



Fourth Annual Report on Canada's State of Trade

Trade Update
MAY 2003

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ABOUT THIS DOCUMENT

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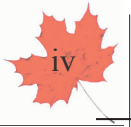


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A MESSAGE FROM THE
HONOURABLE PIERRE S. PETTIGREW,
MINISTER FOR INTERNATIONAL TRADE



Despite lackluster economic performance by most of our trading partners, Canada's trade and even its international investment performance stood up relatively well last year. Our exports fell only marginally for the entire year and our imports, reflecting our strong domestic economy, grew. We can be proud of Canadians from coast-to-coast-to-coast who worked so hard to achieve this outcome.

There are several interesting features in this year's Report besides our surprisingly strong overall trade performance in the difficult circumstances facing all of us last year. One is the strong performance of our traded commercial services where the knowledge and skills of Canadians are so important in activities such as architectural, engineering, and other technical services, other financial services, and royalties and licence fees on services provided by Canadians. Another is the continued importance of our natural resource sector in our trade performance. Despite the relative reduction in the role of resources in our trade, our merchandise trade surpluses over the past decade continue to be derived largely from the strength and success of this sector. Finally, the emergence of China as a major trading partner is clear from the analysis in the Report — China has become our second largest source of merchandise imports.

I look forward to another rather good year for the Canadian economy and hope that our international trade performance can be sustained in view of the uncertain world economy and the current threat to our tourism and related sectors. Helped by our trade agreements negotiated over the years and by sound economic policies at home, Canada has created, particularly in recent years, an innovative, competitive economy. I am convinced that Canadians will continue to achieve many trade successes throughout the year, laying the groundwork for future growth and prosperity in the years to come.



TRADE AND ECONOMIC HIGHLIGHTS, 2002

- ▶ **Exports** of goods and services fell for the second consecutive year, down \$2.7 billion, or 0.6 per cent, in 2002.
 - Goods exports were led lower by declines in machinery and equipment, energy products, and forestry products, while automotive products, industrial goods and materials, as well as consumer goods posted slightly offsetting gains.
 - The \$1.2 billion gain in services exports wiped out the \$0.5 billion decrease recorded in 2001.
- ▶ **Imports** of goods and services advanced \$6.6 billion, or 1.6 per cent, in 2002, as both goods and services registered increases over 2001 levels. Five of the seven major commodity groups posted gains, except for machinery and equipment and energy.
- ▶ Canada's **current account balance** narrowed as the trade surplus declined \$9.3 billion and the deficit on investment income increased \$2.8 billion.
- ▶ **Gross domestic product** at current prices reached \$1.14 trillion in 2002, or \$36,357 on a *per capita* basis.
- ▶ **Real GDP**, or gross domestic product adjusted for inflation, grew 3.4 per cent in 2002, following on the heels of a 1.5 per cent increase a year earlier.
- ▶ **Employment** for 2002 grew some 335 thousand jobs, more than double the 167.1 thousand jobs created in 2001; however, the unemployment rate increased to 7.7 per cent for the year as the labour force grew at a faster pace than employment.
- ▶ **Consumer price inflation** on an annual basis fell to 2.2 per cent in 2002 from 2.6 per cent in 2001. Core inflation, which excludes food and energy, rose to 2.3 percent last year from 2.1 per cent a year earlier.

Total trade

The year 2002 was a blue-ribbon one for Canada as economic activity expanded 3.4 per cent, marking the eleventh consecutive year of economic growth. The past year, however, was not an easy one on the global scene with most of Canada's major trading partners recording mediocre economic performances. The strong performance of Canada relative to the other countries was reflected in Canada's international trade statistics, as exports of goods and services declined while imports increased.

- Canada's exports of goods and services edged down 0.6 per cent to \$468.5 billion in 2002 as the decline in exports slowed from a 2.4 per cent drop the previous year. As overall economic activity increased while exports fell, exports of goods and services as a percentage of Canada's GDP slipped to 41.0 per cent in 2002 from 43.1 per cent in 2001.
- Imports of goods and services into Canada rose to \$422.3 billion last year, posting a 1.6 per cent gain after having fallen 2.9 per cent in 2001. Imports of goods and services as a share of GDP also edged down from 2001 share levels, falling to 37.0 per cent from 38.1 per cent the year earlier.

- Canada's current account surplus declined by \$12.7 billion in 2002, from \$30.0 billion to \$17.3 billion. A \$9.8 billion narrowing of the merchandise trade balance and a \$2.8 billion widening of the deficit on investment income accounted for a majority of the decline of this important international economic indicator.

Trade by regions

- Canadian trade with the United States declined slightly in 2002. Exports of goods and services fell \$1.9 billion (or 0.5 per cent) to \$382.5 billion, while imports were unchanged at \$295.2 billion (up a marginal \$28 million). The U.S. was the destination of 81.6 per cent of total Canadian exports in 2002 (unchanged from 2001) and was the source of 69.9 per cent of all imports (down from 71.0 per cent).
 - ▶ Goods exports to the U.S. fell 0.8 per cent to \$348.0 billion, a decline of \$2.9 billion. Partially offsetting the decline in goods exports was an increase in services exports, which rose 2.8 per cent (\$0.9 billion) to \$34.4 billion.
 - ▶ Services imports from the U.S. rose 0.9 per cent (\$367 million) to \$40.5 billion while merchandise imports were down 0.1 per cent (\$340 million) to \$254.7 billion.
- Exports of goods and services to the EU fell 2.6 per cent (\$0.8 billion) to \$31.1 billion in 2002 while total imports from the EU rose 2.0 per cent (\$0.9 billion) to \$46.7 billion.
 - ▶ A 4.9 per cent decline (\$1.1 billion) in merchandise exports outweighed a 2.8 per cent increase (\$0.3 billion) in services exports.
 - ▶ Gains in merchandise imports (up 3.0 per cent or \$1.1 billion, to \$36.1 billion) more than compensated for declines in services imports (down 1.3 per cent or \$0.1 billion, to \$10.6 billion).
- Total exports to Japan in 2002 were up 2.1 per cent (\$240 million) to \$11.5 billion on the strength of increased exports of both goods and services. Imports of goods and services from Japan were up strongly in 2002, climbing 9.6 per cent (\$1.2 billion) to \$13.8 billion.
 - ▶ Exports of goods to Japan increased by 2.4 per cent (\$226 million) to \$9.7 billion while exports of services edged up 0.9 per cent (\$15 million) to \$1.8 billion.
 - ▶ Imports of Japanese goods into Canada jumped 10.9 per cent to \$11.7 billion, or almost all of the \$1.2 billion increase to total goods and services imports. Imports of services from Japan were up 2.8 per cent (\$57 million) to \$2.1 billion.

Trade by commodities

- Exports of automotive products rose 4.5 per cent to \$97.1 billion for the year. They accounted for 23.6 per cent of total Canadian exports in 2002, up from 22.4 per cent the year before.
 - ▶ Exports of machinery and equipment (M&E) fell 5.0 per cent to \$94.7 billion for 2002. M&E is now the second largest export commodity grouping, at 23.1 per cent of total exports, down from 24.1 per cent a year earlier.
 - ▶ Industrial goods and materials recorded a 3.9 per cent increase in exports in 2002 over 2001, to \$69.4 billion. They accounted for 16.9 per cent of total exports compared to a 16.1 per cent share a year earlier.
-

- ▶ Forestry products, energy products, and agriculture and fishing products experienced declines in their 2002 exports compared with the previous year. The declines were 6.8 per cent, 7.9 per cent, and 1.1 per cent, respectively.
- Imports of machinery and equipment fell 5.9 per cent to \$105.8 billion in 2002. They accounted for 29.7 per cent of total imports, down from 32.1 per cent in 2001.
 - ▶ Automotive imports were next in importance in 2002, at 22.9 per cent of total imports. Auto imports climbed 12.3 per cent to \$81.4 billion for the year.
 - ▶ Imports of industrial goods and materials managed a 0.5 per cent increase in 2002, to \$68.8 billion, equal to 19.3 per cent of total merchandise imports.
 - ▶ Forestry products and agriculture and fishing products experienced increased imports in 2002, up 8.6 per cent and 7.0 per cent, respectively. Imports of energy products fell 7.3 per cent over the year.

Foreign direct investment

- The outflow of Canadian foreign direct investment and the inflow of foreign direct investment into Canada were both down by about 20 per cent in the year 2002.
 - ▶ As was the case last year, the outflow of Canadian direct investment exceeded the inflow of foreign direct investment — \$43.9 billion compared to \$33.6 billion.
- The cumulative stock of Canadian direct investment abroad (CDIA) rose 10.8 per cent to \$431.8 billion in 2002. The U.S. accounted for 46.7 per cent of this investment followed by the United Kingdom at 10.5 per cent last year. The Barbados was the third largest recipient of CDIA at 5.5 per cent of the total. Ireland, with a stunning 87.6 per cent leap in its stock of CDIA from 2001 to 2002, moved into fourth place at 3.8 per cent of the total, displacing the Netherlands (3.2 per cent) to round out the top five destinations for Canadian direct investment abroad.
- As regards the stock of foreign direct investment (FDI) in Canada, the U.S. accounted for 64.2 per cent of the \$349.4 billion total in 2002. France (9.2 per cent), the U.K. (7.5 per cent), the Netherlands (3.9 per cent), and Japan (2.5 per cent) held on to the second-through-fifth spots.
- Total CDIA in the EU was \$99.9 billion with FDI in Canada from the EU at \$94.0 billion last year. The region accounts for 23.1 per cent of the total outward stock of FDI and 26.9 per cent of the inward stock of FDI.

Trends

- Over most of the 1990s, both exports and imports of goods and services grew faster than GDP; their respective ratios relative to GDP climbed to peak levels in the year 2000, from 25.7 per cent in 1990 to 45.3 per cent of GDP for exports and from 25.6 per cent to 40.2 per cent of GDP for imports. Since 2000, overall Canadian economic activity has continued to expand while trade levels have fallen off somewhat, resulting in both exports and imports playing less of a role in total Canadian economic activity. As noted above, exports of goods and services as a share of GDP fell to 43.2 per cent in 2001 and to 41.0 per cent in 2002 while the corresponding shares for imports were 38.1 per cent and 37.0 per cent, respectively.

- Exports of goods and services to the U.S. increased more quickly than total Canadian exports over the 1990s (11.9 per cent vs. 10.3 per cent) and the importance of the United States in Canadian exports consequently rose from 71.2 per cent to 81.7 per cent. Since the year 2000, exports of goods and services to the U.S. have fallen slightly more rapidly than overall exports (-1.51 per cent vs. -1.48 per cent), but not enough to have dramatically affected the share of exports to the U.S. in overall Canadian exports
 - Imports of goods and services from the U.S. also increased more rapidly than total imports of goods and services over the 1990s (10.4 per cent against 9.3 per cent), as the share of imports from the U.S. in total imports increased from 68.1 per cent in 1990 to 72.1 per cent in 2000. Since the year 2000, imports of goods and services from the U.S. have fallen faster than overall Canadian imports (-2.2 per cent compared to -0.7 per cent), and the share of imports from the U.S. in total imports has slipped 2.1 percentage points to 69.9 per cent over the past two years.
 - With exports growing more quickly than imports over the 1990s, Canada's trade balance moved from deficits in the early 1990s to surpluses over the latter part of the decade; however, with total exports falling faster than imports since the year 2000, the trade surplus has begun to narrow.
 - Similarly, with exports to the U.S. growing faster than imports from that country, the bilateral trade surplus expanded from \$1.1 billion in 1991 to \$85.7 billion in 2000. However, with a larger amount of exports falling at a slower rate than a smaller amount of imports in the post-2000 period, the bilateral trade surplus in 2002 remained near its historical high — only \$2.0 billion below the peak \$89.2 billion recorded in 2001.
-



