/d. Kuwait wants to upgrade its existing oil infrastructure and build a new oil refinery, perhaps the world largest. But, increasing output depends on progress on the politically contentious "Project Kuwait." This undertaking would allow foreign oil firms to operate in four Kuwaiti oil fields – Rawdhatain, Sabriey, Ratqa and Abdalli – located in the north of the country. Foreign oil firms could invest up to USD 40 billion in these fields between 2006 and 2020. Foundations have already been laid for two large olefins and aromatics plants. Total investments in Kuwait's upstream and downstream sectors could top USD 55 billion by 2020. The country's domestic and external financial positions are exceptionally strong. The external current account surplus is expected to be equivalent to 55% of GDP in 2006 and 45% of GDP in 2007. Corporate sector profitability has improved as well.

While it is the least hydrocarbon-dependent of the Gulf countries, Bahrain has been among the most vibrant economies of the region. The 2007/08 budget, which was approved in June 2006, is based on conservative oil prices, as for other GCC countries, and is expected to record another surplus. Both the oil and non-oil sectors are expected to sustain strong growth rates of 6% in 2006 and 2007. The country has made a series of investments to boost both oil and non-oil revenues (like low-sulphur diesel and aluminum), and its investment code is among the most liberal of Gulf countries. Bahrain is also seeking to become the most important financial centre in the Gulf region.

Confusion over policy direction in Iran also extends into the economic sphere. President Ahmadinejad promised in May 2006 to return back to the nation all industrial entities that were unfairly privatized. In apparent contrast, Ayatollay Ali Khamenei amended the constitution in July 2006 to allow for privatization of state industries, with the exception of the oil sector. To be successful however, the process must bypass both the bonyads (charitable foundations controlled by the clerics) and the Revolutionary Guards. Iran has been trying to catch up with the Gulf countries in the development and diversification of its oil sector. GDP growth is expected to be 6% in 2006, short of the 7 to 8% target of the current development plan. Iran's politics has led to capital flight, mostly to the GCC countries while resources continue to be directed towards rhetoric-related spending. The outlook for Iran is becoming increasingly uncertain.

The international community recently met in Sweden to raise about USD 500 million for initial reconstruction projects in Lebanon. The Lebanese government has set the bill for Israeli damage to the country's infrastructure at USD 3.6 billion. Even though Lebanon has experienced war damage in the past and will get support from the Gulf countries and Lebanese immigrants, it will take some time before it recovers from the recent destruction.

Countries located in the northern part of Africa – including Algeria, Libya, Tunisia, Egypt, and Morocco – have all been achieving commendable economic performances, which are likely to continue through 2007. Algeria's 2006 budget calls for a sharp rise in capital spending, but another budgetary surplus of 10% of GDP is anticipated this year. Even though it has been pre-paying portions of its external debt, the country has accumulated large foreign exchange reserves (expected to reach USD 70 billion by year-end). Libya's economic growth is expected to remain in the range of 5.0 to 5.5% during 2006 and 2007. Oil windfalls have led to large budgetary and external surpluses and foreign exchange reserves could reach USD 28 billion by year-end. On the downside, Libya's privatization program has gained little momentum, and the course of economic liberalization has been delayed by policy reversal.

The April 2006 bombings in Egypt are not expected to have a major impact on the economy, as the country has demonstrated resilience against such events in the past. The economic liberalization program is expected to result in stronger and more broad-based growth in 2006 and 2007. Egypt has been benefiting from strong economic activity in the GCC countries, primarily in terms of portfolio investments, tourism earnings and workers' remittances. The external current account balance is expected to register a surplus equivalent to 3% of GDP. The outlook over the short and medium term shows that Egypt's external debt and debt servicing will remain manageable.

Tunisia's ambitious economic policy aims at accelerating GDP growth to raise incomes and reduce unemployment by boosting exports and investment, improving productivity, modernizing the financial system and upgrading infrastructure. The government has decided to pre-pay a portion of its external debt after the sale of Tunisia Telecom. High oil prices imperil Morocco's inflation and reforms, but macroeconomic growth has picked up to around 6% in 2006, boosted by the return of a normal harvest and increased exports as a result of the free-trade agreement with the US. Iraq's reconstruction and oil production continue to be seriously affected by security issues. Prior to the conflict with Lebanon, Israel's economy and its foreign exchange position were solid. Even though the recent conflict has put pressures on Israel's finances, lines of credits guaranteed by the US government are available to meet its balance of payments financing needs.

5.2.2 Sub-Saharan Africa

Going for Growth

The theme of the World Economic Forum (WEF) on Africa that took place in mid-2006 was "Going for Growth." African countries have committed themselves to five initiatives to achieve sustainable growth. These are: promoting investment through the "Investment Climate Facility"; improving access to education through the NEPAD e-schools initiative; building social infrastructure; promotion of entrepreneurship; and targeting of corruption.

Economic activity has been on a strong course with growth of 5.6 to 5.8% anticipated for 2006 and possibly 5.5% for 2007. However, Africa has to generate economic growth rates of at least 7 to 8% a year in order to significantly reduce poverty. So far, growth has been concentrated in relatively capital-intensive sectors with limited spillover effects on employment creation and on the rest of the economy.

Table 12: Canadian Merchandise Exports to Sub-Saharan Africa by Country (2004-2005)

Top 5 Markets	2004 (CAD mn)	2005 (CAD Mn)	Growth (2004/2005)
South Africa	345.0	399.8	15.9
Ghana	64.6	91.4	41.5
Nigeria	75.3	90.8	20.6
Angola	22.2	71.4	221.6
Kenya	22.9	37.7	64.6
All others	244.2	253.0	3.6
Total	**774.2**	**944.0**	**21.9**

Source: Statistics Canada, EDC Economics.

Table 13: Canadian Merchandise Exports to Sub-Saharan Africa by Sector (2004-2005)

Top 5 Sectors	2004 (CAD mn)	2005 (CAD mn)	Growth (2004/2005)
Wheat Farming	145	138.4	-4.6
Industrial goods, other	60.4	101.5	68.0
Aircraft & parts	65.8	79.4	20.7
Chemicals	59.2	74.5	25.8
Agricultural & Construction Machinery	50.5	74.2	46.9
Total	**774.2**	**944.0**	**21.9**

Source: Statistics Canada, EDC Economics.

More efforts needed to meet the Millennium Development Goals

It has been clear from the results published by the United Nations at mid-year that the continent must accelerate its pace for meeting the Millennium Development Goals. There are signs of hope that the world is progressing toward the UN's global poverty-cutting targets, although *"more efforts are still needed in some poorest regions of the world."* The main objective of the UN's Millennium Development Goals is the eradication of extreme poverty in cutting by half the proportion of people in the developing world living on $1 or less a day by 2015. While the world is on track, the number of people in Sub-Saharan Africa in extreme poverty increased by 140 million between the early 1990s and 2002.

Trade arrangements remain a key issue for the continent

At the last G8 summit, African governments and Western supporters argued for three things: allow more countries to qualify for the Enhanced HIPC (highly indebted poor country) initiative; greater aid flows; and progress on trade liberalization. Nevertheless, geo-political concerns over the conflicts in the Middle East pushed Africa out of the limelight in recent months. The UK government, along with non-governmental development supporters, revisited the "promises" made in Gleneagles, Scotland in 2005, when the G8 countries pledged to boost aid by USD 50 billion and to cancel the external debts of 27 countries within 12 to 18 months. Out of the 27 countries, 23 are located in Africa. In addition to debt reduction, the G8 countries along with the support of South African President Thabo Mbeki and Nigerian President Olusegun Obasanjo are aiming at providing primary school for all children by 2015; making HIV/AIDS drugs available to all who need them; and doubling the size of their economies by reducing trade barriers by 2015. While major steps have been taken in debt relief and aid, there have been few gains in trade for the poorest countries, and this was particularly evident at the WTO talks in Hong Kong in December 2005.

There are no doubts that both the Enhanced HIPC Initiative (mainly achieved through the Paris Club) and the Multilateral Debt Reduction Initiative (MDRI covers debt owed to international financial agencies – IFIs) have been very demanding, in terms of macroeconomic policy reform for recipient countries, as well as costly exercises for the multilateral and bilateral official creditors that have been providing the debt forgiveness (including Canada). Hence, some G8 countries have been pushing the concept of balance of payments viability and debt sustainability, particularly for "the Low-Income Countries." At present, graduating HIPC countries can engage only in "concessional borrowing" if they (i.e. public sector) want to meet the conditionality of their IMF program (PRGF). However, there is a proposal, which will be discussed over the coming months. The view is to enforce concessional lending after the expiration of formal IMF programs for those countries graduating from HIPC and MDRI. This would help ensure responsible lending and borrowing (desirable for both the debtor and borrower). The jury is still out on whether such a system would be effective for Sub-Saharan Africa, especially given the vulnerability of its commodity-driven economies to global economic conditions. As such, development projects and infrastructure spending have been "put on hold" for years, and certain projects in infrastructure are more likely be supported only by more restrictive financial terms than those available through concessional financing.

HIPC Initiative and Enhanced HIPC Initiative

The international financial community recognized in 1996 that the external debt situation for a number of low-income countries, mostly in Africa, had become extremely difficult and influenced the prospects for economic development. Traditional mechanisms of rescheduling and debt reduction – together with continued provision of concessional financing and pursuit of sound economic policies – would not be sufficient to attain sustainable external debt levels within a reasonable period of time and without additional external support. The Highly Indebted Poor Country (HIPC) Initiative entails coordinated action by the international financial community, including multilateral institutions, to reduce the external debt burden of some 41 countries to sustainable levels. The HIPC Initiative was "enhanced" in September 1999. For countries eligible for the Enhanced HIPC Initiative, the stock of eligible debt will be reduced by at least 90% in present value terms by the Paris Club (or more if needed), subject to fair burden sharing, with at least comparable action by other creditors. Many Paris Club creditors have announced that they will also provide debt forgiveness over and above HIPC Initiative assistance, particularly on ODA (Official Development Assistance) debt. (Source: Paris Club and World Bank).

Multilateral Debt Relief Initiative

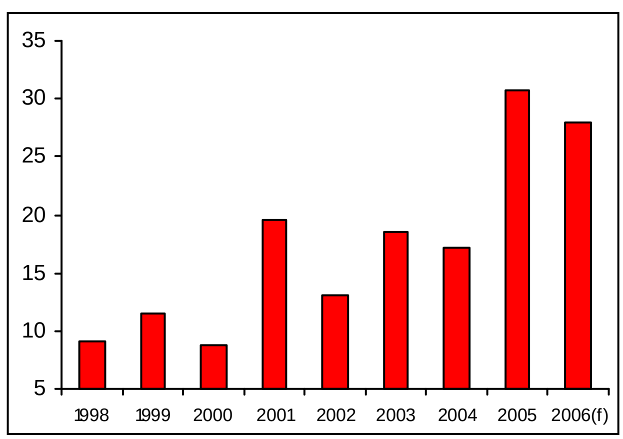
The World Bank Multilateral Debt Relief Initiative (MDRI) took effect on July 1, 2006. This initiative will cancel the International Development Association (IDA) debt of some of the world's poorest countries. Under the MDRI, IDA is expected to provide some USD 37 billion in debt relief over 40 years. This is in addition to some USD 17 billion of debt relief already committed by IDA under the Enhanced HIPC Initiative.

Sub-Saharan countries benefiting from strong global commodity markets

A number of Sub-Saharan African countries – namely Angola, Cameroon, Congo (Brazzaville), Equatorial Guinea, Gabon, Nigeria and Sudan – have been benefiting from record high oil prices. Chad, Mauritania and Sao Tome & Principe have joined the ranks of oil producers. Prospects are equally encouraging, with oil prices projected to remain at elevated levels through the next 2 to 3 years. At the same time, firmer prices for non-energy commodities (e.g. gold, industrial metals), donor support and increasingly generous debt relief have lessened the impact of stronger oil prices on non-oil producing African countries.

GDP growth has finally gained momentum in South Africa, thanks to sound policies and favourable external conditions. Economic output expanded by 4.9% in 2005 (highest in two decades), and growth is likely to average 4.3% in 2006, leading to employment gains. Growth is projected at 4% in 2007 and in subsequent years, reflecting both public and private sector domestic spending. Meanwhile, inflation has remained within the target band of 3 to 6% a year for the past 2½ years. Conservative economic policies have reined in the fiscal deficit, which was down to just 0.6% of GDP in 2005. It is projected to be only 1.2% of GDP in 2006 and perhaps 1.7% of GDP in 2007. Large capital inflows have more than covered the wider external current account deficit (4.9% of GDP in 2006) and resulted in an accumulation of external foreign reserves to perhaps USD 25 billion by year-end, or almost 4 months of import

Figure 18: Global FDI Inflows to Africa (USD bn)



Source: UNCTAD, EDC Economics.

cover. South Africa remains an "Investment grade" or "BBB+" country – a rare beast on the continent. Both the short and the medium-term outlooks are encouraging. International companies are increasingly of the view that being in South Africa opens opportunities into the rest of the continent.

Despite the presidential elections scheduled for 2007 and the departure of former Finance Minister Ngozi Okonjo-Iweala, Nigeria's macroeconomic performance and outlook have improved significantly compared to a few years ago. The past 18 months have signaled a clear break from past "boom-and-bust" policies. The National Economic Empowerment and Development Strategy (NEEDS), which is a home-grown program in the NEPAD spirit, has served as the ground work for the current IMF program, the Policy Supported Instrument (PSI). Because of strong oil prices, Nigeria appears to have taken on a new seriousness in finding a solution to its external debt problems and making progress with its banking sector reform. Credit rating agencies, such as Fitch and S&P, assigned a "BB-" rating to Nigeria in the first quarter of 2006 (a couple notches shy of investment grade).

Angola's economic potential is unrivalled in Sub-Saharan Africa. It has the third largest GDP and is the second largest oil producer on the continent, after Nigeria. It is aiming for an oil production of 2 million b/d by 2007. GDP growth, which was 20% in 2005, is projected to average 15% a year for the remainder of the decade. It is benefiting from buoyant oil conditions, diamond mining, agricultural earnings and reconstruction. The country has been recording fiscal and external current account surpluses (9% of GDP in 2006 and forecast at 12.5% of GDP in 2007). While accumulating external foreign exchange reserves, Angola has been adamant in following a multilateral approach to regularize its external debt arrears. Bilateral oil-backed credit lines have been concluded with countries like China and Brazil. Little progress has been made with structural and governances issues.

In June 2006, Cameroon was granted a stock of debt treatment under the Enhanced HIPC Initiative. Businesses still face numerous challenges, and foreign investment is held back by poor infrastructure. The liquidity position is better, but the "culture of not paying its bills" needs to improve. While its longer term outlook depends on the country's ability to diversify its economy away from depleting oil reserves, the medium-term outlook has improved with the return of oil-rich Bakassi peninsula from Nigeria. S&P gives Cameroon a "B-" rating. Gabon has also been benefiting from buoyant oil and commodity prices. Far-reaching reforms and the regularization of domestic and external arrears have boosted investor confidence. However, presidential elections in late 2005 led to fiscal slippages and delays in structural reforms. Oil windfalls are a window of opportunity to prepare for the post-oil era. A Chinese consortium led by the China National Machinery and Equipment Import and Export Corporation (CEMEC) has been granted the monopoly for iron ore mining by the Gabonese government and has also been commissioned to build the railway links to the mining site.

New oil fields coming on stream in Mauritania are boosting GDP growth to 18.5% this year and to a projected 13.5% in 2007. Moreover, oil and iron ore earnings are addressing fiscal constraints and brightening Mauritania's outlook. Senegal is accelerating its growth strategy, *Stratégie de croissance accélérée* (SCA), now that the country's debt situation has been resolved. Construction (employment) will boost growth in 2006 and 2007, as it is hosting the Islamic Conference in the first quarter of 2008. Senegal may embark on an IMF PSI program in the face of stronger oil prices. Such a program would provide macroeconomic guidance and also enhance

Table 14: Canadian Foreign Direct Investment (CAD mn)

	2001	2002	2003	2004	2005
Algeria	57	--	3	--	252
Ghana	83	87	98	284	255
Libya	199	198	--	--	--
Mauritius	--	--	12	12	12
Namibia	18	18	18	18	18
South Africa	120	158	120	135	119
Zimbabwe	27	27	27	27	27
Total Africa	**3,435**	**2,804**	**2,209**	**3,252**	**3,035**

Source: Statistics Canada. Data refers to stock of FDI.

creditors' confidence in Senegal.

Ghana celebrates its 50th anniversary of independence in 2007, and presidential and legislative elections are scheduled for 2008, so there are strong pressures to boost GDP growth to close to 6% during 2006 and 2007 and to maintain stable inflation and exchange rates. Ghana has greatly improved its balance of payments position and debt sustainability, but its public sector remains vulnerable and currently cannot borrow on commercial terms. Zambia has been recording robust growth, low inflation and fiscal restraint following the implementation of its Poverty Reduction and Growth Facility (PRGF). Zambia has benefited from the Enhanced HIPC and MDRI. The public sector cannot borrow on commercial terms, but with proper risk mitigants, the private sector can play a vibrant role.

Mozambique should benefit from the second generation of smaller mega-projects, such as the Moma titanium sands mine. Such investments are expected to keep GDP growth over 7.5% during 2006 and 2007. Mozambique's proximity to South Africa offers good business opportunities. Tanzania has been affected by drought, which has put pressures on hydroelectric output. However, it has been considered an African success story. The tourism, agriculture and mining sectors have been offering good business opportunities, and the outlook for Tanzania over the short to the medium term is promising.

Kenya has been registering respectable growth rate of perhaps 4.5 to 5% in 2006 despite high oil prices, corruption and drought. Tourism, manufacturing and transport have been doing well, and the country should benefit from its new seaport to transport Sudan's oil. Kenya's inaction on good governance has led to a suspension of IMF disbursements since 2005 under the PRGF that was concluded in late 2004. Following its Paris Club debt rescheduling in 2004, Kenya's external liquidity position is once more reasonably manageable.

Sudan has been recording high GDP growth and strong export earnings due to oil, but the problems in the Darfur region have made it difficult for the international community to address the country's huge debt arrears. The volatility of the political situation in Côte d'Ivoire, Democratic Republic of Congo and Zimbabwe offer little room for a lasting solution to the serious macroeconomic and financial difficulties of these countries.

5.2.3 Central and Eastern Europe

East-Central Europe is continuing its strong growth performance, with the overall region registering average growth of about 5% this year. In most instances, this growth is the result of various combinations of growing domestic demand, stronger exports, FDI inflows, and – for Russia – higher oil export revenues. The continuing process of trade integration within the enlarged EU-25 and the forthcoming new EU accession countries (Bulgaria and Romania, plus countries with EU pre-accession status) is also fueling growth. Finally, the recent growth spurt witnessed in the core Eurozone – where GDP growth strengthened to 2.6% in the second quarter of 2006 compared with an average of 1.5% for all of 2005 – has also boosted export demand within the continent.

Table 15: Canadian Merchandise Exports to Central & Eastern Europe by Country (2004-2005)

Top 5 Markets	2004 (CAD mn)	2005 (CAD mn)	Growth (2004/2005)
Russia	364	512.4	40.8
Turkey	350.9	450.2	28.3
Poland	203.1	228.7	12.6
Romania	85.7	149.3	74.2
Czech Republic	104.9	130.5	24.4
All others	420.4	561.4	33.5
Total	**1,529**	**2,032.4**	**32.9**

Source: Statistics Canada, EDC Economics.

Still, the emerging structural headwinds resulting from – *inter alia* – the slowing US economy and higher global interest rates – have had a dampening impact on the region's economic growth. Hardest hit have been Turkey and Hungary, with the former undergoing significant financial turmoil in June and July, and the latter's sovereign rating downgraded by Fitch on account of its persistently poor fundamentals. Ukraine is also faring poorly this year as a result of twin external shocks in the form of lower demand for its key exports and sharply higher energy costs. Admittedly, these three countries were caught in a vortex of poor domestic fundamentals combined with structural headwinds. But a protracted deterioration in the international economic environment would affect all emerging markets in the region, to some degree. Already, the three largest economies in East-Central Europe – Czech, Poland, Hungary – have been forced to postpone plans for early EU accession to at least 2009 if not beyond, on account of their inability to fulfill the ERM-II criteria for inflation and fiscal stability in the required time period.

Table 16: Canadian Merchandise Exports to Central & Eastern Europe by Sector (2004-2005)

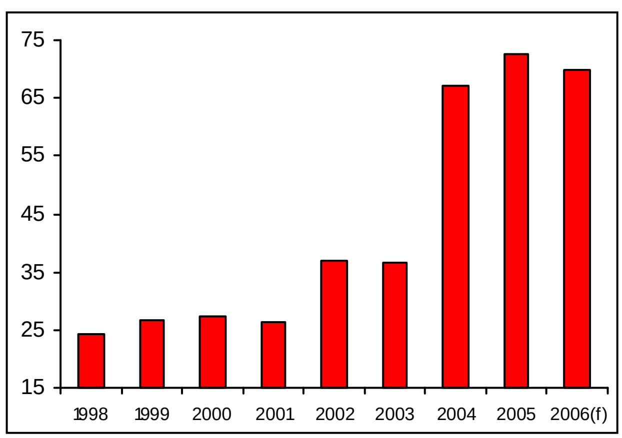
Top 5 Sectors	2004 (CAD mn)	2005 (CAD mn)	Growth (2004/2005)
Other Machinery	161	188.6	17.1
Coal	110	164.5	50.2
Meat, meat preps.	99	163.1	65.6
Computer, electronic equip.	109	151.4	39.0
Agricultural and Construction Machinery	58	129.3	123.7
Total	**1,529**	**2,032.4**	**32.9**

Source: Statistics Canada, EDC Economics.

Growth in the Czech economy rose to 7.4% y/y in the first quarter of 2006, following growth of 6.9% y/y in the fourth quarter of 2005. This expansion is driven by solid (albeit slowing) export growth, mostly due to strong expansion in vehicle export to the EU. Machinery and equipment accounted for at least half of all exports in 2004 – particularly with exports from the Volkswagen-owned Skoda factory. Automotive exports increased further in 2005 with the opening of the new Toyota-Peugeot-Citroen JV, which is ramping up its output to 300,000 vehicles per year in addition to the half-million vehicles from Skoda. Toyota is also building a parts production and distribution centre in the Czech Republic from which to supply all of Central Europe. Canadian exports to the Czech Republic have made strong gains in recent years, with sales reaching $131 million in 2005, a rise of 24.4% from 2004. Export growth has remained strong in 2006 with industrial machinery, telecom equipment and metals posting sizable gains.

The Slovak Republic is continuing its run begun last year as one of the region's economic success stories. Growth in the second quarter of 2006 was 6.6% y/y, more than double the rate of the Eurozone. As a result, our growth estimate for 2006 is forecast at 6.4%, up slightly from last year's 6.1%. Investment and export growth are key ingredients, particularly on the strength of the Korean-based KIA auto plant and French-based Peugeot. A third plant – Volkswagen – is already functioning, and is contributing to the large growth in exports registered by the country so far this year. The country entered the ERM-II Exchange Rate Mechanism (ERMII) late last year as a prelude to complete euro adoption in late 2008 or 2009. Canadian exports to Slovakia fell in 2005 to CAD 18 million from CAD 29 million the previous year. The drop occurred across a broad swath of sectors. Canadian FDI in Slovakia is too small to be broken out individually by Statistics Canada.

Figure 19: FDI Inflows to Central & Eastern Europe (USD bn).



Source: UNCTAD, EDC Economics.

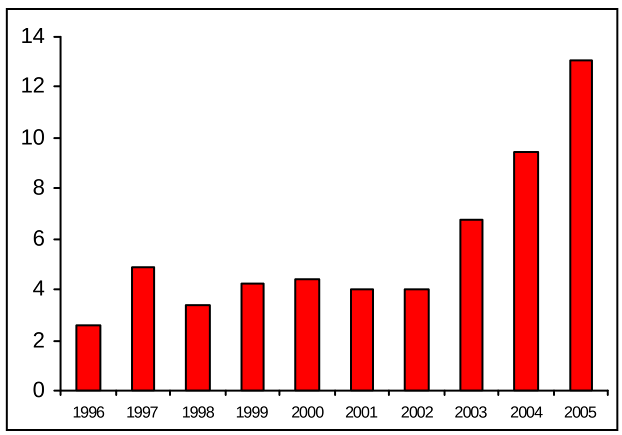
Poland is set to register growth in 2006 of 5.5%, considerably better than last year's 3.4%. Growth is being boosted by a mix of strong FDI inflows attracted by low wage costs, as well as proximity to the EU-15 market. Export growth has been quite strong, too. The country's recent growth spate has been accomplished with no appreciable increase in inflation, which has enabled the country's monetary authorities to stand pat on interest rates from February to early September, following a cumulative

250 bp of cuts previously. Going forward, it is conceivable that the continued strong growth will fuel inflation, forcing authorities to hike interest rates. Looking forward, the country's growth spurt looks set to continue on the strength of growing exports and domestic demand. Canadian exports to Poland in 2005 were $229 million, up from $203 million the previous year.

Hungary's economic performance continues to be dogged by persistent and continuing macroeconomic disequilibrium, particularly in the fiscal aggregates. The country has missed every fiscal target in the past 5 years, and conditions have worsened in recent months on account of the electoral cycle, leading to a significant deterioration of the country's currency, the forint. Net external debt has risen to 44% of GDP; the fiscal deficit is expected to exceed 10% of GDP in 2006, while the current account deficit is also nearing the threshold of 10% of GDP. Late this spring, the newly elected socialist government had to implement strong fiscal cutbacks to reduce the deficit. Tax hikes and tariff increases are expected to boost inflation to 6%, sapping domestic purchasing power and lowering GDP growth to about 2.5% in 2007 before rebounding (somewhat) in 2008. However, the recent package of tax hikes appears more focused on raising tax revenue than structural reforms. Hungary's persistent dual deficits – fiscal and current account – have dogged the country's economic fundamentals, clouded the outlook, and sapped its credit ratings for years. They have now also dashed hopes for Eurozone accession prior to 2012. Canadian exports to Hungary totaled $51 million in 2005, better than the $40 million recorded in 2004, but still below the $97 million recorded in 2003 and $73 million in 2002. For 2006 however, Canadian exports to Hungary are showing some growth, especially for industrial machinery, pharmaceuticals and communications equipment.

Slovenia's economic performance has been robust, with real GDP in 2006Q1 reaching 5.1% y/y, much higher than the previous quarter's 3.7%. Growth was boosted by higher domestic demand (chiefly household consumption) and higher export growth. As a result, the country is set to grow by an estimated 5% in 2006, up from 3.9% in 2005 and 4.4% in 2004. On a positive note, Slovenia has been authorized by the European Council to adopt the euro on January 1, 2007.

Figure 20: Global FDI Inflows to Russia (USD bn).



Source: UNCTAD, EDC Economics.

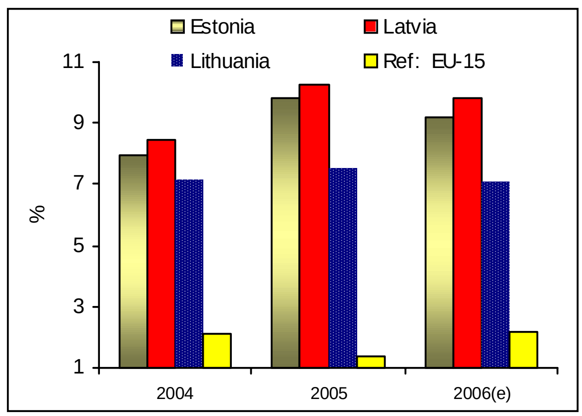
Turkey is continuing its recovery from the 2000-01 financial crisis after weathering a mini-crisis this summer. Indeed, after a 3-year period of almost uninterrupted good economic news, which saw inflation decline to 7.8% y/y in March 2006 from a high of over 60%, the country's economic situation took a turn for the worse in the spring after a spate of poor data releases (rising inflation and worsening external balance figures). This also coincided with the rise of structural economic headwinds, particularly rising global interest rates and a slowing US economy. As a result, international investors pounced on Turkey in early May, selling its stocks, bonds and currency, along with those of many other emerging markets. At one point, Turkish stocks had fallen by more than 30% below their highs, interest rate spreads against US bonds had ballooned by 1.6 percentage points, and the Turkish lira had lost 30% of its value. The central bank raised interest rates by a total of 4.25 percentage points in response, and while there has since been a partial recovery in stocks, bonds and the currency, the episode has left plenty of damage in its wake. Looking into the future, the fact that Turkey weathered the storm as well as it did is indicative of its newfound underlying stability brought about by years of structural and institutional reforms in all economic areas, particularly the banking sector. The country's continuing EU negotiation process is a key underpinning of its ability to converge its economy with the rest of Europe. Canadian merchandise exports to Turkey increased by 28.3% to reach

$450 million in 2005, continuing a steady upward trend seen in recent years. Canadian export shipments so far in 2006 are also showing good growth.

While often overlooked due to its small size, Macedonia has quietly emerged as one of the countries on which a positive economic watch has been placed. Its original rating of BB granted by Fitch has since been upgraded to BB+ by both Moody's and Fitch, on account of both solid economic performance and good performance under the IMF Stand-By Arrangement running from 2005 to 2008.

Preliminary data from Russian authorities shows that GDP grew by 6.3% y/y in the first half of 2006, versus 5.4% for the same period in 2005. As a consequence, the authorities have revised forecast GDP growth for 2006 upward to 6.6% from 6.5%. Oil remains the main driver of the Russian economy, given the country's position as the world's second-largest oil exporter and one of the top three producers. Burgeoning foreign exchange reserves of over $200 billion (the world's third largest) have enabled Russian authorities to prepay Paris Club creditors years ahead of schedule. Continuing high oil prices are expected to result in a baseline GDP growth of at least 5% yearly, along with balance of payments surpluses. However, emerging capacity constraints and bottlenecks will impose progressively more binding constraints on economic growth. This will be exacerbated by structural reforms that are either lagging or postponed. The strong inflationary trend (inflation was about 10% last year) is expected to continue, given its origin in supply-side constraints. Canadian companies continue to grow their export sales in Russia, with shipments rising by 40.8% to reach $512 million in 2005. Canadian export sales are on track to post strong gains again in 2006, with industrial machinery, aerospace components, automotive and meat products taking the lead.

Figure 21: Baltic Tigers–GDP Growth Relative to EU-15



Source: IMF, EDC Economics.

Both Ukraine's economic outlook and creditworthiness continue to be affected by a mixed record of economic policy reform, combined with twin external shocks of steadily higher natural gas import prices from Russia (partly compensated by a hike in transit fees for European-bound gas) and a drop in steel export prices from their 2005 peak. The continuing political uncertainty stemming from the March 2006 election is hindering badly needed economic reform, particularly with a view toward eliminating market-unfriendly institutions. Following the unprecedented growth rate of 12.1% achieved in 2004, economic growth has been reduced to an estimated 2.6% in 2005 and 1.4% in 2006. Growth is expected to pick up again in 2007, although this depends crucially on the success of economic reforms (and thus political will) and the absence of external shocks.

The Baltic countries – Estonia, Latvia and Lithuania – are continuing the strong growth they have recorded in previous years. Recently, these three countries have had to recalculate their national accounts to conform to EU norms, thus affecting the historical series slightly. Still, these countries are still expanding at rates well above those of the EU-15 average. Latvia's GDP growth was the highest of the three in the first quarter of 2006 at 13.1% y/y, followed closely by Estonia's (11.7%) and Lithuania's (8.6% for first half of 2006). In all three cases, growth is coming from rising domestic demand aided by growing exports – mostly to Russia as well as the EU. Growth for the Baltic region as a whole is estimated to average 8.6% in 2006, slowing somewhat to around 7% in 2007.

Central Asia

Most Central Asia countries are expected to fare well in 2006 and 2007, especially countries endowed with oil and natural gas reserves or metallic mineral deposits. The vast majority of these countries will also experience high inflation because of increased consumer demand and governments spending their newfound riches. As a result, central governments' fiscal position will remain either balanced or slightly negative. Outside the mining sector, foreign direct investment in the region will be limited, as political instability will continue to drive away many potential investors. While still small, Canadian exports to the region have significantly increased over the past few years, from $50 million per year in the late 1990s to $182 million last year. In the first half of 2006, Canadian exports in Central Asia were up 1.6% over the same period last year, with increases in Kazakhstan (+16.8%), Azerbaijan (+63.8%), Kyrgyzstan (+204.8%) and Georgia (+22.5%) being partly offset by declines in Turkmenistan (-46.2%), Mongolia (-44.8%), Uzbekistan (-64.5%) and Armenia (-35.2%).

Kazakhstan's economy will continue to expand at a rapid pace in 2006, mostly on the strength of new investment projects in the oil and gas sector. After the first 6 months of 2006, real GDP was 9.3% higher than during the same period last year, which is on par with 2005's increase of 9.4% and slightly lower than the 10.2% annual average growth rate of the previous 6 years. The government's strategy of diversifying oil export routes has generated the extensive development of oil infrastructures, and as a result, construction activity continues to advance furiously. The construction industry grew 37.6% y/y during the first 6 months of the year, as capital investment was 25% higher. The inflow of oil revenues has allowed the central government to expand expenditures and still show positive balance sheets, but has also contributed to the high inflation rate, which the central bank has been unable to rein in so far. Recent data show inflation running between 7 and 8% y/y, above the National Bank of Kazakhstan's target range of 5.7% to 7.3%. The early-year strength had an impact on Kazakhstan's currency, the tenge, which appreciated by more than 9% versus the US dollar at its peak in late July. Since then however, the tenge has retracted most of these gains, losing more than 6% of its peak value. For 2006, real GDP is expected to grow 8% and accelerate to 8.5% in 2007, the year when Kazakhstan should join the WTO.

Azerbaijan is expected to see exceptional GDP growth in 2006 and 2007, of over 20% each year, thanks to higher oil exports, which are now facilitated with the opening of the Baku-Tbilisi-Ceyhan (BTC) pipeline, and the ongoing development of the Caspian Sea oil fields. Armenia will continue to perform well in 2006 and 2007, thanks largely to a mining-related construction boom, significant investments in the transportation and communications sector and the benefits of having low and stable inflation, a rarity in Central Asia. Year-over-year growth during the first half of 2006 was estimated at 11.9% and should maintain the pace as long as metal prices hold. In Georgia, growth in 2006 and 2007, forecasted at 6.5% and 5% respectively, will be boosted by the government's efforts to bring the underground economy out of the shadow, in conjunction with tax reform. The government will also benefit from transit revenues from the BTC pipeline.

Turkmenistan, Tajikistan, Uzbekistan, Kyrgyzstan and Mongolia will all see fairly strong economic growth in 2006 and 2007, coupled with moderate to high inflation. Elevated prices for hydrocarbons (Turkmenistan and Uzbekistan) and base metals (Tajikistan and Mongolia) will result in greater exports and additional investment in the development of mining and oil and gas infrastructure. At the same time, increased government revenues stemming from these sources have, in most cases, encouraged additional public spending and reduced the incentives for market reforms.

5.2.4 Latin America

This year will be another strong year for Canadian exports to Latin America. Year-to-date, exports to the region are up nearly 30%, and 5 of the top 10 markets are on a record pace. EDC Economics projects ongoing stability in Latin America despite an outlook of slower global growth, higher global interest rates and high oil prices. A US recession would add additional downside risk to our outlook but is presently assigned a probability of 30%. Moreover, a recession in the world's largest consumer market would have varying impacts country by country. Mexico and the Caribbean would likely be the most negatively affected. Although history reminds us that no investor/exporter should become complacent, Latin markets are better suited to handle the downside of this and future global business cycles than of those in the past. This is the result of improved inflation fighting credibility and a significant build in hard currency reserves. Moreover, respective governments have generally lowered their external indebtedness via large-scale debt buybacks, while smoothing debt repayment profiles and improving currency and interest rate dynamics. Although the trend of credit upgrades is ending, downside risk looks manageable from a credit perspective, with some exceptions.

Table 17: Canadian Merchandise Exports to Latin America by Sector (2004-2005)

Top 5 Sectors	2004 (CAD mn)	2005 (CAD mn)	Growth (2004/2005)
Wheat Farming	785.8	666	-15.2
Paper Mills	622	641	3.1
Animal Slaughtering and Processing	651.7	545.4	-16.3
Motor Vehicle Manufacturing	459.7	539.4	17.3
Oilseed (except Soybean)	422.3	530.7	25.7
Total	**6,664.6**	**7,467.3**	**12.0**

Source: Statistics Canada, EDC Economics.

Table 18: Canadian Merchandise Exports to Latin America by Country (2004-2005)

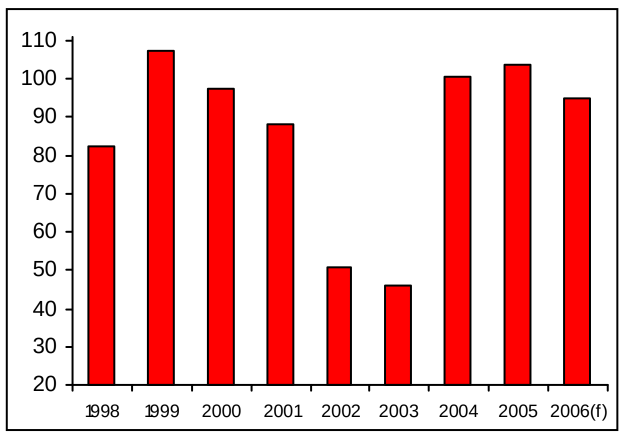
Top 5 Markets	2004 (CAD mn)	2005 (CAD mn)	Growth (2004/2005)
Mexico	2,871.3	3,110.4	8.33
Brazil	917.2	1,060.8	15.66
Venezuela	478.8	510.8	6.68
Colombia	363.7	379.9	4.45
Chile	336.8	372.9	10.72
Others	1,696.7	2,032.4	19.79
Total	**6,664.6**	**7,467.3**	**12.0**

Source: Statistics Canada, EDC Economics.

Mexico

Despite politically themed headlines dominating international newspapers, Mexico's economy is doing quite well. Moreover, so far in 2006 Canadian exporters have benefited with exports up 44% y/y on broad-based gains. The outlook is for much slower export growth over the forecast horizon; nevertheless, we believe the market represents a relatively stable market for Canadian companies. There are several risks to the outlook. Namely, tightening global monetary conditions, ramped up political noise and most importantly the potential for a US recession.

Figure 22: Global FDI Inflows to Latin America (USD bn).



Source: UNCTAD, EDC Economics.

From an economic risk perspective things are as good as they are going to get. Central bank credibility is at an all-time high, oil prices (and therefore government accounts) are in great shape, credit growth remains solid and employment gains high. Thanks to solid macroeconomic fundamentals the impact of political noise and recent global financial volatility has been mitigated. While our basecase scenario calls for a stable peso, moderate domestic interest rates and a generally favourable domestic climate, these risks mean more frequent market surveillance is warranted. A US recession would quickly translate into more generalized weakness in Mexico.

Mexico is an investment grade market and is unlikely to lose this status; however, failure to advance the reform agenda over the next 2 years could prompt a reversal in the trend of Mexico's credit quality. China and other emerging market economies represent an ongoing threat to a do-nothing scenario for Mexico as the country's competitiveness will be eroded. Another threat could come from falling oil prices to which the sovereign is significantly exposed (36% of government revenues are oil related).

Demand for consumer goods will be supported by improved employment, expanding consumer credit, a housing boom and strengthening family remittances. Manufacturing output should continue to expand, benefiting Canadian exporters of raw materials, intermediate goods as well as machinery and equipment. The sector is facing intensifying competitive pressures from globalization, prompting it to seek productivity enhancing investments. A massive expansion in the auto sector will slow in 2007, but recent investments highlight the fact that Mexico continues to have competitiveness offerings for the industry. Finally, overall growth and globalization will stimulate demand for transportation equipment and more generalized infrastructure investment.

Brazil

Since the market turmoil that accompanied the 2002 elections, Brazil has witnessed its strongest expansion in a decade. Spending and inflation continue to best official targets, allowing interest rates to threaten single-digit territory. Bond spreads are down below 225bbps, and the real has appreciated by an impressive 45%. In addition, prudent debt management has helped improve the composition and size of the country's public debt burden. Domestic market financing and enhanced global liquidity have allowed the government to buy back and retire costly obligations, smoothing out its amortization schedule, improving its currency matches, and effectively canceling all IMF obligations. Brazilian corporates too have been financing their operations using retained earnings, domestic issuances and real-denominated external debt.

In sharp contrast to the last election, Lula's strength in the polls seems to prompt a favorable response from financial markets in the run-up to October's presidential election. While questions over last year's corruption scandals continue to dog the President, he is expected to carry the vote. Aside from macroeconomic stability, broad social improvements and some success on microeconomic reforms underpin the achievements of the first Lula administration. However, there is concern that a reinvigorated trade union movement, and the likelihood of facing a more fractured congress, would give way to a slightly more relaxed economic policy. This would make it almost impossible to push through essential social security and public sector reforms.

Improving employment and rising real wages are boosting purchasing power and fueling private consumption. Domestic industry is also taking advantage of the stable real and declining interest rates to catch up on much-needed investment. Furthermore, Brazil's economy appears well-insulated from a global slowdown, with the US making up only 20% of its export market. This trend has paved the way for considerable opportunities for Canadian exporters – particularly in consumer goods, where imports advanced by 33% y/y in the first 7 months of the year. The country's legacy of underinvestment has also created significant opportunities for Canadian investors. In 2005, Canadian FDI stock in Brazil was CAD 8 billion, up 15%. But new entrants into the market should expect to find a much more competitive field than ever before, with a handful of corporates even rated above the sovereign, including CVRD and Petrobras.

Southern Cone

The favourable external environment in 2005 helped keep the recovery on track in **Argentina**, as domestic demand regained its footing. While GDP continues to post strong gains this year, the sources of growth are shifting away from external demand. This trend will only intensify as global demand and commodity prices pull back. The concern, however, is that growing reliance on domestic drivers is making the economy more vulnerable to another downturn, in light of emerging imbalances and the Kirchner administration's increasingly heterodox policy response.

The creation of ENARSA[7] and plans to invest in offshore exploration will do little to address energy supply issues next winter, especially given recent events in Bolivia, which could curtail energy sales to Argentina. Meanwhile, a series of regulatory measures will give only temporary relief to consumers, as demand-generated pricing pressures continue to build.

For Canadian companies eager to do business in the Plata Republic, the time is now. Imports were up by 16% y/y in the first 7 months of the year, led by a 41% increase in foreign passenger vehicle purchases. In addition, given the country's need for additional capital accumulation, and the availability of competitively priced assets, opportunities still exist for the discerning investor. Net FDI, which dropped 83% between 1996 and 2003, has begun to return. Government interference, however, continues to distort the market, cloud the business environment, and undermine profitability in many sectors. Investors are encouraged to seek out opportunities in areas that have little weighting in the CPI, for example, such as the mining sector.

Chile's economy continues to profit from the persistence of high commodity prices. Copper, the country's main commodity export, reached a record high of USD 8,800/mt this past summer. In spite of the tighter monetary environment, domestic demand remains the lead driver. Export revenue is generating solid investment trends and healthy public spending, while the strong labour market continues to power household consumption. A retrenchment in global commodity prices would take a little off growth going forward, but the country's sound economic framework would likely survive any reasonable correction. With benign debt ratios and adequate reserve levels, the government does not face any liquidity concerns, even if copper prices erode significantly. The Bachelet administration must, however, address the issue of potential growth, as the output gap narrows, by reviving productivity-enhancing reforms. A more immediate concern is the energy shortage that threatens the Southern Cone. Hydroelectric potential and plans for an LNG processing plant near Santiago could help alleviate the strain.

The country's mature economy has encouraged the many Canadian companies present in Chile to continue pursuing opportunities there, especially in the mining sector. Canadian investment stock reached almost CAD 6 billion in 2005, facilitating a 20% y/y increase in Canadian exports to Chile in the first 6 months of this year. Urgent need will require further development in the energy sector going forward, presenting Canadian companies with an important opportunity. There will also be strong demand in the pulp and paper and forestry sectors, other areas of considerable Canadian expertise. Doing business in Chile, however, requires constant attention due to a sophisticated and aggressive business environment. International competition remains fierce, making it extremely challenging for Canadian businesses.

Andean

Like the rest of Latin America, the resource-rich Andean countries are benefiting from strong commodity pricing. **Venezuela** led the pack in 2006Q1, with growth of 9.4%, after posting a convincing 9.3% gain in 2005. Despite the fact that the country continues to produce below its OPEC quota, high oil prices are generating funds that are trickling down to the domestic economy. **Colombia**'s favourable domestic conditions combined with healthy global demand laid the ground for 5.2% growth in 2006Q1, a 16th consecutive quarter of growth. This is expected to continue over the forecast horizon, on the strength of strong policymaking, improved security conditions and a new US free trade agreement (FTA). **Ecuador**'s economy continues to disappoint in light of record oil prices, as production declines at Petroecuador and capacity constraints facing foreign oil companies weaken the country's petroleum sector. The new hydrocarbons law and fallout from the Occidental affair will continue to damage crucial investment prospects. In addition, with the expiration of the ATPDEA (Andean Trade Promotion and Drug Eradication Act) at year-end, Ecuador will lose preferential access to the US market.

[7] ENARSA is the Energía Argentina Sociedad Anónima – a state-run oil and gas company founded in 2004 in response to the energy crisis that was caused (in part) by a lack of investment of the private fossil fuel companies.

Economic activity in **Peru** has remained strong so far this year, up almost 7% y/y in Q1, as favourable external conditions finally translated into higher disposable income and growing employment. Escalating consumer confidence is encouraging household consumption and investment just in time to take over from strong commodity prices. President Garcia is expected to maintain good relations with foreign investors, despite some grumblings about a re-negotiation of the US FTA. Mixed messages out of La Paz suggest that the newly elected government in **Bolivia** is looking to keep the door open to trade and investment while pandering to radical domestic sentiment. Indeed, the government appears to be seeking an extension of the ATPDEA[8]. However, the nationalization of the natural gas sector and pledges on land reform would seem to indicate that the role envisioned for foreign companies is very limited.

Canadian exporters, which saw a 7% y/y increase in merchandise export sales to the region over the first half of the year in 2006, can expect demand out of the region to pull back slightly, in line with commodity prices. Investors in the region will require the appropriate due diligence in order to navigate a sometimes precarious business environment. But those that have the appetite and expertise will find significant potential, especially in the resource-based sectors.

Central America and Caribbean

Costa Rica remains the only participant to have not yet ratified DR-CAFTA (Central America Free Trade Agreement – Dominican Republic). The deal has already entered into force for **El Salvador**, **Honduras**, **Nicaragua** and **Guatemala**, boosting those countries' economic prospects. Once the remaining partners are able to adopt the necessary regulatory and legislative framework and implement the agreement, there is hope that they will return to the negotiating table with Canada. Canadian exports to Central America grew by 24% in the first six months of 2006. As industries in this region continue to expand and transform, Canadian exporters should be able to post growth in their exports, while investment opportunities will emerge. Examples of potential growth areas in Central America include the expansion of the telecom infrastructure throughout the region, Costa Rica's high tech-sector and the proposed Panama Canal expansion.

Within the Caribbean, **Cuba** will undoubtedly hold the spotlight. Fidel Castro's temporary handing over of power to his brother Raul has reignited discussions of transition. On the assumption that Fidel returns to power in the near term, Canadian exports should see moderate to strong growth over the forecast period (since stability would be maintained under a Castro regime). Cuba's economy continues to grow, thanks to financing support from China and Venezuela in particular, along with improved access to short-term financing. The **Dominican Republic** is booming with 2006Q1 GDP growth at 12.6% y/y, foreign investment surging, and the peso holding steady. Demand for Canadian goods and services should prove strong over the forecast but the outlook remains vulnerable to confidence shocks. In **Jamaica**, real GDP growth could breach 3% this year and next – the first time in over 20 years – boosted by investments in tourism and resources. The currency has been stable, but significant increases in currency volatility are a persistent possibility. Fiscal challenges are expected to increase in 2007, of particular concern considering roughly half of government revenues are needed to service the country's public debt.

Table 19: Canadian Merchandise Exports to Developing Asia* by Sector (2004-2005)

Top 5 Sectors	2004 (CAD mn)	2005 (CAD mn)	Growth (2004/2005)
Pulp	1,404.6	1,132.7	-19.4
Chemicals	887	957	7.9
Metals and Metals Manufacturing	714.7	932.3	30.4
Wheat Farming	1,059.4	671.1	-36.7
Recyclable Metals	210.2	337.5	60.6
Total	**9,419.4**	**10,260.4**	**8.9**

Source: Statistics Canada, EDC Economics.
*Developing Asia refers to all Asian countries except Japan, Hong Kong, Singapore, South Korea and Taiwan.

[8] The ATPDEA is the Andean Trade Promotion and Drug Eradication Act, an act signed in 2003 by President Bush which provides duty-free trade benefits to the Andean countries of Colombia, Ecuador, Bolivia and Peru, in exchange for cooperation in the war on drugs.

5.2.5 Asia

South and Southeast Asia

The impact of a slowdown in the US, high energy prices and tightening monetary policy will temper growth in the sub-regional economies of South[9] and Southeast[10] Asia in 2007, adding to the moderation that is forecast for the final months of 2006. As domestic demand slows, growth will be led by exports but at a lower rate due to the forecast deceleration in the US economy. However, since this region is integrated into the global supply chain, it will also be driven by strong demand from China, Japan and intra-regional trade. To offset any decline in consumer demand, many Asian governments may start investing in infrastructure projects to boost economic growth. One potential upside risk to our growth projection stems from any unanticipated pick-up in corporate investment in industrialized countries that will improve demand for the region's exports and underpin stronger economic growth.

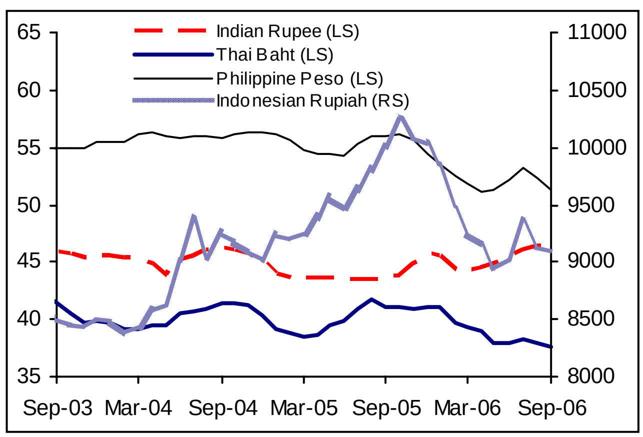
Table 20: Canadian Merchandise Exports to Developing Asia* by Country (2004-2005)

Top 5 Markets	2004 (CAD mn)	2005 (CAD mn)	Growth (2004/2005)
China	6,041.5	6,620.0	9.6
India	811.4	1,030.8	27.0
Indonesia	646.2	678.5	5.0
Thailand	456.9	426.7	-6.6
Malaysia	393.1	346.5	-11.9
All others	1,070.4	1,157.9	8.2
Total	**9,419.4**	**10,260.4**	**8.9**

Source: Statistics Canada, EDC Economics.
*Developing Asia refers to all Asian countries except Japan, Hong Kong, Singapore, South Korea and Taiwan.

Demand for resources will remain high and if inflationary pressures do not abate, Asian central banks will continue to respond with interest rate hikes – also considered necessary to maintain an interest rate differential with the US to prevent any capital flight. Although US short-term interest rates are currently "on hold," many Asian central banks may need to keep raising interest rates. In India, the authorities are maintaining a policy of slowly raising interest rates, reflecting concerns about controlling inflation and growth in domestic credit. In Thailand, authorities seem to suggest that they have achieved their objective of raising interest rates to a normal level, but they may raise them further over the near term if inflation rises higher than anticipated. Indonesia is the outlier as it is lowering interest rates to sustain GDP growth. After aggressively raising its benchmark rate in the second half of 2005, the Indonesian central bank started cutting the rate over the past summer, to 11.75% by August. In a recent press release the central bank hinted that there may be further interest rate cuts this year in order to boost economic growth as long as inflation remains contained. The senior deputy governor has stated it could come down to 10% by year end.

Figure 23: South & Southeast Asian Currencies vs. USD



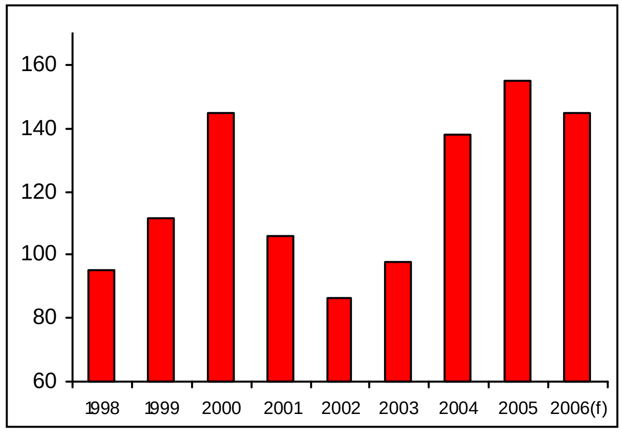
Source: Bloomberg

Rising interest rates have created upward pressures on the region's currencies vis-à-vis the US dollar. Stronger currencies do have the benefit of reducing the import bill – particularly for oil. While some countries' exchange rates have appreciated over the past year (as of September, Thailand's currency is up 9% while Indonesia's rupiah is up 8% against the USD), there has been little change in the exchange rate of China and Malaysia. In the case of Malaysia, authorities there removed the US dollar peg in July 2005. Although China adopted a more flexible trading range for its currency in June of last

[9] South Asia includes India, Afghanistan, Bangladesh, Pakistan and Sri Lanka.
[10] Southeast Asia includes Indonesia, Malaysia, Philippines, Thailand and Vietnam.

year, the range remains quite narrow and the currency has appreciated only by a couple percentage points in the past year. This is in turn having an impact on the magnitude of the appreciation of other countries' currencies due to the regional interdependence and concerns about losing any competitive edge. However, many people believe that Asian currencies are "artificially undervalued" so as to boost their exports. This belief is strengthened by the continued trade surpluses and massive accumulation of foreign exchange reserves. As such, foreign exchange intervention will probably continue, and exchange rates will be managed (toward the downside) in order to support exports.

Figure 24: Global FDI Inflows to Asia (USD bn).



Source: UNCTAD, EDC Economics.

As global interest rates have moved higher – particularly those in the US – we are likely to see increased pressure on those economies that have a large proportion of their external debt denominated in foreign exchange. For South and Southeast Asia, this is particularly true of the Philippines, Indonesia and Pakistan. A higher level of global interest rates typically favours currencies of economies that have a large current account surplus. However, despite attempts to keep their exports competitive by not letting their currencies appreciate, the current account surpluses of some countries in Asia are shrinking or even becoming deficits as imports (particularly energy and other commodities) become more expensive. But the risks could be greater for the open economies of Asia if they allow their currencies to strengthen since this would make their exports less competitive (although imports would be cheaper). Under this scenario, demand would shift away from domestically produced goods toward less expensive imports – a situation with the potential to reduce economic growth in the region, at least over the near term. Over the medium to longer term, regional economies would eventually adjust to any appreciation in their currencies.

The region is not only a large net oil importer, it is also a comparatively energy inefficient one. Sustained high oil prices will act as a drag on Asian economic growth, but the region should cope without suffering a large slowdown or financial crisis. Various factors will cushion the oil shock – such as workers' remittances, strong capital inflows and trade surpluses. Oil prices did not make a large dent on regional growth in 2005 since fuel prices were either directly or indirectly subsidized, shielding consumers and producers. However, as subsidies become increasingly unsustainable from a fiscal standpoint, many countries have started phasing out price controls. In India, as some subsidies remain intact, the full effect of international energy prices passing through to domestic prices is incomplete, unlike in Indonesia and Thailand where rising oil prices did affect growth. If oil prices stay high or go higher and governments do not adjust policies appropriately, Indonesia and the Philippines would be most prone to instability.

One upside to our forecast for the region comes from the potential for a significant injection of government spending – particularly on infrastructure – that has been stalled in some countries due to domestic politics. In Thailand, political uncertainty following the spring elections has meant that investment in large-scale infrastructure projects such as the USD 40 billion "mega-projects" program are on hold. So far, the military coup in Thailand has had little impact on that country's economy. However, we do believe investment and economic activity will be curtailed somewhat, which has led us to downgrade our GDP growth forecast to around 4.0% in 2006 and 3.8% in 2007.

Upgrading and expanding India's inadequate infrastructure has emerged as a key objective for the government. The government has announced a program that calls for increasing infrastructure spending from 4.5% of GDP a year to 7 to 7.5% a year over the next 5 years, a

USD 150 billion program. Malaysia may introduce a stimulatory budget in 2007 that increases public spending by USD 10 billion on infrastructure and development projects to offset the decline in consumer spending.

Table 21: Quarterly GDP Growth in Select Asian Countries (y/y % change)

	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
China	9.9	10.1	9.8	9.9	10.3	11.3
Indonesia	5.6	5.7	5.4	4.7	4.7	5.2
India	8.6	8.5	8.4	7.5	9.3	8.9
Malaysia	6.1	4.1	5.3	5.2	5.5	5.9
Philippines	4.7	5.4	4.8	5.3	5.7	5.5
Thailand	3.2	4.6	5.4	4.7	6.1	4.9
Hong Kong	6.0	7.2	8.2	7.5	8.0	5.2
South Korea	2.7	3.2	4.5	5.3	6.1	5.3
Taiwan	2.5	2.9	4.2	6.4	4.9	4.6

Source: Bloomberg

Table22: Stock of Canadian FDI in Major Asian Markets (C$ mn)

	2001	2002	2003	2004	2005
Hong Kong	3,020	2,642	2,812	2,924	3,804
Singapore	4,493	4,228	3,703	3,577	3,551
Indonesia	2,524	4,193	3,436	3,248	3,171
China	699	721	824	1,003	1,017
South Korea	725	749	698	1364	779
Malaysia	636	718	435	666	667
Thailand	984	1,108	923	507	554
India	145	222	207	217	204
Taiwan	146	66	72	175	149
Philippines	410	153	117	119	145

Source: Statistics Canada.

Canadian Exports to Asia

Canadian exports to the region are growing by double-digit rates in line with the region's ongoing demand for commodities, industrial machinery, and all the parts and components used in manufactured goods. From January to June, Canadian exports to South and Southeast Asia have grown by 11% y/y after growing by 8% for all of 2005. Exports to India continue to lead all other countries. However, in the first 6 months of 2006 exports to Malaysia are up 26%, Pakistan by 15%, Sri Lanka by 170% and Bangladesh by 185%. Exports to these sub-regions continue to be led by wheat, pulp and paper, fertilizer, oilseeds, special crops, metals and minerals, aerospace parts as well as electronics and semi-conductor parts. Of note were the decline in Canadian exports to Indonesia (-2%), Thailand (-3%), and Viet Nam (-14%). The drop in Canadian exports to these three markets was due to a 12% decline in wheat and 24% decline in fertilizer exports to all three markets, as well as a 42% decline in construction machinery to Indonesia and a 16% drop in seafood products to Thailand.

After Canadian merchandise exports to India crossed the $1 billion mark for the first time in 2005, they are on pace to exceed this performance in 2006 as they are up 25.6% y/y in the first 8 months of the year. Service exports add an additional estimated $300 million to this total. The top sectors for exports to India continue to be pulp and paper, diamonds, special crops and fertilizer. However, strong growth is also being seen in manufactured goods such as navigational and medical instruments, telecom parts and industrial machinery.

India – outlook remains strong

Due to the strength of domestic consumer spending, an improvement in the investment climate and robust export growth, India's economy is expected to grow by 7.5 to 8% in 2006/07 after it recorded growth of 8.4% in the fiscal year that ended March 31, 2006. There is sufficient momentum to sustain real GDP growth at 8% in 2006/07, but it may moderate to 7% in 2007/08 in response to high oil prices and the central bank's gradual monetary tightening. Economic growth is also being driven by the manufacturing and services sectors. Manufacturing, which accounts for 15% of GDP, is trending toward 9% growth annually. The construction industry is being helped by growing investment in infrastructure. In August, the credit rating agency Fitch raised India's sovereign rating to investment grade (BBB-) due to an improvement in public finances at the federal level. Although many consider this upgrade long overdue, it may help to attract higher levels of foreign direct investment flows over the near term. The main risk to our forecast comes from the potential for rising interest rates along with the spring's sharp correction in stock prices to dampen consumer spending. A more pronounced downturn in the global economy (perhaps sparked by a "hard" US landing) also creates some downside risk for the Indian economy.

China's economy on a roll – authorities attempting to rein in growth

China's growth continues to impress – advancing just shy of a torrid 11% y/y pace in the first half of 2006. GDP expanded at an average 10% clip in 2003 to 2005. The Chinese statistics were upwardly revised late in 2005 to more accurately reflect the service sector's contribution. Regardless, this heady pace of economic expansion, specifically led by business investment that has recorded double-digit gains since 2001, has boosted employment and subsequently consumer spending growth. Net exports also remain a solid contributor to the stellar performance over the past few years. Although consumer price inflation eased a notch in 2005 from the preceding year, high energy costs are forcing price pressures to once again build. A key concern linked to this impressive economic performance is the potential of an overheating followed by a subsequent hard landing. But the authorities are taking action to stem a boom in fixed asset investment, which is growing at a 30% y/y pace, due largely to foreign manufacturers taking advantage of China's large and relatively lower-wage labour pool. Interest rates have been increased while banks' reserve requirements have also been raised in order to restrict lending to industries deemed to suffer from "overcapacity." Meanwhile, government consumption has been expanding at a more subdued 6% pace – half of the 10 to 12% clip recorded in 2000 and 2001 – as the fiscal deficit has been narrowing.

EDC Economics expects China's GDP growth to clock in a fairly robust 10.0% this year, followed by a somewhat softer 9.1% pace in 2007. The government will continue to do its part as it scales back or delays new projects and directs investment toward less overheated sectors. However, as alluded to earlier, there are risks to this outlook. Namely, a too rapid pace of expansion is forcing interest rates higher, which has implications for domestic demand growth. Higher rates could also lead to challenges within the banking sector should there be a sharp spike in non-performing loans (NPLs) and insolvencies amongst private sector borrowers. Official statistics put NPLs at about 7 to 8% of GDP, although some China analysts speculate that they are significantly higher than official figures suggest (perhaps as high as 40% of GDP). Finally, a sneeze in the US economy – now entering a slower growth phase – could translate into a cold in China due to China's increased globalization of late. Indeed, the US now accounts for almost 30% of China's merchandise trade, almost double the share of 1995. Further, total merchandise trade accounts for 63% of China's GDP, compared with 33% in 1995. But, China also ships a sizable portion of its exports to other Asian counties (like Hong Kong, South Korea and Japan) that are entering a slower growth phase, some of which (Hong Kong, South Korea) are also highly trade dependent – suggesting that the economic domino effect that is unfolding in Asia could be more severe than first glance would suggest.

Over the past 5 years, China witnessed double digit export growth, shipping just under USD 2.4 trillion in goods to the rest of the world over this period with manufactured goods accounting for about 90 to 95% of the total. By the same token, merchandise imports have surged – amounting to over USD 2 trillion over the past 5 years – with raw materials and manufacturing equipment posting solid increases. Canada has also benefited from this rapid pace of Chinese demand growth as merchandise exports to that country have grown at a 14% clip over this period to over $7 billion last year. Key Canadian export growth sectors were raw materials and machinery and equipment. Looking ahead, EDC Economics expects Canadian export sales to China to advance an estimated 2% in 2006 and by 7% in 2007. Though a severe slowdown in China's economy is not forecast, slower GDP growth (as outlined in our alternative downside scenario) could well mean that Canada's exports to China would come under pressure in 2007 before starting to recover in 2008.

5.3 Developing Markets Conclusion

The economic and financial outlook for developing countries is becoming increasingly uncertain as 2006 winds down. Slowing growth in the US, Eurozone and Japan will have a knock-on effect across the developing world. At this point, it is difficult to gauge the full extent of the slowdown we are expecting for emerging markets. The global economy has become highly integrated so that a downturn in the US will almost certainly spread throughout developing markets – the domino effect on a global economic scale. That said, many emerging markets have greatly improved their financial situation and diversified their economies, which will help them weather any slowdown emanating from the US and other industrialized economies. Either way, Canadian companies should be prepared for a more difficult operating environment in 2007. Financial market volatility, higher risk premia and slower sales growth in these markets should be part of companies' business plans.

Canadian exports to many developing markets made significant gains in 2006, building on the even stronger performance of 2004 and 2005. We can expect to see additional export growth for many of these same markets over the coming year, although the pace of growth will slow from the double-digit gains of the past 3 years to around 6%. Longer term, rising consumer demand, higher levels of industrial production and increased business investment will see developing markets importing more goods and services. At the same time, a growing middle class and the resulting rise in disposable incomes should allow consumer goods and higher value-added products gain a bigger share in these countries' imports.

POLITICAL RISK OVERVIEW

6.0 Political Risk Overview: Status quo no longer - new realities for investing abroad

Introduction

In the years between the early 1980s and late 1990s foreign direct investment (FDI) into emerging markets settled into a more or less comfortable and predictable pattern. Developing country governments – many of them cash strapped and reeling from the negative effects of ill-considered nationalizations in the 1960s and 1970s came, to varying degrees, to see inward foreign direct investment as not only tolerable, but as essential to improving their countries' economic development prospects. At the same time investors, the great majority hailing from Western countries, shook off the sting of expropriations and debt crises and resumed their global search for lucrative opportunities in the developing world – albeit somewhat more cautiously than before.

With many countries seeking limited amounts of Western capital and expertise, a *de facto* competition among recipient jurisdictions began to emerge. Attracting FDI became a major task for government, and success in luring fickle Western firms to one's territory became as much a function of policy environment as of resource endowments. In short, the countries that created conditions that allowed Western firms and their financial backers (capital markets, bankers, etc.) to meet their business goals and feel relatively secure in the process were successful: others less so.

From this competitive process a set of norms began to evolve. Privatizations, open markets, national treatment, transparency of process, sanctity of contracts and a host of other measures were viewed as "investor friendly" and encouraged (or demanded) by Western firms, their home governments and financial institutions such as the IMF and World Bank. Developing countries' commercial, legislative and regulatory regimes came to resemble (on paper, at least) those of the investors' home countries and almost every developing county government listed economic reform at or near the top of its list of priorities.

Over time, many Western investors came to regard this evolution as the "way the world worked". Of course, not everything went as smoothly in practice as on paper – there were still plenty of investment-related disagreements and disputes – but, on the whole these were seen either as aberrations or issues that would work themselves out once the country in question 'caught up' or 'bought in' to the emerging global consensus.

Recently, this sense of comfort has given way to trepidation as political developments in many regions of the world have run counter to investors' assumptions. In some places reform programs have slowed or stalled, investors' contracts have been unilaterally altered by host governments and in others Westerners' assets have been seized or nationalized in moves reminiscent of the worst of the bad old days of decades past. For Western investors, accustomed to more or less steady movement in the opposite direction, these developments have come as a shock.

Many in the investment and financial communities have focused on a single driver for these changes. More specifically, they hold that the commodity price cycle, at or near the top of its historic range, has driven opportunistic governments to take actions detrimental to Western investors' interests. Furthermore, they contend, that as prices return to more traditional levels, the emerging market investment environment will revert to past practices and that such detrimental actions will be diminished or reversed.

The following piece examines some of the investment-related developments in a number of emerging markets in which Western investors have a significant interest and attempts to evaluate the reasons behind them. It concludes that host governments' recent moves are motivated by a variety of ideological, political and commercial factors rather than high commodity prices alone.

POLITICAL RISK OVERVIEW

Nationalism in Latin America grabs headlines but less dramatic changes are also on the agenda…

If there was any lingering doubt that some Latin American countries present challenges for Western investors, 2006 is the year when the actions of several governments removed much of the uncertainty. Yet, the drivers behind these actions are as diverse as the countries themselves, and together they illustrate the many facets of Latin American political philosophy and approach to globalization.

In a broad brush review of Latin America, it is common currency to speak of leftist, populist governments that reject globalization in favour of a socialist revolution. Indeed, unfulfilled promises of the 1990s that neo-liberal policies and privatization would address rampant poverty across Latin America has led to widespread, popular disillusionment with the Western economic model. Politicians across the region have exploited this popular sentiment for their own political gains, enabling many of them to rise to power. However, the Latin American populist politician is not a homogeneous being. Each country plots its own course as its government attempts to consolidate the diverging interests of the foreign investment community and its nationalist constituency. As such, the resulting impact on the foreign investment environment varies significantly from one country to the next.

In **Argentina,** the government of Néstor Kirchner is extremely inward-looking. Having inherited a country emerging from an economic crisis largely blamed on the free-market policies of previous governments, Kirchner prioritized the short-term interests of his constituency with nationalist policies detrimental to the contractual rights of foreign investors. Examples include the imposition of price controls on basic goods, utility tariff caps and export controls. On the one hand, these policies have proven successful in controlling inflation, maintaining the government's popularity and paving the way for Kirchner's re-election in October 2007. On the other hand, they have significantly deflated investor interest in the country, further exacerbating infrastructure bottlenecks going forward. While the government is keen to attract new investment in order to mitigate the infrastructure deficit risk, it is probable that Kirchner will maintain his micro-management of the economic and political landscape. This is the new reality in which investors must operate over the medium term in Argentina.

Venezuelan President Hugo Chávez, the poster child for Latin America's radical left, has repeatedly grabbed headlines with his actions to increase state control over Venezuela's oil and gas sector, among other areas of the economy. Over the course of the past year, the Venezuelan government has forced a number of private investors to surrender majority ownership of their oil field operations to the state oil and gas company, PDVSA. In April 2006, Chávez demonstrated the consequences for investors unwilling to cooperate with the government's new operating framework by calling on the military to permanently confiscate the fields of those foreign investors that failed to sign onto the new contracts before the set deadline.

Private property more broadly is also under siege in Venezuela as the government is engaged in an extensive land expropriation plan as part of its socialist policy objectives. Moreover, the level and severity of Chávez' anti-American rhetoric has intensified over the past year, and he is actively seeking new non-Western allies such as China and Iran. This political alignment is opening new sources of foreign direct investment which will serve to reduce the leverage and increase competition for existing foreign investors. It is all but assured that Chávez will be re-elected in the December 2006 presidential elections. As such, the investment environment will continue to be plagued with arbitrary government interference and subject to ad hoc nationalist policies.

Bolivia's President Evo Morales, elected in January 2006, has mirrored Chávez' approach as it relates to the treatment of foreign investors and private property. In May 2006, Morales declared the nationalization of Bolivia's energy fields and sought the re-negotiation of investment contracts to grant a majority stake to Bolivia's state-owned oil and gas company, YPFB. However, Morales is struggling to implement his nationalization plan given the country's lack of resources and technical expertise. Deadlines are being pushed back and some policies are being reversed causing divisions within government and unrest in the streets. Political and legal instability will continue to undermine Bolivia's investment environment for the foreseeable future.

The sovereignty issue is at the core of Venezuelan President Hugo Chávez' Bolivarian Revolution and at the heart of the indigenous' grievances that gave rise to Morales' popularity in Bolivia. As such, Western investors will continue to encounter a challenging business environment in these markets rife with economic nationalism.

In contrast, foreign mining investors in **Peru** and **Chile** have also been subject to recent changes in their investment environments, yet these changes have not proven detrimental to the viability of their operations. In May 2005, the Chilean government passed the Royalty II law, which served to implement a 3% royalty tax on mining windfalls for mining firms with operating margins of over 5%. By doing so, the government sought a larger share of the high profits while attempting to ensure that profitability would be maintained in times of lower commodity prices. In Peru, recently-elected President Alan García is requesting a "voluntary social contribution" from foreign mining companies, rather than breaching the fiscal stability agreements many investors had negotiated with the government in the 1990s. Negotiations to determine the amount and payment schedule for the voluntary contribution are underway. Although the high commodity price environment has brought changes to the investment environment in Peru and Chile, the policy shifts are unlikely to reach a level that will drive foreign investors away, even when the commodity price cycle returns to historic norms.

In some countries, economically driven nationalist policy exists alongside free and open markets. In **Mexico,** for example, the foreign investment environment is welcoming and state approvals are not required for investment in nearly all sectors of the economy. The energy sector, however, remains largely closed to foreign investors. Mexico's state-owned oil company, Pemex, in particular has a distinct role in the economic and political life of the country: the government relies heavily on Pemex revenues to fund the national budget; and petroleum resources are widely seen to be part of each citizen's national patrimony.

Attempts by governments over the years to introduce reforms allowing private capital and foreign investment in Pemex have repeatedly been rebuffed by political pressure to maintain the status quo, in spite of the fact that Pemex is in dire need of additional funds and expertise to maintain its infrastructure and explore for new oil fields. As long as political players in Mexico remain convinced that foreign participation in the sector requires ceding even partial control over the country's oil resources, it is doubtful that substantial changes will be made over the short term. Barring a crisis in Pemex's financial state that forces the government to act quickly, progress in opening the sector is most likely to take place in a slow and piecemeal fashion.

These examples illustrate the fact that Latin America comprises nations with distinct operating environments offering both risk and reward. Following a spate of elections in the region in the past year, the political environment is likely to become more predictable as we head into 2007. As such, investors can assess their strategic opportunities against the relatively stable political backdrop of leaders and legislatures that are set to govern over the medium term.

Investors in sub-Sahara Africa are facing new demands…

Recently, governments of several mineral-producing countries in sub-Sahara Africa such as Botswana, Tanzania, Zambia, South Africa and Zimbabwe have upped the stakes for existing and future foreign investors in various ways. In some cases, governments are reviewing the contracts of investors benefiting from "sweetheart" deals obtained as an incentive to invest. In other cases, investors are forced to adhere to certain social obligations in order to ensure their presence offers benefits to the broader population. In all cases, Western investors are watching their leverage diminish as alternative sources of investments become increasingly more available.

In **Botswana**, the government recently concluded 2 years of negotiations with De Beers, its largest foreign investor, securing a significantly better deal with regard to the exploitation of its mineral wealth. The negotiations were over the extension of the lease De Beers holds for four local mines. In exchange for granting De Beers 25-year lease extensions, the government was able to obtain several concessions, including a larger share in the company and an agreement that the company will process more raw diamonds in-country.

To the northeast, the **Tanzanian** government is undertaking a review of legislation governing the mining sector as well as a number of mining contracts awarded during the past several years. This comes on the heels of an announcement by the Tanzanian Privatization Minister in July 2005 that the royalty rates charged on exports of unprocessed ore will increase from 3 to 5%. Similarly, the **Zambian** government confirmed in July 2006 that it will re-evaluate mining contracts signed with foreign investors in an effort to up the existing mineral royalty rate from 0.6 to 3%.

For its part, **South Africa** has fuelled uncertainty in its mining sector by delaying the release of the latest draft of a new mining royalty bill. The second draft of the bill was finally released in mid-October, more than three years after the original version prompted considerable criticism from investors for what were considered to be excessive royalty rates. The newest draft of the long-awaited bill reduces the royalty rates initially proposed; however, the government has held firm in its decision to apply these rates against gross revenues rather than profits, something the industry opposes. Another feature of the bill is that the government will grant royalty rate reductions on a case-by-case basis to those companies that refine their output domestically.

These examples only touch on a few of the recent developments in the extractive sector across the continent. Other states such as **Zimbabwe, Niger, Namibia** and **Chad** are all making moves in the same direction. Indeed, one interesting aspect of this shifting investment environment is that it is occurring in countries with significantly different political, economic and investment climates. For example, given their recent histories of political and economic uncertainty, expropriatory action on the part of the Zimbabwean and Chadian governments is not surprising. On the other hand, such intervention in the mining sector by Zambia and Tanzania – two model economic reformers – would seem more unusual.

Thus, while some of the impetus for these changes may be the current high price of commodities, these nationalist-style actions should not be interpreted as a strict reflection of an anti-foreign investment trend. It is important to note that Botswana, Tanzania, Zambia and South Africa in particular consider the mineral sector to be a key driver of job creation and economic development. However, in each of these cases, there is some level of disappointment with the benefits, or lack thereof that increased mining activity has delivered. Specifically in Tanzania and Zambia, there is a strong public perception that the governments made too many concessions to entice foreign investors and are receiving paltry revenues from an industry that is currently reaping high profits.

In addition, many African countries are seeing increased interest in their extractive sectors from non-Western investors – most notably from China, India and Russia. The awareness that there are alternative sources of foreign funds, particularly ones that come without strict demands for transparency and democratic consolidation, further encourages governments to take a stronger position vis-à-vis current investors and the Western-dominated international financial institutions more broadly. Furthermore, this increased competition undermines the leverage of existing investors faced with the shifting investment environment.

In some cases, such as Botswana, Tanzania and South Africa, this should not necessarily trigger serious concern, as these governments are attempting to strike a better balance between the interests of their constituents and those of foreign investors, which they are acutely aware, are the engine of growth in the mining sector. As such, governments have a vested interest in ensuring that mineral extraction be seen by the local populations as contributing to broad economic development to continue to justify the presence of Western investors. Conversely, interventions into mining operations by the governments of Chad, Zimbabwe and Niger serve to further erode what were already poor investment environments for Western companies.

…while the emergence of alternative investment sources is leading to a difficult environment for Western investors in Central Asia and Russia.

Many non-traditional (Kazakh, Chinese, Russian, South Korean and Indian) sources of investment capital are looking to expand their influence in Central Asia. This expanded choice of suitors, it can be argued, has led a number of governments of the region to be less favourably disposed toward Western firms than in the past – to the point of directly intervening in the operations of Western firms when it serves their purposes. This, coupled with the fact that many of the region's countries have ineffectual legal systems as well as the presence of endemic corruption, render the environment for Western investors a challenging one.

In **Uzbekistan**, American gold mining company, Newmont, has accused the government of expropriating its USD 94 million stake in the Zarafshan-Newmont joint venture. This summer, the Uzbek authorities launched bankruptcy proceedings against the joint venture, alleging that the entity had USD 48 million in unpaid taxes and fines, and launched criminal investigations against the mine staff. As a result, Newmont put its 900 employees on leave while the government seized the mine's assets and banned the export of its gold. In mid-August, Newmont officially declared that it had lost day-to-day control of the operation and is seeking compensation through international arbitration.

Also in Uzbekistan, Oxus Gold, a UK-based company, was excluded from developing the zinc, silver, copper and lead-rich Khandiza reserve despite the fact that its subsidiary had been exploring the site. It appears the rights will go to a local company. Additionally, operations at Oxus' Muruntau mine will likely be affected by the proposed cancellation of certain tax privileges for foreign investors. This would run counter to guarantees contained in Oxus' stability agreement with the government, not scheduled to expire until 2010.

In **Kyrgyzstan**, the departure of long-time president Askar Akayev (deposed in the so-called Tulip Revolution in March 2005) has given rise to an environment in which the country's assets are up for the taking. Russian and Kazakh companies have made significant inroads at the direct expense of Western firms. As an example, in 2004, Kyrgyz authorities stripped Oxus of its licence for the Jerooy project and turned it over to Global Gold, a privately held company (likely Russian). Similarly, the government granted rights to the Taldy Bulak prospect to Summer Gold (rumoured to be owned by Kazakh businesspersons) rather than the previous licensee Central Asia Gold, which is Australian. For its part, Canadian-based Centerra Gold, owner of the giant Kumtor gold mine, has faced allegations of unpaid back taxes and other questions regarding its legitimacy as a foreign investor operating in the country.

Moreover, Western firms are being hurt by the deterioration in relations between the United States (and the West more generally) and certain Central Asian states as well as by the increasing political and diplomatic closeness between Russia and these same Central Asian states. US-Uzbek relations have deteriorated owing in part to harsh American criticism of the Uzbek government's heavy-handed crackdown on demonstrators in Andijan in May 2005. As a result, the Uzbek government no longer allows the US to base forces in southern Uzbekistan. Additionally, President Islam Karimov expelled foreign-funded NGOs and has clamped down on media outlets. This souring of US-Uzbek relations has also affected the business environment facing Western investors. It is alleged that the government is undertaking tax investigations against Western ventures, while leaving other foreign investors alone. Furthermore, it is believed that Karimov has promised the Russians their pick of planned privatizations in exchange for President Putin's political support. Such anti-Western sentiment is also present in Kyrgyz political rhetoric.

In **Russia**, a competitor to Western foreign investment has also emerged. The resurgence of large state-owned or state-controlled Russian companies (i.e. Rosneft, Gazprom) means that the state can now see a role for its "champions" within projects that were previously foreign-owned and/or controlled. As a result, Western oil giants are being muscled out of the country's important oil sector via various means.

POLITICAL RISK OVERVIEW

In September 2006, the Russian Natural Resources Ministry said that it would oppose any cost overruns for projects with production-sharing agreements (PSAs) with foreign firms, an indirect warning to ExxonMobil's Sakhalin-1 oil and gas project whose costs have gone from USD 12.8 billion to USD 17.0 billion. This comment came after the state withdrew the environmental permit of Sakhalin-2, a large oil and LNG project that is majority-owned by Shell. Additionally, the Ministry stated that it would not grant extended exploration/production rights to ExxonMobil's licence for the Sakhalin-1 oil and gas block.

It is expected that these latest moves will force Shell to grant Gazprom a blocking stake (25% plus one share) in Sakhalin-2, which had already been discussed between the parties, but negotiations stalled. Even though it is not majority ownership, the stake will likely act as the lever for government control over the project.