Canada's trade and investment over 2000-2002, in millions of dollars

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
	<i>Exports of Goods and Services</i>			<i>Imports of Goods and Services</i>			<i>Goods and Services Balance</i>		
World	482,731	471,250	468,546	427,997	415,617	422,256	54,734	55,633	46,290
U.S.	394,299	384,409	382,471	308,550	295,171	295,199	85,749	89,238	87,272
EU-15	32,355	31,943	31,119	43,696	45,790	46,707	-11,341	-13,847	-15,588
Japan	12,496	11,232	11,472	13,726	12,596	13,802	-1,230	-1,364	-2,330
ROW*	43,581	43,666	43,484	62,025	62,060	66,548	-18,444	-18,394	-23,064
	<i>Exports of Goods</i>			<i>Imports of Goods</i>			<i>Goods Balance</i>		
World	425,587	414,638	410,330	363,432	350,623	356,109	62,155	64,015	54,221
U.S.	359,672	350,908	348,027	267,754	255,028	254,688	91,918	95,880	93,339
EU-15	22,885	22,300	21,211	33,463	35,088	36,144	-10,578	-12,788	-14,933
Japan	10,701	9,481	9,707	11,729	10,585	11,736	-1,028	-1,104	-2,029
ROW*	32,329	31,949	31,385	50,486	49,922	53,541	-18,157	-17,973	-22,156
	<i>Exports of Services</i>			<i>Imports of Services</i>			<i>Services Balance</i>		
World	57,144	56,612	58,216	64,565	64,994	66,146	-7,421	-8,382	-7,930
U.S.	34,628	33,501	34,443	40,796	40,143	40,510	-6,168	-6,642	-6,067
EU-15	9,470	9,643	9,909	10,233	10,701	10,563	-763	-1,058	-654
Japan	1,794	1,750	1,765	1,997	2,010	2,067	-203	-260	-302
ROW*	11,252	11,718	12,099	11,539	12,140	13,006	-287	-422	-907
	<i>Canadian Direct Investment Abroad</i>			<i>Foreign Direct Investment in Canada</i>			<i>Balance of Outward less Inward</i>		
Flows:									
World	70,545	54,924	43,862	98,984	42,527	33,604	-28,439	12,397	10,258
U.S.	38,987	33,717	15,456	16,484	38,686	25,086	22,503	-4,969	-9,630
EU-15	15,892	6,415	13,328	76,859	1,105	4,682	-60,967	5,310	8,646
Japan	3,675	1,434	1,575	373	825	1,128	3,302	609	447
ROW*	11,991	13,358	13,503	5,268	1,911	2,708	6,723	11,447	10,795
Stocks:									
World	353,150	389,660	431,819	307,591	333,635	349,388	45,559	56,025	82,431
U.S.	177,839	188,791	201,792	191,870	214,227	224,330	-14,031	-25,436	-22,538
EU-15	74,326	81,349	99,853	86,424	91,158	93,973	-12,098	-9,809	5,880
Japan	5664	7033	9203	8,126	7,909	8,600	-2,462	-876	603
ROW*	95,321	112,487	120,971	21,171	20,341	22,485	74,150	92,146	98,486

* Rest of the world



I. MERCHANDISE TRADE

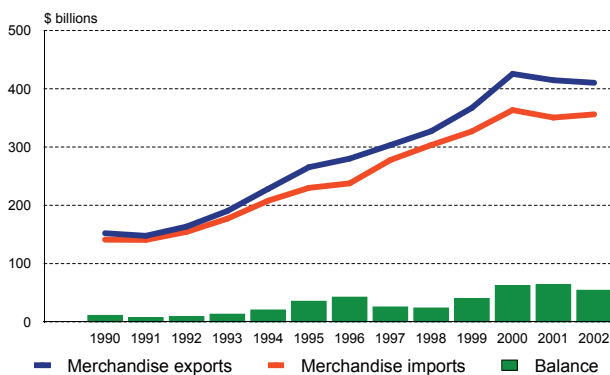
Merchandise trade is one, and in Canada's case, an overwhelmingly important component of the balance of payments, which also includes trade in services as well as direct and portfolio investment.

Overview

Over the first half of 2002, weaknesses in global financial markets and heightened uncertainty related to problems in corporate reporting and governance, particularly in the United States, fostered a softening in aggregate demand and raised uncertainties about the ability of the major developed economies to sustain their rates of economic expansion. Into the second half of the year, the threat of war in the Middle East helped raise oil price premiums; other aspects of geopolitical risks further prolonged the anaemic global recovery. The unfavourable external climate had an impact on Canada's merchandise exports as they fell for the second consecutive year, declining 1.0 per cent (\$4.3 billion) to \$410.3 billion. The declines were geographically widespread, led by declines to the U.S. (down 0.8 per cent, or \$2.9 billion), the European Union (down 4.9 per cent, or \$1.1 billion), and all other countries (down 1.8 per cent, or \$562 million). Only Canadian exports to Japan managed to increase last year (up 2.4 per cent, or \$226 million); the increase was not enough to offset the declines elsewhere.

Figure 1-1

Merchandise trade, 1990-2002

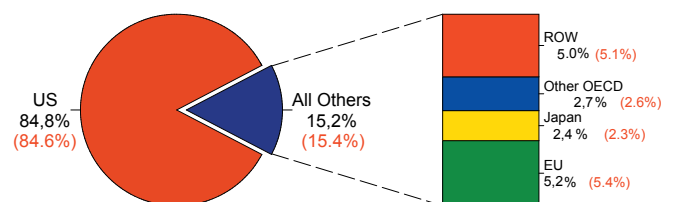


Notwithstanding the decline in exports to the U.S., that country remained Canada's principal export destination, accounting for some 84.8 per cent of Canada's merchandise exports. In fact, the share rose two-tenths of a percentage point last year. The EU (at 5.2 per cent) and Japan (at 2.4 per cent) together made up half of the remaining 15.2 per cent of Canadian exports, leaving the final 7.6 per cent to all other destinations.

The strong economic performance of Canada relative to the other developed countries during 2002 was reflected particularly in Canada's merchandise imports, which generated a 1.6 per cent (or \$5.5 billion) increase. With the exception of the United States, all other major regions posted gains; in particular, imports from all other countries jumped 7.3 per cent (or \$3.6 billion), those from Japan shot up 10.9 per cent (or \$1.2 billion), and imports from the EU rose 3.0 per cent (or \$1.1 billion). Merchandise imports from the U.S. edged down \$340 million to \$254.7 billion, a 0.1 per cent decline.

Figure 1-2

Merchandise export shares by region, 2001 and 2002

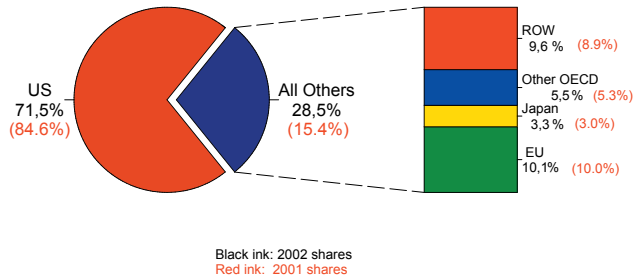


Black ink: 2002 shares
Red ink: 2001 shares

While the U.S. remains by far the principal supplier of merchandise imports into Canada, last year's combination of lower imports from the U.S. coupled with higher imports from all other sources led to the U.S. share in total Canadian merchandise imports falling — from 72.7 per cent in 2001 to 71.5 per cent in 2002. The EU share in total merchandise imports increased 0.1 per cent to 10.1 per cent while Japan's share reached 3.3 per cent, up from 3.0 per cent a year earlier. The share for the rest of the world jumped to 15.0 per cent last year from 14.2 per cent a year earlier.

Figure 1-3

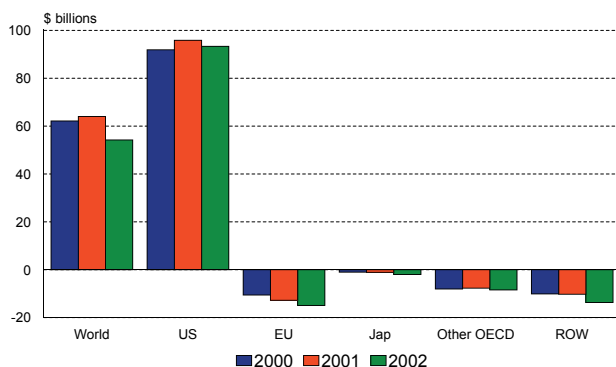
Merchandise import shares by region, 2001 and 2002



The combination of falling exports and rising imports had two effects on Canada's merchandise trade performance last year. The first was to lower the annual merchandise trade surplus with the rest of the world by \$9.4 billion to \$54.6 billion for 2002 as a whole, the lowest level in three years. With exports to the U.S. falling more than imports from the U.S., the bilateral trade surplus with that country narrowed from \$95.9 billion in 2001 to \$93.3 billion in 2002, a decline of slightly over \$2.5 billion. Falling exports and rising imports from both the EU and from all other countries widened the trade deficits that Canada ran with these regions. For the EU, the merchandise trade deficit expanded \$2.1 billion to \$14.9 billion while it grew by \$4.2 billion to \$22.2 billion for all other countries. Lastly, the increase in exports to Japan was not enough to offset the increase in imports from Japan; the bilateral deficit with that country widened \$925 million to just over \$2.0 billion.

Figure 1-4

Merchandise trade balances by region, 2000-2002



The second effect of slightly lower exports and somewhat higher imports was to raise the overall level of Canada's merchandise trade. That is, Canada's two-way trade (i.e., the sum of total exports and total imports) increased in 2002. Two-way merchandise trade grew by 0.2 per cent last year (or by \$1.2 billion) to \$766.4 billion. Increased merchandise trade flows between Canada and Japan were largely responsible for the rise as they expanded by \$1.4 billion. The increased total trade flows recorded between Canada and the all other countries (up \$3.1 billion) were completely offset by a decline in Canada-U.S. trade flows (down \$3.2 billion). Total Canada-EU trade flows edged down \$33 million last year.

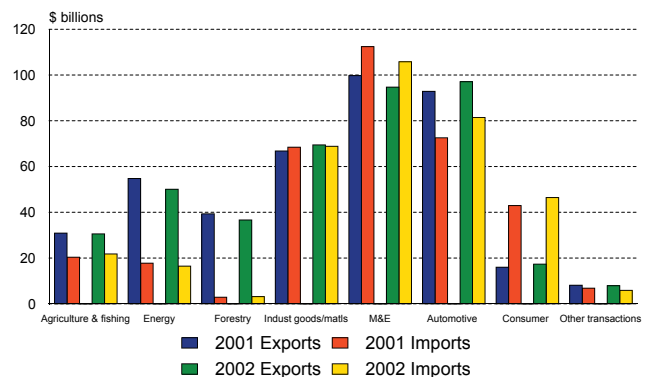
The U.S. remained Canada's principal trading partner at 78.6 per cent of two-way trade in 2002 (down from 79.2 per cent in 2001). The EU accounted for an unchanged 7.5 per cent of this total trade and Japan 2.8 per cent (up from 2.6 per cent a year earlier). Total Canadian trade with the rest of the world was up 0.4 percentage points to 11.1 per cent in 2002.

Merchandise trade by major commodity groupings

Canada's exports of all commodities fell by just under \$4.0 billion (or 1.0 per cent) in 2002, as four of seven major categories declined over the year. Declines were led by a \$5.0 billion drop in exports of machinery and equipment and a \$4.3 billion decrease in exports of energy products. Forestry products (\$2.4 billion) and agricultural and fishing products (\$342 million) also contributed to lower export levels. Partly offsetting the losses were gains to automotive products exports (up \$4.2 billion), industrial goods and materials exports (up \$2.6 billion), and consumer goods exports (\$1.1 billion).