While high oil prices may have contributed to the Russian government's aggressive position, the push to include Gazprom or Rosneft in different projects cannot be solely tied to commodity-price driven greed. There is a deep-seated belief in the Kremlin of the need to control the pillars of the Russian economy, specifically the energy sector. This harkens back to the logic behind the Kremlin's attack on privately owned Yukos through tax fines and criminal investigations. In fact, the actions of the Uzbek and Kyrgyz governments are eerily familiar in this regard.

The behaviour of the Russian, Uzbek and Kyrgyz governments has been rightly criticized as being short-sighted. The simple existence of alternative sources of investment does not mean that it is wise to burn bridges with Western players. The Russian "champions" are limited in their expertise, capital and technology and, as such, are not "perfect substitutes" to Western investment as the Kremlin appears to believe. Meanwhile, the governments of Central Asia may well find that the Russian and Asian investors in Central Asia may arrive with political and business interests that run counter to those of the host states – making them less than ideal partners in the end.

North-East Asia grapples with ideology…

Headlong movement toward capitalism and integration into the global economy in **China** may be slowing down after two and a half decades. Economic reforms launched by former President Deng Xiaoping in the early 1980s, and accelerated by his successors, have helped the country to become an economic and political powerhouse once again. In the process, China's closed, state-heavy, personalized commercial environment has evolved to become more dynamic, rules-based and predictable. Not coincidentally, the country has, in that time, become a favoured destination for foreign investors – attracting over USD 60 billion of FDI in each of 2004 and 2005. During this period of transformational economic and social change, the *raison d'être* of the ruling Chinese Communist Party (CCP) was transformed as well. The party now focuses on raising living standards and economic growth to legitimize its monopoly on power.

However, China's growth, while indisputably colossal and rapid, has been extremely uneven. Large and widening income gaps have emerged between the coastal and inland regions and urban and rural dwellers in all regions. Moreover, some citizens, particularly farmers and those who were laid off from inefficient state-owned enterprises, are worse off now than they were in the 1970s. Basic social security – the iron rice bowl – no longer covers the most vulnerable. Concerns about these gross inequities and the social discontent and protest to which they have given rise have pushed the "left" of the CCP – which had been effectively marginalized by the market reform and growth mania – back into a position of influence in Chinese politics.

A concrete example of this leftist resurgence is seen in the government's decision to postpone passage of a draft law on property rights until at least next year. The draft law, which was to be considered by the National People's Congress (NPC) at its annual meeting in March 2006, had been expected to be adopted without incident like the many other legal, regulatory and constitutional changes that have been implemented as part of the reform process. However, academics and officials criticized the draft law – taking particular issue with the fact that it afforded equal protection to state-owned and private property (including that owned by foreigners), which, they opined, contravened the founding legal principles of the communist state. The debate gained momentum and the leadership, unsure of its ability to gain consensus at the NPC, pulled the bill. Draft anti-monopoly legislation, new regulations on mergers and acquisitions and the capitalization of foreign banks, restrictions on real estate transactions by foreigners and a number of high-profile regulatory interventions in foreign takeover attempts also bear the fingerprints of those cadres that would prefer to slow, if not halt, China's march toward capitalism.

For their part, foreign investors are expressing concern at what they see as a nationalist backlash and, to a certain extent they are hanging onto their money. Inbound FDI to China in the first 7 months of 2006 was down slightly from that of the same period the previous year.

Mongolia is also wrestling with questions about how best to utilize capitalism and foreign investment in its development. The country underwent rapid transformation from a Soviet satellite to a pro-Western, market-oriented democracy during the 1990s. Institutional and regulatory reforms were introduced at breakneck pace and Mongolia was held up as one of the only successful transitions from communism to capitalism. However, elements of the Mongolian political establishment and the members of a number of burgeoning social movements are coming to the conclusion that many of the post-transition reforms need to be revisited because they have not provided adequate benefits to average Mongolians. Much of the debate is focused on the country's mining sector.

Mongolia is financially impoverished but rich in untapped mineral wealth. Development of these deposits is widely seen as the key to lifting the country out of poverty and it is clearly recognized that foreign capital and expertise are needed in order to make this happen. With this picture in mind, the Mongolian government promulgated investment, tax and mining laws that were relatively favourable to foreign investors in the 1990s. As hoped, the rules enabled the country to attract a good deal of foreign capital (USD 175 million from Canada alone) to the sector despite the prevailing environment of low commodity prices.

In the early 2000s, commodity prices rose and a number of promising mineral deposits were discovered so, suddenly, the 1990s era regime did not look so good from the Mongolian perspective. Fixed royalty rates and long tax holidays meant that the country was unable to gain much marginal income from hot commodities markets. All players, including foreign invested companies, agreed that some "rebalancing" was in order but investors became concerned when discussions related to the sector became emotional, highly politicized and largely anti-foreign.

In the midst of this protest and debate, the government has adopted a number of regulatory changes, including a "windfall profits tax" on copper and revisions to the Minerals Law (originally passed in 1997) that raise royalty rates on all metals and establish the government's right to purchase equity stakes in "strategic" mineral deposits. However, given the charged tone and temperament of the discourse, it is not clear that these changes are anything close to the Mongolians' final word or the foundations for a stable investment environment in the medium to long term.

…and coalition politics in India continue to inhibit the government's liberalisation initiatives.

With an economy that is growing at or near 8% per year, an expanding role in both regional and global politics and a rapidly expanding middle class, India is increasingly being seen as one of the drivers of the global economy and a country in which savvy businesses must have a presence if they are to remain competitive. Foreign direct investment has been flowing in rapidly increasing amounts – USD 3.3 billion in 2003, USD 5.7 billion in 2005 and USD 6.5 to 7 billion forecast for 2006. However, these exponential growth rates belie a glaring issue: the Indian economy is not living up to its potential as a destination for FDI. Compared to China's annual inward investment flows of over USD 60 billion, FDI into India is a pittance. Potential investors have long cited overregulation of the economy, high levels of state ownership, rigid labour markets and other bureaucratic and fiscal distortions as reasons for giving the country a pass.

India's "investment gap" and the reasons for it are well known and understood. Furthermore, it is also generally acknowledged that India needs much larger inflows of FDI if it is to develop the manufacturing and services industries to the point where they can provide enough jobs to absorb a rapidly growing urban labour force. FDI is also vital to the country meeting its infrastructure needs in the coming decades. Yet, despite this FDI imperative, the regulatory, banking and labour market reforms that would likely open the investment faucet are agonizingly slow in coming. Measures taken in the 1990s were important to getting India where it is today, but more needs to be done if the country is going to meet both its potential and its needs.

The national government, the Indian National Congress-led United Progressive Alliance (UPA) coalition, adheres to the notion of further liberalisation and "faster and more inclusive growth," but real reform has been scant since the UPA came to power in 2004. To a large extent, the government's reform goals are being thwarted by the very political structure that is keeping it in power.

Since the 2004 national election, the UPA has relied on the support of the Left Front, a coalition of India's communist parties. The front, rather than joining the UPA proper, has chosen to support the ruling coalition "from the outside." As such, the parties of the Left Front have been able to maintain their socialist ideologies and policy agendas in an unfettered form and bring these heavily to bear on the government. The Left Front has acted as a check on the liberalising agenda of Congress. Its strong showing in several key state elections in the spring of 2006 (West Bengal and Kerala) further increased its leverage. In the view of many observers, the desire to stay in power until the next election has led Congress to slacken its reforming pace in order to ensure the support of the Left Front.

Prime Minister Manmohan Singh admits that the UPA's relationship with the Left Front has constrained the government from moving as fast as it would like in terms of reform. Given the need to placate the Left Front in order to guarantee its survival as a coalition, the UPA is increasingly articulating a message of inclusiveness and the "duality" of the government's reform agenda – supporting further liberalisation while also ensuring that the marginalised within Indian society are not left behind. (The vast majority of Indians continue to live in relative poverty and have not benefited much from the liberalisation that has taken place to date.) B.S. Rathor, the Chairman of the All India Resort Development Association, recently argued that "Political gamesmanship has throttled the process of economic growth and wealth creation." While this is somewhat of an overstatement, it does illustrate the frustration of the many – mainly middle class advocates of further liberalisation.

Yet, the state is not entirely retrenching. With 3 years to go before the UPA's term in office expires in 2009, it is likely that the pace of reform will moderate significantly, but by no means will it cease – the country is already too far along the road of reform for that. The necessities of coalition politics will encourage Congress/UPA to find a middle road that seeks to bring together further economic reform and much needed social welfare programmes to effect a more equitable distribution of wealth in the country.

It must be remembered that, at its origin, Congress is itself a socialist party and it continues to depend on the support of India's vast rural population. Therefore, it is not entirely surprising that it has ended up choosing to live with policies that reduce the pace of reform in an effort to effect a more equitable distribution of wealth.

Although coalition politics is hindering India from achieving its economic potential in the short term, ultimately it will serve the important role of ensuring a more balanced distribution of the benefits of economic activity to a broader range of people and should improve the quality of investment opportunities in the medium to long term.

Conclusion

A number of themes emerge from the developments outlined above. It is clear that the dynamics of FDI into emerging markets have changed to the point that much of the comfort, and even complacency, that Western investors and their backers derived from the global consensus of the 1980s and 1990s has dissipated. Western commercial interests are coming under concerted political pressure in many parts of the world. After a couple of decades of more or less calling the shots, owing to their monopolies on capital and know-how and recipient governments' staunch belief in the developmental benefits of their presence, these firms are facing increasingly skeptical and assertive hosts and are having to settle for less than they had come to expect. Furthermore, it is evident that host countries' new-found assertiveness is being driven by multiple factors.

First, there has been a resurgence of the belief that a country must retain sovereignty over its key resources. For the governments of Bolivia, Venezuela and Russia this principle has manifested itself in expropriations aimed at boosting state ownership in resource sectors. Interestingly, Mexico, through PEMEX, retained full state ownership of its oil sector throughout the 1980s and 1990s despite welcoming foreign investment into the rest of its economy.

Second, firms from non-Western nations are gaining a foothold in the global market place and are providing a degree of choice to host nations. Investors from China, India and Russia have developed the ability and desire to rival Western firms in some commercial realms. Furthermore, initial observations indicate that these investors are more willing than their non-Western counterparts willing to accept conditions 'as is' in the markets they enter – thus making them attractive partners for governments that cannot or would prefer not to alter their policies and methods of governing to fit the norms of Western financial markets and environmental / social sensibilities. The effect of this new choice is most evident in Africa but touches on other regions as well.

Third, overt anti-US/Western political sentiment is hurting Western investors. In Venezuela and Central Asia, governments are actively cultivating investment relationships with non-Western entities and taking administrative actions against existing Western investors as a means of reducing their dependence on the West and Western countries' influence over their policy choices.

Fourth, host governments are finding the need to strike new balances with respect to the benefits of FDI both with investing firms and within their own societies. New taxes and levies on mining in Peru, Chile, Mongolia and some African countries stem from the conclusion that FDI has not benefited the countries and their populations to the degree expected. In the burgeoning markets of China and India, investors have witnessed a pause or slowdown in the pace of reform, as governments attempt to focus on a more equitable distribution of income and to answer philosophical and legal questions with respect to what type of societal values they want to foster.

So what lessons can be drawn from this review of recent changes to the investment environments in a handful of markets? Perhaps the most salient point is that the shifting environment is not the result of any one single cause and as such, changes to the investment environment are unlikely to be transitory. Indeed, a single driver such as high commodity prices, does not appear to adequately account for the nature and scope of shifts in the investment environment, and serves to underplay both the longevity and breadth of the change. What is clear is that this environment is undergoing fundamental change and is unlikely to return to the 1980-2000 status quo from which investors took comfort. To remain successful, Western investors will have to take into account the myriad of causes behind this evolution and find new ways to mitigate new risks.

SECTOR OUTLOOK

7.0 Sector Export Outlook

Export Growth: Volumes and Prices

When forecasting the value of Canadian exports, two components have to be considered: volume and price. Volumes refer to the actual physical quantity of the good being shipped while price is the dollar amount paid for those goods. The dollar value of the export is thus simply the volume multiplied by the price. For example, if volume growth is forecast at 5% while prices are projected to rise by 7%, the overall increase in value is 12%. Given the large relative changes in prices and volumes often seen for some goods, it is important to break down the contribution of each component to the overall growth in export value. This differentiation becomes particularly useful in the case of commodities and computer equipment, where prices can be particularly volatile.

7.1 Energy Sector

Canadian energy exports are on track to hit a record high in 2006, rising 11% to an estimated $97.4 billion. Strong demand and pricing account for this year's run-up in export receipts, continuing the growth pattern that has been evident since 2003. Most of this year's run-up in exports is coming from crude petroleum and refined products as natural gas and electricity are expected to finish 2006 in negative territory. Coal is also adding a small amount to this year's growth in the broader energy sector.

Table 23: Energy Export Outlook by Sector

Top Markets	CAD bn 2005	% Share of Energy Exports (2005)	Export Outlook (% growth) 2005	2006(f)	2007(f)
Petroleum*	45.7	52.1	22.0	22	-4
Natural Gas	35.3	40.3	30.4	-1	4
Coal	3.5	4.0	77.2	7	-8
Electricity	3.2	3.6	57.6	-5	3
Total Energy	**87.7**	**100**	**28.0**	**11**	**-2**

Source: Statistics Canada, EDC Economics. 2005 actual, 2006 and 2007 are forecast.
* Includes crude petroleum and refined products.

For 2007, EDC Economics is projecting a decline of about 2% in export earnings for Canada's energy sector. All of this decline stems from an expected easing in oil and coal prices. Natural gas and electricity prices are expected to move up a little through 2007. For all energy sub-sectors, we expect to see increased volume exports next year, but increased output will not be enough to offset the weaker pricing environment we currently envision for 2007.

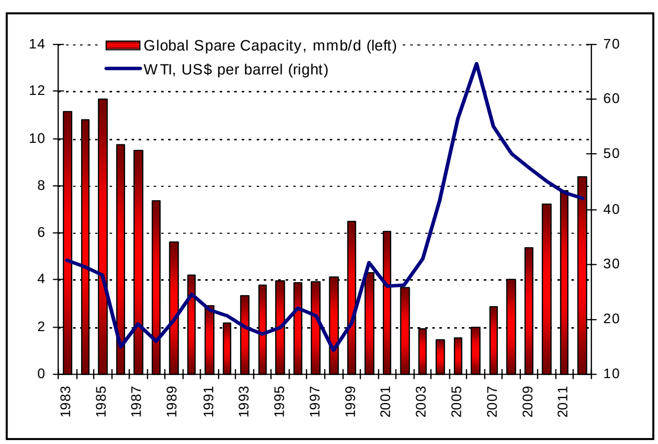
Table 24: Price Forecast for Oil and Natural Gas

	Long-term Average*	2004	2005	2006(f)	2007(f)
Petroleum, WTI –US$/bbl	25.79	41.51	56.59	66.50	55.00
Natural gas(HH) –US$/mmbtu	3.51	5.90	8.89	6.15	6.50

Source: Bloomberg, EDC Economics. 2004 and 2005 actual, 2006 and 2007 are forecast.
*Long-term averages cover 1983 to August 2006 for oil and 1991 to August 2006 for natural gas.

Looking ahead, Canadian petroleum exports will be boosted by rising production, primarily out of Alberta's oil sands. Prospects for further development on Canada's East Coast and in the McKenzie Valley are also promising. Despite EDC Economics' forecast of an easing in oil prices over the next few years, the overall pricing environment will remain supportive of new investment projects in Canada. Global demand for energy will continue to expand at a decent clip, and an increasing number of end-users are looking to tap into politically stable and secure supplies – a requirement for which Canada easily fits the bill. For 2006, we estimate Canadian exports of **crude oil and refined petroleum products**

Figure 25: Rising World Spare Production Capacity will allow Oil Prices to Adjust Downward



Sources: Bloomberg, OPEC, IEA, EDC Economics.

will amount to $54.3 billion, a rise of 22% over last year. Some easing is expected for 2007 (-4%) as we expect pricing to soften over the course of the year.

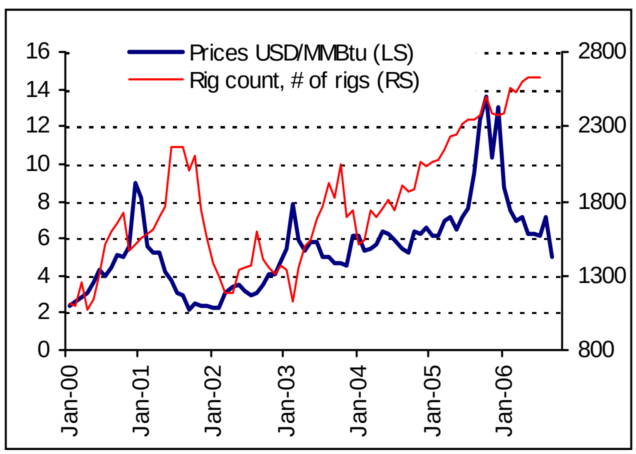
Supply-demand fundamentals tell us the price of oil should trend downward through the next couple of years. Indeed, as of end-September 2006, oil prices had moved down significantly from a peak that nearly hit USD 80 in July. Global economic growth is slowing, crude inventories are being re-built and world production capacity is on the rise. Currently, excess production capacity among the world's oil producers is estimated at around 1.5 million barrels per day – a very small buffer in which to absorb supply disruptions. This thin margin has introduced a large risk premium into world oil prices, perhaps as much as USD25 per barrel.[11]

As spare production capacity increases, the ability of producers to cover unexpected supply shocks will improve, and more importantly, reduce the fear premium that recently pushed prices to historic highs. EDC Economics estimates that global spare production capacity will reach around 8 million barrels per day by 2012. Some forecasts call for spare capacity to reach as high as 10 to 12 mb/d by 2012, but EDC expects a more conservative 8 mb/d in excess capacity. Indeed, there is no guarantee that even this level of spare capacity will emerge given that most of this new capacity is being built by OPEC suppliers that would rather see prices stick near the 50/bbl benchmark. In any case, a more comfortable buffer is anticipated down the road, which should help narrow the premium currently in the markets. While the fundamentals favour a downward move in oil prices, it is important to keep in mind that the market is still very skittish when it comes to oil – we can expect price volatility to remain part of the landscape.

North American natural gas prices have also been extremely volatile in the past year. At the end of September, the price of natural gas on the Henry Hub was trading USD 4.25/mmbtu, just over one-quarter of where it was in December of 2005. The past year's mild winter allowed US natural gas inventories to be rebuilt. While a warm July and August chewed into supplies (as natural gas is used to generate electricity for air conditioning), storage levels remain at comfortable levels. As of mid-September, US natural gas storage was 12.6% above year-ago levels and also ahead of the 5-year average for this time of the year by the same percentage. According to the US Energy Information Administration (EIA), US gas inventories will be starting the upcoming winter heating season at their highest level since 1990, keeping a lid on any upward price movement. For 2007, we believe natural gas prices will increase, but the overall gain will be tempered by a slowing US economy and a satisfactory supply situation. Moreover, the EIA estimates that US liquefied natural gas (LNG) imports will reach 940 bcf in 2007, a rise of 34% over this year's LNG import level. While still a small part of overall consumption, LNG imports will play an increasingly large role in supplying natural gas to North American consumers, especially since most producing fields on the continent have passed their peak in terms of output (for example, US natural gas production has been declining even as the number of gas drilling rigs increases).

EDC Economics estimates that the value of Canadian **natural gas** exports will ease back by 1% in 2006, with lower prices accounting for all of this slippage. For 2007, export

Figure 26: US Natural Gas Price and US Gas Rig Count



Source: Bloomberg.

[11] EDC Economics' outlook for oil prices is roughly in line with a new report from Natural Resources Canada, which has prices dropping to $US 45 per barrel by 2010.

receipts are expected to rise by 4% as pricing improves along with a modest rise in volume shipments. While these numbers suggest a weak outlook for natural gas shipments to the US, they come on top of a 30% increase in export receipts during 2005. To be sure, the value of Canada's natural gas exports will finish 2006 at around $35 billion.

Canada's **coal** (primarily metallurgical and coking) exports are on track to rise by 7% in 2006, building on last year's huge price-driven run-up in export receipts. However, we do expect a pullback in coal prices for 2007 as global steel production loses momentum alongside rising global coal output. Canadian export prices for coal are forecast to fall by 11% in 2007, outweighing the small increase slated for volume shipments. The end result is a projected drop of 8% in the dollar value of Canadian coal exports during 2007.

7.2 Metals and Metal Ores

Table 25: Canadian Metal Ores and Industrial Metal Export Outlook

Top Markets	CAD bn	% Share of Exports (2005)	Export Outlook (% growth)		
	2005		2005	2006(f)	2007(f)
US	29.7	70.0	6.0	20	-7
United Kingdom	3.1	7.2	21.6	6	-5
Eurozone	2.2	5.2	27.8	20	-6
Other West Europe	1.8	4.1	23.3	22	-5
Japan	1.7	4.0	20.3	26	-6
China	1.2	2.7	49.1	16	-3
Asian NIEs	1.0	2.4	-5.1	24	-4
Developing Markets Total	2.8	6.6	40.1	21	-5
Total Metals	**42.5**	**100.0**	**10.8**	**20**	**-7**

Source: EDC Economics. 2005 is actual, 2006 and 2007 are forecast. Asian NIEs are Hong Kong, Singapore, South Korea and Taiwan.

Table 26: Industrial Metal Price Forecast

	10 Year Average	2004	2005	2006(f)	2007(f)
Aluminum (USD/tonne)	**1,591**	**1,720**	**1,902**	**2,400**	**2,050**
Copper (USD/tonne)	**2,402**	**2,867**	**3,682**	**6,500**	**4,200**
Nickel (USD/tonne)	**9,383**	**13,841**	**14,782**	**21,000**	**16,000**
Steel (hot-rolled, USD/ton)	**350**	**592**	**534**	**570**	**500**
Zinc (USD/tonne)	**1,183**	**1,049**	**1,382**	**2,950**	**3,150**

Sources: EDC Economics, Bloomberg. 2004 and 2005 actual, 2006 and 2007 are forecast.

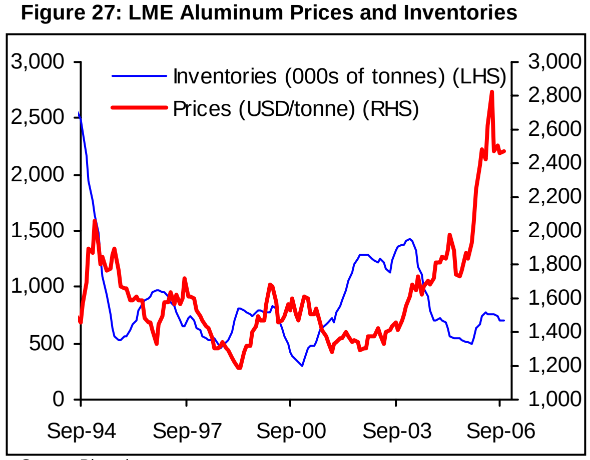
As was the case in our Global Export Forecast summer update, we recommend Canadian businesses be prepared for volatility. Across industrial metals, prices have been incredibly volatile of late and we expect more of the same. Prices have rebounded somewhat from a May sell-off, but if our global growth outlook comes to fruition demand fundamentals will soften. Our forecast calls for lower prices through the rest of this year and for further weakness in 2007. Prices are highly vulnerable to slower global growth and an outflow of speculative capital. Among these, the flow of investment funds into or out of metals is the key consideration. If as we expect there is flight, a precipitous drop in prices will occur, albeit to levels still firmly above historic norms. If our downside scenario is realized, a US recession will quickly transmit into a considerably more weakened global demand picture. This would more quickly close net deficit positions for most metals while likely being accompanied by a more rapid withdrawal of speculative capital. For 2006, record performances for Canadian export receipts are expected for several metal classes. Gains will be price driven, and when combined with modest volume increases, culminate in a growth forecast for metal ores and alloys of 20%. Volume increases in 2007 will be similarly tame, but lower prices will see exports fall 7%. China is the key source of most consumption growth and in many cases is also a big player in terms of production.

Much of the time between 1998 and 2002 was difficult for the mining industry as prices languished and investment suffered. Investment interests have since taken off but the lag time between project concept and actual production remains a constraint on production through the forecast horizon. Medium-term prices are unlikely to return to historic levels amid rising production costs and a scarcity of key inputs, including skilled labour. Nevertheless, the industry is making considerable profits and the incentive to invest is strong. This has been tempered to a small degree by industry consolidation efforts, particularly in steel, nickel, gold and aluminium. But economic fundamentals remain intact over the long term, and the discovery of Jack 2 in the Gulf of Mexico and its impact on crude oil prices is a lesson that is applicable across all commodities. High prices drive exploration and development, restoring market balance, which brings down their marginal cost of production.

Inventories on the London Metals Exchange (LME) remain near historic lows for copper, nickel and zinc. The latter is certain to experience continued tightening while copper and perhaps nickel should see some improvement over the forecast period. In terms of prices, the outlook for zinc is perhaps the most supportive and could indeed hang on to current levels. Nickel will likely be the most volatile with inventories on the LME at only 7,000 tons. Indeed, in the 3 months from June to August of this year the price of nickel rose by 95%. Substitution will certainly be looked at with more interest in 2007. Copper has formidable substitutes in the form of PVC and aluminium for pipe and wire applications, respectively. Nickel will see demand moderate as stainless steel producers switch to steels using lower nickel content or no nickel content at all. The same cannot be said of zinc whose predominant use in galvanized steel has few viable alternatives (painted steel is one alternative but is not practical).

Our outlook for slowing global economic activity is highlighted by and begins with a US housing construction downturn, which is already well underway. Weaker US housing starts, with double-digit percentage declines, will remove a key source of copper demand while the general global slowdown sees softening demand for commodities in general. The moderation of demand growth allows ongoing production increases to better close the gap between demand and supply – a situation spooking speculative investors that are long in copper, nickel and aluminium in particular. In our downside scenario of a US recession (20 to 25% probability), the speed of capital flight from metals and more accelerated restocking of inventories would see an even greater drop in metals prices than is envisaged in our basecase scenario. China's (yet unproven) ability to grow on its own will be key to mitigating downside risks. This will come from more long-term investment projects such as energy and electricity investments in that country, which account for 50% of China's copper demand.

Figure 27: LME Aluminum Prices and Inventories

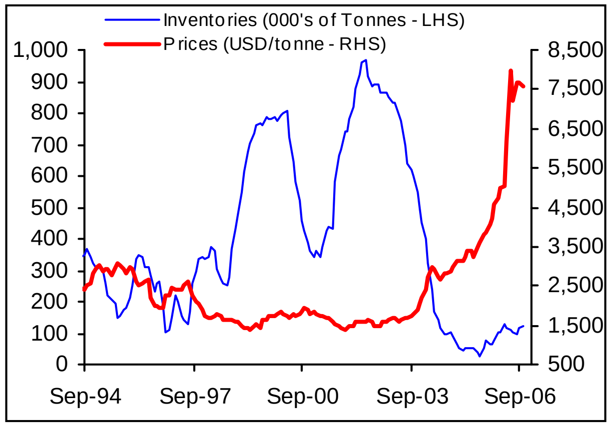


Source: Bloomberg.

As with all major tradable metals, fund activity has influenced **aluminium** prices. The increase has been comparatively modest however, as supply increases have nearly kept pace with that of demand. China leads both the demand and supply surge. With respect to the latter, Chinese output is up 17.5% to July y/y and looks likely to hold this growth over the whole of 2006. Efforts to reel in aluminium investment have not met with much success, but authorities continue with their piecemeal approach to put on the breaks. China will remain a net importer of aluminium in 2007 as demand there continues to rise and domestic investment finally starts to slow. Considering the high energy intensity of aluminium production, exporting the metal is akin to exporting power, and Chinese power is costly and in short supply. Here perhaps more than for any major metal, the ball is in China's court as the global balance hinges on that country's net export position. Canadian aluminium exports in 2006 will benefit from a combination of higher prices and tonnage volumes. As the US and global economy decelerates, prices will fall. Downward pricing pressure will also come from lower prices of alumina, which have already taken place following increased refining this year. In 2007, lower aluminium prices will drag down export receipts while volumes show only modest changes. Longer term investment plans for aluminium production are advancing around the world, including in China, the Middle East, Iceland, Latin America and here in Canada too.

Looking back at the winter GEF it is interesting to note that industry observers, including those at EDC Economics, were marvelling at the fact that **copper** had broken through the USD 5,000/tonne price barrier. Fast forward to the present and it has since broken through the USD 8,000/tonne mark on several occasions. The degree of price movements and a quick look at results of similar price spikes over history should be a warning that a correction is inevitable. High prices will attract investment, which will increase production and bring the market into balance. As production slowly increases in 2007, market tightness should be alleviated, especially when combined with decelerating demand growth. At present, determining the global supply-demand balance for copper is complicated by sales from China's State Reserve Board. China, the world's number one consumer, will continue to lead global demand mostly due to its power sector expansion (50% of Chinese copper consumption). Closer to home, a tumbling housing market will reduce demand from the US (50% of US copper demand comes from all forms of construction). The US remains a major copper consumer, and this will be a key catalyst in turning around the fundamentals for copper prices. This should permit a rebuilding, albeit a painfully slow one and from a very low level, of copper inventories in 2007. Fund purchases have been a key contributor to this year's price growth but such support can last only in the short term. Moreover, the longer the price of copper stays high the greater the degree of substitution into aluminium and PVC for some wire and pipe applications. We continue to forecast a large correction for copper prices in 2007, with prices settling well above historic norms. With the overall market so tight, it remains a risk that strikes/supply disruptions, similar to those that have characterized 2006, will allow prices to persist at stubbornly high levels.

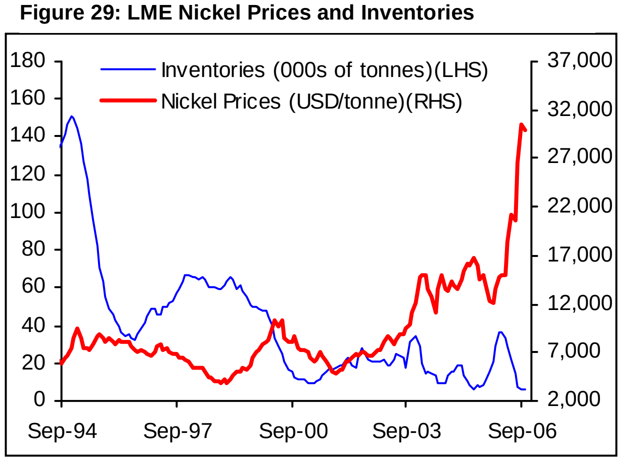
Figure 28: LME Copper Prices and Inventories



Source: Bloomberg.

With an average annual price of USD 14,782/tonne, **nickel** prices hit a record on the LME last year. Prices continued to rise this year while volatility has hit unprecedented highs. After flagging demand from stainless steel producers in 2005 (stainless accounts for 65% of nickel demand), first-quarter global production of stainless hit an all-time record and production will rise 8 to 10% for the year as a whole. This surge has pillaged LME nickel inventories with supplies moving in a range of 4100 to 7100 tonnes versus a 10-year average of 31,200 tonnes. With prices so elevated, we expect stainless producers will move toward lower nickel content output allowing inventories to see some appreciation and beginning a trend toward lower prices. Stainless production growth should slow in 2007 but nickel demand from other sources, aerospace in particular, will remain robust. Most major producers are planning production increases and there are large scale greenfield nickel projects in the works. Increasingly, it appears as though refined nickel from these operations will not come onto the market until 2008 – that is with the exception of Voisey's

Figure 29: LME Nickel Prices and Inventories

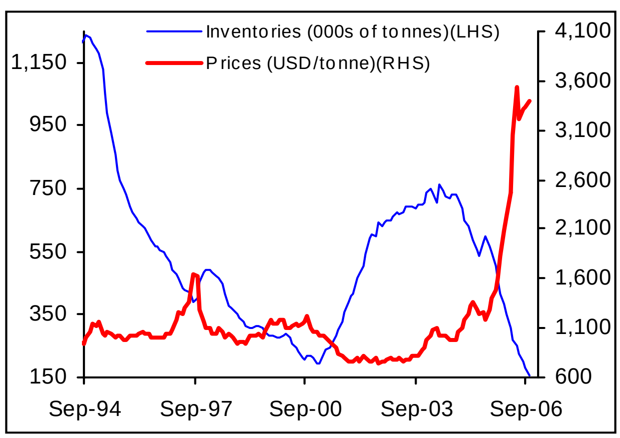


Source: Bloomberg.

Bay, which is has now been in operation for over a year. Nevertheless, our outlook for export volumes in 2006 has been scaled down due to lower refined output. Further downside could result if the strike at Voisey's Bay becomes protracted. While our basecase for the global economy calls for a slowdown, given the potential for production problems, the forecasted price retreat may fail to materialize to the degree currently envisaged. Either way, the nickel market will remain tight through the forecast with prices down from current levels but well above historic norms (10-year average of USD 9,500/tonne). Production problems are a key risk to our output and price forecasts, and indeed one of the large new mines has already run into scheduling and cost overruns.

According to data from the International Iron and Steel Institute, China now accounts for 34% of global **steel** production, greater than the combined output of the US, Japan, Russia, South Korea and India. Chinese steel output rose 22% y/y in July and 19% y/y in the first 7 months of 2006. Concerns of overcapacity have increased, with output moving further ahead of domestic demand as proposed government initiatives to stem investment and close unproductive facilities have failed to bear fruit. Domestic oversupply has deflated prices in China, resulting in strong growth of exports onto the global market. China continues to demand sizable shipments of high-end steel products, but failure to slow steel investment next year could bring out the protectionist voice in markets like the United States and the EU. In the US, steel prices have been considerably higher than in China making the US an attractive market in which to sell. US steel producers have also taken advantage of the price environment with domestic steel output up 9.5% on the year through July. Over the summer, US scrap prices took a hit on lower auto production but appear to be showing some signs of recovery. With increased imports from other markets and slower growth in US GDP and industrial production, steel prices in that market are expected to fall through 2007. The decline will be tempered somewhat by the high cost of iron ore. Following a 71% increase in the price of **iron ore** fines in 2005, continued solid gains in global steel production resulted in a negotiated 19% increase this year. Numerous global investment plans are in the works that will add to output, with 2008 showing significant production gains. For 2007, the price of iron ore fines should hold flat with a slight decline in the price of iron ore pellets.

Figure 30: LME Zinc Prices and Inventories



Source: Bloomberg.

Zinc exports from Canada are showing a healthy price-driven expansion in 2006. Zinc was a late show to the commodities price boom but is making up for it with a 150% price rise in the year to September. A global deficit (supply minus demand) of 300,000 to 400,000 tonnes is expected to continue through rest of 2006. China will be the driving factor for demand in the forecast period, but said demand has been scaled back slightly from our Summer 2006 Outlook. Increased investment in transportation infrastructure in China, India and other fast-growing markets is boosting demand for zinc (a key ingredient for galvanized steel). In 2005, refiners' capacity utilization rates suffered as companies' inventories of zinc concentrate were nearly exhausted. This year, although concentrate supply remains the key problem, improved availability has allowed some improvement in utilization rates and refined output. As with all the major metals, high prices are driving considerable exploration and development plans. This will help to narrow the production deficit to under 100,000 tones in 2007. Still, as LME and privately held inventories fall through the next year there will remain considerable price support for zinc. This is true even in the face of a global economic slowdown, but not necessarily in the case of our downside US recession scenario. It is important to note that galvanized steel accounts for the greatest share of zinc demand, and substitution away from galvanized steel is not viable in most applications.

7.3 Forestry Products

After going through some rough waters in 2005, the three sub-sectors of the Canadian forestry sector are having another challenging year so far in 2006. They are not out of the woods yet, so to speak. A number of challenges are common to all three sectors, mainly the higher value of the Canadian dollar, increasing energy costs and greater international competition. Overall, the sector will see exports decline in 2006 and again in 2007, primarily because of weaker fundamentals in the lumber industry and a continued deterioration of newsprint demand.

After declining 7.7% in 2005, exports of **wood products** are on route for an even steeper drop in 2006, having to face the rapidly deteriorating US housing market on top of the higher Canadian dollar and increased international competition. Prices have also continued their downward trend, losing 24% in US dollar terms since the beginning of the year for **lumber** and 40% for **oriented strand board (OSB)**. The long-running softwood lumber dispute may finally be coming to a temporary end, as the latest agreement between Canada and the US seems to have enough support in Parliament to pass. At current prices however, this would result in either an increased tax burden on Canadian exporters of softwood lumber to the US, or in a combination of export tax and quotas on shipments to US markets.

Table 27: Lumber and Wood Products Export Outlook by Region

Top Markets	CAD bn 2005	% Share of Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
US	17.72	87.7	-6.9	-12	-8
Japan	1.39	6.9	-20.7	1	2
Eurozone	0.34	1.7	-5.5	14	-6
Asian NIEs	0.15	0.8	-19.8	10	12
United Kingdom	0.12	0.6	-0.2	-1	-6
Total World	**20.19**	**100**	**-7.7**	**-10**	**-7**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.
The Asian Newly Industrialized Economies (NIE's) are Hong Kong, Singapore, South Korea and Taiwan.

In the US, it looks like housing, the main market for softwood lumber and structural panels, has finally ended its growth streak that started at the turn of the century, after peaking in 2005, thanks to the lowest mortgage rates in a generation, fast-rising housing prices and the reconstruction efforts in New Orleans. Since the beginning of 2006, housing starts have been on a downward trend, losing steam every month since January, with the exception of May. As of July, year-to-date US housing starts were 5.1% below their level from a year ago. And the outlook for the remainder of 2006 is not promising either, with residential building permits also showing a declining trend. July figures were down 6.5% from June, a recurring theme since the beginning of the year. The list of indicators pointing to a bearish housing outlook is growing, from a surge in the inventory of homes for sale to flattening housing prices, declining affordability and housing sales. In Canada, the housing market has shown some signs of weakness too, with housing starts and MLS® unit sales on a downward trend. Residential building permits however, remain at elevated levels while renovation activity continues to grow, albeit at a slower pace.

While demand drivers for wood products have deteriorated, Canadian production has nonetheless held up despite lower prices. This is due in part to stepped-up efforts in British Columbia to combat the mountain pine beetle infestation that has plagued the province's forests for the past few years, and now affects an area covering over 8.7 million hectares of BC forests. This has more than offset the impact of the 20% reduction in Quebec's annual allowable cut that the province's mills have had to deal with, which was one of the recommendations of the Commission to Review Public Forest Management in Quebec. Sawn lumber production in Canada has declined just 0.6% in volume y/y during the first half of 2006, while manufacturing shipments are down 6.2% in value during the same period. Similarly, exports of lumber and sawmill products in nominal terms have shown steep declines since the beginning of the year (-8.7%), but after adjusting for price variations, exports are actually up 1.3% during the same period.

SECTOR OUTLOOK

The US market should continue to be well supplied in the near term thanks to the increased production in BC and additional imports from overseas, which have ramped up in recent years. As a result of supply outpacing demand, we expect prices for softwood lumber and OSB to drop through the rest of 2006 and 2007. This will likely mean some mill curtailments in Canada are in the cards to eventually balance both sides of the supply-demand equation. Given these weakening fundamentals, EDC Economics anticipates that lumber prices will fall by 17% in 2006 and another 8% in 2007, while OSB prices are expected to fall by more than 30% in 2006 and another 14% in 2007. Canadian exports to the US, which is the destination for over 85% of Canadian lumber, have declined by almost 9% so far this year and, with the more bearish outlook for wood products, exports are expected to continue to decline in 2006, and again in 2007. Overall, Canadian wood products exporters are looking at a 10% decline in 2006 and a 7% one in 2007.

Table 28: Lumber and OSB Price Outlook

	Long-term average*	2004	2005	2006(f)	2007(f)
Lumber, spf, 2x4 (USD/mbf)	311	394	355	295	270
OSB, 7/16" (USD/000 ft.)	231	372	318	210	180

Source: Bloomberg, EDC Economics. 2004 and 2005 actual, 2006 and 2007 are forecast.
*Long-term average figures are for 1994 to 2004.

After a difficult year in 2005, Canadian **pulp** producers continue to face a number of challenges, including fibre costs, labour costs, increased international competition, high energy prices and the higher Canadian dollar. While prices in US dollars continue to increase, the strong Canadian dollar continues to affect the bottom line of pulp producers and squeeze already razor-thin profit margins. The price increases seen in the US, Europe and China since the beginning of the year are due partly to strong demand coming from North America and Asia, but also to supply management and permanent capacity reductions. In North America, capacity reduction during the past few years has come mostly from plant closures in Canada where profitability was greatly reduced following the appreciation of the Canadian dollar. As a result, pulp inventories have remained tight since the beginning of the year, allowing producers to implement a series of price increases to buyers. In August, the price for Northern Bleached Softwood Kraft (NBSK) pulp to Europe averaged USD709 per thousand metric tonne, a 17% increase since January.

Table 29: Market Pulp Export Outlook by Region by Region

Top Markets	CAD bn 2005	% Share of Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
US	2.84	45.4	-4.4	-13	-5
Eurozone	1.00	16.1	-15.4	-28	-4
China	0.82	13.1	-17.3	46	16
Asian NIEs	0.49	7.8	-19.9	21	11
Japan	0.44	7.0	-20.3	6	-4
Total World	**6.27**	**100.0**	**-12.2**	**0**	**2**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.
The Asian Newly Industrialized Economies (NIEs) are Hong Kong, Singapore, South Korea and Taiwan.

In the first 7 months of this year however, Canadian pulp exports are down 0.9%, although the decline is completely price driven, as exports are up 7% after adjusting for price changes. Exports to China, one the key drivers of demand in the recent past, have jumped by 40% compared to last year, surpassing exports to Western Europe as Canada's number two destination for pulp. Other Asian markets have also caught the attention of pulp producers in Canada, with higher exports to South Korea (+14%), Indonesia (+28%), Taiwan (+25%) and India (+49%). Canadian pulp producers could benefit even further from the growing demand emanating from the Asian markets.

Table 30: Pulp and Paper Price Outlook

	Long-term average*	2004	2005	2006(f)	2007(f)
Market Pulp (USD/tonne)	593	616	611	675	680
Newsprint (USD/tonne)	559	531	580	640	660

Source: Bloomberg, EDC Economics. 2004 and 2005 actual, 2006 and 2007 are forecast.
*Long-term average figures are for 1994 to 2004.

A number of pulp plants in Latin American are expected to come online during the second half of this year or in 2007, adding 1.6 million metric tonnes of annual capacity, roughly the equivalent of capacity shutdown in Canada. As a result of additional capacity and softer demand, pulp prices are expected to show only modest growth in 2007 (+1%) in US dollars, following an anticipated increase of approximately 5% in 2006. Overall, EDC expects Canadian exports of pulp to decline by 1% in 2006 before increasing by 2% in 2007.

Newsprint consumption in North America has been on the decline since 1999 and has continued to decline so far in 2006, dropping to 5.8 million tonnes in the first seven months of 2006, a 4.7% y/y drop according to the Pulp and Paper Products Council (PPPC). The decrease was prompted by a 5.4% year-over-year decline in consumption by daily US newspapers during the same period. As a result, Canadian exports of newsprint during the January to July period are 9.4% lower than last year's. The decline is strictly volume-related however, as price-adjusted exports are down 9.9% during that time, while newsprint production was down 7.7% in the first half. This basically means that the higher prices in US dollars, which are on average 12% above their previous-year through August, have been wiped out by the appreciation in the Canadian dollar. Other paper products and paperboard have fared somewhat better, with exports declining 6.1% in value y/y through July, or 5.3% after adjusting for price changes.

Table 31: Newsprint and Other Paper Export Outlook by Region

Top Markets	CAD bn 2005	% Share of Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
US	14.42	85.4	-1.6	-8	-1
Eurozone	0.48	2.8	1.5	-35	14
United Kingdom	0.30	1.7	28.3	-32	14
South America	0.23	1.4	13.0	21	14
Asian NIEs	0.19	1.2	0.9	3	13
Total World	**16.90**	**100.0**	**-0.3**	**-7**	**1**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.
The Asian Newly Industrialized Economies (NIEs) are Hong Kong, Singapore, South Korea and Taiwan.

Paper mills in North America have been operating at close to 95% of capacity since the beginning of the year, meaning that there is very little room available to generate additional output at the plant level. This reflects the downtime, permanent shutdowns and plant conversion to other products that have occurred in the past few years in response to declining demand. At the same time, lower newsprint production in both Canada and the US has helped reduce the overall level of North American newsprint inventories. In July, North American inventories, at both the mill and consumer levels, were estimated at 1.3 million tonnes by the PPPC, or 9% below historical averages for the month. The tightness in inventories and the lack of additional production capacity have allowed producers to successfully push through price increases so far this year.

Despite the fact that we anticipate the downward trend in North American demand to continue, we expect aggressive supply management and additional demand from Asia and South America to lead to further price increases in US dollars this year and in 2007. While still relatively small, Canadian exports of paper products to Latin America have shown strong increases so far this year, with jumps of 31% in both Mexico and South America and 18% to Central America (including the Caribbean). Overall, EDC expects newsprint prices (in US dollar terms) to increase by approximately 10% on average in 2006, and an additional 3% in 2007. Despite stronger USD prices, lower production and a stronger loonie will push Canadian paper exports down 7% in 2006 before increasing 1% in 2007.

7.4 Advanced Technology

Advanced technology equipment is a broad sector consisting of computers and related peripherals, semiconductors, instrumentation, satellites, and advanced types of electrical equipment. This sector saw its exports increase across most markets in 2005 in response to robust economic growth. While Canadian advanced technology exports to most countries continue to rise in 2006, sales to the key US market have turned down. Weakness in export sales to the US will pull overall exports for 2006 down by an estimated 2%.

Table 32: Advanced Technology Export Outlook

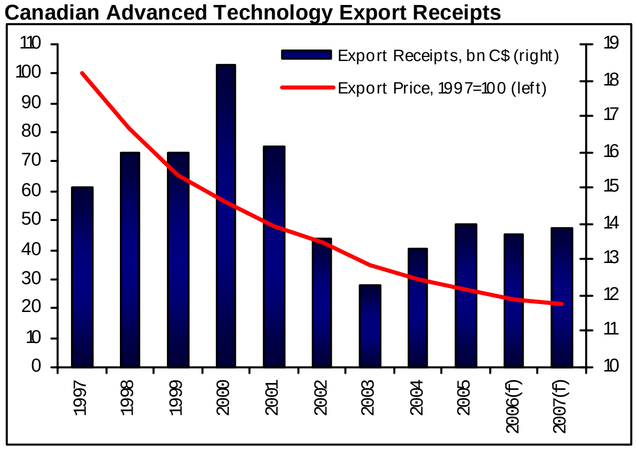
Top Markets	CAD bn 2005	% Share of Exports (2005)	Export Outlook (% growth) 2005	2006(f)	2007f)
US	10.33	73.9	3.5	-5	-1
Eurozone	0.85	6.1	6.0	12	6
Asian NIEs	0.52	3.7	25.9	1	3
United Kingdom	0.51	3.6	-1.3	1	3
China	0.27	1.9	11.9	15	12
Japan	0.23	1.6	-10.6	11	8
Middle East	0.20	1.4	35.6	6	6
Oceania	0.15	1.1	34.4	-7	3
Central/Eastern Europe	0.12	0.9	65.6	11	9
Mexico	0.11	0.8	33.7	40	11
Total Developing Markets	**1.27**	**9.1**	**13.0**	**11**	**9**
Total World	**13.98**	**100**	**5.0**	**-2**	**1**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.
The Asian Newly Industrialized Economies (NIEs) are Hong Kong, Singapore, South Korea and Taiwan.

For 2007, we expect export receipts will stabilize with a small gain of 1%. Companies around the world will maintain investment in new technologies and related equipment in order to maintain a cost edge over their competitors. This type of defensive investment has supported Canadian sales of advanced technology in recent years, and we expect this relationship will continue. For 2007 however, slower economic growth will chew into corporate profits in the US and overseas, so we expect exports will remain sluggish through the next 12 to 18 months. In the event of a more serious economic downturn as outlined in our alternative global growth scenario, we would expect to see the value of advanced technology sales decline in 2007.

Sales into developing markets will lead overall export growth in 2006 and 2007, continuing the pattern of the past few years. China, Mexico, India and Central/Eastern Europe are expected to offer the best opportunities over the next couple of years, although next year's slowing in the global economy is likely to temporarily diminish sales growth into these markets. Despite the drop in the value of advanced tech exports to the US during 2006, the broader Canadian sector is performing reasonably well. Indeed, this year's entire decline stems from falling export prices for advanced technology goods, which are on track to drop by 12% in 2006. Although technology goods have been experiencing significant price declines in recent years, the stronger Canadian dollar has added to the overall decline in C$ export prices. Pricing may be weak but volume shipments to the US (adjusted for price movements) are estimated to rise by 8% this year. For total exports to all markets, we expect export volumes will be up by about 10% in 2006 followed by a 9% rise in 2007 – roughly offsetting projected price declines in both years.

Figure 31: Falling Export Prices are Capping Growth in Canadian Advanced Technology Export Receipts



Source: Statistics Canada, EDC Economics.

As with other higher value-added manufactured goods, Canadian producers of advanced technology equipment have managed to grow their export sales during the past couple of years. The strong loonie, lack of pricing power, higher input costs and offshore competition have certainly put up serious roadblocks, but Canadian tech companies were able to increase their export sales – thanks in large part to strong demand from customers in developing countries. Since 2002, Canada's advanced tech exports to emerging markets have grown at an annual average of 20% compared with an average annual decline of 1% for industrialized countries. The drop in sales to industrialized markets (mostly the US) must be put in perspective. Since 2002, C$ export prices for advanced tech goods have fallen by about 13% per year, which shows just how strong volume shipments have been in recent years. The fact that the value of Canadian tech exports to most non-US markets is showing steady growth is strong evidence that the weakness in shipments to the US is mainly the result of the rise in the Canadian dollar against the US greenback. To be sure, the loonie has appreciated much less (and in some cases, not at all) against the euro, yen and most of the major developing economy currencies.

7.5 Communications Equipment

Canadian exports of communication equipment are expected to finish 2006 with a gain of 4% – a respectable outcome given the strong Canadian dollar, falling prices and a highly competitive international market for telecom equipment. In fact, the value of Canadian telecom exports was up 13.7% in 2005 and by 11.2% in 2004. The 2004 to 2006 run-up in communication equipment exports is all the more remarkable when stacked up against the near 30% appreciation in the dollar over the same period. Canadian manufacturers in this sector have managed to partially mitigate the stronger loonie by increasing their usage of imported inputs. The most recent data from Statistics Canada show that imported inputs make up 51% of all inputs used in the production of Canadian telecom equipment destined for export markets – and the stronger dollar means these imports are now purchased at a significant discount.

Table 33: Communications Equipment Export Outlook

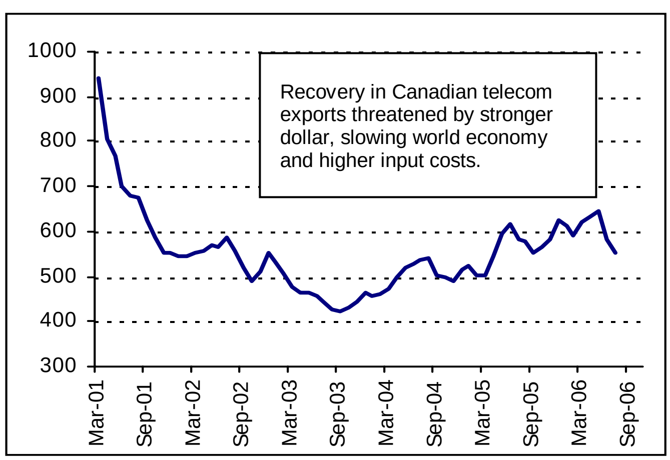
Top Markets	CAD bn 2005	% Share of Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
US	4.73	68.7	14.6	2	1
Eurozone	0.49	7.1	10.6	19	8
United Kingdom	0.48	7.0	-3.9	-4	-1
Asian NIEs	0.19	2.8	2.8	6	5
China	0.13	1.9	29.9	3	3
Japan	0.13	1.9	6.8	-14	3
Oceania	0.12	1.7	21.5	59	12
Mexico	0.10	1.5	128.4	42	9
Total Developing Markets	**0.71**	**10.3**	**28.0**	**5**	**5**
Total World	**6.89**	**100.0**	**13.7**	**4**	**3**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.
The Asian Newly Industrialized Economies (NIEs) are Hong Kong, Singapore, South Korea and Taiwan.

But a slowing global economy, rising competition, higher input costs and the stubbornly high dollar are now starting to impact export sales. Indeed, export growth has been losing momentum in the past couple of months and we now expect overall shipments will expand by just 2 to 3% in 2007, down from our earlier forecast of 5% growth for next year. Our alternative scenario of a much deeper downturn in the global economy has Canadian telecom exports contracting by 2% in 2007.

In 2005, export growth for communications equipment was widespread with most geographic markets showing gains. The primary exception was the UK where export sales fell by 3.9%, but this came after two exceptionally strong years of export growth. Telecom exports to most major markets are up again in

Figure 32: Canadian Telecom Equipment Exports (monthly, millions of C$, 3-month MA)



Source: Statistics Canada, EDC Economics.

2006, but the overall pace of growth is slowing. The most noticeable pullbacks this year are in the US and Japan. We believe the stronger Canadian dollar and offshore competition is starting to impact telecom equipment shipments to the US, although modest growth will still be registered for the year. In the case of Japan, the decline in exports during 2006 follows a string of solid gains stretching all the way back to 2000. Exports to most industrialized countries will continue to moderate through 2007, in tandem with the overall pullback in economic growth. In contrast, we expect shipments to the developing world will maintain steady growth. Emerging markets will account for more than 10% of Canadian telecom equipment exports in 2006, and we anticipate this share will rise through the coming years as developing economies expand and modernize their communications infrastructure – a trend that will offer further opportunities for Canadian companies. At the same time, many governments are relaxing foreign ownership regulations in their domestic telecom markets.

7.6 Industrial Machinery and Equipment

The industrial machinery and equipment (M&E) sector encompasses several machinery sub-sectors: mining and energy, metal and woodworking, agriculture and construction, rubber and plastic, and all other machinery and equipment. The performance of the M&E sector relies heavily on the strength of various industries and the global economy as a whole. Companies around the world are looking for ways to improve productivity and efficiency, and investment in new M&E is an important element in achieving these goals.

Table 34: Machinery and Equipment Export Outlook by Region

Top Markets	CAD bn 2005	% Share of Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
United States	20.5	78.4	1.5	0	3
Eurozone	1.4	5.2	9.4	17	8
Middle East	0.5	1.9	28.7	10	10
China	0.4	1.6	30.1	9	11
United Kingdom	0.4	1.5	-5.2	14	4
South America	0.4	1.5	39.1	-1	16
Asian NIEs	0.3	1.3	-12.0	3	7
Oceania	0.3	1.3	-3.0	20	5
Total Developing Markets	**2.8**	**10.8**	**27**	**15**	**11**
Total Machinery & Equipment	**26.2**	**100.0**	**3.9**	**3**	**4**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.
The Asian Newly Industrialized Economies (NIEs) are Hong Kong, Singapore, South Korea and Taiwan.

Canadian manufacturers of industrial M&E have gained from this mindset, and many continue to do so. Indeed, Canadian exports of industrial machinery and equipment grew by almost 4% in 2005. For 2006, exports of M&E are forecast to expand by 3%, while 2007 should see growth move up to around 4%. Over the forecast period, export prices are expected to show modest increases of roughly 1% per year. Growth is heavily directed toward the expansion of industrial output in developing economies, and we expect growth in Canadian M&E exports to these markets to reach 14% in 2007 versus only 2% for sales to developed economies. The most improved markets will include China, India, Russia, Mexico, along with countries in Africa and Central and South America.

Agricultural and construction machinery exports have lost momentum in 2006 after growing by 11.5% in 2005. Prices for a number of crops and livestock declined in 2006, withdrawing some of the incentive to increase production further. Add to that the bearish outlook in the US residential sector, and the overall picture for this sector in the short term is bleak at the moment. After posting the largest export growth of all machinery sub-sectors for three consecutive years, this sector is expected to decline by 8% in 2006. Exports are expected to show growth again in 2007, rising 6%, as agricultural production expands again, but this will be partly offset by the decline in the US housing market. While approximately 75% of Canada's exports of agricultural and construction machinery goes to the US market, Central Europe and developing Asia/Pacific countries offer the most growth potential for Canadian exporters. As these economies expand, foreign producers will seek to modernize their production technology in response to greater demand for food and lodging. As a result, there will be higher demand for agriculture and construction machinery. India, one of the world's largest wheat importers, announced its aim to increase the country's wheat production by 4.5 million tonnes next year in a bid to reduce its dependency on imports, which are expected to total approximately 6 million tonnes this year. South America and Africa are two other key markets that stood out in 2005 and are anticipated to remain strong over the forecast period, with anticipated annual export growth in 2006 of 10% and 30% respectively.

Exports of Canadian **metal and wood working machinery** finished 2005 up a solid 9.2% over 2004 levels. A further 3% increase is projected for 2006, while exports in 2007 are anticipated to slow further with 2% growth. US demand for metal working machinery has weakened in 2006, and spending should slow further through the next couple of years as commodity prices for base metals and forestry products soften. Canadian exports to the US are expected to grow 2.5% in 2006. The US accounts for 86% of total Canadian metal and wood working machinery exports. In 2005, exports to China and India posted tremendous growth, a trend that continued through 2006 – and should do so again in 2007, albeit not at the same pace.

Industrial metal prices, and to a lesser extent the price of crude, saw a significant rally in 2006. And although we continue to call for a price correction, the average price expected in 2006 for copper, nickel, zinc and crude oil will remain above historic norms. In this price environment, demand for **mining and oil and gas equipment** will remain robust over the medium term. Along with sustained strong demand, another key trend we expect over the medium term is for emerging markets to take an increasingly greater share of total Canadian exports. Sector exports to Algeria, Mexico and China are forecasted to rise 80%, 50% and 25% respectively in 2006. The first two are increasing investments in their oil sectors and we expect this to continue. PEMEX in Mexico is experiencing a rapid decline in "easy oil" from its Cantarell oilfield. New reserves need to be found to improve the county's replacement ratio while future output is likely to require more drilling per barrel of output. Pemex announced record investments totaling USD 13 billion in 2006 and we expect 2007 to be as strong or better. China and another commodities powerhouse, Australia, will see considerable investment in exploration for and development of industrial and other metals. Latin America too shows great prospects in metals mining especially in light of existing high levels of capacity utilization rates. This paints a robust picture for mining and oil and gas equipment, and we expect Canadian exports to grow 8% in 2006 and another 7 to 10% in 2007. Over this period, exports to emerging market should grow 10% and 18% respectively.

Canada's exports of **rubber and plastics machinery** are expected to increase by 1% in 2006 and 4% in 2007. Exports to the US – which account for 60% of the total – are projected to register no growth in 2006. The same result is expected for 2007 as demand for chemicals and plastics falls in line with weakened US housing and economic activity. We expect exports to developing markets should remain healthy but may not show up in export figures to these countries because of data recording problems. While the US chemical industry faces pressures, chemical output continues to expand in countries like Mexico and China. Countries with large hydrocarbon resources such as Russia, Mexico, and Trinidad and Tobago along with countries in the Middle East and Eastern Europe are also expected to record healthy growth as they leverage their lower costs of key feedstocks, especially natural gas. Because of transportation costs, natural gas is not a global commodity and prices vary by region. Chemical production facilities can benefit from long-term purchase arrangements of natural gas in regions of the world where gas supplies exceed regional demand.

The **miscellaneous machinery and equipment** sub-sector accounts for the largest portion of the broader industrial M&E industry. This sub-sector includes commercial and service industry machinery, material handling equipment, heating and refrigeration equipment, and office furniture and supplies manufacturing. Some export diversification has happened this year with the US share of such exports falling to 79.0% from 82.4% in 2005. Export prices are down but demand spurred by a global industrial boom will lead to a 7% increase in Canadian export volumes this year. Next year, our basecase calls for global GDP growth to slow to 4% (from 4.7% in 2005). This will scale back demand for M&E, but Canadian exporters will get some relief from the slightly lower Canadian dollar. With US GDP growth showing the most pronounced decline, exports to this important market will grow only 1 to 2% but this is dependent on the lower dollar scenario.

We expect the value of shipments to China will increase by 5%, 9% to the Middle East and 5% to South America. There was a surge of exports to Japan in 2006 (estimated at 50 to 60%) but we expect next year will show a correction as that economy fails to maintain recent strong momentum. Overall, exports of miscellaneous M&E are expected to rise by 2% in 2007 after advancing 3% this year.

7.7 Automotive Products

Canadian exporters of motor vehicles and parts had a difficult year in 2005, with foreign shipments slumping 2.4%. The exception was assemblers of medium/heavy-duty trucks, which saw exports jump by 27.8%. Falling auto and parts prices were partly to blame for last year's negative results, as was the stronger Canadian dollar. Looking forward to the final months of 2006 and 2007, we see an escalation of this trend, as a deteriorating US economy places downward pressure on the demand fundamentals facing the industry. We project Canadian automotive exports will fall by 5% this year, and a further 6% in 2007.

Table 35: Automotive Exports by Product and Market

Market Segments/Top Markets	CAD bn 2005	% Share of Total Exports (2005)	Export Outlook (% growth) 2005	2006(f)	2007(f)
Passenger Vehicles	53.9	66.7	-5.0	-5	-7
Automotive Parts	22.0	27.2	-0.9	-7	-5
Medium/Heavy Duty Trucks	5.0	6.2	27.8	-4	-4
United States	79.0	97.6	-3.0	-6	-6
Mexico	0.8	1.0	93.3	-6	-3
Total Automotive	**80.9**	**100**	**-2.4**	**-5**	**-6**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

After recording their fourth best year on record in 2005, due largely to incentives like the employee discount scheme, US auto sales are down more than 4% this year. The spate of dealer incentives prompted considerable forward buying last year, undermining demand prospects for this year, and likely next. In the first 8 months of 2006, industry-wide sales averaged a seasonally adjusted annualized rate of 16.7 million units, from a high of about 17.0 million units booked in 2005. Canadian **passenger vehicle** exports have managed to escape these trends so far this year. Despite price erosion and the effects of a stronger CAD, export earnings were up 3.8% y/y in the year-to-July, on strong export volumes. However, the continued erosion of Big Three market share (which still constitute the bulk of Canadian auto production), capacity reductions at both GM and Ford operations in Ontario, a slowing US economy and higher interest rates all threaten to pull exports down 5% in 2006, and a further 7% in 2007.

The Big Three continue to struggle with weakening demand for sport utility vehicle (SUVs), typically their largest profit generators. Although gas prices have eased lately, the spectre of elevated gas prices through the forecast horizon will continue to weigh on sales of SUVs and pick-up trucks. In addition, slowing housing starts correlate historically to a cooling of the pick-up truck market – accounting for 60% of their sales. Meanwhile, a crumbling US housing market and an end to the refinancing wave, amid higher interest rates, will take a bite out of household wealth. This will translate into slower consumer spending, and more trouble ahead for the beleaguered automakers.

Any gains are being made mainly by the non-US brands, which continued to see their market share increase during 2006. Demographics too are playing a role, where the fast-rising Echo generation cohort favours the smaller vehicles. Baby-boomers, meanwhile, tend to favour cross-over utility vehicles, hybrids and luxury cars – so far predominantly the turf of the Japanese and European brands. Aside from enduring legacy commitments and spiraling labour costs, another factor that continues to plague the US brands is the quality-gap perception among consumers. In spite of substantial quality improvements, this perception is reinforced by the reliance of the Domestics on fleet sales, which lower a vehicle's residual value at resale.

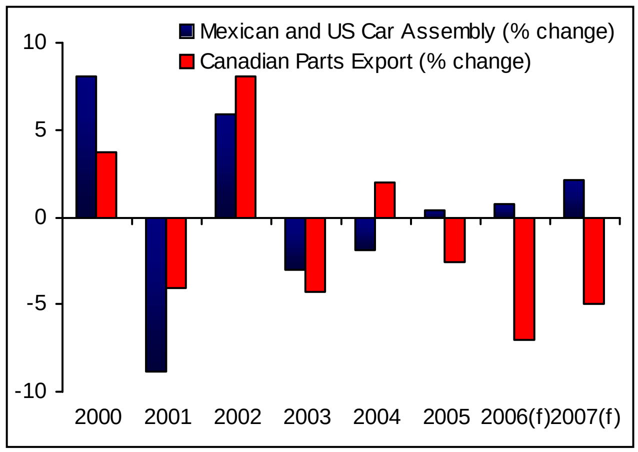
A difficult 2005 for the Big Three and their loss of market share caused them to shut down plants and cut payrolls by the thousands across North America. While 14 of the 26 models produced in Canada have seen production increases in the past year – including the Chevrolet Impala (up

50,000 units over last year) and the Dodge Charger (up 46,000 units) – about 40% of the growth is coming from Japanese automakers. The woes affecting the Domestics will cause Canadian export earnings to decline through 2007. In addition to capacity reductions at GM's Oshawa plants, Ford is looking to cut one shift at its St. Thomas plant in 2007. The transformation of the Ford Oakville facility into a flexible manufacturing unit capable of producing multiple models will alleviate some of the declines in Canadian auto assembly output, but will not be enough to offset the deeper capacity cuts. In addition, downtime at GM's Oshawa truck plant has cut into this year's production.

On the flip side, however, a number of recent investment announcements have bolstered the longer term outlook. GM is moving ahead with its $3 billion Beacon project – which includes the move to flex manufacturing in Oshawa, and the return of the Camaro. Chrysler is spending $768 million in Brampton and Windsor, and Ford has committed $1 billion to re-tool its Oakville facility. In addition, Toyota is spending nearly $1 billion in Woodstock and Cambridge, and Honda will spend $154 million in Alliston.

Given the operating environment of the OEM's, Canada's **auto parts** exporters face a challenging outlook. We expect parts exports to fall 7% this year, before declining by another 5% in 2007. The reasons behind our forecast are predominantly the same as those that caused export shipments to drop almost 1% last year. Being dependent on OEM demand exposes parts manufacturers to the same risks that face the passenger vehicle segment. In addition, with the Big Three constituting the bulk of their customer base, Canadian suppliers will suffer from the shrinking market share of the Domestics.

Figure 33: Canadian Auto Parts Exports



Source: Statistics Canada, EDC Economics and CSM Automotive

The closure of large Canadian parts producers continues to make headlines in 2006. As tier 2 suppliers see their contracts being cancelled, subsequent tier suppliers in the lower end of the supply chain are being hit as well, presaging poor prospects for the sector as a whole. The recent shutdown of Michelin's facility in Kitchener is indeed causing the closure of many smaller suppliers in the area. The same is happening in St. Catherines and Windsor, where GM and Ford will be closing their powertrain and casting plants by 2008. Dana Corp. has scaled back production in St. Mary's, at a plant that makes frames for Ford's F-series trucks. Dura Automotive Systems Inc., which closed a Brantford plant earlier this year, plans to close its Stratford brake cable plant by the end of 2007.

The lack of pricing power coupled with the strong Canadian dollar will continue depressing overall export earnings. Furthermore, because automakers are under increasing pressure to reduce their own cost structures, they are outsourcing an increasing number of provisioning contracts to cheaper Asian and East European suppliers, at the expense of their long-time North American partners. In contrast, the New Domestics (especially the Asians) continue to rely heavily on their own supply network from back home, making it difficult for Canadian companies to diversify their customer base outside of the Detroit makers.

Meanwhile, Chinese carmakers are looking to take over foreign parts companies (especially engine plants), in order to have access to state-of-the-art technology that will allow them to penetrate Western markets in the near term. Like many other goods now being made in China, these vehicles promise to be technologically sophisticated, offering some of the most fuel-efficient and comfortable cars on the market. At around USD 10,000, these vehicles will compete directly with the North American, Japanese and European brands. And of course, most of the parts in these cars will be Chinese-sourced. A study conducted by Accenture Research consulting forecasts that by 2010, consolidation will have eliminated about half of worldwide part makers.

In this increasingly competitive environment, it is imperative for Canadian suppliers to diversify their customer base outside of North America. Staying power will require a presence in overseas markets, either alone or through joint ventures with local companies, and more investment in R&D. And given the strength of the Canadian dollar and still favourable long-term interest rates, there has probably never been a better time.

The outlook for **specialty and medium/heavy duty trucks** is not as grim as that for the sector's other two segments, though export earnings will contract over the forecast horizon. Following last year's impressive 27.8% gain, exports are down 3.4% in the year-to-July (mainly as a result of pricing effects). We anticipate full-year contractions of 4% in both 2006 and 2007, due to lower export volumes and prices. Although Class 5 to 7 truck sales are now past their peak, we still see some momentum building for Class 8 trucks in view of stricter emission standards by 2007. However, flagging economic prospects and waning North American trade flows will cut into freight traffic, impeding demand for new trucks.

The outlook for specialty vehicles, such as mass transit buses, motor coaches, school buses, fire trucks and ambulances, is something of a mixed bag. Even though investment in infrastructure and transit is not counted in their budgets, US states and municipalities are likely to remain constrained by higher interest rates and fiscal imbalances. Sales to the private sector, however, will be less affected. Demographic trends in the US will continue to support the leisure and tourism industry, creating demand for private motor coaches. In addition, non-traditional markets may create new pockets of demand for Canadian manufacturers.

7.8 Aerospace

Canadian manufacturers of aerospace products are expected to see their export sales fall by 4 to 5% in 2006. A slump in regional jet sales to the key US market is the major drag on this year's overall exports, as virtually all other industry sub-segments are seeing shipments and new orders increase. The situation is expected to stabilize in 2007 as weakness in RJ sales is offset by modest gains across other parts of the industry. Overall, export shipments for the Canadian aerospace sector are forecast to rise 1 to 2% next year. In the case that our downside scenario prevails (which calls for a mild US recession in 2007), we would expect aerospace exports to decline a further 3 to 4% next year.

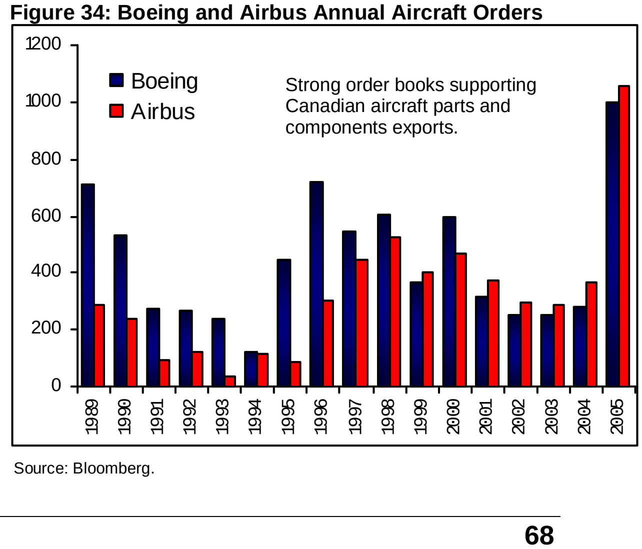
Table 36: Aerospace Export Outlook by Region

Top Markets	CAD bn 2005	% Share of Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
United States	7.79	76.3	1.5	-18	0
Eurozone	1.03	10.1	8.1	65	7
Asia, Oceania (ex. Japan)	0.35	3.4	-4.3	53	-17
UK	0.31	3.0	-19.1	41	8
Japan	0.23	2.3	44.5	-6	3
Developing Market Total	**0.70**	**6.9**	**38.9**	**-16**	**9**
Total World	**10.21**	**100.0**	**2.9**	**-4**	**1**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

Helicopters, business jets, parts and related components now make up about half of all Canadian aerospace exports – and these products are expected to put in a good performance through the next 12 to 18 months. Indeed, the next couple of years look very promising for Canadian companies selling into the respective supply chains of Airbus, Boeing and other aircraft manufacturers. Combined orders for Boeing and Airbus reached a record 2057 airplanes in 2005. While orders are down in 2006, they are still running well above the annual average of recent years – in the first 9 months of 2006, Boeing recorded 666 new

Figure 34: Boeing and Airbus Annual Aircraft Orders



Source: Bloomberg.

orders while Airbus added 222 new orders from January to August. Much of the new demand is coming from Asia and the Middle East where air traffic growth is boosting the need for more aircraft. Strong oil revenues are providing many Middle Eastern airlines with the financial means to purchase new airplanes (national airlines and oil companies are typically both owned by the government in this part of the world). Increased cargo demand has been adding to Boeing and Airbus order books as well. Globalization and the resulting rise in global trade flows is boosting demand for cargo services, including air, and we expect this upward trend will continue over the next several years.

Worldwide shipments of corporate jets and general aviation aircraft are also up strongly this year, providing further sales support for Canadian aerospace parts suppliers. In addition, the recent run-up in energy and metal prices has benefited the Canadian aerospace sector as oil and mining companies purchase more helicopters to support their increased exploration activity. Large and small Canadian suppliers tied to defense spending have been seeing an increase in contracts since last year. But we expect the trend in new orders across all three of these sub-sectors – corporate jets, helicopters and defense – will ease back in 2007. A slowing global economy will impact companies' cashflow and profits, diminishing a key demand driver for business jet sales. In the case of helicopters, the pace of growth in new orders is expected to moderate through 2007 in response to lower oil and metal prices. Finally, defense spending is expected to level off for some countries over the next year or two.

In contrast to other segments of the Canadian aerospace sector, regional jets are having a tough time again in 2006. Canadian regional jet deliveries were down to 55 units through the first 7 months of 2006 compared with 103 units in the same 7-month period of 2005. High operating costs and the relaxation of scope clauses (which originally helped RJs become the aircraft of choice for short to medium range routes in the US) have depressed demand for this class of airplane. Rising traffic and relaxed scope clauses are pushing cost-conscious airlines to shift demand away from 50-seat RJs to larger RJs and turboprops. For higher volume routes, 70-plus seaters allow carriers to raise yields by increasing their passenger capacity without incurring proportionally more expenses. For less-trafficked and shorter routes, the more fuel-efficient turboprops have become the planes of choice. Indeed, turboprop orders have been on the rise over the past year. Also encouraging is the recent improvement in orders for Bombardier's larger RJs from customers in Europe and parts of Asia. There is upside potential in the US market as well, in that some US carriers that are currently reorganizing their operations may add additional 70 to 90 seat RJs to their fleets.

Meanwhile, strong product investment by some of Canada's leading names will shore up exports. To cite but a few, Pratt & Whitney Canada is seeing strong demand for its new super light engine, obliging it to churn up production by 25% and hire back previously discharged employees. Strong demand for its new MAPL product line will allow Bell Textron Helicopter to continue operating at full capacity for the next several years. The success of the helicopter maker will have significant ripple-down effects for the whole Canadian aerospace industry, benefiting Pratt & Whitney Canada and Mecaer among others, which are producing their engines and landing gear.

7.9 Rail and Other Transportation Equipment

In 2005, the rail and other transportation equipment sector witnessed a 19.6% decline in exports, led by a 29.0% plunge in the "other transportation" sub-sector. The sector is seeing a sharp reversal in 2006, with exports up 8.3% y/y in the first 7 months of the year. While other transportation equipment exports remain more or less flat, rail equipment exports have jumped by almost 30%. We anticipate a solid year for the broader sector in 2006, with export growth of

Table 37: Rail and Other Transportation Equipment Export Outlook

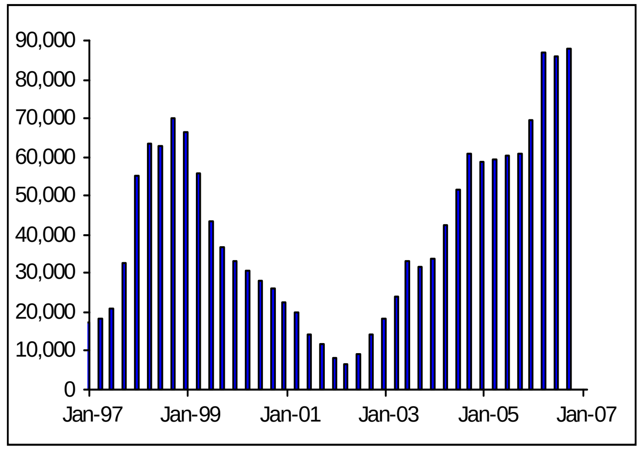
Top Sectors	CAD bn 2005	% Share of Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Rail Transport Equipment	0.6	33.7	8.8	25	5
Other Transportation Equipment	1.3	66.2	-29.0	5	2
Total Rail and Other Transport.	**1.9**	**100.0**	**-19.6**	**12**	**3**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

12%. Prospects should moderate somewhat heading into 2007, when a cooling of the global economy brings export growth down to 3%.

The rail transport equipment segment is notoriously volatile, following the whims of economic cycles, commodity prices and fleet lifecycles. In 2005, Canadian exports benefited from robust global economic activity, and that trend appears to be intensifying this year, with growth of 25% expected in 2006. But rail traffic volumes reflect a global economy that has reached a plateau. Total volume on US railroads was up by a solid, albeit more moderate, 2.7% y/y in the year-to-August. US freight railcar deliveries were up by only 8.7% y/y in 2006Q2, versus growth of 77.9% a year earlier. In fact, backlog orders, which had reached a record high the previous quarter, fell back for the first time since 2004Q4. New orders are also trending down, falling 49.5% on a sequential basis. The trend will likely begin hitting Canadian suppliers next year, portending growth of only 5% in 2007.

Figure 35: Backlog Orders for US freight Cars Point to Steady Growth for Canadian Rail Equipment Exports



Source: Railway Supply Institute.

Underpinning the sub-sector's longer term prospects are emerging infrastructure shortfalls in the US, amid increased traffic and declining capacity. Freight traffic increased more than 50% between 1990 and 2003, and is expected to double from its current rate by 2025. Meanwhile, the US freight rail network suffers from a legacy of underinvestment. Over the next 20 years, some estimates show that class 1 railroads (those with operating revenues in excess of USD 275mn per year) will need to spend at least USD 4bn annually in repairs and maintenance, and USD 3.5bn each year on new infrastructure. There is some downside structural risk, however, in that renewed consolidation of the US freight railroad industry could weaken new capacity investments. This would force Canadian companies to look elsewhere for trade and investment opportunities.

Rail equipment exports to Mexico jumped 453% y/y in the year-to-July, while exports to Brazil surged by 2,058%. In Africa, exports to Ivory Coast were up 2,343% and sales to Zimbabwe climbed 206%. But because much of the sector is geared toward contract work, exports can fluctuate substantially year to year as contracts are filled and not renewed. However, these numbers illustrate the point that opportunities abound in the emerging markets. China, with the highest rail traffic density in the world, is a prime example. The Chinese rail system accounts for a mere 6% of global track mileage, but carries one quarter of the world's annual railway freight. Over the next 5 years, the Chinese government has numerous plans to expand its rail capacity to meet growing demand, presenting an unprecedented opportunity to Canadian exporters. In addition, in order to meet construction targets, the Chinese government is encouraging the use of private capital – including foreign investment – in accordance with WTO rules that provide for rail transport to be fully opened to foreign capital by 2007.

Ever since the global military build-up that ensued from the September 11th attacks, the "other transportation equipment" segment, which includes armoured military vehicles, has increased in relative importance. In the first 7 months of 2006, the "other transportation" sub-sector accounted for two thirds of the greater sector's total exports, up from half in 2001. But it is ship/boat building and repair that accounts for almost two thirds of the sub-sector. Export receipts earned from the latter were up by a fragile 1.2% y/y in the first half of 2006, driven mostly by steady sales to the US and some major contracts in Belgium and Australia. The ship/boat building and repair segment will continue to face listless demand through the forecast horizon, as the global downturn eases the capacity shortages experienced over the last few years. Canadian exporters will benefit, however, from new pockets of activity in 2007, with the coming into force of new

Sulphur Emission Control Areas (SECA) in the Baltic Sea, the North Sea and Channel Islands, and NAFTA.

Exports of all other transportation equipment saw a 14.9% y/y increase over the first 7 months of the year, even as military vehicle sales to Iraq dropped off significantly. Exports to Saudi Arabia accounted for nearly 10% of total sales, a result of a number of substantial military orders. Exports to the Middle East are expected to pull back in the next 2 years, from the peaks reached in 2005. But as in ship/boat building, the US accounts for the bulk of the exports in this segment, reflecting demand for both military and recreational vehicles. We expect exports to remain strong through 2006, before easing back next year, reflecting a retrenchment in US consumer spending as well as government efforts to reign in a runaway military budget. Consequently, the sub-sector will see export growth of 5% in 2006, before slowing to 2% in 2007.

7.10 Consumer Goods

Prolonging a 3-year string of declines, exports of consumer goods fell 7% y/y in the year through July, in line with our Spring GEF forecast of a 6% decline for all of 2006. Going ahead, our earlier call for a further 7% decline next year still remains in place. The strong Canadian dollar, the Fed's tightening bias, and persistently high energy prices have all converged to erode demand for Canadian consumer goods. This broad category – which includes products ranging from apparel, textiles and footwear to toys, household appliances and furniture – has also felt the brunt of strong Asian competition in the US and European markets.

The reasons for our bleak consumer goods forecast are both structural and cyclical in nature. The globalization of supply chain management continues to transform the sector in ways that favour lower cost centres, at the expense of Canadian exporters. As trade barriers are torn down, suppliers from low-wage countries, especially China, gain the upper-hand in the production of labour-intensive products, like apparel and textiles. Disconcertingly, however, this trend is also becoming increasingly visible on the higher value-added end, in products like furniture and sporting equipment. In this extremely competitive environment, many small and large players have already disappeared. Those that have survived have done so by outsourcing part, if not most, of their production abroad.