Figure 1-5

Merchandise trade by major categories, 2001-2002



BOX A: A SNAPSHOT OF CANADA'S RESOURCE SECTOR

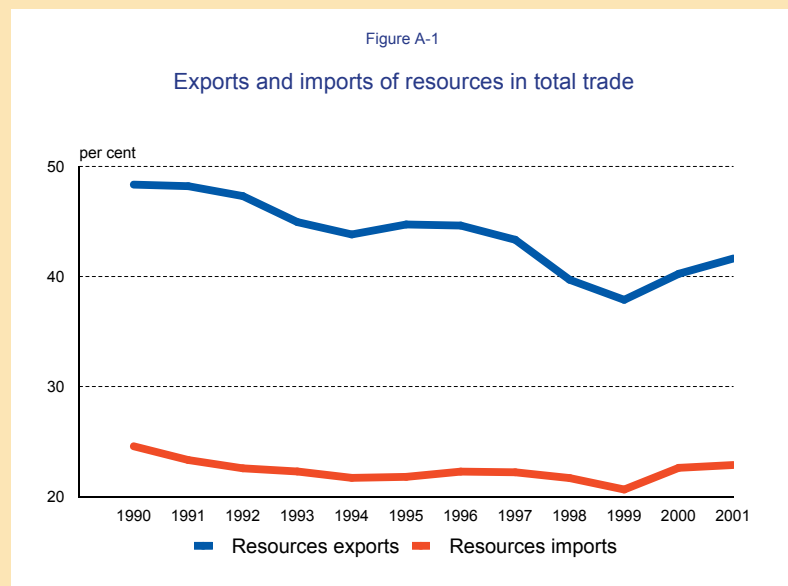
From Canada's origins as a colony to today, resources have played an important role in this country's development as one of the premier trading nations of the world. Along the way, pelts and timber exports have given way to ores and lumber which, in turn, have given way to refined petroleum products, processed foods, and fine papers. And, of course, Canada has moved beyond resource-based products into non-resource-based manufactures such as computers, mechanical machines, automobiles and other forms of transportation equipment, and services, to name but a few. The purpose of this highlight section is to examine the role of the resource sector in Canadian trade over the past decade-or-so, focusing on two elements: its impact on the merchandise trade balance and its role in provincial trade.

For purposes of analysis, an industry classification rather than a commodity classification is used here. The resources sector is partitioned into two principal groupings: primary resource industries and resource-based manufacturing industries. The former group consists of the agriculture, fishing, logging, crude petroleum and natural gas, and mining and quarrying industries, while the latter includes both primary and fabricated metals, food, beverages, and tobacco, wood products, paper products, non-metallic minerals, and the refined petroleum and coal products industries¹.

The driver of Canada's merchandise trade surpluses

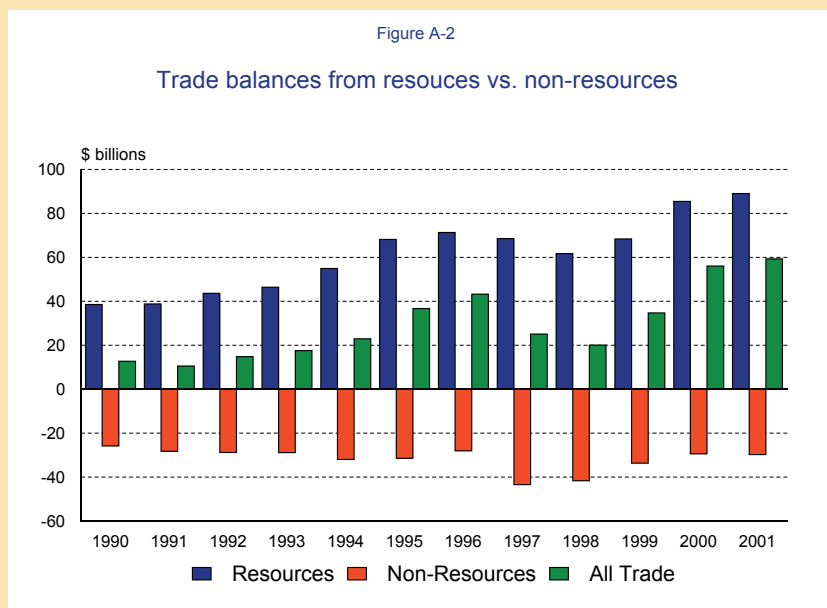
Canadian exports of resources more than doubled over the period 1990-2001, growing from \$72.0 billion to \$167.5 billion. This is equivalent to an annual rate of growth of just under 8.0 per cent for the period. However, this resource-based growth rate was less than the 10.7 per cent average annual rate recorded by non-resource exports, which increased from \$76.9 billion to \$234.8 billion. Thus, over the 1990s, the resource sector's share in total exports has dropped more-or-less steadily from about half of total exports in the early part of the decade to below 40 per cent beginning in 1998 before recovering somewhat to around the 40 per cent level in recent years.

Similarly, on the import side, the average annual rate of growth of resource imports has lagged behind that of non-resources, although the difference in the two rates is less pronounced than on the export side — 8.0 per cent vs. 9.0 per cent. As a result, resource-based imports as a share of total imports have also declined somewhat over time, hovering just above the 20 per cent mark for the last decade (Figure A-1). Canadian imports of resources have climbed from \$33.5 billion in 1991 to \$78.4 billion in 2001 while non-resource imports have risen from \$102.8 billion to \$264.6 billion over the same period.



Despite the relative reduction in the role of resources in Canadian trade, the data above show a substantial increase in the merchandise trade surplus generated by the resource sector. In contrast, trade data show both a trade deficit for non-resources and a slight deterioration in that merchandise trade deficit between 1990 and 2001. Notwithstanding the fact that non-resource exports have grown at a faster pace than non-resource imports (10.7 per cent vs. 9.0 per cent), the differences in the initial magnitudes of the sectoral exports and imports have permitted the level of increase in non-resource imports to be slightly greater than that for resource-based exports. As a result, the overall merchandise trade surpluses that Canada has been running over the past decade have been driven entirely by the resources sector (Figure A-2).

Turning towards a sectoral breakdown of the resource sector surplus, the resource-based manufacturing surplus was about double that of primary resources in 1990 (\$25.4 billion vs. \$13.2 billion). On account of faster growing exports and slower growing imports, the primary resource surplus climbed to over 90 per cent of the surplus for resource-based manufactures by 2001 — \$42.8 billion vs. \$46.3 billion. The bulk of the \$29.6 billion increase in the primary resource surplus came from the crude petroleum and natural gas industry, which accounted for \$24.8 billion, or almost 85 per cent of the increase in the surplus. Agriculture (\$2.4 billion) and mining (\$2.0 billion) accounted for most of the remaining increase to the primary resource surplus. For resource-based manufactures, advances with respect to the surplus were led by wood industries, paper, refined petroleum products, and the food industry, while primary and fabricated metals and beverages limited the gains.



Resources dominate exports in most provinces

Ontario and Quebec together accounted for some two-thirds of total Canadian exports throughout the 1990s. Into the new decade, Ontario alone accounted for at least half of all exports. Given that the two provinces comprise the manufacturing heartland of the nation and also that Canadian exports contain a large proportion of imports (on average 33.1 per cent in 1999), it should come as no surprise that the two provinces are also heavy importers. Indeed, in any given year over the past decade, these two provinces have accounted for over three-quarters of total Canadian imports.

Looking at trade in resources, the Ontario and Quebec are important players to be sure: however, their dominance, particularly on the exports side, is less pronounced than is the case for all commodities trade. Throughout much of the past decade, the two provinces have recorded about 42-43 per cent of resources exports, with the share dropping off towards 38 per cent starting in the year 2000. Ontario, with its strong resource-based manufacturing sector, has traditionally been the largest resource-exporting province, though with the rise in energy prices beginning around the year 2000, Alberta has overtaken Ontario as the leading

resource-exporting province. For imports, Ontario accounts for about half of all resource imports and for Quebec, the provincial share is usually between a fifth and a quarter of all resource imports.

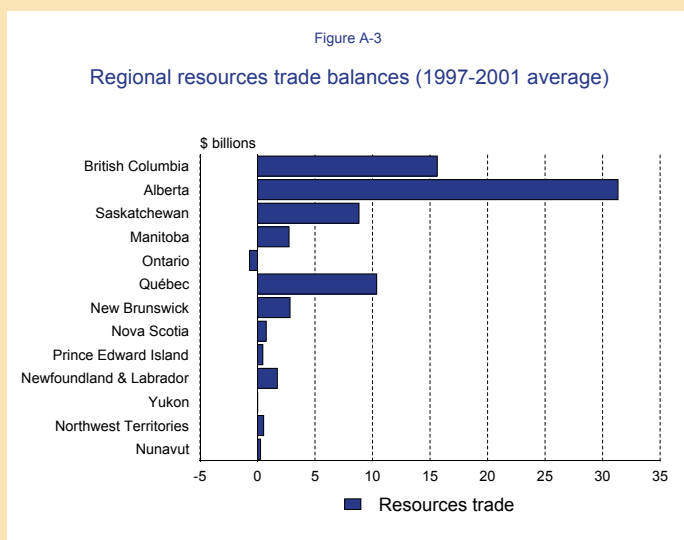
The role of resources in the various provinces is best demonstrated by two sets of statistics. The first shows the ratio of the provincial share in resources trade to the national share of resources in total trade. This is what economists call a revealed comparative advantage. If this statistic is greater than unity, then the province trades relatively more in resources than it does for all commodities. Conversely, if the ratio is less than unity, resources are less important in the overall scheme of provincial trade. The second set of statistics is the more traditional dependency ratio which shows the share of resources in total provincial trade. This statistic simply says that a certain percentage of total provincial trade is accounted for by trade in resources. The analysis below will focus on the export side of these two sets of statistics.

Table A-1: The role of resources in provincial exports: 1997-2001 average

	Revealed comparative advantage	Export dependency
British Columbia	1.87	75.87
Alberta	1.97	79.95
Saskatchewan	2.19	88.56
Manitoba	1.42	57.41
Ontario	0.46	18.60
Quebec	0.99	39.99
New Brunswick	2.24	90.60
Nova Scotia	1.59	64.30
Prince Edward Island	1.94	78.76
Newfoundland & Labrador	2.38	96.48
Yukon	2.13	86.20
Northwest Territories	2.45	99.08
Nunavut	2.46	99.64

As is evident from Table A-1, all provinces with the exception of Ontario and Quebec have resources accounting for more than one-half of their total exports. For Quebec, resources account for about 40 per cent of their total exports, while for Ontario it is only about 18.6 per cent. The Territories, Newfoundland & Labrador, New Brunswick, and Saskatchewan are all highly dependent on resources in their exports. For the nation as a whole, resources accounted for an average 40.5 per cent of total exports over 1997-2001. With this as a base, we see from the revealed comparative advantage column that the share of resources in total exports are more than twice the national average for the Territories, Newfoundland & Labrador, New Brunswick, and Saskatchewan, about par for Quebec and less than half the national average for Ontario. In short, all provinces and territories, except for Ontario, are quite dependent on resources in their overall export patterns. Moreover, with the preponderance of resource imports going to Ontario while, at the same time, the province is less oriented towards resource exports, it comes as no surprise that all provinces except for Ontario run surpluses in their overall resources trade, as seen quite clearly in Figure A-3.

Despite a gradually diminishing share in national trade, resources still play an important role in both Canada's merchandise trade balance and in the export performance and merchandise trade balances of most of its provinces and territories.



¹ Services incidental to agriculture, forestry and mineral extraction, the leather, textiles, and furniture industries and utilities have been excluded from the analysis.

Imports increased with respect to all major commodities last year, except for machinery and equipment and energy products which fell by \$6.6 billion and \$1.3 billion, respectively. Leading the advances were increased imports of automotive products (up \$8.9 billion), consumer goods (up \$3.5 billion), and agricultural and fishing products (up \$1.4 billion). Smaller increases were recorded for industrial goods and materials (up \$371 million) and forestry products (up \$248 million).

Automotive products

Automotive products regained their position as the largest major category of exports in 2002 at 23.6 per cent of total exports, lowering machinery and equipment to second place. It was the fourth time in the past five years that the two categories have switched rankings for top spot. Automotive exports rebounded in 2002, up 4.5 per cent following a 5.4 per cent decline in 2001. The overall advance was \$4.2 billion for the sector. Gains were registered in all three sub-components of the category, led by *motor vehicle parts* (up \$2.3 billion), *passenger cars* (up \$1.3 billion) and *trucks* (up \$632 million).