Table 38: Consumer Goods Export Outlook by Region

Top Markets	CAD bn 2005	% Share of Total Exports (2005)	Export Outlook (% growth) 2005	2006(f)	2007(f)
United States	9.0	89.5	-8.9	-7	-8
Eurozone	0.4	3.6	3.2	0	2
UK	0.2	1.8	-9.9	-16	3
Asia/Oceania	0.2	1.6	-6.3	-2	-5
Japan	0.1	0.7	15.9	5	-8
Total World	10.1	100.0	-8.1	**-6**	**-7**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.
Asia and Oceania does not include Japan.

Despite an expected moderation of the Canadian dollar, the currency will continue to trade at elevated levels through the forecast horizon. This will add to the woes of the sector. Unfortunately, the appreciation of the loonie has been quite rapid, and some Canadian manufacturers have not had enough time to adjust, pricing many of them out of the critically important US market. This is especially true in the apparel, sporting and athletic goods industries. However, in those countries whose currencies have appreciated faster than the Canadian dollar, Canadian consumer goods exports have performed relatively well. For instance, despite the sluggishness in European consumer spending, exports to the Eurozone are actually up so far this year, albeit by a pale 1%. Meanwhile, a weaker sterling has exaggerated the fall in Canadian export sales to the UK, which plunged 18.8% over the first 7 months of the year. Heading into 2007, moderate appreciations of the euro and the pound sterling vis-à-vis the Canadian dollar should give a boost to Canada's European exports.

However, the expected easing in US consumer spending through the remainder of this year, and into 2007, will contribute to a weaker outlook. Without new tax rebates and mortgage refinancing money to provide additional stimulus, growth in US consumption will come mostly from wage and earning gains. These will likely be limited, given that further improvements in the labour market will be more modest. Meanwhile, higher interest rates, while not crippling the U.S. consumer, will act as a disincentive to spend.

Because of the wide diversity of industries in this broad category, not all will experience the same fate. Prospects remain brighter for those manufacturers that can emphasize their specific "know-how" and their distinctive Canadian labels. For instance, medical equipment, jewellery and motion picture production, to cite but a few, will continue to fare well despite a deterioration of the broader underlying fundamentals.

7.11 Agri-Food

With the reopening of major international markets to imports of Canadian cattle and expected bumper crops for canola and durum wheat, exports of agri-food products are expected to grow 4% in 2006, following a 1.5% decline in 2005. Next year, an increase of about 5% is expected, as growth returns to trend in most sectors.

Table 39: Agri-food Export Outlook by Product

Top Sector	CAD bn 2005	% Share of Total Agri-food Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Food and beverage manufacturing	8.5	27.9	-2.7	1	-1
Meat, meat preps.	5.7	18.7	3.6	-20	10
Fish, fish preps.	4.3	14.2	-3.3	-3	3
Oilseeds and Pulse	4.3	14.2	-2.1	20	-3
Wheat Farming	3.1	10.2	-20.5	14	20
Other Crop Farming	2.0	6.6	-3.1	4	1
Live Animals	1.8	5.9	63.5	48	12
Coarse Grains	0.7	2.3	0.9	9	5
Total	**30.5**	**100.0**	**-1.5**	**4**	**5**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

Canada began shipping cattle under 30 months of age to the US on July 18, 2005 after a 2-year ban was lifted. Exports of live animals have returned to more normal levels since, resulting in impressive growth in the first 7 months of 2006. Gains in the second half will be far more modest however, as the year-over-year impact dissipates. For 2006 as a whole, exports are expected to fall well short of the $1.8 billion level achieved in 2003, with exports of $648 million in the first 7 months of the year. The on-again, off-again Japan ban on imports of US beef continues to threaten exports of Canadian live cattle to the US, where it is processed before being shipped to Japan and other markets. However, the latest Japanese ban on US beef imports was lifted in July, while the 3-year old South Korean ban on US beef imports was lifted in early September. With higher exports of live cattle, Canadian exports of all live animals (excluding seafood) are expected to grow by 48% in 2006 and 12% in 2007. Additional cases of BSE-infected cattle will not affect this forecast unless such cases occur in large numbers in Canada or the US. Since the end of the ban, prices for live cattle in the US and Canada have converged, showing a strong upward trend in Canada while declining from their peaks in the US. In 2006, US cattle prices are forecast to average USD 85 per carcass weight, down slightly form an average of USD 87 in 2005.

Exports of meat and meat preparations are expected to decline by 20% in 2006, following a 3.6% increase in 2005. While part of the decline so far this year has been linked to the reopening of the US border to imports of live Canadian beef where they are being shipped for processing instead of Canada, it is not limited to cattle only, or to the US market. The declining demand for chicken in Asia and Europe, where consumers are worried about the deadly avian flu, has created a backup of chicken supplies in the US. This has driven down the price of poultry and at the same time affected the demand for pork as consumers are switching to lower priced chicken. Supplies of pork are currently outpacing demand, causing inventories in both the US and Canada to rise. At the same time, pork exports to Asia have fallen abruptly as Japan continues to go through the large amounts of inventories it acquired last year as a substitute to poultry in response to the avian flu scare. We expect pork exports will be down in 2006, but there is additional downside risk here as it appears a growing number of US consumers are abandoning the high-protein meat diets that were popular over the past few years.

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The higher production of major crops from the 2005 harvest will result in greater Canadian exports in 2006 despite generally lower prices resulting from increased supplies in all the main producing countries. Exports of wheat are forecast to grow by 14% in 2006 and by 20% in 2007, with the pick-up in 2007 resulting from lower world output (especially in Australia) and stronger pricing. A lower harvest of non-durum wheat in India has forced it to increase imports in order to meet domestic needs and stave off inflation pressures, which should benefit Canadian exporters. Canadian exports of the higher quality (and higher priced) durum wheat are down 4% so far in 2006 as lower prices have offset larger volumes. Exports of durum will probably decline again in 2007 as production in 2006 is expected to fall by as much as 40% due to lower yields and fewer harvested acres.

A larger inventory of cattle and hogs in the US, and therefore greater demand for feed crops, has increased Canadian shipments of coarse grains to the US despite greater supply from the EU. Canadian exports of coarse grains are up 11% so far this year. Exports of oats have increased 13.7% in value so far in 2006; and with a greater crop expected this year thanks to a larger area and a return to normal abandonment rates, oat shipments will see further growth in 2007. Barley exports have also increased so far this year, up by 18.1%, with greater market penetration in Saudi Arabia, Japan and Columbia offsetting weaker exports to the US and China. Overall, the exports of coarse grains are projected to rise 9% in 2006 and another 5% in 2007.

Table 40: Agri-Food Export Outlook by Region

Top Markets	CAD bn 2005	% Share of Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
United States	18.4	60.3	-2.1	2	3
Japan	3.1	10.2	3.5	-9	6
Eurozone	1.4	4.6	-5.9	21	4
Asian NIEs	1.2	4.0	38.1	-1	7
China	1.2	4.0	-21.3	-18	6
Total World	**30.5**	**100.0**	**-1.5**	**4**	**5**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.
The Asian Newly Industrialized Economies (NIEs) are Hong Kong, Singapore, South Korea and Taiwan.

Canadian production of canola is estimated to have reached record levels in 2005 and as a result exports of oilseeds and pulse have surged 22.7% y/y in January to July despite lower prices and the higher Canadian dollar. Canada is the world's largest exporter of canola and is in a good position to take advantage of the decline in world output this year. In China, greater consumption and lower output in 2005 have resulted in exports quadrupling year-over-year. The recent expansion of the bio-diesel industry in the EU has left the door to canola markets in the US and Mexico wide open to Canadian exporters. Exports to Pakistan, a market with high growth potential for Canada's canola exports, started again in October 2005 and have continued uninterrupted since. For pulse crops, higher world supply was more than offset by increased demand, especially in the domestic feed market. With the exception of dry beans and chickpeas, all prices are forecasted to increase or remain the same. Overall, Canadian exports of oilseeds and pulses are forecast to grow by 20% in 2006 before declining by 3% in 2007, as substantial production declines for canola (-17.4%) and dry field peas (-10.2%) are expected in 2006. Canola prices are expected to rise next year, but the strong Canadian dollar and low US soybean prices will keep prices under pressure.

Canadian exports of processed food and beverage products usually follow the economic growth rates of the US economy. The recent easing of prices at the pump should encourage consumer demand for other products, especially higher value-added and luxury food items, although overall inflationary pressures in the US remain high. Although the US is the main market for Canadian exports of food and beverage products, the strong Canadian dollar has so far only dented profit margins in the industry. However, the overall environment remains challenging, not only with the high dollar, but also slower growth in the domestic market and increased global competition. Real personal disposable income in the US is expected to grow by about 2% in 2006, but slow next year along with the rest of the US economy. Overall, exports of food and beverage products are expected to grow by 1% in 2006 but decline by 1% in 2007 on expectations that growth in US consumer spending will ease.

A number of trends are expected to continue in the US, which will impact mostly the composition of Canadian exports. Although US consumers continue to be more and more health conscious, the declining popularity of high protein diets has restored Americans' appetite for potatoes and fries. Recent research has started to question the extent of health benefits from omega-3 fatty acids, and so the popularity of products rich in it may start to wane. The 'cola wars' of the past have been replaced by the bottled water and juice wars and more recently, the high-energy drinks war. As well, the demand is growing for a greater variety of food – particularly ethnic cuisine. And with busier lifestyles, consumers continue to want convenience with food and meal preparation, and food manufacturers are responding to both trends. However, should the economic situation in the US deteriorate, consumer confidence decline, or unemployment creep up, demand for Canadian exports of food and beverages would weaken, especially those in the higher value-added and luxury categories. And if any event jeopardizes US consumers' confidence in the safety of food production and distribution (such as BSE), this could potentially impact the demand for such products indefinitely.

A mixed outlook for seafood products

Canadian exports of seafood products are expected to fall 3% in 2006, led by lower prices for crab, lobster and shrimp, all of which have already seen sizable price declines so far this year. This will mark the fourth consecutive annual decline in seafood exports, as the industry continues to find itself negatively impacted by the strong Canadian dollar and an inability to pass higher input costs on to consumers. Groundfish processors face even greater challenges as competition from China's low-cost labour pool remains fierce. One exception to the rather weak outlook this year is salmon, which will see a considerable price increase in 2006.

Next year, we forecast slightly lower energy prices and a 5% decline in the Canadian dollar against the USD. The latter will boost prices for most seafood products, but the gain will be mitigated by softening demand from Japanese and US consumers. Indeed, economic growth in both of these countries should prove tame in 2007, with GDP growth forecasted at 1.9% in Japan and 2.2% in the US. All told, export volumes should be relatively flat next year, which when combined with our price outlook results in a modest 3% increase in seafood exports.

7.12 Fertilizers

Tight supplies and high demand for fertilizers pushed prices to unprecedented levels in foreign and North American markets in 2005. At the same time, last year's abundant harvest for a number of crops resulted in weaker prices for agricultural commodities. With fertilizer prices rising by over 30% in 2005, and declining crop prices, US and overseas customers slowed their purchases in the second half of 2005, a lull that carried over into early 2006. Demand improved in the second quarter of 2006, with the traditional North American demand peak, and should continue to do so during the rest of the year and into 2007. Exports to Brazil are expected to be higher in 2006 than 2005, particularly in the second half of the year when it traditionally buys potash in order to prepare for its spring growing season.

Potash Corp. of Saskatchewan, the world's largest producer of potash, temporarily reduced production in January at three mines to reduce inventories that had built up in the final months of 2005. The downtime was largely in response to falling demand from Brazil, the company's biggest customer. Despite the closures, North American producers' inventories have remained above their 5-year average since the beginning of 2006. Inventories have accumulated due to very weak shipments during the prolonged price negotiations between Potash Corp. and China and India. Nevertheless, higher inventories have failed to weaken potash prices. With a price agreement now in place, Canadian exports are expected to increase at a fairly strong pace in the second half to make up for some of the overdue purchases.

Overall, we expect Canadian exports of fertilizers to decline by 4% in 2006 before returning to a more sustainable growth level of around 8% next year. The increase next year will partly come from additional volume by Potash Corp, which announced investments to bring back idle capacity at the Lanigan and Allan mines in Saskatchewan. Going forward, world demand for Canadian fertilizers will be driven by demand in the main agricultural markets of the US, China, Brazil and India. Other Asian nations such as Malaysia, Indonesia and Viet Nam are also likely to increase their demand for Canadian fertilizers after reducing their consumption in 2005 due to adverse growing conditions. One upside risk to the forecast includes the possibility of farmers increasing their acreage of corn for ethanol production as countries look to alternative fuel sources in the presence of high oil prices. Corn is the most fertilizer-intensive crop and accounts for most US demand. Perhaps the biggest downside risk for Canadian producers stems from any unexpected strengthening in the Canadian dollar.

7.13 Chemicals and Plastics

Chemicals and plastics – The export outlook for the **chemicals**, and **rubber and plastics** sector is little changed from our last report. Exports for these two sectors are expected to expand some 2 to 4% in 2006, with exports of chemicals growing 2%, while rubber and plastics are expected to post export growth of 3 to 4%. Export growth remains heavily dependent on the US market, but the pace of economic growth in this dominant market is softening. Demand for Canadian chemical and rubber and plastics outside the US market will continue to exceed US demand growth in the coming 12 to 24 months. However, planned capacity additions in Asia and the Middle East will keep a lid on Canadian growth prospects over the mid to longer term (as new product from these markets competes with Canadian producers). For 2007, combined exports of chemicals, plastics and rubber products should expand by about 3%.

Table 41: Chemicals and Plastics Outlook by Sector and Region

Top Markets	CAD bn (2005)	% Share of Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Chemicals	24.1	69.9	9.8	2	3
Rubber and Plastics	10.4	30.1	2.6	3	1
Total Chemical and Plastics	**34.6**	**100.0**	**7.6**	**2**	**3**
Total Chemicals and Plastics by Market					
United States	28.7	83.0	5.5	2	2
Eurozone	1.4	4.1	41.1	-2	6
China	1.3	3.9	11.6	-10	10
Asian NIE's	0.5	1.5	-8.6	-4	12
Developing Markets Total	2.5	7.2	12.3	1	8

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.
The Asian Newly Industrialized Economies (NIE's) are Hong Kong, Singapore, South Korea and Taiwan.

Capacity utilization rates for Canada's **plastics** industries have been falling since the third quarter of 2004 and in 2006Q2 sat at 82.4% versus a 10-year average of 85.1%. Going forward, high North American prices for feedstock (petroleum and natural gas) relative to other parts of the world may curb production in the chemical sector. Recent price declines for natural gas and for crude are welcome developments for the industry, but cost advantages in other markets are expected to widen in the future. For **rubber** products, Canadian capacity utilization has come down, but at 90% in the second quarter of this year it remains above the 10-year average.

The building blocks of chemical derivatives for many of the chemical industry's products are made from primary petrochemicals such as ethylene, propylene, benzene and olefins. As the petrochemical industry uses oil and natural gas as principal feedstock and energy, it makes this industry one of the most energy-dependent and sensitive to fluctuations in hydrocarbon prices. For example, synthetic resins, which are derived from hydrocarbons, account for 30 to 50% of the total cost of manufactured plastic. Although US producers have been able to pass along higher input costs, the prices for Canadian exports have been mixed with the impact of the higher dollar.

Exports of **inorganic chemicals**, a broad category accounting for over 10% of Canada's chemical exports, are not as tied to energy prices. Key factors influencing export values are C$ exchange rate fluctuations, vis-à-vis the US dollar and euro, along with global industrial production. Within the chemicals and plastics sector, inorganic chemicals are among the least reliant upon the US market – accounting for roughly 70% of total Canadian exports in this sub-sector. Exports of inorganic chemicals rose by a solid 34% in 2005. Shipments should rise another 8% this year on significantly higher prices and lower volumes. Next year, slower US and global growth should add weakness to prices and export volumes.

After two years of double-digit growth, Canadian **pharmaceutical and medicine** exports slowed to growth of 7% in 2005. This is well below the average 20% annual rates seen in the 10 years leading up to 2005. This year we expect growth to accelerate slightly to 10%. In the long term, export growth for this sector is promising as producers benefit from a steady rise in non-cyclical demand supported by an aging population, rising prices, and expansion into the lucrative European and Asian growth markets. Growth in non-US markets should outpace that of the US, allowing a continued diversification of export markets.

Canada's **plastics** industry has three principal end-use markets: packaging (34%), construction (26%) and automotive (18%). The remaining 22% includes a wide range of plastic products with a likewise vast number of end users. This broad range of end-use applications is in stark contrast to the concentration of export demand by country, with 95% of total Canadian plastic exports destined for the US. **Rubber**, on the other hand, is more varied in export destination. Exports in 2006 will rise roughly 4% on a combination of higher prices and volumes. Looking ahead, we see little growth in export volumes for these two sectors, in line with plunging US housing starts and softening auto markets. We expect Canadian exports of plastic products will rise by 3 to 5% in 2006, followed by a 2% increase in 2007.

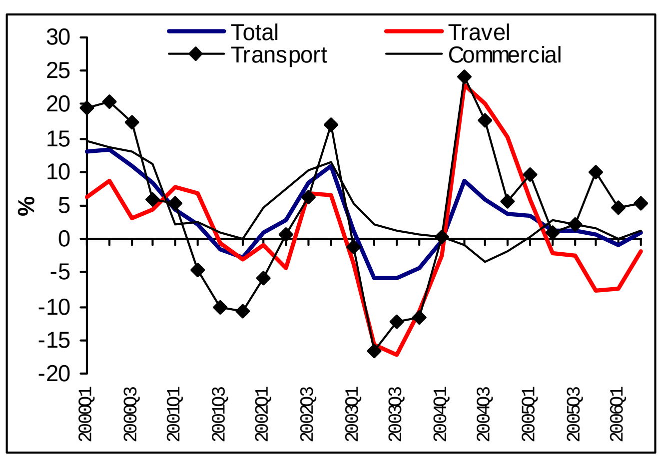
Risks to the outlook for the Canadian chemical industry are dependent on feedstock prices and the economic performance of its largest market, the United States. Higher energy prices can affect the industry through two channels. First is higher feedstock prices, and the second is the negative knock-on effect on demand. With regards to the former, higher feedstock prices bring the production of chemical products in competition with users in other industrial sectors and households. Proximity to the US means that Canada will likely face a long-term comparative disadvantage in terms of natural gas feedstock (since most natural gas in North America is used for electricity generation) – particularly against energy-rich Russia and the Middle East where investments by major global chemical companies are expected to increase dramatically.

While energy prices have seen a decline in the early fall of 2006, prices are likely to settle well above historical norms. This has and will continue to spur interest in increasing the usage of renewable energy sources and is likely to see support via government legislation. Currently, the most promising fuel alternative lies in **ethanol**, which is derived from either sugarcane or corn fermentation. Indeed a new ethanol plant, Canada's largest, with a 200 million litre annual capacity, recently came on line. The resulting fuel, called E85, allows vehicles to run on an 85% ethanol and 15% gasoline blend and is priced comparably to gasoline. Currently, several vehicles use E85 and other vehicles will certainly be added to this list.

7.14 Canada's Services Export Sector

Over the past several years, service exports have been affected by numerous shocks, ranging from the tech wreck in 2001 (resulting in lower software and computer service exports) to the impact of SARS and forest fires on inbound tourism in 2003 and 2004, and finally the rising value of the Canadian dollar, which has negatively impacted in-bound tourism. Moreover, transport and travel follow the global business cycle more closely than commercial services, suggesting transportation and travel services could take a bigger hit from the global economic slowdown projected for 2007.

Figure 36: Canada Quarterly Services Export Growth (y/y)
Transportation and travel services show greater volatility



Source: US Census Bureau, US Bureau of Economic Analysis, EDC Economics.

SECTOR OUTLOOK

Key Developments

Still, in 2005, weaknesses in some key sectors – particularly travel and specific commercial services sub-sectors – slowed export growth of total services exports to just 1.7%. The transport sub-sector fared well with growth of 5.5%, mainly thanks to a stupendous 14% growth rate in waterborne transport, which comes on top of a 20% hike in 2004. Commercial services rose by 1.8%, but travel (tourism) declined by 1.7% – mainly on account of fewer US visitors, possibly detracted by a more expensive Canadian dollar and higher gas prices.

Table 42: Canadian Services Export Outlook

	2001	2002	2003	2004	2005	2006(e)	2007(f)
Total Services Exports ($ mn)	60,066	63,486	61,133	63,862	64,968	65,911	66,717
annual % change	0.6	4.5	-3.7	4.5	1.7	2	1
Commercial Services ($ mn)	31,546	34,248	35,024	34,510	35.114	35,892	36,184
annual % change	1.4	8.6	2.3	-1.5	1.8	2	1
Transport Services ($ mn)	10,626	11,061	9,895	11,023	11,632	12,270	12,981
annual % change	-5.1	4.1	-10.5	11.4	5.5	6	6
Travel Services ($ mn)	16,437	16,742	14,776	16,746	16,460	16,969	15,764
annual % change	2.8	1.9	-11.7	13.3	-1.7	-3	-1
Government Services ($ mn)	1,457	1,435	1,438	1,583	1,762	1,780	1,789
annual % change	2.4	-1.5	0.2	10.1	11.3	1	1

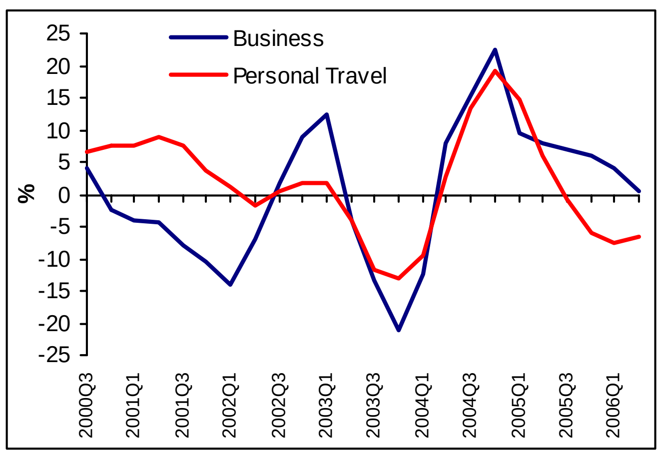
Sources : Statistics Canada, EDC Economics.

For 2006, the services forecast calls for overall growth of around 2%, with performances varying substantially across sectors. Commercial services are expected to grow by 2%, albeit with large variations among individual sub-sectors. Transportation revenues are expected to grow by 5 to 6%, although with specific sub-sectors – like waterborne transport – growing faster. Export receipts in the travel sector (mostly tourism) are expected to decline by 3% in 2006, continuing last year's 1.7% decline. The drop in travel receipts results from a confluence of economic problems involving US border security and the impact of the high Canadian dollar and fuel prices on budget-sensitive US tourists, who account for the vast majority of Canada's tourists from abroad.

Travel Sub-Sector

While all components of international trade are vulnerable to higher friction stemming from higher security requirements, this is particularly true for the tourist sub-sector. Specifically, the US is gearing up for the implementation of the Western Hemisphere Travel Initiative (WHTI) beginning in 2007. The WHTI essentially requires citizens of the Americas – including US citizens – to carry a passport or other document establishing the bearer's identity prior to entering or re-entering the United States. The WHTI is expected to have a dampening effect on Canada's travel industry.

Figure 37: Business Travel and Tourism Receipts (y/y % change)
Growth impacted by higher C$ and slowing Economy



Source: Statistics Canada, EDC Economics.

While normally associated with tourism, the **travel sub-sector** includes receipts from all types of travel, including business and personal travel for health and education. This sector experienced rapid growth through the mid-1990s until 2003, when it declined by 12% as a result of the perfect storm resulting from SARS, higher fuel prices, terrorism, war in Iraq and generally slower economic growth. It rebounded by 13% in 2004, but declined by 1.7% in 2005 – coinciding with the sharp hikes in fuel prices and the Canadian dollar. By individual sub-sector, personal travel (i.e. tourism), which accounts for four fifths of the sector's receipts, fell by 3% in 2005. Recent Canadian Tourism Commission data show visitors to Canada from the US declined by 4.3% in the first half of 2006 relative to the same period in 2005 (down to 5.6 million), while non-US origin travel to Canada increased by 2.5% (to 1.8 million) during the same period. While higher inflows from non-US countries are reassuring, the fact remains that over three quarters of Canada's nearly 19 million tourists in 2005 were from the US. Tourist inflows from non-US countries would need to increase by a very large amount to compensate for the drop in visitors from the US.

Table 43: Canadian Travel Services – Export Outlook

	2004	2005	2006(f)	2007(f)
Total Receipts ($ mn)	16,746	16,460	15,969	15,764
% Change	13.3	-1.7	-3	-1
Business Travel ($ mn)	2,660	2,792	2,848	2,905
% Change	11.7	5.0	2	2
Personal Travel ($ mn)	14,086	13,668	13,121	12,859
% Change	13.6	-3.0	-4	-2

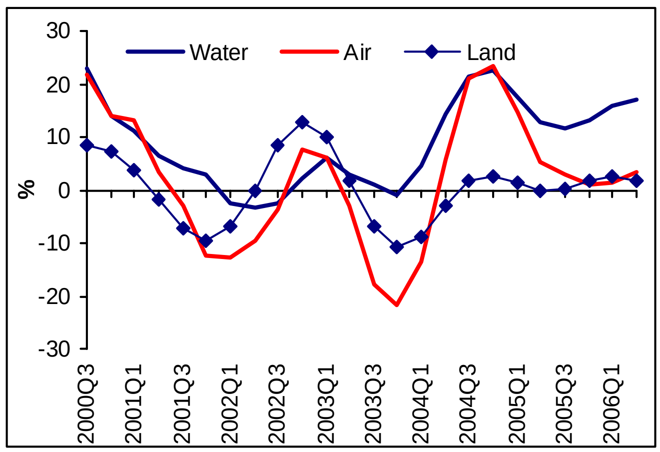
Sources : Statistics Canada, EDC Economics.

Transportation Sub-Sector

Export receipts from transportation, especially waterborne, have reflected strong global economic growth and trade flows. Shocks have also affected demand for transportation services in the past 3 to 4 years. Particularly, overall receipts declined dramatically in 2003 – the height of the SARS crisis – though rebounded in 2004. Air transport receipts declined through 2003, though showed strong growth in 2004 and into the first quarter of 2005, but have since declined.

Receipts from land transport (trucking and rail) showed a smaller decline than air during the SARS crisis, but also experienced less of a subsequent rebound. Finally, water transport has shown very rapid growth both in 2004 and 2005 (+20% and +14% respectively), and this momentum has extended into the first two quarters of 2006. In the past, water transport has been often touted as an under-appreciated resource, though recent sectoral growth appears to be changing this. Looking forward, our forecast for overall transportation services calls for an easing toward the end of 2006 and through 2007, largely a result of slowing world economic growth.

Figure 38: Transportation Sub-Sector Export Receipts (y/y, %)



Sources: Statistics Canada, EDC Economics.

Table 44: Canadian Transportation Services – Export Outlook

	2004	2005	2006(f)	2007(f)
Total Receipts	11,023	11,632	12,270	12,981
% Change	11.4	5.5	6	6
Water Transport	2,886	3,278	3,737	4,297
% Change	19.6	13.6	14	15
Air Transport	4,674	4,841	5,020	5,171
% Change	15.4	3.6	3.7	3
Land and Other Transport	3,463	3,513	3,513	3,513
% Change	0.9	1.4	0	0

Sources : Statistics Canada, EDC Economics.

Commercial Services

Commercial service exports rose by 1.8% in 2005 – not a bad outcome considering that receipts declined by 1.5% in 2004 following growth of just 2.3% in 2003. From a general standpoint it appears that the recent appreciation of the Canadian dollar could be responsible for some of the lacklustre growth seen recently in this sector.

Receipts from "other financial services" increased in 2005 by 52% to $2.1 billion, largely as a result of higher bank commissions. This result carried over in the first half of 2006, with revenues rising by 21% relative to the first half of 2005. Foreign revenues from Canadian financial institutions are increasing dramatically as a result of these institutions' growing presence abroad. A recent Statistics Canada study[12] notes that as Canadian banks increasingly expand abroad, their foreign revenue growth is faster than that from domestic sources. Specifically, between 1997 and 2004 the total real value of services produced by the domestic banks rose at an annual average rate of 1.8% in Canada, compared to 4.8% worldwide. The recent growth in export receipts to banks and insurance is not an accident, with companies in these two sectors having invested abroad for years. Particularly, the big six Canadian banks are currently pursuing a policy of expanding abroad in certain key markets, including the United States and Latin America. In addition, Canadian insurance companies continue to add to their already sizable investments throughout Asia.

Table 45: Commercial Service Export Outlook by Sub-Sector

Service Exports	CAD bn 2005	% Share of Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Communication Services	2.7	7.6	0.5	1	1
Insurance	3.7	10.6	-0.3	1	1
Other Financial Services	2.1	6.1	52.3	15	2
Computer & Information Services	4.1	11.8	1.4	0	1
Royalties & License fees	4.2	12.0	-1.0	-1	-1
Management Services	4.9	13.8	-7.6	0	0
Research & Development	2.9	8.3	0.7	1	1
Architectural, Engineering, and Other Technical	4.1	11.6	-1.6	2	1
Miscellaneous Services to Business	4.3	12.1	3.1	1	1
Audio-Visual Services	2.0	5.7	9.7	9	5
All Other Commercial Services	0.1	0.5	0	3	2
Total Commercial Services	35.1	100.0	1.8	2	1

Source: Statistics Canada, EDC Economics. 2005 actual, 2006 and 2007 are forecast.

Construction services, not a large export sector when compared with others, reported export growth of 47% in the first half of 2006 relative to last year. Allowing for the downturn in the US housing market, Canadian construction receipts should still put in a strong performance in 2006, but the outlook for 2007 calls for more subdued growth. Audio-visual services turned in a respectable performance in 2005 as receipts increased 9.7% to $2.1 billion. Another good performance is expected for 2006 while 2007 is expected to see some moderation in the sector's export growth.

Miscellaneous services to business rose slightly by 3.1% to $4.3 billion in 2005. Export receipts accruing to this immense catch-all sector – which includes advertising, equipment rentals and non-financial commissions – declined by 3.4% in 2004. In the first half of 2006 revenues were down by 8% over the same period last year as the stronger Canadian dollar chewed into export receipts.

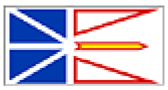
Success across financial services, construction and audio-visual services has been dampened by declines or pauses in most other sectors, including insurance services (no change in export volumes during 2005, with total receipts at $3.72 billion); communication services (+0.5% to $2.7 billion); computer and information services (+1.4% to $4.1 billion); management services (-7.6% to $4.9 billion); and R&D (+0.7% to $2.9 billion). We expect these sectors to post export growth of 1 to 2% through the next 12 to 18 months.

[12] Christine Hinchley, *Foreign Banks in the Canadian Market* - Statistics Canada 11-621-MIE2006041 2006.

8.0 Provincial Export Outlook

Interprovincial versus International Exports

It is important to point out our export outlook is for international exports only. Interprovincial exports can make up a significant share of a province's shipments but is not included in international exports data from EDC or Statistics Canada. Shipments of raw materials or goods to other provinces for additional value-added processing are recorded as an international export from the province where the final good is eventually shipped. The distinction is significant as interprovincial exports do create jobs and gross domestic product in the province of origin. Perhaps the best example where this discrepancy has the most impact is in Newfoundland and Labrador where roughly 50% of offshore crude and all of Voisey's Bay nickel are shipped interprovincially and therefore do not show up as international exports.



8.1 Newfoundland and Labrador

The value of international exports from the province is expected to rise 16% in 2006 and 11% in 2007. Note that our forecast is for international exports only. As such, Voisey's Bay nickel does not show up in our data. This is an accounting issue more than anything, as these shipments still add to the province's GDP and interprovincial exports.

Table 46: Newfoundland & Labrador Merchandise Export Outlook

Top Sectors	CAD mn 2005	% Share of Province's Total Exports (2005)	Export Outlook (% growth) 2005(e)	2006(f)	2007(f)
Energy*	5,576	69.1	16.9	21	13
Industrial Goods	934	11.6	90.2	18	8
Agri-food	900	11.1	-11.3	-1	5
Forestry	538	6.7	2.9	-11	0
All Others	126	1.6	5.2	7	6
Total*	8,075	100.0	16.7	16	11
Total ex. Energy*	2,499	30.9	16.3	4	5

Source: Statistics Canada; EDC Economics.
* NOTE – Energy exports history and forecast estimated by EDC Economics

International exports of crude are estimated to have been between \$3.5 and \$3.6 billion in 2005. These figures have to be estimated as our primary source for merchandise trade data from Statistics Canada indicates international crude exports from Newfoundland were \$0 in 2005. The discrepancy is a data collection problem, and indeed EDC Economics uses other Statistics Canada data (from the *Provincial Economic Accounts* and *Sources and Disposition of Crude* reports) to reconcile the error. This year, we expect to see total crude exports increase to nearly 120 million barrels as White Rose offsets a slight decline in output from Hibernia and problems at Terra Nova. This, along with higher crude prices and a slight increase in the share of crude destined for international markets (51% in 2006 versus 49% in 2005) culminate in a 24% increase in crude exports for 2006. Next year, better conditions at Terra Nova and enhanced efforts at the other two offshore facilities should boost output, offsetting lower crude prices and boosting crude exports by another 17%. High oil prices have stimulated investments in exploration off the Island with drilling started this year on an estimated 7,200 metre wildcat well in the Orphan basin. Finally, exports of refined petroleum products from the Come-by-Chance refinery should move in line with our dollar and energy price forecasts.

Crab exports are down a modest 5% through the first half of the year but this follows a disastrous 2005. Processors' selling prices are down significantly, but there has been a recovery from very low levels. We are forecasting a modest price increase for crab in 2007 as reports of depleted inventories in key markets should offset weakness in US consumer demand. After a slight increase in landings this year, we expect no change in volumes in 2007. Shrimp prices remain in the doldrums but next year a slightly weaker Canadian dollar with no change in export tonnage should boost related C\$ export receipts. Ongoing competition from warm water species reduces the likelihood of significant gains in prices in the years ahead. This increases the potential benefits of improving market access to the European Union where cold water shrimp can be sold at a premium. The high price of crude and strength of the Canadian dollar remain key issues to watch for all harvested species. This is especially true in the ground fish processing sector, which is being increasingly challenged by low-cost Chinese labour. For processors, this is a long-term threat that is unlikely to go away any time soon. Largely because of a forecasted decline in the Canadian dollar versus the USD, we are forecasting a 5% increase in the level of agri-food exports in 2007.

Canadian producers of newsprint are facing a very challenging environment. The combination of a strong Canadian currency, along with high energy and fibre costs has motivated the closing of several Canadian mills (including in Stephenville). This will see total estimated capacity on the Island drop from 810,000 tons to 670,000 tons. Uncertainty persists regarding the fate of the number 7 machine in Grand Falls-Windsor (with 60,000 tons of annual capacity), but we assume it will remain on line. The price outlook is positive with a forecasted 15% and 5% increase in prices for 2006 and 2007 respectively. Demand for newsprint is still suffering but the negative impact on pricing is being more than offset by capacity cutbacks. Newsprint shipments are expected to drop 15% in 2006 before rising 3% in 2007. Meanwhile, lumber exports – representing only 2% of forestry exports – have shown solid growth so far this year but are projected to fall in 2007 as demand falls in line with the weak US housing market.

High metals prices and key finds of uranium and iron ore have stimulated exploration in the province. Another good news story is the Duck Pond copper and zinc mine which should add to exports in 2006. Iron ore dominates the province's industrial good exports, accounting for 98% of the sector's total export value. Iron ore prices have surged as a result of China's voracious demand for steel. Chinese steel production is forecasted to grow 20% this year, adding to its capacity the equivalent of two thirds of US steel output in 2005. Iron ore exports from Newfoundland and Labrador rose 94% in 2005 on a combination of higher prices and production. Benchmark prices were settled at a 19% increase this year for iron ore fines but there was a slight reduction in the price of iron ore pellets. Next year, we expect prices for iron ore to be relatively unchanged but slightly higher export volumes and a slightly lower Canadian dollar will boost export receipts. Together, Duck Pond and iron ore exports from Labrador City and Wabush should boost industrial goods exports 18% this year and another 8% in 2007. As indicated above, ore shipments from Voisey's Bay will not show up in international exports but the impact on the Newfoundland economy and GDP remains significant.

While still a small part of the province's export profile, shipments of high value-added manufactured goods have shown very strong gains in 2006. These include aerospace components, computer-related goods, navigation equipment and industrial machinery.

8.2 Prince Edward Island

After a 20% expansion in 2005, exports should increase 3% in 2006. Outside of some agri-food export categories, the general picture has been relatively negative so far this year. Some of the weakness could be a timing issue as categories such as transportation and M&E tend to be quite volatile. Next year, we expect another modest expansion of 1%. With roughly 83% of exports destined for the US, weakness in that economy will keep a lid on growth in the province's export sales.

Table 47: PEI Merchandise Export Outlook

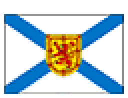
Top Sectors	CAD mn 2005	% Share of Province's Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Agri-Food	497	64.3	13.6	6	1
Industrial Goods	54	6.9	16.3	-3	4
Transportation	41	5.3	31.5	-12	3
M&E	29	3.7	50.3	-8	7
Forestry	22	2.8	12.7	-18	-5
All Others	130	17.0	43.0	2	1
Total	773	100.0	19.9	3	1

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

Prince Edward Island's agri-food sector is dominated by potato production, which consists of fresh, frozen, seed and manufactured potato products. Frozen potato exports (french fries) account for approximately 75% of the value of the Island's potato exports and were down 4% in 2005. Exports are relatively unchanged this year and 2007 is expected to be no different. However, in the event of a mild US recession (as outlined in our alternative downside scenario), fast food restaurant sales would likely weaken and frozen food exports along with it. Prices for fresh potatoes have strengthened this year as scaled-back acreage in Canada has led to considerably lower inventories, reducing a supply glut that had been hanging over prices. On top of this, an early spring and good growing conditions will see a healthy yield for this year's island crop. The result should add to fresh and chilled exports in 2007. We anticipate export prices will show little change next year from where they are now as a slightly lower USD price is offset by positive impacts of a weaker Canadian dollar.

Seafood exports were down 7% y/y through the first half of this year. The market price of lobster started out the year quite well but has fallen through the summer, reaching USD 5.30/lb versus an annual average of USD 6.80/lb in 2005. This backdrop, along with our expectation of no change in the total number of lobsters that are exported, results in a modest decline for lobster export receipts this year. South of the border, sales by large seafood chains have been solid but with our forecast of 2.2% growth for the US economy in 2007, restaurant receipts and therefore seafood prices are unlikely to see significant growth next year. Some relief should come in the form of a projected 5% drop in the Canadian dollar and lower energy costs. PEI's second largest seafood export, cultivated mussels, is expected to show little change in export value next year. There remains little room to expand the aquaculture industry and prices are expected to remain stable.

Although agri-food exports account for 64% of the Island's total merchandise exports, there are other notable industries. For example, pharmaceuticals and medicine exports totaled roughly $20 million last year. Although said exports are expected to show a modest decline in 2006 the industry continues to show promise, supported by increased medical spending due to an aging population in key export markets. Efforts to expand biosciences on the Island have seen results, and there are plans to expand existing and new facilities. Shipbuilding is also doing quite well as global seaborne transportation, expanding port facilities and offshore oil exploration drive an active order book for tug boats. Exports of rail equipment (PEI's rail products are designed for passenger rail cars) are expected to record modest growth in 2007 while aerospace results will be mixed after recording a drop in 2006. Sales in aerospace have been weak in 2006 but demand, including from makers of turboprop planes, is healthy with manufacturers seeing busy order books. Given the underlying fundamentals, EDC Economics is a little surprised by the weaker-than-expected numbers in shipbuilding, rail equipment and aerospace exports from the Island so far this year but it should be noted that these series tend to be very volatile and the outlook for all three sectors remains positive. Sales of lumber should see a slight contraction in 2007 after a double-digit percentage decline in 2006. The US housing market went into a near free fall during the summer, and we expect this will continue to drag down demand for lumber and building products into next year.



8.3 Nova Scotia

Exports are forecasted to fall 5% this year before rising 6% in 2007. Much of the volatilty relates to significantly scaled-back newsprint production this year and an ensuing increase in output next year.

Table 48: Nova Scotia Merchandise Export Outlook

Top Sectors	CAD mn 2005	% Share of Province's Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Energy	1,438	25.4	14.8	-2	10
Agri-Food	1,313	23.2	-3.8	-5	3
Forestry	1,041	18.4	0.0	-26	18
Motor Vehicle	828	14.6	-1.8	-2	4
Industrial Goods	506	8.9	5.9	2	0
All Others	540	9.5	7.8	15	-2
Total	**5,666**	**100.0**	**3.4**	**-5**	**6**
Total ex. Energy	**4,227**	**74.6**	**0.0**	**-6**	**5**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

PROVINCES OUTLOOK

Although there was weakness in energy, agri-food and motor vehicles during 2006, there were some key areas of strength in sectors like aerospace. The outlook for 2007 is generally more favourable for most sectors.

This year will prove a poor one for seafood exports. Through the first 7 months of 2006, export receipts have fallen 8%. The strong Canadian dollar along with the high price of crude has added to an environment of poor pricing, and in some cases lower landings. A rise in lobster export volumes should offset lower prices this year. But for shipments of crab, both price and landings are going into negative territory. Scallops are showing interesting results with a lower catch rate being more than offset by higher prices. Next year, we expect prices to rebound slightly due in part to a 5% depreciation in the Canadian dollar, which will offset a moderation of demand from the US and Japan as GDP growth in those markets slows to 2.2% and 1.9% respectively. Meanwhile, in the groundfish processing industry, intense competitive pressures from Chinese processors is likely to build as the country continues to leverage its low-cost labour.

North American natural gas prices surged over 50% in 2005 to average USD 8.88/mmbtu on the Henry Hub (HH). Prices have fallen in 2006 but should rebound somewhat from recent lows to result in an average annual price of USD 6.15/mmbtu for the year. Adding to the weakness this year is an estimated 7% reduction in export volumes, marking the fourth consecutive annual production decline. The trend could be interrupted in 2007 as a new compressor platform boosts production, adding to a modest price increase. According to the US Energy Information Administration (EIA), US gas inventories will be starting the upcoming winter heating season at their highest level since 1990, keeping a lid on any upward price movement. For 2007, we believe natural gas prices will increase, but the overall gain will be tempered by a slowing US economy and a satisfactory supply situation. Refined petroleum products production has already shown considerable strength this year but we expect exports to fall in 2007, in line with our forecast for crude prices of USD 66.50/barrel and USD 55.00 in 2006 and 2007 respectively.

Newsprint, pulp and lumber are all facing pressures from the strong Canadian dollar, high energy costs and aggressive international competition. These factors came to a head this year prompting significantly scaled-back newsprint mill activity and a 69% drop in newsprint exports in the first 7 months of 2006. Lost revenues will be too much to make up for this year, but as production ramps up again volume growth will spill over into next year. Prices should also increase in 2007 supported by supply management and new demand from Asia and South America. Through early fall, lumber prices fell nearly 25% in US dollar terms as the US housing market weakened steadily since January. Nova Scotia exporters have been able to mitigate this via increased shipments of lumber and some manufactured wood products, but with a growing list of indicators pointing to a bearish housing outlook we expect lumber sales to fall in 2007. For pulp, exports will be balanced this year as a rise in shipment volumes is offset by the exchange rate's impact on Canadian dollar prices. In 2007, sluggish demand along with the addition of 1.6 million metric tones of annual capacity in Latin America will keep a lid on pulp prices. The exchange rate will again prove key, but for 2007 a depreciating Canadian dollar will help support C$ export prices for pulp.

Aerospace exports will add a kick to Nova Scotia's non-energy exports this year as exports in the first half of 2006 already doubled the previous record for aerospace shipments (set in 2003 at $27 million). In 2005, Boeing and Airbus received a record 2057 orders for new aircraft. This strength is being felt throughout the aircraft industry's global supply chain, including producers in Nova Scotia. Softening demand for autos and a strong Canadian dollar are expected to see exports of Canadian auto parts fall in 2006. But Nova Scotia will fair better than other parts of the country, absent any further large-scale shutdowns in North American auto output. Also, Michelin plans to expand production of its X-One wide-base truck tire in the province with an investment that should be completed in 2007. The company also plans increased production of tires for larger earth moving equipment to fill demand brought on by booming global investment in mining activity. Although rail equipment demand has been robust in North America, there have been layoffs in the province as the strong dollar and reduced demand for the specific type of flatbed rail cars made in the province has declined. Exports of industrial goods are showing further growth in

2006 after rising nearly 6% in 2005. Prices among industrial goods are likely to see some weakening or remain unchanged, but ongoing global demand and strong investment will support export volumes. Such growth has boosted the US price of gypsum by more than 60% since 2003.

8.4 New Brunswick

New Brunswick's international exports have grown rapidly over the past 2 years, with increases of 11% in 2004 and 13% in 2005. The province's export performance in the past few years reflects the increasing price of refined petroleum products and its increasingly dominant share of total exports. Energy exports now account for over 60% of the province's foreign exports, compared with less than 25% in 1999. Excluding energy, the picture is not as impressive, as New Brunswick's non-energy exports have declined in 4 of the past 5 years.

Table 49: New Brunswick Merchandise Export Outlook

Top Sectors	CAD mn 2005	% Share of Province's Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Energy	6,365.9	59.6	39.0	6	-4
Forestry	1,919.5	18.0	-21.7	0	-2
Agri-Food	1,213.1	11.4	-1.1	-6	2
Industrial Goods	756.7	7.1	7.2	3	-2
M&E	216.6	2.0	-20	3	3
All Others	203.6	1.9	0.5	1	-3
Total	**10,675.5**	**100.0**	**13.1**	**3**	**-3**
Total ex. Energy	**4,309.5**	**40.4**	**-11.3**	**-1**	**-1**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

The contrast between the growth of energy and non-energy exports in New Brunswick was nowhere as evident as in 2005, when energy exports rose 39% while non-energy exports fell 11%. Last year's decline in non-energy exports was the result of an important restructuring in the province's pulp and paper industry, which was affected by permanent capacity closures, plant conversions and a labour dispute. While the challenges for the industry are no different from other parts of the country, a battalion of bad news invaded New Brunswick in late 2004 and 2005. Throughout 2005, the pulp mill in Nackawic remained closed while its new owners, the Aditya Birla Group and Tembec, refitted it to make cellulosic man-made fibre for the textile industry. The Miramichi UPM-Kymmene paper mill permanently shut down the plant's aging pulp kraft operations, which had previously supplied the paper mill, opting to import the pulp instead. The paper mill itself was shut down for the first 7½ months of 2005, due to a labour dispute. Smurfit-Stone Containers closed its containerboard plant in Bathurst and Fraser Papers sold the assets of its paperboard operations located in Edmundston to Cascades Inc, which then moved the assets. Irving Paper announced it was abandoning the newsprint market and converted the machine at the Saint John mill to a higher grade supercalendar paper. While the news bodes well for the future of the plant, the investment resulted in lower production in 2005 and consequently, lower exports.

Following 2 consecutive years of double-digit growth, the total value of New Brunswick's exports lost some momentum in 2006. Exports are expected to decline by 3% in 2007, mostly reflecting the expected movement in oil prices and refined petroleum products, and the decline in exports of wood products to the US, where the housing market has gone into a downturn. Activity at the Irving Oil refinery in Saint John, the largest in Canada, is expected to continue at full capacity until the end of the year once the planned month-long turnaround in September/October is completed. A total of 85 planned turnaround days has been reported so far in 2006 at the refinery.

Exports of agriculture and fishing products are down 7% so far this year. Both production and exports have been affected by a number of factors, from a decline in potato production last year related to the pink blight disease, to an 18% drop in total allowable catches for snow crab and weaker prices for lobster, which have partly offset higher landings. Exports from the pulp and paper industry have recovered after the adjustments in 2005, as some mills have reopened while the year-over-year impact of the events mentioned above dissipate. Less than 6 months after reopening, the Miramichi paper mill closed for 3 months to find ways to cut costs. The Nackawic pulp mill reopened in January and has been performing well since. Overall, New Brunswick's foreign exports are expected to increase 3% in 2006, with again most of the gains being located in the energy sector, as non-energy exports are expected to decline by 1%.

Over 90% of the province's international exports are destined for US markets, mainly the New England states. As a result, the expected slowdown of the US economy next year will surely have an impact on commodity demand, especially in the province's key commodity sectors. Exports of energy are expected to decline 4% next year, as lower prices for crude oil and refined petroleum products will only be partially offset by the weaker Canadian dollar. For 2007, EDC is forecasting a 4 to 5% depreciation in the Canadian dollar and an average of USD 55/barrel for crude oil. The continued decline in the US housing market will lead to more weakness in the wood products industry, where exports are anticipated to drop another 7% next year. The pulp and paper industry will provide only little relief, thanks in part to the weaker Canadian dollar, as demand and prices follow the economic cycle. The outlook next year for the paper industry in New Brunswick will also depend on the fate of the Miramichi paper mill, as UPM-Kymmene stated that the plant would be closed if it failed to cut costs sufficiently to turn in a profit.

8.5 Quebec

Provincial exports are expected to advance 2% in 2006, cutting last year's pace almost in half. While most sectors will post weaker results this year, Quebec's ailing forestry and consumer goods industries will be the main drag on headline growth. Prospects for 2007 are even more downbeat, with exports forecast to contract slightly owing to slower global demand. Continuing problems in the lumber industry, a fall in metals prices, sluggish demand for regional jets and specialty vehicles, and unresolved difficulties in the furniture and garment industries will add to the woes of the province's exporters.

Table 50: Quebec Merchandise Export Outlook

Top Sectors	CAD mn 2005	% Share of Province's Total Exports (2005)	Export Outlook (% growth) 2005	2006(f)	2007(f)
Industrial Goods	20,316	30.4	7.7	12	-4
Forestry	11,964	17.9	-2.1	-7	-2
M&E	10,210	15.3	2.9	1	3
Transportation	9,308	13.9	1.8	-3	2
Consumer Goods	3,887	5.8	-11.2	-6	-7
Agri-Food	3,818	5.7	0.7	-5	4
All Others	7,347	11.0	17.4	1	-3
Total	**66,850**	**100.0**	**3.5**	**2**	**-1**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

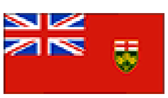
The heavy reliance of Quebec's aerospace industry on sales of regional jets (RJs) will continue to weigh on the broader transportation sector. Indeed, the continued pressure of a strong Canadian dollar and a maturing 50-seat RJ market will drag transportation equipment exports down 4% this year, before allowing for modest improvements in 2007. Aside from the RJ market, prospects for the rest of the transport equipment sector are stable. There is a revival in demand for railway and other aerospace products – including aircraft parts, helicopters and avionics.

On the heels of a 7.7% rise in 2005, shipments of industrial goods will post even stronger gains this year. Robust metal prices in 2006, and rising production capacity at Alcan's Alouette aluminum smelter will underpin growth in the broader sector. Thanks to generally healthy global fundamentals, demand for chemicals and plastics will also remain solid this year. But as we head into 2007, a slowing global economy and the anticipated correction in commodity prices should produce an easing in exports of industrial goods.

Quebec's forestry exports are expected to drop 7% in 2006 and a further 2% in 2007 with risks weighted on the downside following recently announced mill closures. A persistently strong domestic currency, surging electricity prices and falling US demand will continue to depress exports of newsprint, Quebec's main forestry product, causing a number of plant shutdowns and conversions to higher grade papers. In addition, pulp producers are being hit by some of the highest wood fibre prices in the East. The outlook for the timber industry is equally challenging, as it faces slower construction activity in the all important US market. Moreover, as of April 2005 the provincial government implemented Bill 71, which calls for a 20% reduction in allowable timber cuts – a restriction that is expected to shrink lumber output by 10 to 15% through 2007. The drop in demand and the implementation of such voluntary restraints have forced the closure of many mills over the course of 2005, further limiting timber shipments this year. Looking forward to 2007, a deteriorating pricing environment, and a further drop in US homebuilding are expected to keep lumber and building product exports on a downward path.

Despite very healthy fundamentals for capital investment in the US last year, Quebec's exports of machinery and equipment (M&E) grew by about half the national average. This poor performance was underlined by a severe contraction in telecom equipment exports and, to a lesser extent, weakness in mining and oil and gas equipment sales. This year, despite a rebound of those segments, the greater sector is expected to climb by an unexceptional 1%. Weakness in agricultural and construction equipment exports, and disappointing results in provincial information technology exports, will offset most of the gains made by exporters of other industrial-use machinery and equipment. Looking forward to 2007, however, the gap with the rest of Canada will disappear, as Quebec's M&E exports are forecast to grow 3%.

The province's consumer goods exporters have hit hard times in the last few years, with export sales declining 16% since 2000. After falling 11% in 2005, the sector's prospects continue to appear quite dim over the forecast horizon. The phasing out of the Multi-Fiber Agreement, increasing competition from low-wage countries, and a strong Canadian dollar are the main forces dragging down the outlook for Quebec's apparel and furniture industries, the sector's two main components. At the same time, the end of the mortgage refinancing wave, higher interest rates and high energy prices will converge to constrain US consumer spending, reducing discretionary income available for spending on consumer goods south of the border. In Europe and the UK, moderate appreciations of the euro and the pound vis-à-vis the Canadian dollar should give a boost to the industry heading through 2007. In aggregate, however, EDC Economics forecasts that Quebec's exports of consumer goods will continue their decline over the next 2 years.



8.6 Ontario

Ontario's exporters experienced another tough year in 2006, with overall exports estimated to have shown no growth during the year. In fact, exports managed to eke out a gain of only 0.7% in 2005. The culprit is the downturn in forestry, automotive and consumer goods – all sectors facing the challenge of a stronger Canadian dollar, excess capacity and intense global competition. For 2007, we expect the province's export sales will drop by 3% as lower prices for industrial goods (metals, petrochemicals) add to continuing weakness in forestry and autos.

Table 51: Ontario Merchandise Export Outlook

Top Sectors	CAD mn 2005	% Share of Province's Total Exports (2005)	Export Outlook (% growth) 2005	2006(f)	2007(f)
Motor Vehicle	75,832	42.1	-2.6	-5	-6
Industrial Goods	42,734	23.7	5.7	10	-2
M&E	28,937	16.1	7.0	2	3
Forestry	9,046	5.0	-5.8	-13	-2
Agri-Food	8,511	4.7	-1.3	3	2
Consumer Goods	3,747	2.1	-6.9	-6	-7
All Others	11,306	6.3	0.0	6	-2
Total	**180,113**	**100.0**	**0.7**	**0**	**-3**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

A difficult couple of years for the Big Three and their loss of market share have caused them to shut down plants across North America. While 14 of the 26 models produced in Canada have seen production increases in the past year – including the Chevrolet Impala (up 50,000 units over last year) and the Dodge Charger (up 46,000 units) – about 40% of the growth is coming from Japanese automakers. The woes affecting the Domestics will cause Canadian export earnings to decline through 2007. In addition to capacity reductions at GM's Oshawa plants, Ford is looking to cut one shift at its St. Thomas plant in 2007. The transformation of the Ford Oakville facility into a flexible manufacturing unit capable of producing multiple models will alleviate some of the declines in Canadian auto assembly output, but will not be enough to offset the deeper capacity cuts. In addition, downtime at GM's Oshawa truck plant has cut into this year's production. Declining North American vehicle production will also drag down exports of auto parts in 2007. Overall, we expect Canadian exports of autos and parts will finish 2006 with a 5% decline. Export sales are projected to drop another 6% as US vehicle sales undergo further declines.

On the flip side, however, a number of recent investment announcements have bolstered the longer term outlook. GM is moving ahead with its $3 billion Beacon project – which includes the move to flex manufacturing in Oshawa, and the return of the Camaro. Chrysler is spending $768 million in Brampton and Windsor, and Ford has committed $1 billion to re-tool its Oakville facility. In addition, Toyota is spending nearly $1 billion in Woodstock and Cambridge, and Honda will spend $154 million in Alliston.

As in other parts of the country, Ontario's pulp and paper mills have been plagued by sluggish North American demand and growing production capacity in other countries. The province has had to deal with its own mill closures and downtime as well. Lumber and wood building exports will experience another challenging year in 2007 as the slump in US housing reduces demand and prices. Total forestry exports are likely to finish 2006 with a drop of 13%. A further contraction of 2% is projected for 2007.

Despite the overall weakness in Ontario's exports, there are some bright spots. Exports of industrial goods are on track to rise by 10% in 2006, bolstered by a strong pricing and demand environment. Aluminum, precious metals and some sub-sectors of the chemical industry are showing decent growth this year. Industrial export receipts will decline by 2 to 3% in 2007 as foreign demand growth moderates and commodity prices ratchet down.

Ontario's manufacturing sector is showing a mixed export performance. The strong Canadian dollar and higher input costs have certainly chewed into sales and profit margins for many of the province's exporters. Nevertheless, some key manufacturing sectors such as aerospace, communications equipment, industrial machinery and rail equipment are notching up respectable gains. On the downside, clothing, textiles and furniture continued to see exports erode in 2006 – a pattern expected to continue through the coming year.

8.7 Manitoba

After falling below the national average in 2005, Manitoba's export growth is expected to accelerate to 5% in 2006, almost double the overall Canadian figure. The rebound will come on the back of returning agri-food and industrial goods exports, as well as continued strength in energy sales. Strong growth in the province's main export sectors this year, however, will give way to weaker momentum

Table 52: Manitoba Merchandise Export Outlook

Top Sectors	CAD mn 2005	% Share of Province's Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Agri-Food	2,809.4	29.0	-9.6	10	7
Industrial Goods	1,897.4	19.6	0.9	11	-3
Energy	1,232.3	12.7	30.1	16	-1
M&E	1,059.1	10.9	4.9	0	4
Forestry	851.2	8.8	-0.8	-16	-3
Motor Vehicle	678.4	7.0	1.7	-6	-4
All Others	1,151.0	11.9	7.8	0	-2
Total	**9,678.8**	**100.0**	**1.5**	**5**	**1**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

next year, as export sales level off in 2007.

Drought and early frost in 2004, followed by excessive rains last summer, led to poor grain quality and low harvest levels in 2005. As a result, wheat, oilseeds and pulse exports all suffered large declines last year. Despite generally lower prices resulting from increased global supply, wheat exports are expected to rebound in 2006 due to higher yields from last year's growing season. A still-reduced harvest, however, will mean less carry-over inventory available for shipping in 2007.

Higher canola prices in 2005 led farmers to increase the amount of land used to grow the crop, pushing production to record levels last year. As a result, exports of oilseeds have surged so far this year, notwithstanding moderating prices and the strong Canadian dollar. Manitoba farmers are taking advantage of weak global production of canola and strong demand, amid an expansion of the bio-diesel industry and strong Chinese consumption.

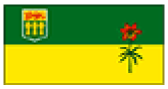
For pulse crops, increased global supply has been more than offset by growing demand, setting the stage for strong pricing for most varieties and a rebound in export earnings this year. But production declines for canola and dry field peas this year should curb oilseed and pulse export growth in 2007, especially as soybean prices pull back. Larger cattle and hog inventories in the US have prompted stronger demand for feed crops, and are supporting robust shipments of coarse grains this year. In addition, increased penetration of barley exports into non-traditional markets should help sustain gains through the forecast horizon.

Live animal exports out of Manitoba were up almost 50% in 2005, after tariffs on Canadian hogs and cattle were lifted mid-year. So far this year, exports continue to post impressive gains, and the recent lifting of the Japanese and South Korean bans on US beef presage continued demand for Canadian live animal exports. But growth in the final months of the year and into 2007 promises to be much more modest, as the year-over-year impact moderates. In addition, due to the integrated nature of the North American hog market, many hog producers have been retaining ownership of their hogs and renting finishing space south of the border. Factors like cheaper corn can make finishing space up to 20% less expensive in the US. But as corn prices rise in line with demand from the ethanol industry, this could change.

After a couple of lean years, the excess rains that plagued crop farmers helped boost energy exports by 30% in 2005, led by a 51% increase in electricity receipts. As a result, exports of energy in the forms of oil, electricity and coal reached $1.2 billion in 2005, close to the annual records set in 2001 and 2002. Going forward, strong oil prices have encouraged investment, leading to a 70% increase in drilling licenses and a 60% jump in the number of wells drilled last year. This should allow for continued strength in oil exports this year, before growth pulls back again in 2007 due to a moderation in pricing. On the electricity side, though we expect export growth to pull back after last year's remarkable results, ongoing investment in the province's underdeveloped hydroelectric potential portend longer term gains. The billion-dollar Wuskwatim Project has cleared its last hurdle and is set to get underway, and the anticipated in-service date for the 1380 MW Conawapa generating station is 2017. In addition, the province is developing 1,000 MW of wind power for export. Manitoba Hydro plans to issue a solicitation this winter for 300 MW, and three further requests for proposals of 200 MW each are targeted for 2013, 2015 and 2017. Earlier this year, 99 MW of wind power went on line. Manitoba currently has transmission lines into Minnesota.

After posting solid gains in 2005, machinery and equipment exporters will take a slight hit this year, with growth expected to remain flat. Telecommunications, mining and other industrial equipment manufacturers should still benefit from foreign companies looking to boost productivity and efficiency in light of increased global competition. But agricultural machinery providers should see foreign sales slow from last year, when American farm income reached record highs. Considering the province's concentration in the sale of farming implements, retreating agricultural prices will weaken demand fundamentals going forward. Sustained high energy prices and weakening credit conditions in the US will add to constraints on investment decisions in 2007. Further, as global growth pulls back, spending on new and replacement capacity will ease in other machinery industry segments as well.

Steady growth in global industrial production and still-strong pricing will continue to power Manitoba's industrial goods exports in 2006. But as global surplus positions for most industrial metals become clearer in 2007, prices are expected to pull back. Any correction in nickel prices – the largest component in Manitoba's metal exports – will be partially offset by planned production increases at Inco's operations next year. After weaker-than-expected production growth this year, shipments of Voisey's Bay nickel-in-concentrate for processing and export should help output bounce back. Chemical exports, led by pharmaceutical and medicine manufacturing, have fallen on hard times in the past 2 years, due to the US administration's offensive against Canada's $1 billion internet pharmaceutical industry, the bulk of which is out of Manitoba. Going forward, bilateral pressures may lead to legislation in this country banning the practice outright.



8.8 Saskatchewan

Saskatchewan's exports are maintaining momentum in 2006, rising an estimated 13% after having grown by 14% in 2005. Growth will continue to be led by strong demand for Saskatchewan's energy and agri-food exports, as well as growing global demand for its uranium to fuel nuclear power plants. Overall growth will be tempered as potash prices come down off their record highs of last year, although energy prices are expected to remain high. We expect exports to level off in 2007.

Table 53: Saskatchewan Merchandise Export Outlook

Top Sectors	CAD mn 2005	% Share of Province's Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Energy	4,958	35.5	21.6	29	-8
Agri-Food	3,729	26.7	-0.8	19	7
Industrial Goods	3,627	26.0	29.7	-3	7
Forestry	904	6.5	7.9	-29	-2
M&E	515	3.7	4.3	2	4
All Others	228	1.6	-4.7	-3	7
Total	**13,960**	**100.0**	**14.4**	**13**	**0**
Total ex. Energy	**9,003**	**64.5**	**9.8**	**5**	**6**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

The province's energy exports are forecast to rise by 29% in 2006 after expanding by nearly 22% in 2005. High oil prices have contributed to the energy sector becoming the province's top export. Prices should trend lower over the longer term as global production capacity increases, likely causing the value of energy exports to decline by 8% in 2007. Saskatchewan's energy exports are almost wholly made up of crude oil, followed by smaller amounts of coal and electricity. Saskatchewan accounted for nearly 18% of oil production in Canada in 2005.

Saskatchewan's exports of agri-food products are expected to grow by 19% in 2006 and by 7% in 2007 (in value terms). Growth in 2006 is being led by exports of oilseeds – canola exports in particular. Global use of the oilseed is forecast to increase to record levels in 2006 due to higher consumption in China and India. As such, Saskatchewan's exports of canola are expected to increase by 29% in 2006 – mostly driven by increased volume. A combination of lower supplies and higher prices will see canola exports level off in 2007. The province's exports of coarse grains are projected to grow by 10% in 2006 and a further 4% in 2007 as farmers increase the amount of their land used to grow oats and barley – a move intended to take advantage of higher world prices and lower production costs. Wheat exports (including durum) are forecast to increase by 15% in 2006 and 30% in 2007. This is mainly due to increased supplies of good quality wheat and reduced competition from other exporters. Industrial use of wheat is expected to rise due to increased ethanol production. A new ethanol plant is coming on stream in Lloydminster (Husky Energy) and another one in Belle Plaine (Terra Grain Fuels Inc.) will begin construction in 2006.

During 2006, the cattle industry in Saskatchewan is poised to recapture lost export sales of live cattle to the US after a 2-year ban was overturned on July 18, 2005. Although opening the border for cattle less than 30 months of age will help Saskatchewan cattle ranchers recapture much of the export sales that were estimated to be worth $390 million before the ban was imposed, a full return to the trading levels of 2002 will not occur until the ban is completely lifted. The latest Japanese ban on US beef imports was lifted in July, while the 3-year old South Korean ban on US beef was lifted in early September. Both of these events will further increase exports of live cattle. We do expect Saskatchewan's exports of all live animals and meat products combined to reach $450 million this year (compared with $580 million in 2002), which represents a 38% increase from 2005.

Saskatchewan's exports of industrial goods are projected to decline by 3% in 2006 after growing by nearly 30% in 2005 – a run-up due mostly to the sharp rise in potash prices. Tight supplies and high demand for fertilizers pushed prices to unprecedented levels in foreign and North American markets in 2005; however, growth in exports started to decline near the end of 2005 (as high prices forced some customers to delay purchases). Potash production continued to back off throughout the first half of this year as China postponed consumption due to negotiations over 2006 potash prices (China is the world's largest consumer of potash). This caused shutdowns in Canada and Russia in an attempt to match demand with supply. World demand for fertilizer is expected to pick up in the second half of the year following the conclusion of price negotiations with China and India. Suppliers will be shipping at high rates to meet the needs of these countries. Saskatchewan's fertilizer exports are expected to fall by 6% in 2006 but expand by 9% in 2007. The increase next year will partly come from additional volume by Potash Corp, which announced investments to bring back idle capacity at the Lanigan and Allan mines. In excess of three quarters of the province's industrial goods exports consist of potash (Saskatchewan's Potash Corp. is the world's largest producer of potash), followed by metals and minerals (including uranium) and chemicals.

Production of uranium continues to expand at Saskatchewan's McArthur River mine due to strong global demand for nuclear energy sources amid high oil prices. Uranium prices are still at record levels, hitting a 25-year high in US dollar terms as world supply is not keeping up with demand (although C$ export prices were partially offset by the stronger Canadian dollar). Exports of uranium should receive a further boost in late 2007 once construction on a second mine (Cigar Lake) is completed. All of Canada's uranium production comes from Saskatchewan. The province is the world's largest uranium producer, accounting for 30% of world production in 2005.

Strong global demand for Saskatchewan's exports of crops, oil, potash and uranium will drive overall export growth in 2006. The downside risks to the export forecast include a further strengthening of the Canadian dollar, lower-than-expected energy prices, and adverse weather conditions that would impact crop production and the cost of feed.

8.9 Alberta

Alberta's exports advanced a frothy 19.8% in 2005, following 2 years of equally dynamic 16 to 17% export growth in 2003 and 2004. Hefty gains were posted in energy, industrial goods, trucks and some agri-food sub-categories. Developments in oil and gas markets in particular powered total energy sales ahead, and contributed to the $12.5 billion gain in last year's total exports to $80 billion. Indeed, substantial price gains for crude oil have been at play for 3 years running now, even as

Table 54: Alberta Merchandise Export Outlook

Top Sectors	CAD mn 2005	% Share of Province's Total Exports (2005)	Export Outlook (% growth) 2005	2006(f)	2007(f)
Energy	58,318	72.8	25.7	11	-1
Industrial Goods	8,686	10.8	19.1	7	-2
Agri-Food	5,277	6.6	4.5	4	8
M&E	3,256	4.1	3.0	3	4
Forestry	3,054	3.8	-11.1	-11	-2
All Others	1,505	1.9	-0.1	2	-2
Total	**80,096**	**100.0**	**19.8**	**9**	**-1**
Total ex. Energy	**21,778**	**27.2**	**4.7**	**3**	**1**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

natural gas prices have pulled back since the beginning of 2006.

Rising oil prices, alongside gains in export prices for other commodities, have combined to lift Alberta's export performance for a third year running, though a moderating trend is emerging in 2006 and 2007 as price gains level off or possibly retreat for some commodities. Alberta will remain one of the top export growth leaders among the provinces this year, with overall exports estimated to rise by 9% in 2006. We expect export sales to decline by 1% in 2007 as oil and commodity prices pull back. More modest gains are projected for the non-energy sector in 2006, which is expected to post average export growth of about 3%, followed by 1% growth in 2007.

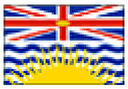
While crude prices added a significant boost to Alberta's export earnings in 2006, the appreciation of the Canadian dollar has trimmed back the final price impact. A modest weakening in oil prices is expected over the next 2 to 3 years, due to a combination of increased global output and a moderation in demand growth for energy. Meanwhile, global inventories should gradually rebound as new capacity comes on stream. WTI averaged about USD 66.50/bbl in 2006 and EDC Economics is forecasting an average of USD 55/bbl for 2007. Crude oil and refined petroleum products provide about 35% of the province's total foreign sales, and we expect exports to reach CAD 34 billion this year – marking a 24% increase over the 2005 result. This is due to a stronger rebound in volumes (Alberta oil sands in particular) and modest price gains. Some easing in exports is expected for 2007 (-4%) as we expect pricing to soften over the course of the year.

Natural gas, Alberta's other key export, provided over 38% of total export earnings last year. Foreign sales rose 30% in 2005 to total CAD 30.6 billion – an outcome that was held back to some extent by a less robust 1% volume gain as prices rose sharply in 2005. The spot price for natural gas on the Henry Hub (HH) rose over 50% in 2005, though an easing was experienced in 2006 as North American gas inventories recovered. As of late September, US natural gas inventories were 12% above their 5-year historical average and 13% higher than a year ago. According to the US Energy Information Administration (EIA), US gas inventories will be starting the upcoming winter season at their highest level since 1990. EDC Economics expects the price of natural gas to average about USD 6.15/mmbtu in 2006 and 6.50/mmbtu in 2007. The price rise for 2007 will be supported by uncertainty over well productivity, which continues to feed concerns of supply scarcity (despite the substantial rise in rig count and drilling activity). Natural gas export sales are on track to slip about 2% in 2006, followed by a 3 to 4% rise in 2007. A rise in the Canadian dollar and a slide in gas prices dampened export revenues this year, but a softer loonie in 2007 should help lift C$ denominated export sales.

While the energy sector accounts for almost three-quarters of total export earnings (estimated at close to $65 billion in 2006), industrial goods is the second largest sector accounting for 11% of total export earnings. Foreign sales of resin and synthetic rubber are up strongly in 2006 and should top $3.7 billion for the year, a rise of 25%. Petrochemicals also posted significant export gains this year. Overall, exports of industrial goods are expected to finish out 2006 with growth of 7% before dropping by 2% in 2007, resulting from a weaker pricing environment for the province's commodities.

Agri-food exports will be lifted by increased export sales of cattle. During 2006, the cattle industry in Alberta recaptured lost export sales of cattle to the US after a 2-year ban was overturned on July 18, 2005. Although opening the border for cattle less than 30 months of age will help Alberta cattle ranchers recoup much of the export sales that were estimated to be worth CAD 713 million before the ban was imposed, a full return to the trading levels of 2001 will not occur until the ban is completely lifted. The latest Japanese ban on US beef imports was lifted in July, while the 3-year old South Korean ban on US beef was lifted in early September. This should further increase Canadian exports in 2007. What is a gain to the cattle ranchers is a loss to the animal slaughtering industry. The slaughtering industry benefited from the ban on live cattle as exports of processed meat reached $2.2 billion in 2005, matching the high set in 2001. In 2006, the meat processing industry is expected to see foreign sales fall by 20%, offsetting the gains from live animal exports.

Although the Alberta economy is moving toward diversification, export earnings are still heavily dependent on oil and natural gas sales. Moreover, the Alberta economy exports extensively to the United States – 68% of total export earnings are accounted for by oil and gas shipments to the US market. For all of the province's sectors combined, the US purchases some 90% of total exports. As such, the Alberta economy is vulnerable to downside movements in the price of oil and the health of the US economy.



8.10 British Columbia

Foreign exports from British Columbia have grown at a rapid rate in the past 2 years, as the province has been able to capitalize on higher commodity prices and its abundance of natural resources. In 2004 and 2005, British Columbia's exports grew 10% per year. Last year's growth was even more impressive considering that forestry exports, which represent over 40% of the province's total, declined 6.5%. Considerably higher exports of energy products more than compensated for the decline in forestry products, as energy prices made substantial gains in 2005.

Table 55: British Columbia Merchandise Export Outlook

Top Sectors	CAD mn 2005	% Share of Province's Total Exports (2005)	Export Outlook (% growth)		
			2005	2006(f)	2007(f)
Forestry	13,866	40.7	-6.5	-2	-4
Energy	7,812	22.9	71.4	2	-2
Industrial Goods	5,153	15.1	13.8	16	-5
M&E	2,520	7.4	6.8	5	3
Agri-Food	2,417	7.1	-5.8	-2	1
All Others	2,294	6.7	7.8	-3	-4
Total	**34,064**	**100**	**10.0**	**2**	**-3**
Total ex. Energy	**26,251**	**77.1**	**-0.6**	**2**	**-3**

Source: EDC Economics. 2005 actual, 2006 and 2007 are forecast.

Lower exports of wood products to the US (-3.5%) and the Japanese (-19.5%) markets occurred last year, despite higher housing starts in both countries and a drop in the US softwood duties following the first administrative review by the International Trade Commission (ITC). The decline in exports mostly reflected lower prices for softwood lumber and the higher value of the Canadian dollar against the greenback. Lumber prices retreated 10% in 2005 in US dollars, but by as much as 16% in Canadian dollars after adjusting for the appreciation of the currency. While exports declined in terms of value during 2005, the volume of exports rose as demand for residential construction in Japan and in the US increased. Housing starts in the US reached their highest level since 1972 at over 2.1 million units, while Japan starts increased for the fourth consecutive year to 1.2 million, the highest level since 1997. The duties imposed on Canadian exporters of softwood lumber to the US were reduced from 27.2% to 20.2% by the ITC, as the countervailing (from 18.8% to 16.4%) and anti-dumping (from 8.4% to 3.8%) duty rates were both adjusted down. Exports of pulp were also hit hard, declining 13% last year, reflecting not only lower prices and the higher Canadian dollar, but also the year-long closure of the Port Alice pulp mill, whose owners declared bankruptcy in late 2004. Strong price increases for newsprint and most paper grades in 2005 offset the impact of the higher dollar and the dismantling of the no. 3 paper machine at Catalyst's (formerly NorskeCanada) paper mill in Port Alberni. BC's foreign exports of newsprint and other paper were flat in 2005.

The province's efforts at fighting the mountain pine beetle infestation have resulted in an abundance of logs and low-priced wood chips. This has not only helped the province's lumber industry increase the volume of production and exports, but has also benefited the province's pulp and paper sector which, compared to some of the other provinces, has come out relatively unscathed from the troubles facing the industry.

In 2006, BC's forestry exports are expected to decline approximately 2%, as a recovery in export sales of pulp will partly offset lower exports of lumber and paper. With the rapidly declining housing market in the US and weaker lumber prices, lumber exports from BC will decline in 2006 despite a higher volume of exports, again supported by the fight against the mountain pine beetle. Lumber exports will decline yet again in 2007, as prices continue to weaken with the downfall of the US housing market. Strong demand out of China has supported a series of price increases in both pulp and newsprint since the beginning of 2006. The reopening of the Port Alice pulp mill in early May gave a short-lived boost to pulp exports, but the permanent shutdown of the Western Forest Product pulp mill in Squamish in March and the indefinite closure of Catalyst's Port Alberni pulp mill in September will offset its positive impact. However, global demand will start to wane next year and with new pulp and paper capacity coming online in Asia and South America next year, exports will again be hard pressed to make any headway.

Energy exports expanded rapidly in 2005, rising 71.4% with vastly higher exports of coal, natural gas and electricity. Greater electricity demand from the US resulted in exports rising 132% last year, while higher prices for coal have led to a 90% jump in exports of coal to Asia, Europe and the US. Natural gas exports have also shown rapid growth, rising 59%, again thanks to price increases. Record investment in 2006 in the BC energy sector will support continued expansion of the province's production capacity in coming years. In 2005, oil and gas companies drilled a record 1,424 wells in the province, an increase of 11% over 2004. The government expects another increase in drilling activity in 2006, at 1,600 wells. In 2006, a decline in electricity exports will partly offset the continued strong growth in exports of coal and natural gas, resulting in a 2% growth of energy exports. In 2007, coal and natural gas exports will mostly follow price trends, despite the opening of the Cline Mining's Lossan and Lodgepole mines expected to commence in 2007 and additional natural gas capacity. Overall, the value of energy exports is expected to decline 2% in 2007.

Industrial good exports grew by 13.8% in 2005 – led by metallic ore exports, which rose 69% in 2005, on the heels of a 67% increase in 2004. Strong demand coming from Asia, particularly with the expansion of industrial production in China, has led to record commodity prices. This demand is driving a wave of exploration in the province's mining sector, which rose from $39 million in 2002 to $212 million in 2005. In 2006, exports are expected to rise 16%, with higher exports from metal manufacturing and from metallic ores. Developments in the Meziadin-Dease Lake Corridor, in northwest BC, are expected to lead to additional capacity in the coming years. However, the global slowdown expected next year will lead to weaker metal prices and, as a result, BC's industrial export receipts should decline approximately 5% in 2007.

9.0 Annexes

9.1 EDC Experience and Attitude

9.2 Short-, Medium- and Long-Term Payment Risk Maps

To receive free economic and political research covering over 200 markets worldwide, please visit our website at www.edc.ca and register under EXPORT Market Insight.

Just one of the excellent services provided by EDC Economics. If you have any questions, or require additional information regarding the **Global Export Forecast**, please call us at our toll-free number 866-574-0452 or e-mail us at EDCEconomics@edc.ca

ALGERIA

Collection Experience

- Usual Trading Terms: ILC is the norm. Some Europeans use “Open Account.”
- Overall Experience: Good with L/Cs; delays could be due to buyer and administration difficulties, not to lack of foreign exchange. Payment slowness remains common.
- Credit/Financial Issues: Private sector generally requires Banque Nationale d’Algerie or Banque Exterieure d’Algerie for L/C guarantee. Be cautious with the banking sector and state enterprises.

EDC Experience and Attitude

- Short Term: Case-by-case.
- Claims Experience: Claim paid in the first half of 2006.
- Medium/Long Term: Open under total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Open.

ANGOLA

Collection Experience

- Usual Trading Terms: Very secured terms: CIA and confirmed ILC.
- Overall Experience: Arrears mainly with ECA creditors and with MT/LT business; concluding bilateral agreements because they cannot meet IMF conditionality, postponing regularization of payments with Paris Club.
- Credit/Financial Issues: Extreme caution with banking sector; liquidity of the official sector has decidedly improved, but fluctuating arrears; payment process is still slow even for ST business.

EDC Experience and Attitude

- Short Term: Case-by-case on ILC terms with select banks.
- Claims Experience: Little experience due to lack of business.
- Medium/Long Term: High country risk; consult with Head office.
- Political Risk Insurance: Case-by-case.
- Wrongful Calling of Bonds Insurance: High country risk.

ARGENTINA

Collection Experience

- Usual Trading Terms: Move toward open terms decelerating.
- Overall Experience: In the short term there are no concerns over access to FX. A number of more serious concerns exist for the longer term, and caution is advised.
- Credit/Financial Issues: The private market has little capacity, and many public insurers are basically off cover. Some will consider structured financing arrangements that offer assurance of FX access.

EDC Experience and Attitude

- Short Term: Case-by-case, while ILC preferred, other terms considered.
- Claims Experience: No recent claims paid.
- Medium/Long Term: Case by case, with preference for FX-generating business. Caution for energy-dependent business.
- Political Risk Insurance: Highly selective, with preference for FX-generating business.
- Wrongful Calling of Bonds Insurance: Medium country risk.

ARMENIA

Collection Experience

- Usual Trading Terms: Secured terms. ILC is the norm.
- Overall Experience: Very limited experience, but poor.
- Credit/Financial Issues: Caution advised due to lack of information. Weak banking sector.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: EDC has not paid any recent claims.
- Medium/Long Term: Highly selective. Public sector cannot borrow on commercial terms.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

AUSTRALIA

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Stable business environment.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Decline in value of claims paid in 2005. No claims in first half of 2006.
- Medium/Long Term: Low risk.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

AZERBAIJAN

Collection Experience

- Usual Trading Terms: Secured terms. ILC is the norm.
- Overall Experience: Very limited experience.
- Credit/Financial Issues: Weak banking sector undergoing reforms. Improved government liquidity.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No claims experience in this market in view of limited business.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

BAHAMAS

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Fairly stable business environment.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Favourable.
- Medium/Long Term: Low risk. Open under total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low risk.