Automotive imports also increased in 2002, with all three sub-components contributing to the increase. For the year as a whole, automotive imports were up \$8.9 billion in 2002, the largest increase in imports of the seven major commodity groupings. A little under half of the increase was in *passenger vehicles*, where imports increased by \$4.0 billion over 2001 levels. *Motor vehicle parts* accounted for a further 30 per cent of the increase, as they advanced \$2.7 billion over the year, while *trucks* accounted for about one-quarter of the increase, or \$2.1 billion.

Machinery and equipment

As noted above, machinery and equipment exports were the next largest class of commodity exports, accounting for some 23.1 per cent of Canadian merchandise exports last year, down from 24.1 per cent a year earlier. Exports fell in two of the top three sub-components — *other machinery and equipment* and *aircraft and other transportation equipment*. Only *industrial and agricultural equipment* managed to expand their exports last year.

Exports of *television, telecommunications and related equipment* fell for the second straight year which resulted in exports of *other machinery and equipment* falling \$2.6 billion after having fallen \$9.7 billion in 2001. At \$12.4 billion, exports of *television, telecommunications and related equipment* are now roughly half the value of their 2000 level — \$24.7 billion. *Office machines and equipment* exports also declined in 2002, down a fifth in value from the previous year, or \$1.8 billion. Exports of *other equipment and tools* were unchanged over the year while exports of *other end products* increased \$880 million to help staunch the losses to *other machinery and equipment*.

Exports of *aircraft and other transportation equipment* also fell in 2002 as exports of *aircraft, aircraft engines and parts* decreased \$1.4 billion over the year while exports of *other transportation equipment* were off \$348 million for the year.

On the import side, all four sub-components experienced a decline in their levels in 2002. *Office machines and equipment* imports fell \$2.1 billion last year while *other machinery and equipment* fell further, by \$2.3 billion, led by a \$2.8 billion decline in *other communications and related equipment* imports. Imports of *aircraft and other transportation equipment* fell \$1.5 billion, as imports of both *aircraft, aircraft engines and parts* and *other transportation equipment* fell by about three-quarters of a billion dollars each. Finally, imports of *industrial and agricultural equipment* were off by \$659 million as imports of most industrial machinery components were down while imports of agricultural machinery registered a modest \$46 million increase.

Industrial goods and materials

Industrial goods and materials is a broad class of commodities ranging from various metals in ores to plastics and from crude animal products to textile fabricated materials. On the export side, these goods and materials are broken down into four major sub-component groupings : *metal ores; chemicals, plastics and fertilizers; metals and alloys; and other industrial goods and materials*. In 2002, exports of industrial goods and materials increased \$2.6 billion over 2001 levels. Gains were widespread as all four export sub-components registered gains for the year. Most of the

gains came from *metals and alloys* as increases to *steel bars, rods, plates, and sheets* (up \$860 million) and to *precious metals and alloys* (up \$665 million) helped push the overall gains to this sub-component of industrial goods and materials to \$1.9 billion last year. *Chemicals, plastics and fertilizers* made up most of the other gains in industrial goods and materials exports as their exports increased \$490 million from the previous year. Only the *organic chemicals* experienced a small decline in exports (down \$81 million) under this sub-component. Overall, industrial goods and materials accounted for 16.9 per cent of total merchandise exports in 2002.

There are only three sub-components to industrial goods and materials on the import side: *metals and metal ores*; *chemicals and plastics*; and *other industrial goods and materials*. Last year, a \$1.2 billion increase in imports of *metals and metal ores* was completely offset by a \$1.4 billion decrease in imports of *other industrial goods and materials*. With imports of *chemicals and plastics* rising \$521 million, overall imports of industrial goods and materials managed a \$371 million increase for the year. Broadly speaking, import gains were widespread while the decline in imports was largely restricted to "miscellaneous" or *other fabricated materials*, which experienced a \$2.0 billion decline from 2001 levels. In all, industrial goods and materials accounted for 19.3 per cent of total merchandise imports in 2002.

Consumer goods

Consumer goods exports accounted for some 4.2 per cent of total commodity exports in 2002, up from 3.9 per cent in 2001. Underpinning this share increase was a \$1.4 billion increase in exports of consumer goods from 2001 to 2002.

Imports of consumer goods also increased last year, posting a \$3.5 billion gain. Notable increases over 2001 levels were registered for *miscellaneous end products* (up \$2.0 billion), *household furnishings and utensils* (up \$572 million), and *watches and sporting goods* (\$414 million). *Apparel and footwear* accounted for much of the remainder of the advances. Overall, consumer goods accounted for some 13.0 per cent of total goods imports in 2002.

Energy products

Energy products fell in importance as a share of Canadian exports in 2002, declining to 12.3 per cent of total exports from 13.2 per cent a year earlier. Exports of these products declined \$4.3 billion in 2002 as a \$3.6 billion advance in crude petroleum exports was not enough to offset the \$6.4 billion decline in natural gas exports and the \$1.4 billion decline in electricity exports.

Energy products imports also fell last year, declining by almost \$1.3 billion. Crude petroleum imports declined by \$1.1 billion when compared to 2001 levels while all other energy products combined experienced a \$213 million fall in their level of imports. Lower prices for natural gas and electricity last year and higher prices for crude petroleum contributed to these shifts in exports.

Forestry products

Forestry products exports fell \$2.7 billion in 2002. Nearly half the decline was experienced in *newsprint paper*, where exports declined \$1.3 billion from 2001 levels. Declines in *lumber* exports (down \$642 million), *other paper and paperboard* exports (down \$602 million), and *pulp* exports (down \$473 million) also contributed to the losses. Forestry products accounted for almost one-eighth of merchandise exports, or 12.3 per cent, in 2002.

Canada is not much of an importer of forestry products, as they account for less than one per cent of total commodity imports. However, forestry products imports did increase in 2002, up slightly less than one-quarter of a billion dollars from 2001 levels. The increase came from *wood fabricated materials*.

Agricultural and fishing products

Exports of agricultural and fishing products accounted for 7.4 per cent of total merchandise exports in 2002, unchanged from 2001. Exports of agricultural and fishing products fell \$342 million in 2002 as the decline in *wheat* exports (down \$750 million) outweighed the gains in *other products* (up \$408 million). Performance within the *other agricultural and fishing products*

sub-component, however, was mixed. Exports of *rapeseed* fell \$305 million, while those of *barley* and *alcoholic beverages* were down \$190 million and \$161 million, respectively. *Fish* (up \$411 million), *other food, beverages and tobacco* (up \$242 million) and *other cereal preparations* (also up \$242 million) led the advances.

Imports of agricultural and fishing products climbed \$1.4 billion in 2002 as both components — *fruits and vegetables* (up \$629 million) and *other agricultural and fishing products* (up \$789 million) — advanced. Imports of agricultural and fishing products accounted for 6.1 per cent of total goods imports in 2002, up from 5.8 per cent in 2001.

We now turn to a closer examination of merchandise trade by regions. We will also be using a slightly different data base — customs basis data — than the balance of payments data used in this Report so far. The reason for the switch is that balance of payments valuations are not provided for detailed product-level data. Consequently, the numbers cited in the forthcoming section might differ slightly from those already described.

Merchandise trade by region

The United States

At 87.4 per cent of the total¹, the United States is by far Canada's largest destination for merchandise exports². It, thus, should come as no surprise that the U.S. dominates as the leading destination for all major sub-categories of merchandise exports: the range runs from a low of 68.3 per cent for Canadian exports of agricultural and fishing products to a high of 97.4 per cent for Canadian exports of automotive products.

Canada's total merchandise exports to the U.S. in 2002 fell 1.5 per cent, or \$5.3 billion, to \$346.5 billion. Bilateral exports were led downward during the year by declines in energy products which plummeted 12.9 per cent (or \$7.2 billion) to \$48.7 billion as declines in natural gas exports (down \$7.1 billion) and electricity (down \$2.4 billion) more than offset increases to crude petroleum oils and preparations (up \$2.3 billion).

The "tech meltdown" of 2001 also spilled over into 2002 as American firms were still importing less information technology (IT) equipment than was the case in the late 1990's. As a consequence, Canadian exports of machinery and equipment to the U.S. fell last year, declining \$4.9 billion to \$70.1 billion. In connection with the overall reduction in exports of television, telecommunications and related equipment as well as office equipment noted in the previous section, Canadian exports to the U.S. of mechanical (or non-electrical) machinery and equipment and electrical machinery and equipment (chapters 84 and 85 of the Harmonised System) fell by \$1.1 billion and \$3.1 billion, respectively. Elsewhere in the machinery and equipment sub-group, Canadian exports of aircraft to the U.S. (HS chapter 80) fell some \$1.2 billion.

Exports of forestry products to the U.S. were also down from 2001 levels. The year 2002 saw the re-emergence of the long-standing bilateral dispute over softwood lumber. In May 2002, the U.S. imposed anti-dumping and countervailing duties in the neighbourhood of 27.2 per cent on Canadian softwood lumber imports into that country. However, notwithstanding this barrier, it was not lumber exports that led to reduced Canadian forestry exports; rather, it was reductions in pulp exports and in paper and paperboard products exports (HS chapters 47 and 48, respectively) that were responsible for the decrease in forestry products exports to the U.S. Pulp exports south of the border were down \$308 million from 2001 levels while exports of paper and paperboard were down \$785 million for the year.

Partially offsetting these declines were increased exports of automotive products to the United States. As noted above, virtually all Canadian exports of automotive products are destined for the U.S. Each of the three sub-categories of automotive products — passenger vehicles, trucks, and automotive parts — registered export increases last year. With these increases, passenger vehicle and truck exports last year almost returned to their 1999-2000 peak levels, while parts exports established a new record high.

In addition to automotive products, increased exports of industrial goods and materials, consumer goods, as well as of agricultural and fishing products also helped to offset the declines in other exports to the U.S. These three sectors saw their exports to the U.S. advance \$1.7 billion, \$1.1 billion, and \$1.0 billion, respectively.

Imports from the U.S. fell marginally in the course of 2002, down 0.1 per cent, or about \$133 million. Gains were led by automotive products (up \$6.4 billion), consumer goods (up \$1.0 billion), and agricultural and fishing products (up \$918 million) which were more than offset by declines in machinery and equipment (down \$6.8 billion) and in industrial goods and materials (down \$1.7 billion). The increase in automotive products reflects the high degree of integrated production and the just-in-time inventory practices of this sector. All key components of the machinery and equipment sector were down — electrical/electronic goods - down \$2.8 billion, mechanical products - down \$1.8 billion, aircraft transportation equipment - down \$800 million, and medical/scientific/technical equipment - down \$642 million.

The European Union

At 4.3 per cent of total exports and 11.2 per cent of total imports, the EU remains a major trading partner for Canada. Nearly two-thirds of Canadian exports to the EU are in machinery and equipment (36.2 per cent) and in industrial goods and materials (29.1 per cent). Forestry products are a distant third-in-importance, at 15.6 per cent of exports to the region, followed by agricultural and fishing products (8.6 per cent) and consumer goods (4.0 per cent). Machinery and equipment (37.9 per cent) and industrial goods (19.9 per cent) also dominate the Canada-EU import categories, but are not as prevalent as on the export side. Consumer goods (17.1 per cent), energy products (9.8 per cent) and automotive products (8.4 per cent) round out the top 5 import categories.

Merchandise exports to the EU were down \$1.3 billion, or 7.2 per cent, to just over \$17.0 billion in 2002, while merchandise imports from the region increased \$476 million, a rise of 1.2 per cent, to \$40.0 billion. Thus, the bilateral Canada-EU merchandise trade balance deteriorated by \$1.8 billion for the year, to \$23.0 billion.

The fall in Canadian exports to the EU was led by machinery and equipment. Aircraft and other forms of non-automotive transportation equipment accounted for about half the \$984 million decline in this category of exports. Forestry exports to the EU decreased by \$232 million in 2002, led by declines in pulp (down

\$214 million) and lumber (down \$32 million). Exports of agricultural and fishing products fell \$193 million as gains by oilseeds (up \$58 million) were not enough to offset declines in vegetables, roots, and tubers (down \$129 million) and in cereals (down \$76 million). Energy products exports to the EU also fell \$176 million in 2002.

Partly offsetting the losses were increased exports of industrial goods and materials, which advanced \$173 million last year, of consumer goods, which increased \$44 million, and of automotive products, which grew \$35 million.

On the import side, increased imports from the EU were led by consumer goods, which increased \$1.0 billion to \$6.6 billion, automotive products (up \$574 million), and industrial goods, up almost \$400 million. Largely offsetting the gains in imports from the EU were decreased imports of energy products (down \$1.4 billion) and of machinery and equipment (down \$264 million).

Japan

Exports to Japan edged down nearly \$44 million in 2002 as exports of forestry products (principally lumber (down \$152 million), pulp (down \$100 million), and paper and paperboard (down \$58 million)) were offset by small, albeit widespread, gains in most other sectors. Along with forestry, energy products also registered a decline in exports to Japan — down \$28 million.

Imports from Japan increased by over three-quarters of a billion dollars in 2002, as declines in machinery and equipment (down \$537 million) and consumer goods (down \$134 million) were more than offset by gains in industrial goods (up \$220 million) and automotive products (up \$1.2 billion). The machinery and equipment declines were concentrated in electrical/electronic products (down \$382 million), medical/scientific/technical equipment (down \$277 million), mechanical machinery and equipment (down \$125 million), and aircraft (down \$95 million). Gains in other sub-categories helped limit the declines.

Overall, the merchandise trade deficit with Japan in 2002 widened \$814 million to \$7.1 billion.

The rest of the world

Merchandise exports to the rest of the world fell \$1.0 billion to \$24.5 billion in 2002 while imports climbed \$4.3 billion to \$75.9 billion. As a result, Canada's merchandise trade deficit with the rest of the world widened by \$5.3 billion to \$51.4 billion. The ratio of imports to exports with the region also surpassed a 3:1 rate for the first time ever.

Exports of agricultural and fishing products were responsible for more than all of the decline as they fell \$1.4 billion, led by declines in cereal exports (down \$822 million), oilseeds (down \$432 million),

and vegetables, roots, and tubers (down \$413 million). Most other sectors registered small export gains to the rest of the world last year — except for forestry products which also fell \$36 million — and machinery and equipment, which recorded a moderately strong advance of \$277 million.

Imports from the rest of the world registered advances across the board led by consumer goods (\$1.6 billion), industrial goods (\$1.0 billion), and machinery and equipment (\$857 million). The smallest increase was recorded in agricultural and fishing products, at \$369 million.

¹ The 87.4 per cent U.S. share in total exports is calculated on a *Customs* data basis — in contrast to the 84.8 per cent share reported earlier, which is calculated on a *Balance of Payments* data basis.

² Data on Canada's exports to the United States, which are compiled from U.S. import data sources, are overstated as they include some shipments to third countries via the United States often referred to as trans-shipments. As a result, Canada's exports to the rest of the world are correspondingly understated.

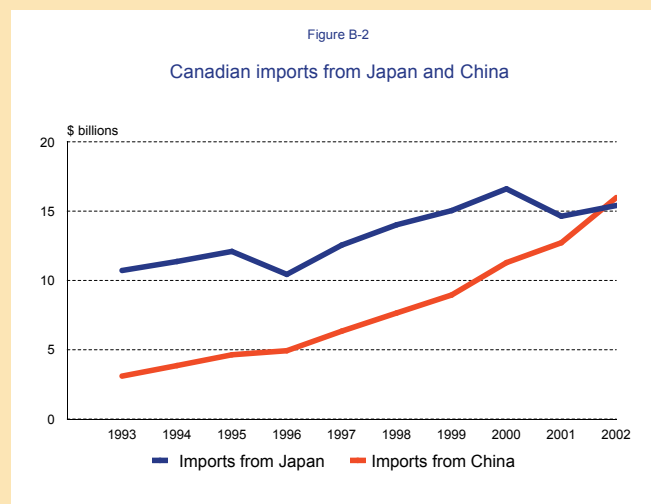
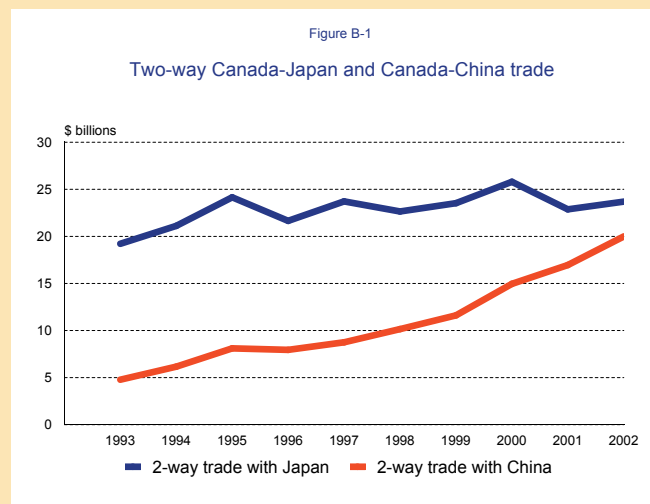
BOX B: WHO IS NUMBER TWO?

Canadian producers of goods buy and sell their products domestically and abroad. This special feature examines the issue of who is our second largest “partner” in this merchandise trade. The first part of this feature will look at international trade while in the second part, a domestic element is introduced to give a full picture of Canadian international trade performance.

Offshore trade

After the United States, Canada trades more internationally with the European Union than with any other trading partner. However, comparisons of any other single country with respect to the EU are not totally compelling, since the EU is an agglomeration at present of 15 countries, albeit with a common trade policy. So which individual nation is Canada's second largest trading partner?

The answer to the above question depends upon what one is measuring. We see from Figure B-1 below that if one looks at total, or two-way trade, defined as the sum of total imports and total exports, Japan is Canada's second largest trading partner. Until only very recently, this question was very straightforward because Japan was both Canada's second largest export destination and its second largest source of imports after the U.S. However, over the 1990s, China has been narrowing the gap; over the course of the year 2002, China has overtaken Japan as Canada's second largest supplier of imports (Figure B-2). Thus, the answer to which individual country is our second largest trading partner depends on whether one is asking about exports, or about imports, or about two-way trade.



So what if we step back to look at something more comparable to the European Union to see who is number two? Alas, there is no other bloc of countries with a single trade policy organized in quite the same way as the EU, so there is nothing quite comparable to the EU. So what if we step back to look at the continent of Europe (as recorded by Statistics Canada¹) and compare it against the other continents? Who is our second largest trading partner in this case?

As it turns out, Europe and Asia have been vying for the position of second-largest over much of the previous decade with Asia appearing to earn to second place on the imports side and, at least for 2002, also squeaking in just ahead of Europe on the exports side (Figures B-3 and B-4). So who is our second largest trading partner? It could well be argued that it is Asia!

Figure B-3

Canadian imports from Asia and Europe

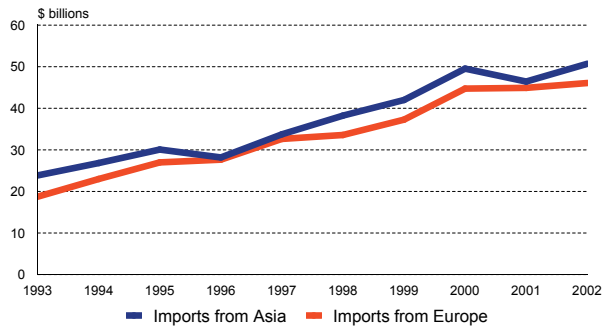
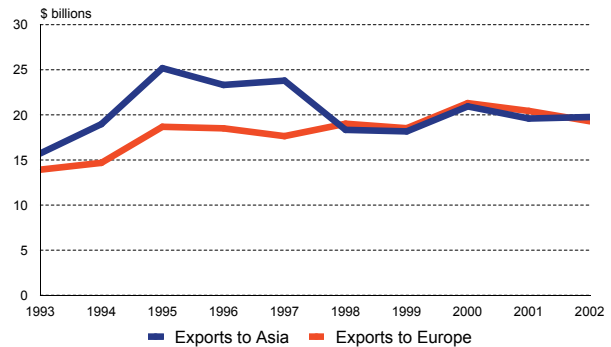


Figure B-4

Canadian exports to Asia and Europe



Introducing the domestic market

So far, only Canada’s sales abroad or purchases from abroad in the case of imports have been examined. What happens if domestic sales to the Canadian market are introduced into the analysis? Who is then Canada’s largest trading partner? And who is second?

Before these last questions can be answered, we first have to make a minor adjustment to the trade data, specifically to the export data. When what we Canadians sell to ourselves is measured, we look at our domestic manufacturing shipments; that is, the value of shipments to purchasers within Canada from Canadian producers. We must, therefore, adjust the value of exports to look only at those products that are manufactured in Canada and then sold abroad. In other words, we exclude those products imported into Canada and re-exported in a substantially unchanged manner. This is what is referred to as “domestic exports”.

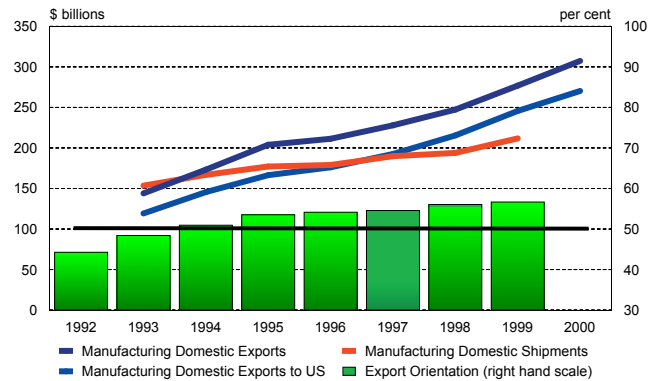
With the adjustments described above, we can begin to answer more definitively the questions posed above.

Figure B-5 provides the necessary information. The dark blue line shows domestic exports of manufactures over 1993-1999 while the red line shows domestic shipments of manufactures, that is total manufacturing shipments less domestic exports, or goods that have stayed in Canada. The first thing to note is that between 1993 and 1994, the two lines cross and Canadian exports exceeded domestic shipments. In simple terms, Canadians began to export more than they produced for their own domestic market. To see this in another way, the green bar represents the ratio of domestic exports to total manufacturing shipments and the black line is set to the 50 per cent level. When the green bar starts to appear above the black line, Canadian exports exceed production for the Canadian market. This occurred in 1994 and all subsequent years.

The lighter-blue line in the graph represents Canadian domestic exports to the United States. This line also crosses the red line — between 1996 and 1997. Thus, analogous to the reasoning provided above, the US export market became a larger market for Canadian goods than even the Canadian market. So who is our second largest trading partner? Well, it is Canada itself!

Figure B-5

Canada's domestic market vs. its export market to the U.S.



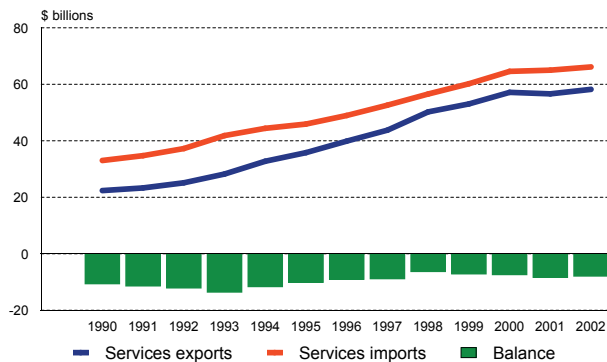
¹ See, for example, Statistics Canada catalogue number 65-001 or 65-202 for regional definitions.

II. SERVICES

Services exports were the bright spot with respect to Canada's export performance for 2002. In fact, services have been "a bright spot" in Canadian export performance for quite some time, having outpaced the growth in goods exports (or declined less than goods as was the case in 2001) in five of the past seven years dating back to 1996. Services exports registered a \$1.6 billion, or 2.8 per cent, increase last year. The increase brought services exports to a record high of \$58.2 billion for the year, or approximately 12.4 per cent of total exports of goods and services. That is, one dollar of every eight dollars earned from Canadian exports last year were in services.

Figure 2-1

Services trade, 1990-2002



Services imports also increased in 2002, but at a slower pace than that for exports. They increased 1.8 per cent over 2001 levels, or almost \$1.2 billion, to reach \$66.1 billion. At this level, they represented about 15.7 per cent of total imports of goods and services into Canada, or nearly one dollar of every six dollars imported. Services imports have increased each and every year of the 1990s and into the first decade of the twenty-first century.