BAHRAIN

Collection Experience

- Usual Trading Terms: Full range of terms. Terms rarely exceed 60 days.
- Overall Experience: Good.
- Credit/Financial Issues: Strong financial sector; one of the most advanced in Middle East regulatory regimes. Basically no FDI barriers.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: EDC has not paid any recent claims.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

BANGLADESH

Collection Experience

- Usual Trading Terms: Secured terms – Confirmed L/C constitutes minimum and recommended terms, but L/Cs remain acceptable for repeat business or with large importers. Some open account transactions reported, though they remain the exception.
- Overall Experience: Little experience due to lack of business.
- Credit/Financial Issues: Most ECAs and the private market are very restrictive in this market due to the nation's recurring international liquidity problems.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: Claims paid in 2005. None in first half of 2006.
- Medium/Long Term: High to very high risk market.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: High country risk.

BARBADOS

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Fairly stable business environment.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: None from 2003 to 2006.
- Medium/Long Term: Low risk. Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low risk.

BOLIVIA

Collection Experience

- Usual Trading Terms: Move toward open account.
- Overall Experience: Payment delays are less common, but the new policy environment should be monitored.
- Credit/Financial Issues: Caution advised with respect to banking sector.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No claims in 2005 and none in first half of 2006.
- Medium/Long Term: High risk. Case by case in public and private sectors, public subject to HIPC guidelines.
- Political Risk Insurance: Case-by-case.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

BOTSWANA

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Business conditions are challenged by high inflation (10.5%) and high domestic interest rate (16.5%).

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Very limited experience, but there have been no claims recently.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

BRAZIL

Collection Experience

- Usual Trading Terms: Full range of terms, with open account predominant.
- Overall Experience: Fair. The high cost of local credit can lead to payment delays, but mostly for smaller companies.
- Credit/Financial Issues: Recent strengthening of the currency and robust export markets have eased short-term credit concerns.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Claims appear to be on the decline in 2006 versus previous year.
- Medium/Long Term: Open for private and public sector coverage.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

BULGARIA

Collection Experience

- Usual Trading Terms: Secured terms the norm, but trend toward open account.
- Overall Experience: A few arrears are still reported, but situation improving.
- Credit/Financial Issues: Good outlook. Banking privatization well under way.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No recent experience.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

CAMEROON

Collection Experience

- Usual Trading Terms: Confirmed and unconfirmed ILCs are the norm and predominantly with public sector.
- Overall Experience: It should improve. Arrears (domestic and external) are expected to reduce oil windfalls and the 2006 Paris Club stock of debt treatment.
- Credit/Financial Issues: Cumbersome administration; needs to develop “the culture of paying its debts”; Fitch & S&P upgraded risk rating. Private and public sectors have access to the CFA franc zone for transfer.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred other terms considered.
- Claims Experience: Very limited experience due to limited business.
- Medium/Long Term: Public sector cannot borrow on commercial terms. Private sector with appropriate financial structure.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

CHILE

Collection Experience

- Usual Trading Terms: Full range of terms, with open account predominant.
- Overall Experience: Good. Some payment delays are reported, more often at the state or state-linked level than in the private sector.
- Credit/Financial Issues: None.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Decline in claims so far this year.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

CHINA

Collection Experience

- Usual Trading Terms: While most business is done on ILC terms, open account is becoming more common.
- Overall Experience: Good.
- Credit/Financial Issues: Difficulty obtaining credit and financial information. China is still a relations rather than a law-based system, where it is imperative to know the customer well and where legal recourse is still difficult if things go wrong.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Some claims paid in 2004, 2005 and 2006 due to buyer default. No material increase in the number of claims.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

COLOMBIA

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Fair to good. Occasional payment delays still occur and economy remains vulnerable to security situation.
- Credit/Financial Issues: Banks on a steady recovery path.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: An increase in the number of claims in 2006, after a decline the previous year.
- Medium/Long Term: Open subject to country guidelines.
- Political Risk Insurance: Case-by-case, depending on region of the country.
- Wrongful Calling of Bonds Insurance: Medium country risk.

COSTA RICA

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Fair.
- Credit/Financial Issues: Caution advised with banking sector.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No claims have been paid so far in 2006, after an increase in 2005.
- Medium/Long Term: Open subject to the availability of acceptable financial information.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

CÔTE D'IVOIRE

Collection Experience

- Usual Trading Terms: Very secured terms. (Cash in advance)
- Overall Experience: Very poor. Accumulating domestic and external arrears. No solution in sight.
- Credit/Financial Issues: Extreme caution warranted. Business conditions are extremely difficult. Private and public sectors have access to the CFA franc zone for transfer.

EDC Experience and Attitude

- Short Term: Cover subject to strong risk mitigants, preferably offshore payment.
- Claims Experience: Very limited experience due to very difficult situation.
- Medium/Long Term: Highly selective. Accumulating arrears since 2002 and last rescue package is in limbo. There is no sign that situation might change dramatically.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: High country risk.

CROATIA

Collection Experience

- Usual Trading Terms: Full range of terms with open account increasingly common.
- Overall Experience: Fair.
- Credit/Financial Issues: Bank sector is weakened by dearth of official credit histories.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No recent experience.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

CUBA

Collection Experience

- Usual Trading Terms: Very secure terms. ILC required.
- Overall Experience: Poor.
- Credit/Financial Issues: Caution advised.

EDC Experience and Attitude

- Short Term: Case-by-case on ILC terms with select banks.
- Claims Experience: Long-standing and accumulating arrears; there have been improvements on the short term.
- Medium/Long Term: Highly selective.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high risk.

CZECH REPUBLIC

Collection Experience

- Usual Trading Terms: Full range of terms; open account predominant.
- Overall Experience: Generally good.
- Credit/Financial Issues: None.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Minimal claims in 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

DOMINICAN REPUBLIC

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Fair.
- Credit/Financial Issues: Conditions continue to improve but risks remain. Currency stable and inflation holding in single-digit territory resulting in a stable business environment. Risks could rise in 2008. The strength of the peso has negatively impacted the competitiveness of some enterprises.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Fair experience, with a trend of improvement continuing through 2006. Payment delays are a relatively normal occurrence.
- Medium/Long Term: Medium risk in the short term. High risk in long term as concerns relating to government debt, global economic conditions and the troubled power sector present challenges.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

ECUADOR

Collection Experience

- Usual Trading Terms: Full range of terms, but extreme caution is advised.
- Overall Experience: Poor to fair. Country's international liquidity position could become strained; caution is advised especially with longer term commitments.
- Credit/Financial Issues: Caution advised with banking sector.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No claims in 2005, and none so far this year.
- Medium/Long Term: High risk. Open on a restricted case-by-case basis for the public sector. Open on a case-by-case basis for private, non-bank risk.
- Political Risk Insurance: Open case-by-case.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

EGYPT

Collection Experience

- Usual Trading Terms: ILC and DOP/SD.
- Overall Experience: There has been a clear improvement since 2004.
- Credit/Financial Issues: Concerns over periodic dollar shortages have dissipated. Liquidity is better. Caution advised for state banks and enterprises. World Bank is supporting banking sector reform.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis.
- Claims Experience: There has been an improvement, but EDC has had to pay claims in the first half of 2006; frequent extensions or payment demands on contract bonds remains an issue.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

EL SALVADOR

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Fair to good.
- Credit/Financial Issues: Caution advised with banking sector.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Very limited experience.
- Medium/Long Term: Open for the public sector. Open on a case-by-case basis for private, non-bank risk.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

EQUATORIAL GUINEA

Collection Experience

- Usual Trading Terms: Very secured terms.
- Overall Experience: Fair.
- Credit/Financial Issues: Banking sector needs reform. Serious governance and transparency issues. Private and public sectors have access to the CFA franc zone for transfer.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No recent experience.
- Medium/Long Term: Highly selective on a case-by-case basis.
- Political Risk Insurance: Case-by-case.
- Wrongful Calling of Bonds Insurance: High country risk.

ESTONIA

Collection Experience
- Usual Trading Terms: Generally open account.
- Overall Experience: Very limited experience; some payment delays reported.
- Credit/Financial Issues: Exchange rate is fixed. No exchange controls.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: No recent experience.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

ETHIOPIA

Collection Experience
- Usual Trading Terms: Very secured terms; usually confirmed ILC.
- Overall Experience: Needs new track record after recent stock of debt treatment.
- Credit/Financial Issues: Caution is required with banking sector and state enterprises. Liquidity has been tightening, but is at a manageable level.

EDC Experience and Attitude
- Short Term: Case-by-case, though preference for L/Cs given limited experience.
- Claims Experience: Very limited experience; very difficult to recover if payment difficulties occur.
- Medium/Long Term: Public sector is quite vulnerable; private sector on case-by-case basis.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

FRANCE

Collection Experience
- Usual Trading Terms: Full range of terms.
- Overall Experience: Overall, it has been holding up well. Customers in the manufacturing, construction and trade sectors could be a problem due to a higher rate of insolvencies.
- Credit/Financial Issues: Business insolvencies increased 5% in 2005. Current trend suggests a similar number of insolvencies for 2006 (i.e. around 50,000 cases).

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: Claims paid in first half of 2006 suggest some deterioration this year.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

GABON

Collection Experience
- Usual Trading Terms: Secured terms. Confirmed and unconfirmed ILCs.
- Overall Experience: Has decidedly improved.
- Credit/Financial Issues: Liquidity has eased due to debt relief (covering June 2004 to June 2005) and stronger oil prices. Transparency and falling oil reserves remain issues. Private businesses are often linked to public sector. Private and public sectors have access to the CFA franc zone for transfer.

EDC Experience and Attitude
- Short Term: Open on a case-by-case basis.
- Claims Experience: No recent claim experience due to restrictive cover policy.
- Medium/Long Term: Prepare to consider business under a total commitment limit; case-by-case.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

GEORGIA

Collection Experience

- Usual Trading Terms: Secured terms. ILC and CILC.
- Overall Experience: Poor.
- Credit/Financial Issues: Weak banking sector. Local and FX/bank delays remain extensive. Confirmed L/Cs recommended.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No claims experience in recent years.
- Medium/Long Term: Highly selective. Public sector cannot borrow on commercial terms. Only concessional financing is allowed.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: High country risk.

GERMANY

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Generally good. The slight improvement in payment performance in 2005 is expected to continue. Agriculture, extractive and manufacturing industries are currently experiencing the highest rate of insolvencies.
- Credit/Financial Issues: Business failures could rise marginally (by 4%) in 2006.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Lower claim payments in 2005 and first half of 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

GHANA

Collection Experience

- Usual Trading Terms: ILC is the norm.
- Overall Experience: Bank delays of 1 to 2 months, resulting in some slowness.
- Credit/Financial Issues: High domestic interest rates to deal with high inflation affecting business conditions. Government heavily involved in private sector.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis, though preference for L/Cs.
- Claims Experience: Minimal claims in 2004 and 2005, but none in the first half of 2006.
- Medium/Long Term: Public sector cannot borrow. Private sector is case-by-case.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

GUATEMALA

Collection Experience

- Usual Trading Terms: Full range of terms, case-by-case.
- Overall Experience: Fair to good.
- Credit/Financial Issues: Caution advised with banking sector.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis.
- Claims Experience: One claim paid in 2006, after no claims in 2005.
- Medium/Long Term: Open on a case-by-case basis for the public sector. Open on a case-by-case basis for private, non-bank risk.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

GUINEA

Collection Experience
- Usual Trading Terms: Very secured terms.
- Overall Experience: Very poor.
- Credit/Financial Issues: Poor business conditions. Domestic and external arrears are accumulating.

EDC Experience and Attitude
- Short Term: Case-by-case subject to strong risk mitigants, preferably offshore payment.
- Claims Experience: No recent experience due to little business.
- Medium/Long Term: Highly selective due to accumulating arrears.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: High country risk.

HAITI

Collection Experience
- Usual Trading Terms: Very secured terms.
- Overall Experience: Very limited experience.
- Credit/Financial Issues: Business conditions are very difficult.

EDC Experience and Attitude
- Short Term: Case-by-case, subject to strong risk mitigants, preferably offshore payment.
- Claims Experience: Limited experience.
- Medium/Long Term: Extremely selective, third-party offshore guarantees encouraged.
- Political Risk Insurance: Case-by-case.
- Wrongful Calling of Bonds Insurance: High country risk.

HONG KONG

Collection Experience
- Usual Trading Terms: Open account predominant.
- Overall Experience: Most transactions continue to be settled promptly. The local bankruptcy rate has been going down, a trend that is expected to persist for the foreseeable future.
- Credit/Financial Issues: It is important to know your buyer's business as there is often an end buyer in China involved, which should be considered when assessing the credit risk.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: A few small claims in 2004, 2005 and 2006 due to default of the buyer.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

HUNGARY

Collection Experience
- Usual Trading Terms: Full range of terms.
- Overall Experience: Experience ranges from excellent to poor, but generally good.
- Credit/Financial Issues: Stable banking sector.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: Small claim paid in first half of 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

INDIA

Collection Experience

- Usual Trading Terms: Full range of terms; L/C becoming less prevalent as open account is becoming more common; but L/C still recommended for first-time customers.
- Overall Experience: Payment performance is improving but expect delays on most transactions.
- Credit/Financial Issues: Focus on customer risk rather than country risk; caution in dealing with regional and local governments since some are in financial straits.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Claims paid in 2005 and in first half of 2006.
- Medium/Long Term: Medium risk.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

INDONESIA

Collection Experience

- Usual Trading Terms: Secured terms – L/C is the minimum but C L/C is recommended; new business with private sector is approved on a case-by-case basis; longer term deals with the public sector are approved as long as it has the full faith and credit of the government.
- Overall Experience: Payment delays are reported.
- Credit/Financial Issues: Concern about weakness in banking system and slow improvements. Continue to exercise caution in assessing customer and bank risk.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis.
- Claims Experience: Claim paid in 2005 and again in first half of 2006.
- Medium/Long Term: High risk.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

IRAN

Collection Experience

- Usual Trading Terms: Preference for ILC with specific banks.
- Overall Experience: Could be affected by position toward human rights and nuclear issues.
- Credit/Financial Issues: Caution with certain banks and state enterprises. ECAs have experienced retaliation.

EDC Experience and Attitude

- Short Term: Case-by-case on ILC terms, with select banks – volatile situation, subject to sudden change. Consult Head Office.
- Claims Experience: EDC paid claims due to default and call on bond.
- Medium/Long Term: Consult with Head Office; subject to the Canadian government "Controlled Engagement Policy".
- Political Risk Insurance: Case-by-case.
- Wrongful Calling of Bonds Insurance: High country risk.

IRAQ

Collection Experience

- Usual Trading Terms: Third-party financing structure and risks stop at the border.
- Overall Experience: Very limited experience due to political conditions. Moratorium on external debt.
- Credit/Financial Issues: Business conditions remain challenging. Security (kidnapping) is a serious concern. The three foreign banks – HSBC, National Bank of Kuwait and the Standard Chartered Bank – have been awarded licenses to set up operations, but are concerned by security.

EDC Experience and Attitude

- Short Term: Case-by-case with strong risk mitigants – third-party financing structure/offshore payment.
- Claims Experience: No recent experience.
- Medium/Long Term: Third-party financing structure and risks stop at the border.
- Political Risk Insurance: Case-by-case.
- Wrongful Calling of Bonds Insurance: Case-by-case.

ISRAEL

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good
- Credit/Financial Issues: High oil prices putting pressure on inflation. Higher military expenditures putting pressures on budget and future purchases.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Claims in 2005 and in the first half of 2006 due to buyer default.
- Medium/Long Term: Open under total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

ITALY

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Payments continue to be slow, below EU average.
- Credit/Financial Issues: Outdated bankruptcy legislation leads to costs and delays. Business liquidations up 5.6% in 2005 and expected to remain high in 2006 due to economic difficulties.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Small number of claims in 2005 and first half of 2006 due to buyer default.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

JAMAICA

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Fair but delays are relatively common.
- Credit/Financial Issues: Economy is on a modest upswing led by tourism and some mining. Although stable environment at present, caution remains a persistent recommendation as currency volatility and government liquidity crunches could re-emerge.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Two claims submitted so far in 2006. No claims in 2005 and only one in 2004.
- Medium/Long Term: Sovereign has large debt overhang but fiscal policy is on the right track. Little fiscal reserve available in the event of a shock.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium risk.

JAPAN

Collection Experience

- Usual Trading Terms: Full range of terms, with lenient terms predominating.
- Overall Experience: Good.
- Credit/Financial Issues: Growth in bank lending declined in August 2006 after rising for almost 2 years, possibly due to disappointing growth in the second quarter. The Bank of Japan hiked interest rates in August 2006 for the first time since 2000. Bankruptcies up 3.1% y/y in first 8 months of 2006.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: One claim each in 2005 and first half of 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

JORDAN

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Foreign reserves have been falling and liquidity could become an issue depending on aid. Credit rating agencies are more concerned about Jordan due to larger deficits.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Claims declined in 2004 and 2005. None in the first half of 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

KAZAKHSTAN

Collection Experience

- Usual Trading Terms: Mostly secured terms, but some open account, generally with oil companies or affiliates, or agents of well-established companies.
- Overall Experience: Continued improvement in promptness of payments.
- Credit/Financial Issues: Relatively well-developed banking sector; challenging (but improving) business environment due to corruption and lack of transparency. Liquidity is much better because of oil and gas revenues.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis.
- Claims Experience: No recent claims experience.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

KENYA

Collection Experience

- Usual Trading Terms: Confirmed and unconfirmed ILCs are the norm.
- Overall Experience: Satisfactory.
- Credit/Financial Issues: Financial statements need to be scrutinized. Banking sector needs to be watched. Corruption is a real issue. Experiencing problems with IFIs due to corruption. Business conditions have been improving.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis. Preference for ILCs.
- Claims Experience: No recent claims experience.
- Medium/Long Term: Public sector cannot borrow; private sector on case-by-case.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

KUWAIT

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Large foreign exchange assets. Sound banking sector.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Claims in 2004 and 2005 due to default and call on bond, but none in the first half of 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

KYRGYZSTAN

Collection Experience

- Usual Trading Terms: Secured terms. ILC is the norm.
- Overall Experience: Very limited experience.
- Credit/Financial Issues: Banking sector reforms stalled.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No claims experience due to very limited business.
- Medium/Long Term: Highly selective. Public sector cannot borrow on commercial terms.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

LEBANON

Collection Experience

- Usual Trading Terms: Slowly returning to pre-war terms of trade (i.e. mainly ILCs). Infrastructure (including communications) has experienced major destruction. The central bank forced Lebanese to use the Lebanese pound instead of the US dollar during the war with Israel.
- Overall Experience: No sign of deterioration. However, business became impossible during the blockade. Country had an external debt overhang before the war.
- Credit/Financial Issues: Pledges to rebuild Lebanon have been flooding in from the Gulf countries. Workers' remittances will help the reconstruction. The Gulf countries have been supporting Lebanese banks. Business conditions remain very difficult.

EDC Experience and Attitude

- Short Term: Case-by-case – ILC preferred. Consult with Head Office.
- Claims Experience: Experience was good (prior to the war).
- Medium/Long Term: Highly selective; very concerned with the public sector. Consult Head Office.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

LIBYA

Collection Experience

- Usual Trading Terms: Confirmed and unconfirmed ILCs.
- Overall Experience: Payment experience reasonably good on secure terms. Payment process is slow despite abundance of foreign exchange reserves.
- Credit/Financial Issues: Business done through the Libyan Arab Foreign Bank or Central Bank.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis. Preference for L/Cs.
- Claims Experience: One claim received (denied) due to absence of an import permit for the commodity.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

LITHUANIA

Collection Experience

- Usual Trading Terms: Generally open account, although North American exporters tend to be more restrictive.
- Overall Experience: Limited, but good.
- Credit/Financial Issues: Fairly stable business environment.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No recent experience.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

MALAYSIA

Collection Experience
- Usual Trading Terms: Full range of terms, although open account is predominant.
- Overall Experience: Payment experience with Malaysian importers remains good but still need to carefully assess customer risk.
- Credit/Financial Issues: Local bankruptcy rate receding; easing of capital restrictions.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: No claim paid in 2005.
- Medium/Long Term: Slight risk.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

MALI

Collection Experience
- Usual Trading Terms: Mainly ILC.
- Overall Experience: Expected to improve
- Credit/Financial Issues: Caution is needed with state enterprises; belongs to the CFA franc zone.

EDC Experience and Attitude
- Short Term: Open on a case-by-case basis.
- Claims Experience: EDC has not paid claims in recent years.
- Medium/Long Term: Public sector cannot borrow at this juncture; private sector with appropriate financial structure.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

MAURITANIA

Collection Experience
- Usual Trading Terms: Mainly ILCs.
- Overall Experience: Satisfactory.
- Credit/Financial Issues: Corruption and bureaucracy are issues in business activities. Legal system cumbersome. Oil revenues coming on stream. Disputing four offshore production sharing agreements (PSAs).

EDC Experience and Attitude
- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: EDC did not pay any claims in recent years due to limited business.
- Medium/Long Term: High-risk market; considering well-secured transactions.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

MAURITIUS

Collection Experience
- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Fairly high domestic interest rates. Corruption is an issue.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: EDC did not pay any claims in recent years.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

MEXICO

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Short term – challenging; Medium to long term – good.
- Credit/Financial Issues: Difficult to obtain financial information. Commercial morality can be problematic and therefore promissory notes ("pagares") are recommended in order to expedite possible Mexican court proceedings.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Challenging. Slow and cumbersome court system makes recoveries challenging.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium risk.

MOLDOVA

Collection Experience

- Usual Trading Terms: Secured terms, usually L/Cs.
- Overall Experience: Limited, as business is mainly done with a few trading partners.
- Credit/Financial Issues: Limited information; very difficult business conditions.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No recent claims experience.
- Medium/Long Term: Highly selective.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-High country risk.

MONGOLIA

Collection Experience

- Usual Trading Terms: Secured terms. ILC is the norm.
- Overall Experience: Very limited experience.
- Credit/Financial Issues: High level of non-performing loans in banking sector is a concern.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No recent claims experience due to very limited business.
- Medium/Long Term: Highly selective. Subject to availability of financial information.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

MOROCCO

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: New banking law with more powers for the central bank. Pressure on the dirham receded, but appears to be overvalued.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No claims in 2005 and none in the first half of 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

MOZAMBIQUE

Collection Experience

- Usual Trading Terms: Secured terms, mainly ILC.
- Overall Experience: Satisfactory.
- Credit/Financial Issues: Banking sector would be weak without Portuguese support; the choice of domestic bank is important.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis. Preference for L/Cs.
- Claims Experience: Very little experience with the market.
- Medium/Long Term: Open under a total commitment limit. Public sector cannot borrow on commercial terms.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

NAMIBIA

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Low foreign exchange reserves. Namibian dollar is a strong currency. This has helped to contain inflationary pressures.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No claims experience, but very little business.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

NETHERLANDS

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Payment experience remains better than EU average. Trade, construction and financial services are the most vulnerable sectors for insolvencies.
- Credit/Financial Issues: Bankruptcies have been declining in 2006, but are still at record levels.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Claims in 2005 and in the first half of 2006 remain low.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

NIGERIA

Collection Experience

- Usual Trading Terms: Confirmed ILC is the norm.
- Overall Experience: It has improved with ECAs; still large domestic arrears to be dealt with.
- Credit/Financial Issues: Domestic interest rates are high (16%); major banking reform. Widespread campaign against corruption, but it is still an issue; cumbersome administration due to three levels of management. Large foreign reserves and more serious about reforms than in the past.

EDC Experience and Attitude

- Short Term: Case-by-case on ILC terms with select banks.
- Claims Experience: No recent experience due to cover policy.
- Medium/Long Term: Lines of credit signed in 2006 to support private sector business.
- Political Risk Insurance: Case-by-case.
- Wrongful Calling of Bonds Insurance: High country risk.

OMAN

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Rial is pegged to the US dollar. Public spending should encourage private consumption. Buoyant business conditions.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No recent experience.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

PAKISTAN

Collection Experience

- Usual Trading Terms: Full range of terms, with a growing reliance on open account.
- Overall Experience: Fair to good with an improving trend.
- Credit/Financial Issues: Loosening terms for established customers but private sector transactions typically limited to those with a commercial bank as obligor or guarantor; public sector deals need evidence of full faith and backing of the government.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No claims in 2005 or in the first half of 2006.
- Medium/Long Term: High to very high risk.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: High country risk.

PANAMA

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Fair to good.
- Credit/Financial Issues: Fairly stable business environment.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No claims paid in 2006, after slight increase in 2005.
- Medium/Long Term: Open for the public sector, while on a case-by-case basis for private risk.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

PERU

Collection Experience

- Usual Trading Terms: Full range of cover.
- Overall Experience: Experiences are generally good, but secure terms are recommended for less well-known customers. Note: Local laws give creditors only 7 days to protest a draft.
- Credit/Financial Issues: Banking system improving, but caution still advised.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Reduction in claims paid in 2005 to seven occurrences.
- Medium/Long Term: Open for both public and private sector with a preference for sovereign guarantee.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

PHILIPPINES

Collection Experience

- Usual Trading Terms: Full range of terms but an L/C is recommended based on customer rather than country risk.
- Overall Experience: Fair to good.
- Credit/Financial Issues: Country risk has been declining and is not a grave concern over the near term; customer risk needs to be assessed thoroughly.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No claims paid in 2005. One claim paid in first half of 2006.
- Medium/Long Term: High risk – fiscal problems are presenting dilemma for policy makers.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

POLAND

Collection Experience

- Usual Trading Terms: Open account has become predominant.
- Overall Experience: Satisfactory.
- Credit/Financial Issues: Stable banking sector. Polish law caps past-due interest on receivables.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: One claim paid in first half of 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

PORTUGAL

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Payment experience remains poor in comparison with other EU countries.
- Credit/Financial Issues: Company bankruptcies fell by an estimated 8% in 2005, but have been rising in 2006 due to persistently weak economic conditions. Manufacturing, wholesaling and construction are the sectors recording the highest level of insolvencies.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Claims paid in first six months of 2006 are on the rise.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

QATAR

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Buoyant business conditions. Trying to attract foreign investment. Fixed exchange rate to the US dollar.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: EDC has recovered claims paid in 2005.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

ROMANIA

Collection Experience
- Usual Trading Terms: Open account is becoming more prevalent.
- Overall Experience: Generally satisfactory, but caution still advised.
- Credit/Financial Issues: Reforms are continuing, but caution is still warranted.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: No recent claims experience.
- Medium/Long Term: Selectively open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

RUSSIA

Collection Experience
- Usual Trading Terms: It is no longer difficult to get an ILC by a Russia bank; usage of open account terms has increased considerably.
- Overall Experience: It has decidedly improved, and the bulk of payments are made within 60 days.
- Credit/Financial Issues: Bank restructuring moving slowly in Russia. Appreciation of the ruble.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: No claims experience since 2002, but collection work is difficult if needed.
- Medium/Long Term: Open under a total commitment limit, but selective (for leading corporations and banks).
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

SAUDI ARABIA

Collection Experience
- Usual Trading Terms: Full range of terms.
- Overall Experience: Showing distinct improvement, especially government bodies, since tenders are now covered by budget allocations.
- Credit/Financial Issues: Problems occur more often with government agencies than with private sector buyers. Local practice forces foreign suppliers to government entities or royal family to sell to intermediaries. Recourse and interest on late payments are very difficult.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: EDC paid several claims in 2005 and in the first half of 2006. Recovery of claims in this market is very difficult due to high cost of legal action and a lack of collection agencies.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

SENEGAL

Collection Experience
- Usual Trading Terms: Secured terms, particularly for the public sector.
- Overall Experience: It has been improving.
- Credit/Financial Issues: Private and public sectors benefit from membership in the CFA franc zone. State enterprises are bankrupt or badly managed.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: No claims in 2004 or 2005, but EDC paid small claims in the first half of 2006.
- Medium/Long Term: Public sector could not borrow on commercial terms in the first half of 2006; private sector under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

Singapore

Collection Experience

- Usual Trading Terms: Full range of terms, though open account predominant.
- Overall Experience: Excellent.
- Credit/Financial Issues: Due to payment experience and virtually no claims paid, private market premiums remain attractive.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Claims paid in 2005 and 2006.
- Medium/Long Term: Lowest to slight risk.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

Slovakia

Collection Experience

- Usual Trading Terms: Open account terms are predominant.
- Overall Experience: Satisfactory.
- Credit/Financial Issues: Banking sector has improved.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Small claim paid in 2004 and 2005.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

Slovenia

Collection Experience

- Usual Trading Terms: Open account terms are predominant, followed by draft terms.
- Overall Experience: Satisfactory.
- Credit/Financial Issues: Bank sector has improved.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No recent experience.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

South Africa

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Satisfactory, depending on buyers.
- Credit/Financial Issues: Good year ahead; lower domestic interest rates; caution with private buyers.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: EDC paid claims due to defaulting buyers in 2004 and 2005.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

SOUTH KOREA

Collection Experience

- Usual Trading Terms: Full range of terms, and SD is in common use.
- Overall Experience: Good.
- Credit/Financial Issues: Banking system has much improved. Customer risks should still be assessed with care. Bankruptcies are running at a similar rate to last year, though delinquency rates on loans are up noticeably since the recent interest rate hikes.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Claims have risen in 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

SPAIN

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Payment experience improved in 2005 and first half of 2006, and remains above EU average. Customer delays could be experienced. A sharp fall in insolvencies has been recorded.
- Credit/Financial Issues: Business insolvencies fell by about 18% in 2005. Construction, hotel and restaurants recorded the largest number of insolvencies. Data show a downward trend for 2006.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: First half 2006 suggests a downward trend.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

SRI LANKA

Collection Experience

- Usual Trading Terms: Use of ILCs declining in line with increasing liberalization of conditions, although a measure of caution is still recommended.
- Overall Experience: Improved but limited experience.
- Credit/Financial Issues: Inexperience with the market or customer requires caution to be exercised; received its first sovereign rating by Fitch and S&P in December 2005.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No claims paid in 2005, or in first half of 2006.
- Medium/Long Term: Medium risk.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

SYRIA

Collection Experience

- Usual Trading Terms: Secured terms, mainly ILC.
- Overall Experience: Satisfactory if properly secured.
- Credit/Financial Issues: Cumbersome administration; Commercial Bank of Syria is under US sanctions, no US bank, broker-dealer or mutual fund can open an account with this Syrian bank.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis. Preference for ILCs, except from the Commercial Bank of Syria.
- Claims Experience: No claim paid in 2004 but claim paid in 2005 and in the first half of 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

TAJIKISTAN

Collection Experience
- Usual Trading Terms: Secured terms. ILC is the norm.
- Overall Experience: Limited to key trading partners.
- Credit/Financial Issues: Weak financial institutions; monetary policy instruments insufficient; difficult risk assessments due to lack of transparency and poor accounting practices.

EDC Experience and Attitude
- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No recent claims experience due to very limited business.
- Medium/Long Term: Highly selective. Public sector cannot borrow on commercial terms.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: High country risk.

TANZANIA

Collection Experience
- Usual Trading Terms: Mainly L/Cs.
- Overall Experience: Has been improving, but preference for L/Cs.
- Credit/Financial Issues: Business conditions are better; corruption and high oil prices remain an issue. Banking reform resulted in privatization of a few banks.

EDC Experience and Attitude
- Short Term: Open on a case-by-case basis.
- Claims Experience: EDC has not paid any claims recently.
- Medium/Long Term: Public sector could not borrow through August 2006; private sector case-by-case.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

THAILAND

Collection Experience
- Usual Trading Terms: ILC is common, but open account is the preference.
- Overall Experience: Fair to good.
- Credit/Financial Issues: Lenient terms acceptable with established customers – subject to financial disclosure.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: Small claim paid in 2005, none in first half of 2006.
- Medium/Long Term: Medium risk but improving.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

TRINIDAD & TOBAGO

Collection Experience
- Usual Trading Terms: Full range.
- Overall Experience: Fair to poor.
- Credit/Financial Issues: Economy booming with no concerns regarding currency stability. Caution advised when limited buyer information available.

EDC Experience and Attitude
- Short Term: Open without restrictions.
- Claims Experience: Two claims in first half of 2006, but experience is limited.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium risk.

TUNISIA

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good.
- Credit/Financial Issues: Caution with banking sector. Good business conditions. Stronger investor protection among Maghreb countries.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No claims in first half of 2006, continuing pattern seen in 2004 and 2005.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

TURKEY

Collection Experience

- Usual Trading Terms: Full range of terms. Private sector much more solid.
- Overall Experience: Despite the recent mini-financial crisis, experience remains broadly positive with most exporters continuing to report satisfactory collection experience.
- Credit/Financial Issues: Banking industry has strengthened following the 2001 crisis.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Small claims paid in 2004 and 2005.
- Medium/Long Term: Selectively open subject to total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

TURKMENISTAN

Collection Experience

- Usual Trading Terms: Very secured terms. This includes payment in advance.
- Overall Experience: Limited to key trading partners.
- Credit/Financial Issues: Lack of transparency, weak corporate governance and foreign exchange rationing compound an already difficult business environment.

EDC Experience and Attitude

- Short Term: Case-by-case, subject to strong risk mitigants, preferably offshore payment.
- Claims Experience: No claims experience due to very limited business.
- Medium/Long Term: Highly selective.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

UGANDA

Collection Experience

- Usual Trading Terms: Secured terms; CIA and confirmed ILC.
- Overall Experience: Satisfactory if well packaged.
- Credit/Financial Issues: Coffee exporter affected by higher oil prices.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis.
- Claims Experience: No recent experience.
- Medium/Long Term: Subject to a total commitment limit, but public sector is weak.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

UKRAINE

Collection Experience

- Usual Trading Terms: Usual trading terms; transactions are still often cash in advance, although some liberalization of terms has occurred in recent months. The banking system remains in questionable health.
- Overall Experience: Poor due to difficult business environment.
- Credit/Financial Issues: Creditworthiness of customers remains difficult to assess. Kiev enjoys substantial goodwill from the US.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis.
- Claims Experience: Limited experience.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

UNITED ARAB EMIRATES

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Good, but distinction should be made between Dubai and Abu Dhabi and the other five emirates.
- Credit/Financial Issues: Dirham is pegged to the US dollar. Despite large foreign reserves, buyer default is an issue.

EDC Experience and Attitude

- Short Term: Open without restrictions
- Claims Experience: EDC paid claims in 2004 and 2005 and again in the first half of 2006.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Low country risk.

UNITED KINGDOM

Collection Experience

- Usual Trading Terms: Full range of terms; most sales on open account.
- Overall Experience: Payments are usually made within 60 days.
- Credit/Financial Issues: Bankruptcies increased in 2005 by about 3%, as the economy faced a slowdown; bankruptcies are expected to increase by 2.7% in 2006. Services, construction, industry and transport have been the sectors recording the largest number of insolvencies.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Claims continue to be paid in 2006, as in 2005.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

UNITED STATES

Collection Experience

- Usual Trading Terms: Full range of terms.
- Overall Experience: Auto-related companies, air transport and grocery retailers are reporting highest rates of insolvencies and payment difficulties.
- Credit/Financial Issues: Rise in interest rates and slowing growth in the US brought a worsening in companies' finances. Number of insolvencies increased in first half of 2006 despite tightened insolvency law.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: Upturn in claims paid in first half of 2006 likely to continue in near term.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Very low country risk.

URUGUAY

Collection Experience

- Usual Trading Terms: Secured terms the norm.
- Overall Experience: Fair. A healthier financial system and increased liquidity should help improve conditions, but credit exposure to Uruguay should be monitored.
- Credit/Financial Issues: Business and banking conditions are improving.

EDC Experience and Attitude

- Short Term: Open on a case-by-case basis.
- Claims Experience: Generally satisfactory.
- Medium/Long Term: Open on case-by-case basis subject to the availability of acceptable financial information.
- Political Risk Insurance: Open on a selective basis for FX-generating transactions.
- Wrongful Calling of Bonds Insurance: Low-medium country risk.

UZBEKISTAN

Collection Experience

- Usual Trading Terms: Very secured terms. ILC is the norm.
- Overall Experience: Limited to a few trading partners.
- Credit/Financial Issues: Lack of transparency, weak corporate governance and foreign exchange rationing compound an already difficult business environment.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No recent claims experience.
- Medium/Long Term: Highly selective.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

VENEZUELA

Collection Experience

- Usual Trading Terms: Full range of terms, secured terms the norm.
- Overall Experience: Experience varies depending on buyer. FX controls require authorization and disbursements from CADIVI, a process subject to politics and corruption.
- Credit/Financial Issues: Caution advised. Full disclosure of financial information is often difficult to obtain. Close monitoring of buyers and their relation to the government is recommended. Possible devaluation of the Bolivar should be monitored.

EDC Experience and Attitude

- Short Term: Case-by-case, while ILC preferred, other terms considered.
- Claims Experience: One claim paid in first half of 2006, after two large claims the previous year.
- Medium/Long Term: New MLT transactions are considered on a selective case-by-case basis – with preference for sovereign, FX-generating entities.
- Political Risk Insurance: Case-by-case.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

VIETNAM

Collection Experience

- Usual Trading Terms: Secured terms – mainly L/C (not always confirmed).
- Overall Experience: Fair but limited experience.
- Credit/Financial Issues: Capacity in private sector is tight and restricted, particularly for private sector deals; public sector deals require full faith and credit of the government; banking system weak.

EDC Experience and Attitude

- Short Term: Open without restrictions.
- Claims Experience: No claims paid in 2005, or in first half of 2006.
- Medium/Long Term: Medium risk but limited experience.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium country risk.

YEMEN

Collection Experience

- Usual Trading Terms: ILC terms the norm.
- Overall Experience: Satisfactory.
- Credit/Financial Issues: Slow administration, weak banking sector and unpredictable business environment.

EDC Experience and Attitude

- Short Term: Case-by-case; while ILC preferred, other terms considered.
- Claims Experience: No claims in the first half of 2006, continuing pattern seen in 2004 and 2005.
- Medium/Long Term: Open under a total commitment limit.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

ZAMBIA

Collection Experience

- Usual Trading Terms: Secured terms – Confirmed and unconfirmed ILCs.
- Overall Experience: Satisfactory, but payments have to be secured.
- Credit/Financial Issues: Slow administration, weak banking sector. Liquidity improved after generous debt relief. Business conditions are challenged by high interest rates. Currency has been falling since June 2006.

EDC Experience and Attitude

- Short Term: Case-by-case; preference for secure terms.
- Claims Experience: No claims in 2005. None during the first half of 2006.
- Medium/Long Term: Public sector cannot borrow on commercial terms.
- Political Risk Insurance: Open.
- Wrongful Calling of Bonds Insurance: Medium-high country risk.

ZIMBABWE

Collection Experience

- Usual Trading Terms: If trade is to be done, recommend only most secured terms (off-shore ILC).
- Overall Experience: Very difficult, characterized by domestic and external arrears to all type of creditors.
- Credit/Financial Issues: Extreme caution. Very difficult business conditions. Acute liquidity crisis.