With services exports growing faster than services imports, Canada's traditional services trade deficit narrowed in 2002, reversing three consecutive years of a growing services deficit. For the year as a whole, a \$315 million improvement in the transportation services balance was entirely offset by a \$339 million decline in the travel services balance, while the commercial services balance improved by \$484 million. Government services experienced a slight decline in their trade balance last year, deteriorating by \$8 million. Each of these categories is discussed in greater detail below.

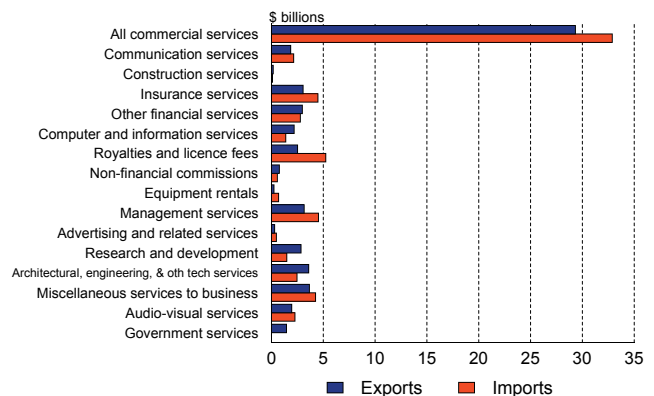
Services trade by major groupings

Commercial services

Commercial services made up just over half (50.4 per cent) of all services exports in 2002, compared to just under half (49.4 per cent) in 2001. Commercial services include such things as accounting, legal, insurance, financial, architectural, computer, communications and construction services, to name but a few. Overall, commercial services were responsible for the bulk of the gains in services exports, increasing almost \$1.4 billion (or 4.9 per cent) over 2001 levels to reach \$29.3 billion in 2002. This increase accounted for over 85 per cent of the total advance for services exports last year.

Figure 2-2

Commercial services trade, 2002



Gains in commercial services exports were led by *Architectural, engineering, and other technical services* (up \$1,008 million, or 38.9 per cent), *Other financial services* (up \$635 million, or 27.0 per cent), and *Royalties and licence fees* (up \$202 million, or 8.7 per cent). Limiting the advances were declines in *Research and development* services exports (down \$383 million, or 11.8 per cent) and *Construction* (down \$126 million, or 42.0 per cent).

At 49.7 per cent of total services imports, commercial services is also the largest services import category. Commercial services imports rose faster than total services imports (2.8 per cent vs. 1.8 per cent), led by gains in *Architectural, engineering, and other technical services* (up \$649 million, or 35.7 per cent), *Other financial services* (up \$222 million, or 8.6 per cent), and *Communications services* (up \$170 million, or 8.6 per cent). Falling imports of *Management services* (down \$269 million, or 5.6 per cent), and *Royalties and licence fees* (down \$139 million, or 2.6 per cent) limited the overall advance of commercial services imports.

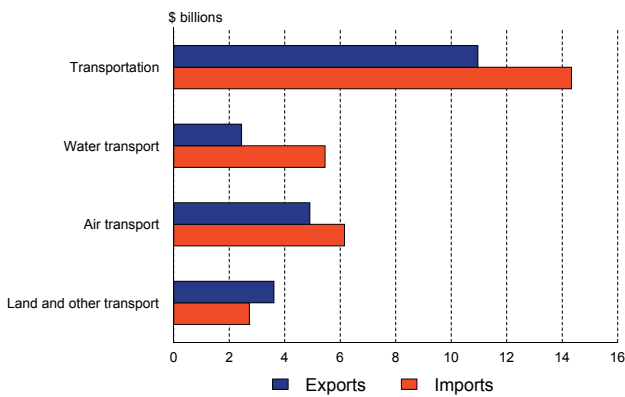
For the commercial services category as a whole, the trade balance improved by \$484 million, reducing the trade deficit to \$3.6 billion.

Transportation services

Transportation services also contributed positively to the gains in Canadian services exports last year. This sector, which accounts for slightly less than one-fifth of total services exports (18.8 per cent), saw its exports rise by \$437 million (4.2 per cent) from 2001 to 2002, to \$11.0 billion. Exports increased in all three sub-categories of transportation, as *Land and other transportation services* exports advanced \$249 million (7.4 per cent), *Air transportation services* exports rose by \$146 million (3.1 per cent), and *Water transportation services* managed a \$42 million increase (1.7 per cent).

Figure 2-3

Transportation services trade, 2002



On the import side, advances in *Water transportation services* (up \$306 million or 5.9 per cent) and *Land and other transportation services* (up \$147 million or 5.7 per cent) were partly offset by a decline in *Air transportation services* (down \$331 million or 5.1 per cent). Total imports of transportation services climbed 0.9 per cent in 2002, to \$14.3 billion, up \$122 million from 2001 levels.

With the developments outlined above, the transportation services deficit narrowed \$315 million to \$3.8 billion for 2002.

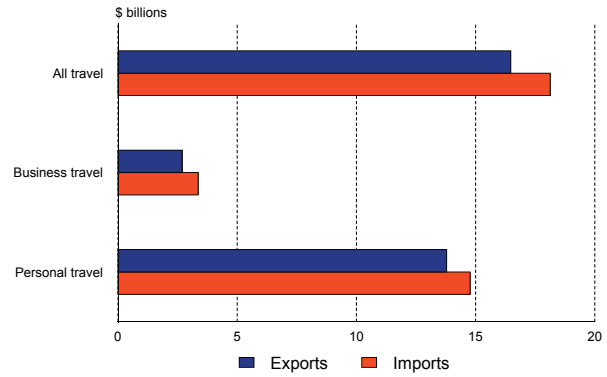
Travel services

Exports of travel services fell 1.2 per cent in 2002, down \$207 million to \$16.5 billion. Both sub-categories fell: *Personal travel services* exports, at \$13.8 billion, were \$120 million (or 0.9 per cent) lower than a year earlier while *Business travel services* exports were off by \$87 million (3.1 per cent), declining to \$2.7 billion.

Total travel imports rose 0.7 per cent in 2002, up \$131 million to \$18.1 billion as the advance in *Personal travel services* imports (up \$539 million) outweighed the decline in *Business travel services* imports (down \$408 million).

Figure 2-4

Travel services trade, 2002



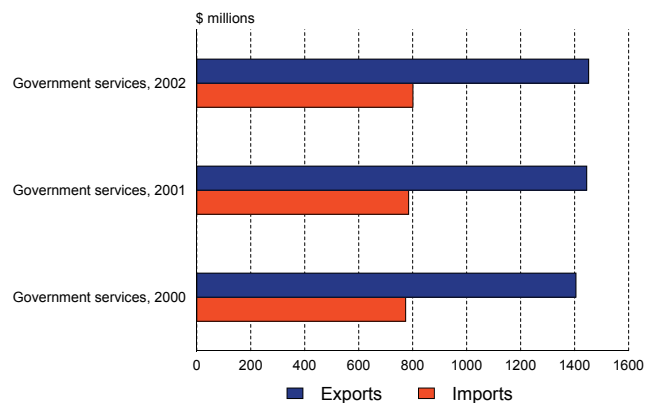
The combination of falling exports and rising imports means that there was a deterioration in the Canadian travel services balance: for 2002, the deficit in this category widened \$339 million to \$1.7 billion.

Government services

Government services cover international transactions arising largely from official representation and military activities. They eked out a small, half-percentage point increase in exports (to \$1.5 billion) while government services imports rose 1.9 per cent (to \$800 million). As a result, the trade surplus in government services edged lower, slipping \$8 million to \$651 million in 2002.

Figure 2-5

Government services trade, 2000-2002



BOX C: TRADE COSTS AND CANADA'S CHANGING TRADE PATTERNS

Introduction

International trade might be more costly than is commonly supposed, notwithstanding improvements in technology and in communications as well as trade liberalization that has occurred over the past half-century. Many elements of trade costs are not directly “observable”; such “unobserved trade costs” are thought by some to be responsible for what has become known as the home bias/border effect in international trade¹.

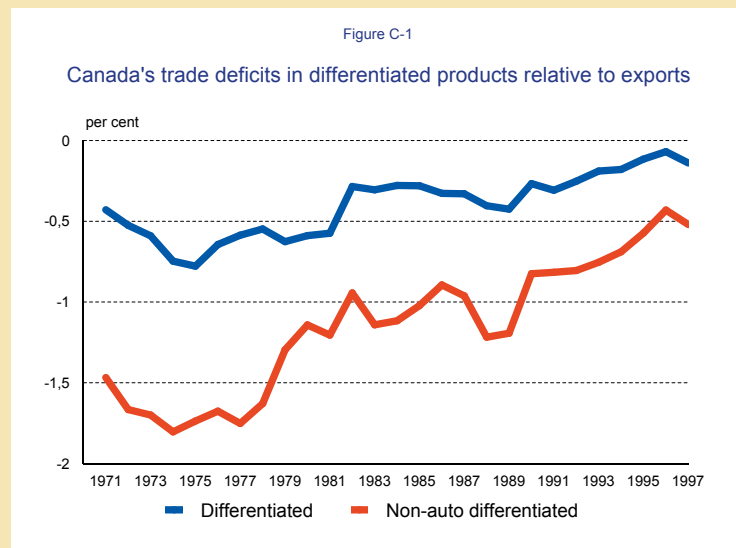
This highlight section attempts to shed new light on “unobserved trade costs” by looking beyond traditional trade-related costs. More specifically, it measures the size and composition of non-tariff, service related costs such as transport, distribution, and information costs incurred in Canada's merchandise trade using Statistics Canada's latest “trade margin” statistics². It tracks the pattern of these trade costs, noting how changes in these costs have influenced Canada's merchandise trade pattern and thus the course of economic integration.

Trade costs play a prominent role in the so-called “economic geography” model of trade; this model suggests that in some industries, there is a strong economic incentive to shift production to the larger market in order to minimize trade costs and to achieve scale economies: trade liberalization could further reinforce the “home-market effect”. Declines in trade costs, on the other hand, could potentially “reverse” the “home market effect”, facilitating the expansion of production and exports from smaller countries.

Changes in Canada's merchandise trade pattern

Over the past four decades, Canada's merchandise trade pattern experienced profound changes. Exports of so-called differentiated products³ expanded rapidly, resulting in a steady rise in their share of Canada's total merchandise exports, to 55.9 per cent in 1997 from only 18 per cent in the early 1960s. Concomitantly, the share for homogeneous products in Canada's merchandise exports fell to 17.6 per cent from 34.1 per cent over the same period.

While Canada's trade balance in differentiated products remained in deficit, the relative size of this deficit (measured as shares of trade deficits relative to their exports) decreased considerably, from 0.7 per cent in the mid-1970s to only 0.14 per cent in 1997 (Figure C-1). These developments require some further analysis to understand the dynamism in Canada's merchandise trade pattern.



The time-series pattern of trade costs

Transport costs

Table C-1 reports *ad valorem* transport rates incurred in Canada's merchandise exports over four decades. The data show that transport costs for differentiated products were far lower than that for homogeneous products. Further, overall transport costs for Canada's merchandise exports declined to 4.1 per cent in the 1990s from 6.7 per cent in the 1960s, a decrease of 38.3 per cent over the past four decades.

Table C-1. Average transport costs in Canada's merchandise exports by product type (per cent)

	Homogeneous	Referenced	Differentiated	Total
1965-69	6.9	10.4	3.2	6.7
1970-79	6.4	9.5	2.9	5.7
1980-89	7.1	8.3	2.5	5.3
1990-97	6.1	6.9	2.0	4.1
Growth (60s-90s)	-11.7	-33.2	-38.2	-38.3

Across products, *ad valorem* transport rates for homogeneous products fluctuated in a range of 6-7 per cent over the decades under review; only in the 1990s did they start to show a clear declining trend. Decreases in transport costs for referenced products are evident; *ad valorem* transport rates for that category of products declined steadily from 10.4 per cent in the 1960s to 6.9 per cent in the 1990s. *Ad valorem* transport rates for differentiated products experienced the most significant drop — 38.2 per cent — over the same period, suggesting that improvements in transportation technologies and related institutional innovations over the past decades had more significant cost-saving effects on transporting differentiated products than on the two other categories of products.

Distribution Costs (wholesale)

In the contemporary distribution system, there are two essential characteristics that have a profound impact on international merchandise trade. First, there is services variety. One can identify at least five broad categories of output of distribution services: accessibility of location, breadth and depth of assortment, assurance of product delivery at the desired time and in the desired form, information, and ambiance. Second, there has been increased backward vertical integration in the distribution sector, shifting the wholesale functions from manufacturers to wholesalers to achieve a better division of labour between them. These developments led to an increase in the share of wholesale costs in merchandise exports. On the other hand, efficiency enhancement in wholesale services arising from investment in information technologies, the adoption of new inventory control methods, and increased competition, tended to drive down wholesale costs in merchandise exports.

Table C-2 indicates that wholesale services attached to Canada's merchandise exports amounted to \$11.7 billion in 1997. The role of wholesale services in facilitating Canada's merchandise exports was thus rising: the share of wholesale costs in the value of merchandise exports increased to 4.1 per cent in the 1990s from 2.7 per cent during 1960s and 1970s; this pattern was consistent across different categories of products. The rising share of wholesale costs in the value of exports suggests that although labour productivity in the wholesale sector grew at a respectable pace of 2.5 per cent annually over the past four decades, the forces representing services variety and cost shifting overwhelmed the cost-saving effect in the wholesale sector.

Table C-2. Average wholesale costs in Canada's merchandise exports by product type (per cent)

	Homogeneous	Referenced	Differentiated	Total
1965-69	2.1	3.6	2.7	2.8
1970-79	2.4	2.9	2.8	2.7
1980-89	3.3	3.2	3.2	3.2
1990-97	3.9	4.7	3.9	4.1
Growth (60s-90s)	87.1	33.0	45.1	47.2

Information costs (network)

Overall, the role of direct sales⁴ in total export sales has been declining; social and business networks shrink in importance for international trade (Table C-3). Falling information costs due to improvements in technologies for information dissemination, as well as increased transparency and better enforcement of international contracts in foreign countries, could be possible explanations. Nevertheless, direct sales remain significant for many highly specialized and time-sensitive differentiated and referenced products. Direct sales represented 12.8 per cent of total export sales for differentiated products, and 15.3 per cent for referenced products in 1997, but only 3.0 per cent for homogeneous products. The high proportion of direct sales for differentiated products suggests that networks are far more important for differentiated products than for homogenous products⁵.

Table C-3. Direct export sales as a share of manufacturers total export sales (per cent)

	1962	1970	1980	1990	1997
Homogeneous	16.3	17.8	2.6	3.9	3.0
Referenced	15.6	11.7	12.1	16.9	15.3
Differentiated	32.3	12.6	10.9	12.9	12.8

Custom duties

Because of various trade agreements (the GATT/WTO, the Canada-U.S. FTA, and NAFTA), *ad valorem* custom duties for Canadian merchandise imports fell by more than a half to 4.6 per cent in the 1990s from 10.3 per cent in the 1960s⁶ (Table C-4). Across products, duty rates for resources-based homogeneous products were low even in the early 1960s; progressively reducing or eliminating tariffs for differentiated and referenced products had always been the focus of trade liberalization in goods. Between the 1960s and 1990s, tariff duties for differentiated products fell by 47.6 per cent and for referenced products by 60.9 per cent. These tariffs changes occurred in parallel with the broad changes in Canada's trade pattern over the entire period; that is, the rising share of differentiated products in total exports.

Table C-4. Ad valorem duty rates for total Canadian merchandise imports, in per cent

	Homogeneous	Referenced	Differentiated	Total
1965-69	2.2	13.9	9.2	9.3
1970-79	0.7	12.4	7.8	7.6
1980-89	0.3	9.9	7.1	6.8
1990-97	0.3	5.4	4.8	4.6
Growth (60s-90s)	-85.0	-60.9	-47.6	-50.5

Further, as tariffs have been substantially reduced and largely abolished, trade costs associated with transport and distribution services now appear larger than remaining tariff duties (Table C-5). For instance, in the 1960s, the wholesale and transport costs accounted for 9.5 per cent of total Canadian merchandise exports, similar to the 9.3 per cent level of custom duties. In the 1990s, however, average duty rates on total imports dropped to 4.6 per cent, while wholesale and transport costs stood at 8.2 per cent (the custom duty rate fell to 2.6 per cent in 1997, while wholesale and transportation rates combined were 7.8 per cent in the same year). Given the importance of these services components in total trade costs, liberalization in services might be the next key step in promoting greater merchandise trade.

Table C-5. Ad valorem, wholesale, and transport rates for Canadian exports and duty rates for total Canadian imports (per cent)

	Wholesale	Transport	Duties
1965-69	2.8	6.7	9.3
1970-79	2.7	5.7	7.6
1980-89	3.2	5.3	6.8
1990-97	4.1	4.1	4.6

The home-market effect

Having examined the time-series pattern of trade costs, the following section summarizes some econometric estimations to quantify the impact of changes in trade costs on Canada's merchandise trade pattern using the gravity or economic geography model. In particular, it tests a hypothesis of whether or not declines in trade costs have helped "reverse" the home-market effect, strengthening the advantage of smaller countries in producing differentiated products. Table C-6 shows that the estimated coefficient for home-income is 1.08, higher than that of foreign-income of 0.72. This result appears to confirm the reverse of the "home-market effect"⁷.

Table C-6. Estimation results for exports of differentiated products

Dependent variable: Exports of differentiated products				
The Method of Instrumental Variables:				
Instrument list: Canada GDP, wholesale, transport, and time				
1965-97	Canada GDP	Foreign GDP	Duties	$R^2 = 0.99$
	1.08	0.72	-0.51	
	(2.54)	(1.74)	(-3.98)	

Conclusions

Evidence presented here suggests that falling transport costs and expanding distribution services could offset the location advantage of larger countries, leading to the expansion of production and exports of high-valued differentiated products from smaller countries. Thus, freer trade, particularly in the services sectors, could further strengthen smaller countries' advantages by enhancing their market access to a large market.

¹ Obstfeld, Maurice and Kenneth Rogoff "The Six Major Puzzles in International Macroeconomics: is There a Common Cause?" NBER Working Paper 7777, Cambridge, MA.

² In the Canadian input-output tables, there are seven "trade margins" distinguished: retail, wholesale, tax, transport, gas, storage, and pipelines. These are extra trade-related costs that are attached to Canadian merchandise exports. This paper will focus on transport and wholesale margins only.

³ We regroup merchandise trade statistics into three groups — homogeneous, which refers to products traded on organized exchanges; differentiated, which refers to products that are “branded” (industries associated with differentiated products are often characterized as having increasing returns); and referenced products, which refers to those that are “in-between”, whose prices are often quoted in trade publications, based on Rauch’s classification (Rauch, James E. 1996 “Networks versus Markets in International Trade”, NBER Working paper no. 5617).

⁴ Canadian manufacturers sometimes sell directly to foreign buyers. Direct sales mean that manufacturers rely on their own social and business networks, rather than on wholesale distribution channels, for accessing information, overcoming informal trade barriers, and implementing international contract enforcement.

⁵ See Rauch James, E. (1996) “Networks versus Markets in International Trade”, NBER Working Paper no. 5617.

⁶ Since import duties collected by Canada’s major trading partners on Canadian exports based on the IO classification are not available, this study will use Canada’s import duties as a proxy for foreign tariffs charged on Canada’s merchandise exports.

⁷ The detailed description of estimation procedures is available upon request to shenjie.chen@dfait-maeci.gc.ca.

Services trade by region

As is the case for goods, the United States is Canada’s principal trading partner for services. Through the 1990s, the U.S. share of Canadian services exports rose from 55.8 per cent in 1991 to a peak of 60.6 per cent in the year 2000. For both the years 2001 and last year, the U.S. share has remained at 59.2 per cent. In contrast, the U.S. share in Canadian imports of services has fallen from a peak of 66.0 per cent, also in 1991, to 61.2 per cent last year.

Services trade with the United States

In 2002, Canadian services exports to the United States rose \$942 million, resulting in a 2.8 per cent rise in the share of these exports in that country. Exports of travel services led the way, accounting for almost half the increase, or \$463 million. Exports of commercial and government services were next in importance, rising \$255 million while exports of transportation services contributed the remaining \$223 million. Total exports of services to the U.S. amounted to \$34.4 billion for the year.

On the import side, a \$718 million increase in commercial and government services imports from the U.S. was more than enough to offset declines in travel services imports (down \$272 million) and transportation services imports (down \$78 million), as total services imports from the United States increased 0.9 per cent, or \$367 million, to \$40.5 billion.

Services trade with the European Union

Exports of services to the European Union also increased by 2.8 per cent in 2002, leaving the share of services exports to this region unchanged from the previous year at 17.0 per cent. Increases of \$552 million and \$74 million for commercial and government services and transportation services, respectively, were partly offset by falling exports of travel services to the EU (down \$361 million). For the year as a whole, Canadian services exports to the EU rose \$266 million to \$9.9 billion.

Services imports from the EU in 2002 fell \$138 million to \$10.6 billion, or 16.0 per cent of total services imports from all sources. Declines in commercial and government services imports (down \$145 million) and transportation services imports (down \$152 million) pulled services imports from the EU down. Travel services imports from the EU managed a \$161 million increase for the year.

Services trade with Japan

Japan holds a 3.0 per cent share of Canada’s services exports and a 3.1 per cent share of Canada’s services imports. This import share held steady over 2001 to 2002 as imports of services from Japan grew at a slightly faster pace than total services imports — 2.8 per cent vs. 1.8 per cent; the overall change was not enough to increase Japan’s share in total services imports. The pace of services exports to Japan did not

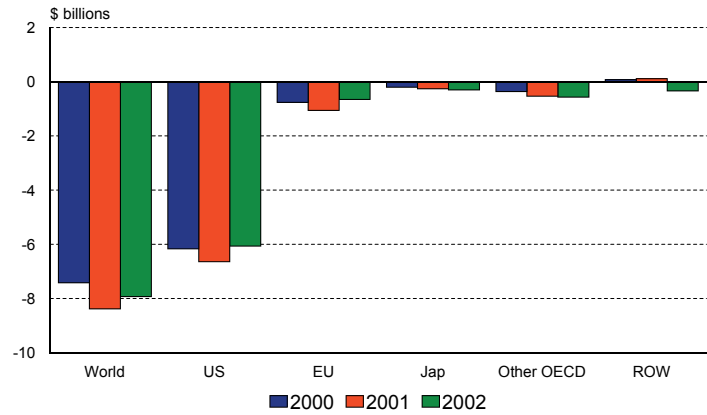
keep up with the pace for overall services exports — 0.9 per cent against 2.8 per cent — and as a result Japan’s share in total Canadian services exports edged down one-tenth of a percentage point in 2002, from 3.1 per cent in 2001.

Services trade with all other destinations

Services exports to other destinations, other than the U.S., the EU, and Japan, were led higher by services exports to other OECD countries, which expanded by 4.4 per cent in 2002 over 2001 levels. On the other hand, services imports from non-OECD countries grew 7.9 per cent over 2001-2002 compared to 4.8 per cent from other OECD sources. As both rates were considerably higher than the overall 1.8 per cent increase for total services imports, the share of services imports from non-U.S.- non-EU-non-Japanese sources increased from 18.6 per cent of total services imports in 2001 to 19.7 per cent in 2002.

Figure 2-6

Services trade balances by principal regions, 2000-2002



III. CURRENT ACCOUNT

This chapter encapsulates the previous two chapters and serves to introduce the next chapter of this Report. That is, it bridges Canada's performance concerning the flow of goods and services with the transfer of funds.