EDC Experience and Attitude

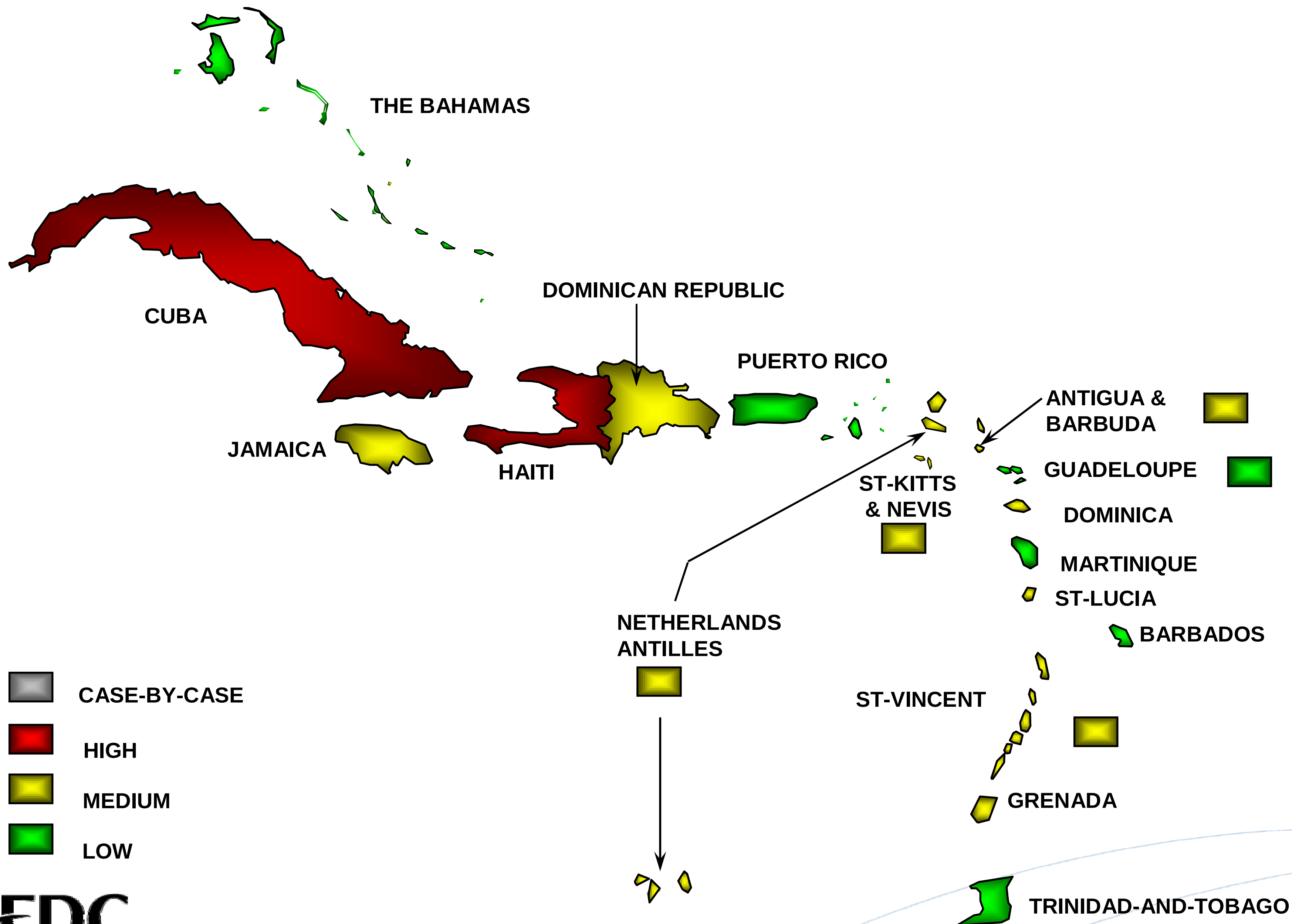
- Short Term: Off cover.
- Claims Experience: No recent experience.
- Medium/Long Term: Off cover.
- Political Risk Insurance: Off cover.
- Wrongful Calling of Bonds Insurance: Off cover.

Latin America

Short-term payment risks

Caribbean

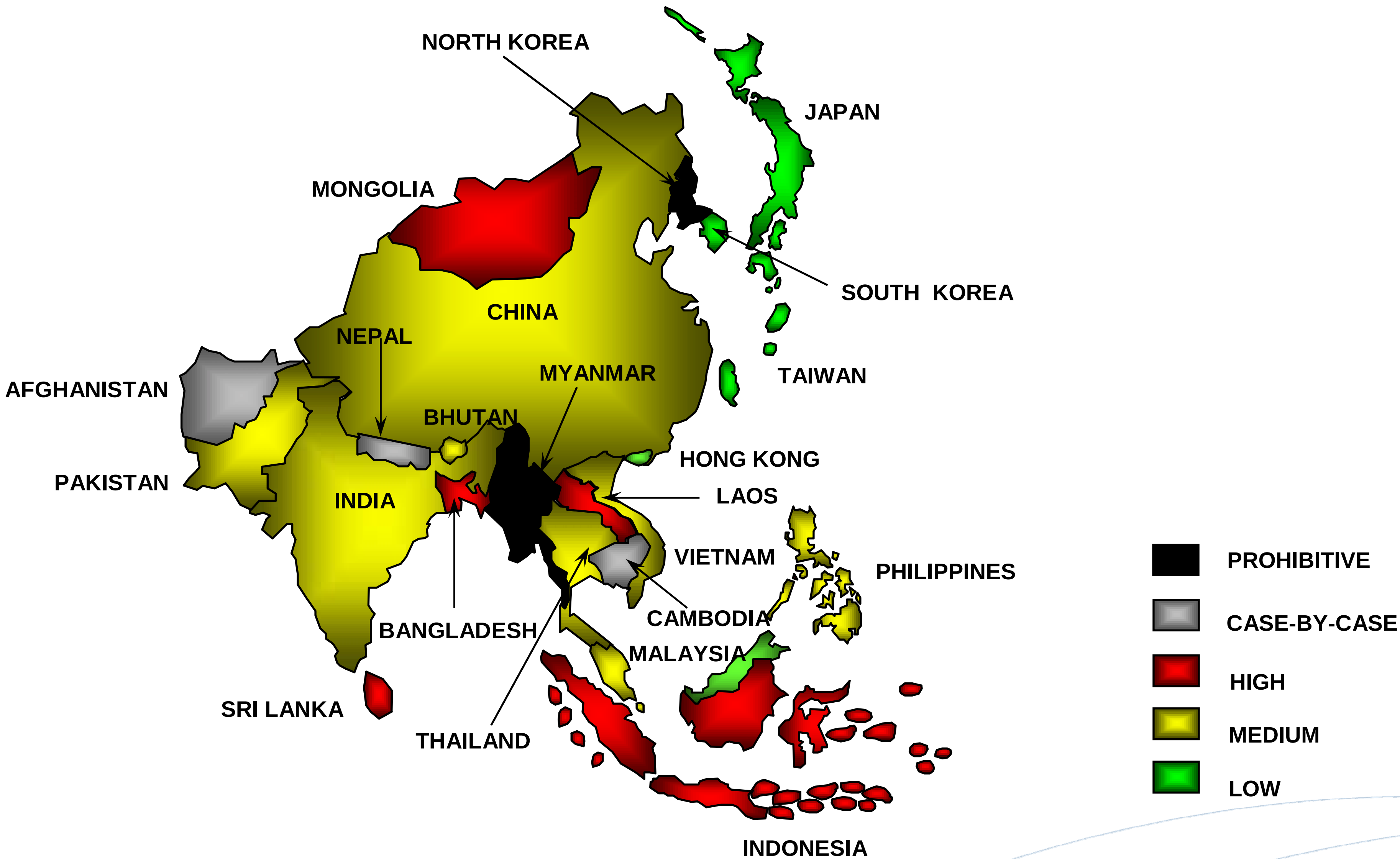
Short-term payment risks



EDC

Asia / Pacific

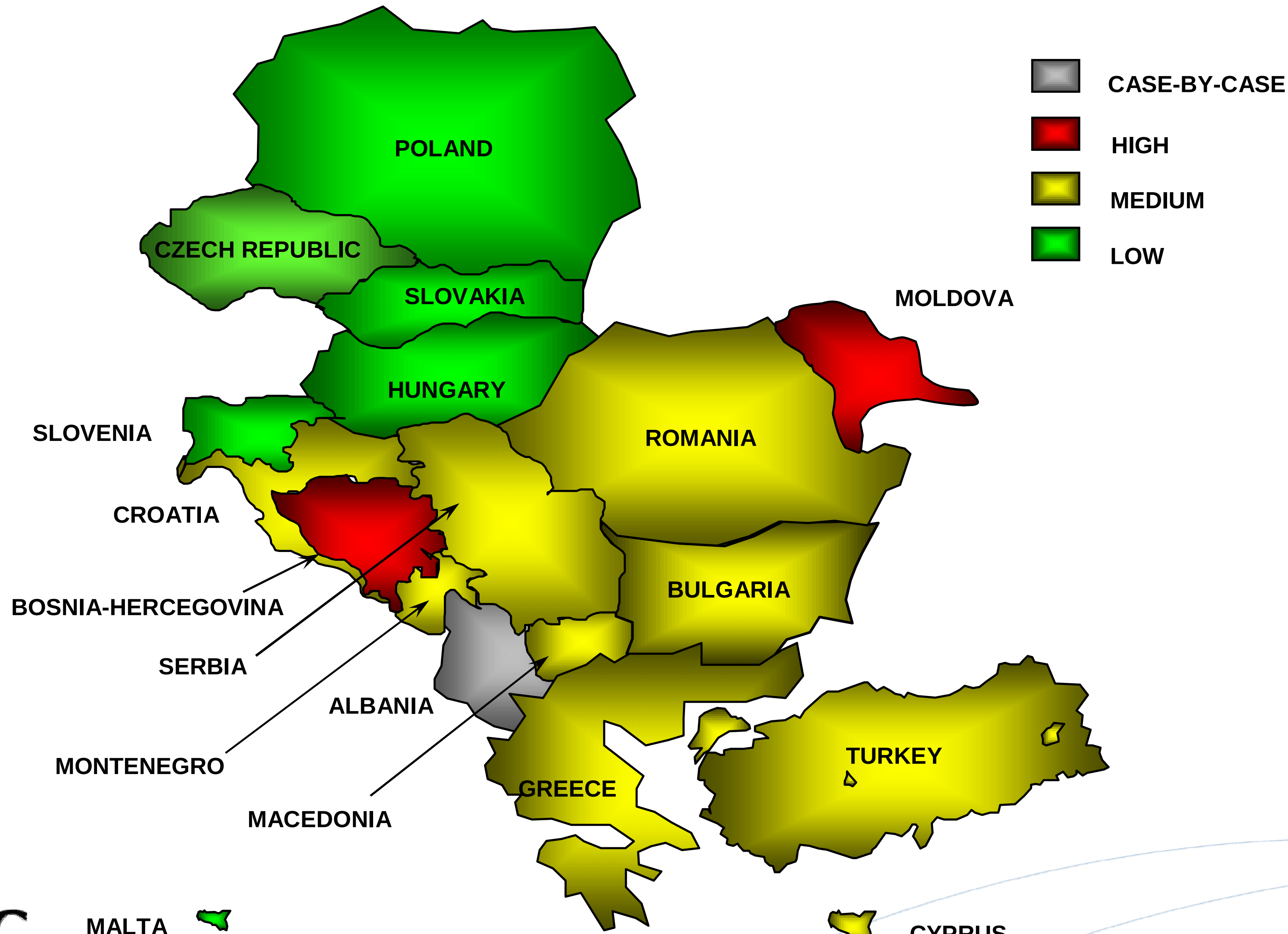
Short-term payment risks



EDC

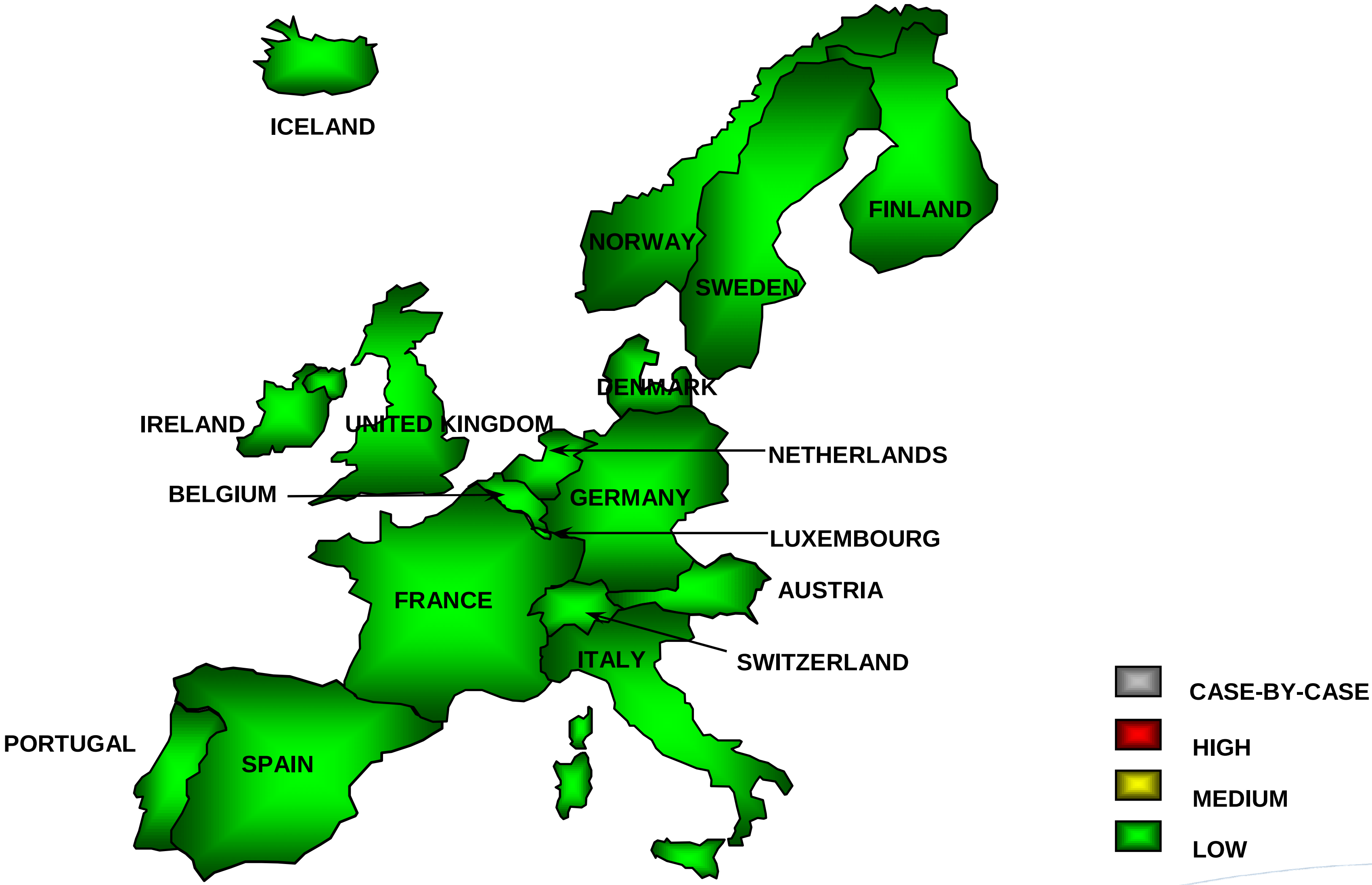
Central Europe

Short-term payment risks



Western Europe

Short-term payment risks



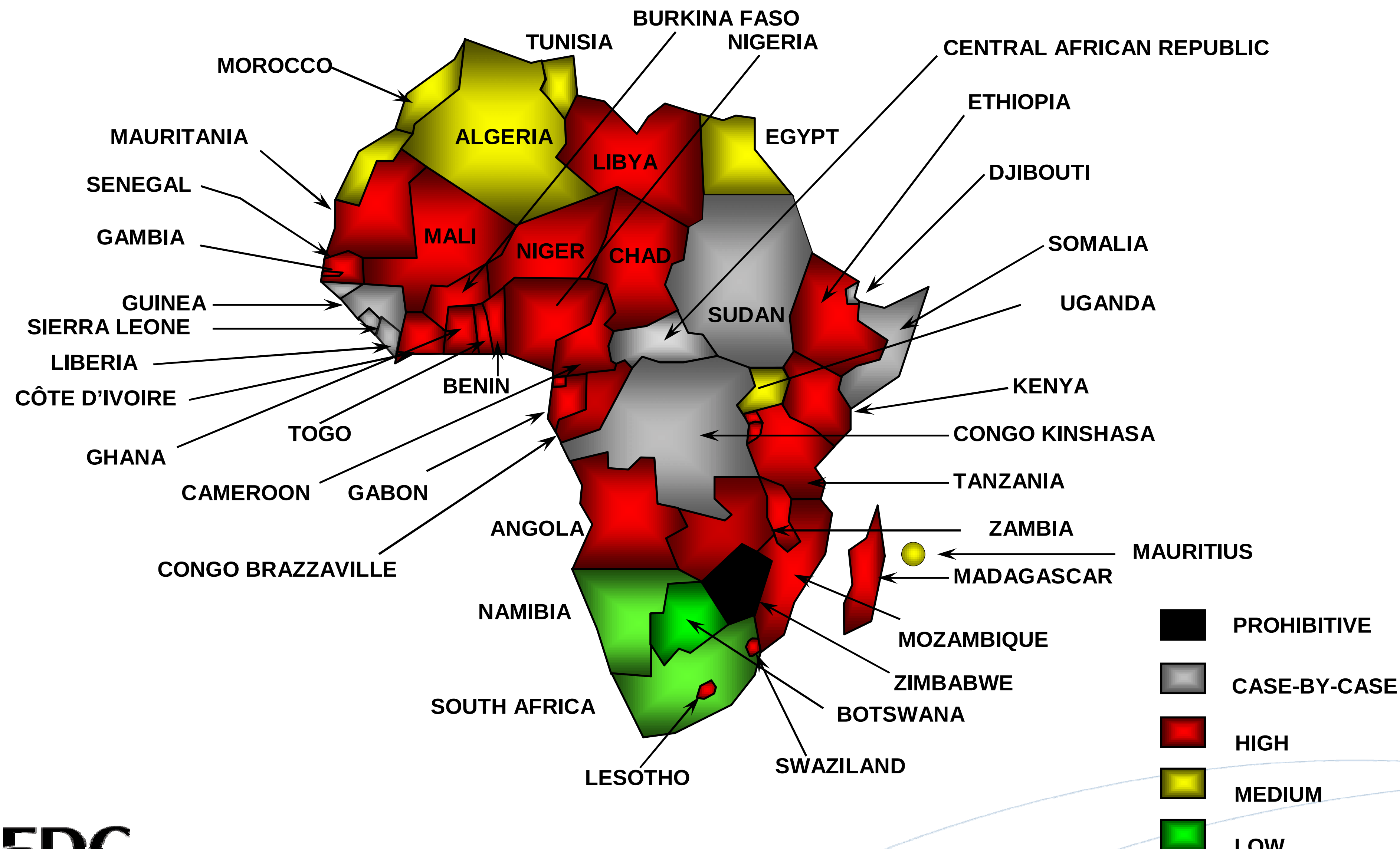
Former Soviet Union

Short-term payment risks

EDC

Africa

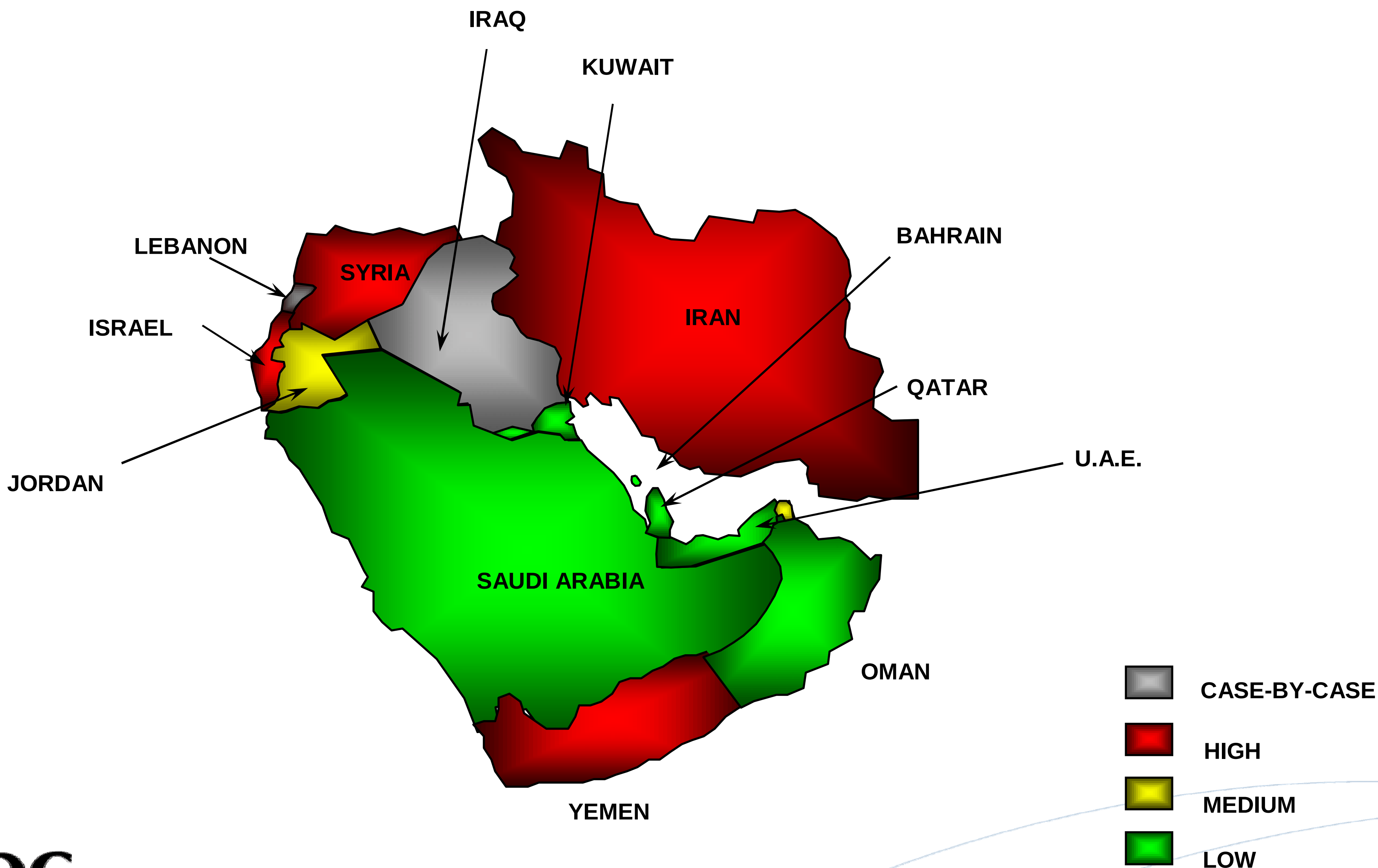
Short-term payment risks



EDC

Middle East

Short-term payment risks



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Short-term payment risk maps

This assessment is valid at date of issue but always subject to review.

Please contact the EDC Economics Division for current position.

Please visit our website at www.edc.ca/economics

Latin America

Medium & long-term payment risks

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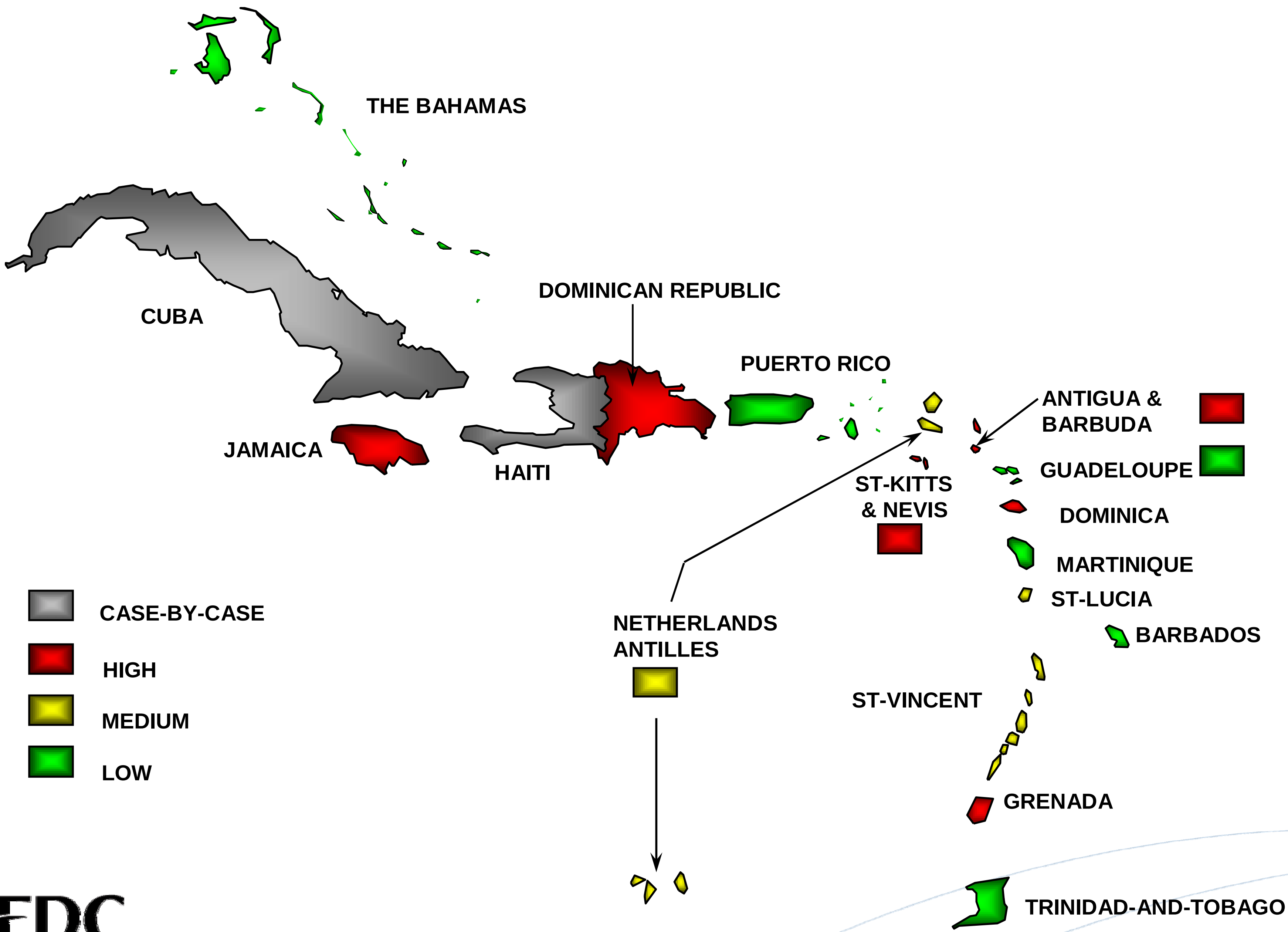
Caribbean

Medium & long-term payment risks



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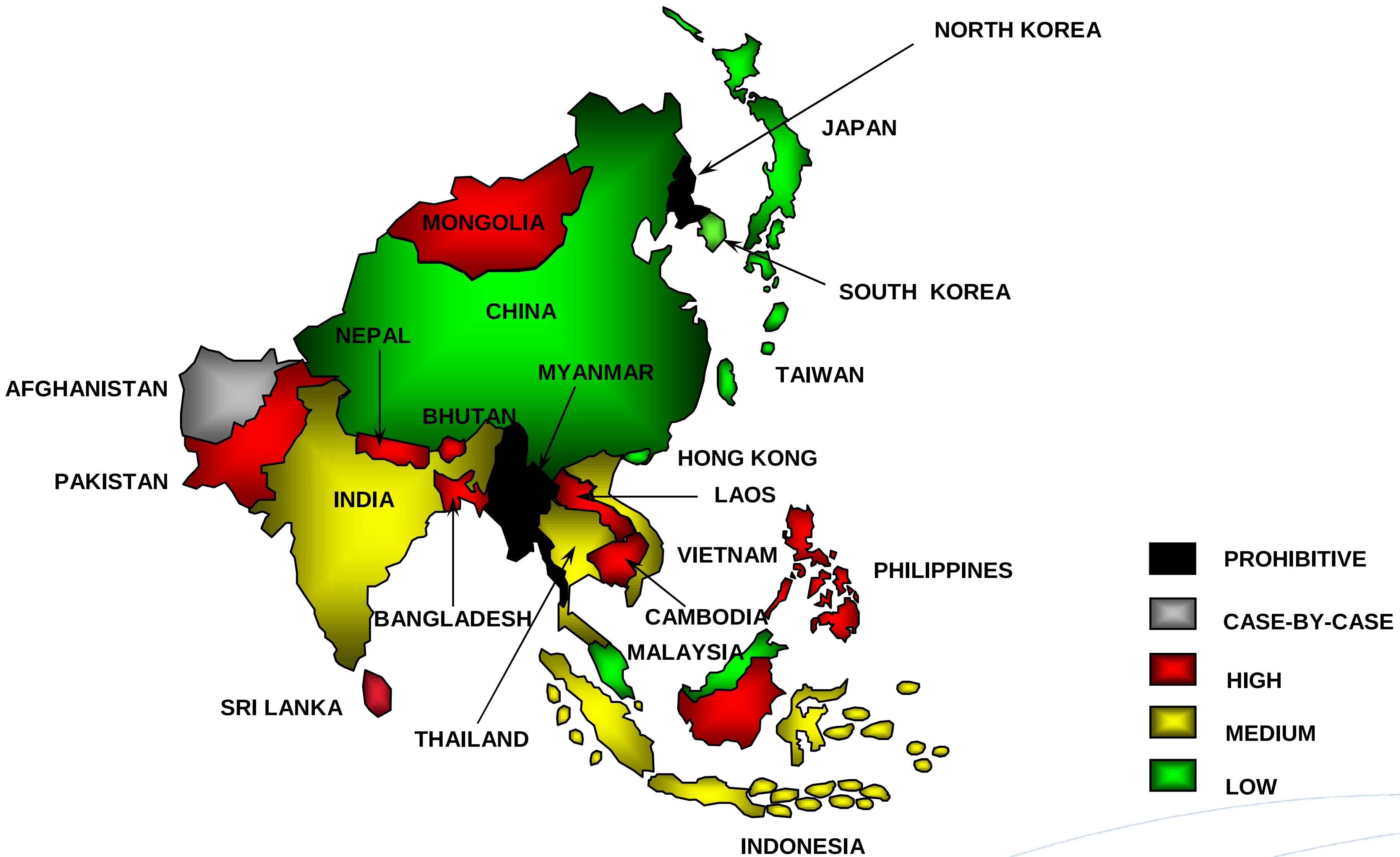
Asia / Pacific

Medium & long-term payment risks



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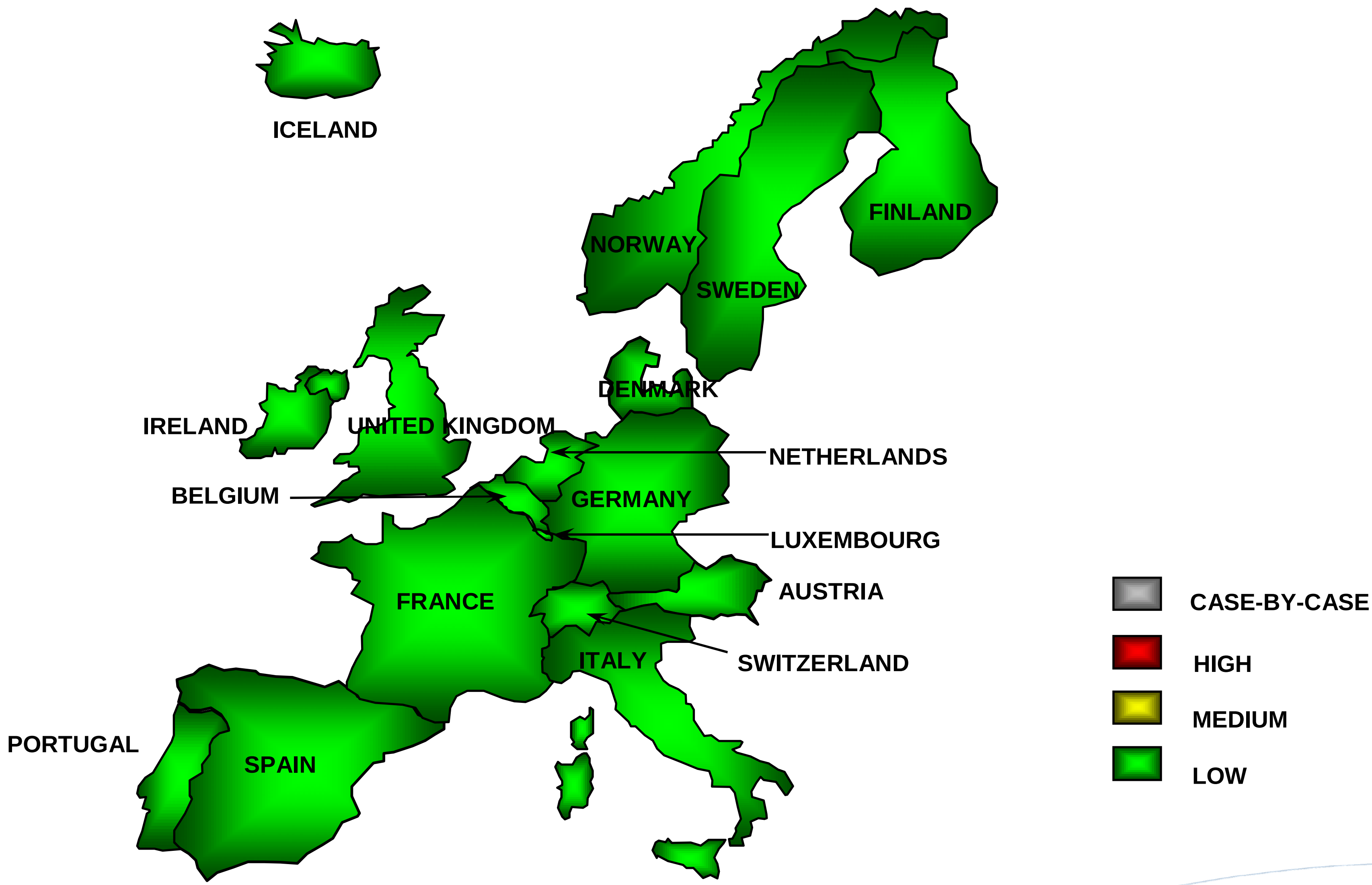
Central Europe

Medium & long-term payment risks

Western Europe

Medium & long-term payment risks



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Former Soviet Union

Medium & long-term payment risks

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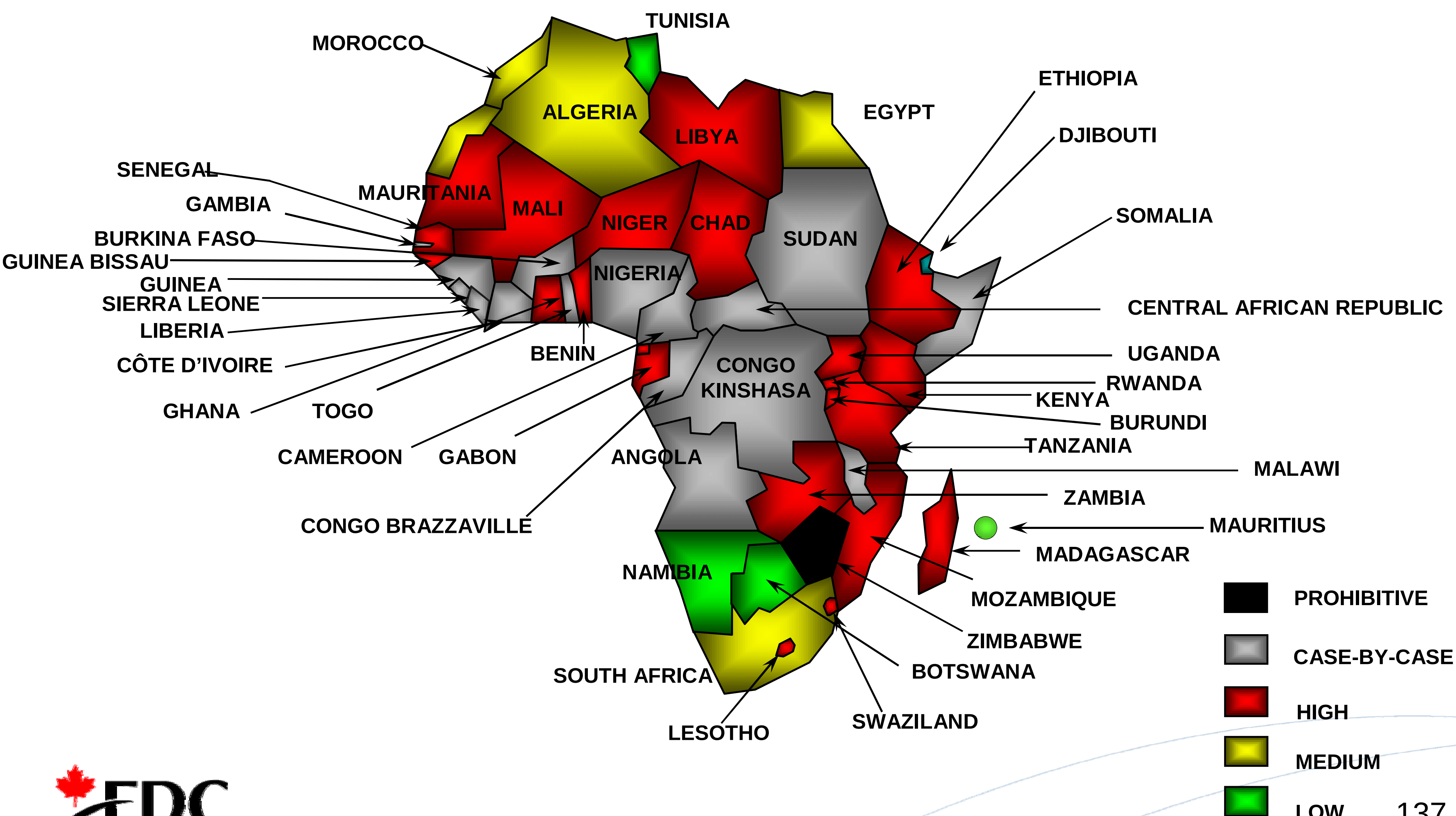
Africa

Medium & long-term payment risks



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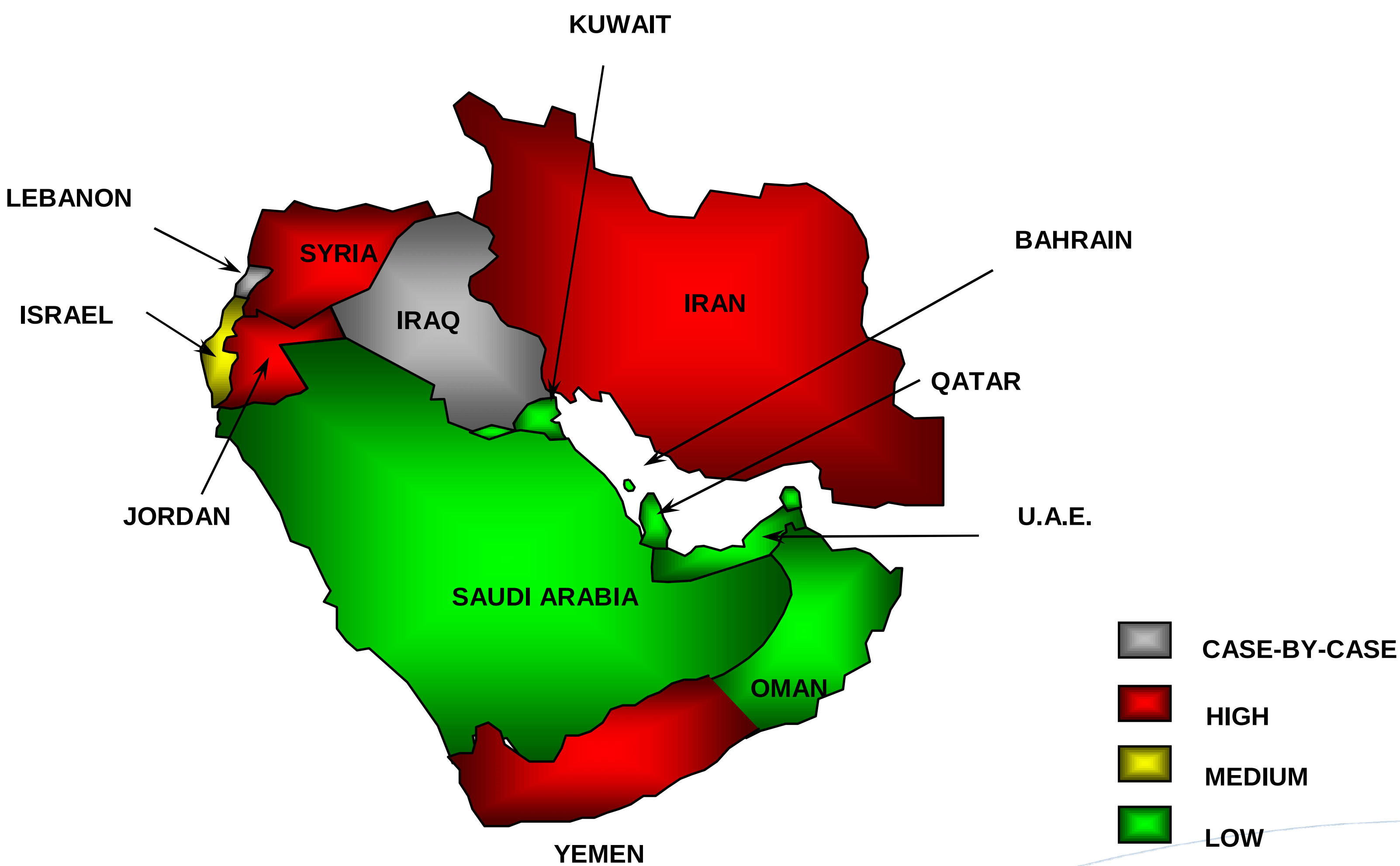
Middle East

Medium & long-term payment risks



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Medium & long-term payment risk maps

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