The current account is one of two major accounts that comprise the balance of payments: the other is the capital account. The current account records the flow of goods and services between Canada and other countries — merchandise exports and imports and non-merchandise transactions such as travel and tourist spending, payments and receipts for shipping, freight, banking, and insurance, payments to corporate head offices for management fees and intellectual property rights, such as trademark and licensing fees. The capital and financial account, on the other hand, measures the short- and long-term capital flows between Canada and the rest of the world. Since the balance of payments must balance out at zero, the size of the surplus (deficit) in the current account is mirrored as a deficit (surplus) in the capital and financial account¹.

For 2002, the surplus in the Canadian current account fell to \$17.3 billion from the record \$30.0 billion registered in 2001. The decline in the surplus was due to the fact that the goods surplus, as reported in Chapter 1 above, declined \$9.8 billion because of lower exports and higher imports of goods. The deficit on direct investment income also widened (by \$3.2 billion) compared to 2001 (Figure 3-1).

Regional analysis

The United States

The current account balance between Canada and the United States fell \$7.1 billion to \$58.7 billion in 2002. The majority of the deterioration came via a \$4.9 billion widening of the investment income deficit with the U.S. Profits accruing to Canadian direct investors in the U.S. tumbled \$3.7 billion while those accruing to U.S. holders of direct investment in Canada rose \$0.5 billion. Dividends and interest paid to U.S. portfolio investors were also up \$1.1 billion while remittances to Canadian investors rose marginally (up \$28 million).

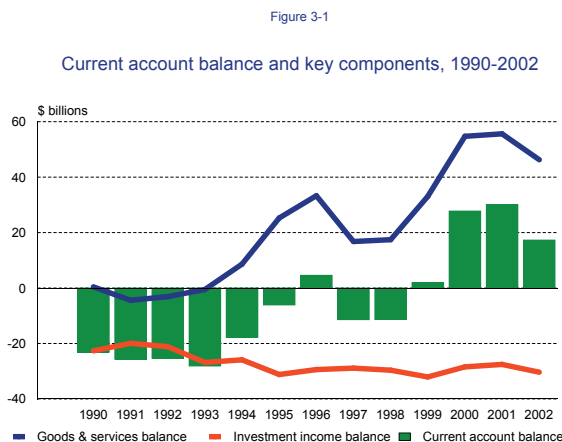
The goods balance with the U.S. fell \$2.5 billion as a \$340 million decline in imports was not enough to offset a \$2.9 billion decline in exports to the U.S. The services deficit narrowed \$573 million on the year as improvements to the travel deficit (\$735 million) and to the transportation balance (\$301 million) were only partially offset by a \$463 million decline in the deficit to commercial and all other services.

The European Union

The deficit in Canada's current account with the EU reached \$17.0 billion in 2002, a \$2.2 billion decline from the 2001 deficit level. The goods deficit widened by over \$2.1 billion, accounting for most of the overall decline: exports fell and imports increased by almost \$1.1 billion each. A \$406 million narrowing in the services deficit (led by improvements of \$228 million and \$699 million to the transportation and the commercial and other services balances, respectively, and only partially offset by a \$520 million decline in the travel balance) more than offset a \$371 million widening of the deficit in investment income. An \$85 million decline in current transfers accounted for the remainder of the difference.

Japan

The current account deficit with Japan widened \$1.4 billion, to \$4.9 billion, in 2002. All principal components and most sub-components experienced a deterioration in their balances over the year. The goods deficit surpassed \$2.0 billion last year, a \$925 million deterioration from the previous year, as a \$226 million increase in goods exports to Japan was outweighed by a \$1.2 billion increase in imports from Japan.



The services deficit slipped \$40 million as declines to the travel and transportation balances outweighed the \$100 million narrowing of the commercial and other services deficit. The investment income deficit widened \$238 million over the year: bilateral inflows of direct investment profits fell while outflows increased, and the direct investment income deficit with Japan widened \$498 million. The deficit on portfolio investment income fell \$160 million last year, largely the result of falling interest and dividend payments to Japanese investors.

Other OECD countries and all other countries

The bilateral current account deficits between Canada and the other OECD countries and all other countries fell \$0.5 billion and \$1.6 billion, respectively last year, to \$8.5 billion and \$11.0 billion. In both cases, declines to the goods deficits (wider by \$753 million and by \$3.4 billion, respectively) and services deficits (wider by \$35 million and by \$451 million, respectively) were only partially offset by improvements to the investment income surpluses (up by \$264 million and by \$2.4 billion, respectively).

Since the mid-1970s, Canada has consistently run current account deficits, coinciding with rising levels of government debt. At the same time, however, the share of private savings in Canadian GDP has been trending downward, falling as low as 17.0 per cent in 1998 from a rate as high as 24.3 per cent in 1985 (Table 3-1). As a result, Canada has relied on net borrowing from abroad to finance domestic investment throughout much of the past 30-or-so years. Since the mid-1990s, Canada has made concerted efforts to reduce public-sector deficits and has, in the past six years, registered federal budget surpluses. In turn, Canada has achieved the sharpest decline in the debt burden among the G7 countries since the mid-1990s: between 1995 and 2002, the net debt-to-GDP ratio was reduced by 26.8 percentage points to 41.1 per cent of GDP, resulting in Canada's debt burden being now below the G7 average. The improvement in Canada's budgetary surpluses implies a corresponding reduction in debt-servicing costs. It has also permitted the government room to lower taxes, which has likely had positive effects on savings rates. These factors in combination have contributed favourably to Canada's current account balances in recent years.

Table 3-1: Domestic savings and investment, as share of GDP, 1981 to 2002

	Private		Excess saving over investment	Public	
	Saving	Investment		Budget surplus (+) Budget deficit (-)	Current account balance
1981-1985	23.4	18.0	5.5	-5.1	-1.2
1986-1990	21.1	19.3	1.8	-4.0	-3.3
1991-1995	19.9	15.6	4.2	-6.7	-2.8
1996	19.1	15.7	3.4	-2.5	0.5
1997	17.4	18.5	-1.0	0.2	-1.3
1998	17.0	18.2	-1.2	0.0	-1.2
1999	17.3	18.1	-0.8	1.7	0.2
2000	18.8	18.2	0.6	3.3	2.6
2001	18.5	16.8	1.7	2.0	2.8
2002	18.5	17.5	1.0	1.6	1.5

Source: Statistics Canada, *National Income and Expenditure Accounts*, Catalogue No. 13-001-PPB, 4th Quarter 2002.

Note: due to the statistical discrepancy in the nation accounts, the sum of the share of excess private saving over private investment and budget surplus or deficit in GDP may not add to share of current account deficit in GDP.

¹ When the current account is in deficit, for example, it measures the extent to which Canada is drawing on the resources of the rest of the world for current consumption and investment; when the current account is in surplus, it measures the extent to which Canada is providing such resources to the rest of the world. In other words, a surplus on the current account indicates that a country has earned (or obtained via transfers) more money abroad than it has paid out and is, thus, a net saver internationally. This surplus is mirrored by a deficit on the capital and financial account and requires a net outflow of capital. Likewise, a current account deficit means that a country is a net borrower internationally, as reflected in a net inflow of capital and thus a surplus on the capital and financial account. In an accounting sense, a current account deficit reflects a shortage of domestic savings relative to domestic investment.

IV. CAPITAL AND FINANCIAL ACCOUNT

As noted earlier, this account measures capital and financial transactions of Canadian residents with non-residents. It comprises the capital account, which measures capital transfers and non-produced, non-financial assets, and the financial account, which measures transactions in financial instruments. Capital transfers represent changes of ownership of savings and wealth across the border with no *quid pro quo* whereas transactions in non-produced, non-financial assets give rise to rights and obligations that create an opportunity to generate cash or other assets. Transactions in financial instruments give the right to receive or the obligation to provide cash or other financial instruments. There are two types of financial instruments: primary instruments — such as bonds, receivables, and equities — and derivative instruments¹ — such as financial options, futures and forwards.

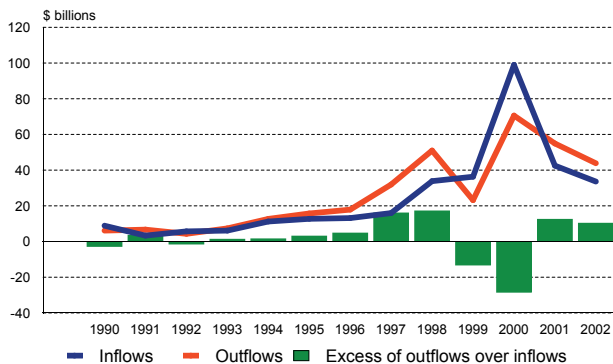
We are mostly interested in the financial account because it provides information about the financing and investing activities of Canadian residents with non-residents. Transactions in financial instruments have a direct impact on the international investment position of the country by creating, extinguishing, or modifying these assets and liabilities.

Direct investment (flows)

Canadian foreign direct investment (FDI) flows continued to decline in 2002, down by about 20 per cent from the previous year's level. Inflows fell by 21 per cent and outflows by 20 per cent. It was the second consecutive year of decline following nine years of uninterrupted expansion of FDI flows. The decline

Figure 4-1

Inflows, outflows, and balance of direct investment flows, 1990-2002



in inflows was broadly in line with, but slightly better than, UNCTAD's prediction of a 27 per cent reduction in world FDI inflows for 2002 (UNCTAD: TAD/INF/PR/63 - 24/10/02), suggesting that Canada remains a highly attractive place to invest in the world-wide competition for global investment.

The continuing contraction of inflows into Canada reflects two key factors: the continuing sub-par economic activity in the other major industrialized economies and a bearish stock market world-wide. In turn, these forces have combined to slow down new investment into Canada and reverse the trend towards rising cross-border mergers and acquisitions (M&As) that has driven much of the recent inward FDI flows. Cross-border M&A activity in Canada has plummeted from \$64.1 billion in the year 2000 to \$13.5 billion last year, falling some 62 per cent and 45 per cent over these two years, respectively.

For 2002, FDI inflows into Canada amounted to \$33.6 billion, down \$8.9 billion from the previous year's level. Net mergers and acquisitions activity was down by slightly less than \$11.0 billion, more than accounting for the entire decline in FDI inflows between 2001 and 2002.

Regionally, the United States has accounted for the lion's share of inward investment into Canada over the recent past. With the exception of the year 2000, when there was a one-time surge of EU investment led by the French takeovers of Seagrams by Vivendi and of Newbridge by Alcatel, U.S. investment into Canada has accounted for about three-quarters-or-more of total FDI inflows. The year 2002 was no exception, as U.S. investors accounted for nearly \$25.1 billion of the total \$33.6 billion, or 74.7 per cent. EU investors were second in importance last year, accounting for 13.9 per cent of total inflows, or \$4.7 billion. Non-OECD foreign investors were responsible for a further 7.0 per cent of the 2002 total, followed by Japan at 3.4 per cent and by the remaining OECD countries not mentioned above, at 1.1 per cent.

On a sectoral basis, foreign investors channelled just over half the total investment (or \$16.9 billion) into the energy/metallic minerals industries and about one-fifth (or \$6.7 billion) to several other industries within the "other industries" category. For the remainder of the sectors, \$3.8 billion of foreign investment flows were directed to the machinery and transportation equipment industries and \$2.8 billion went to each of the finance and insurance, and the services and retailing segments of the market.

Figure 4-2

Inflows of direct investment by sector, 2000-2002

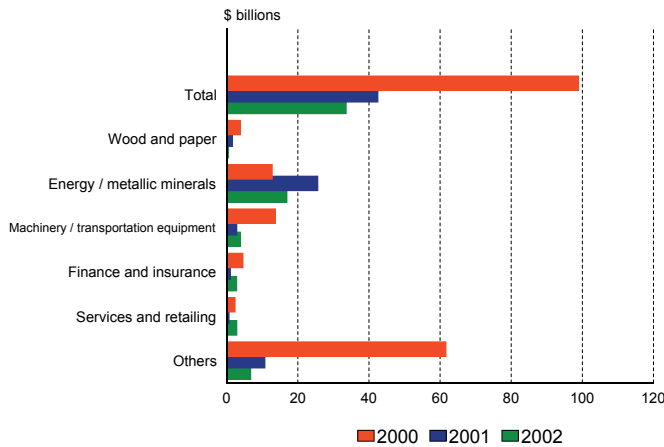
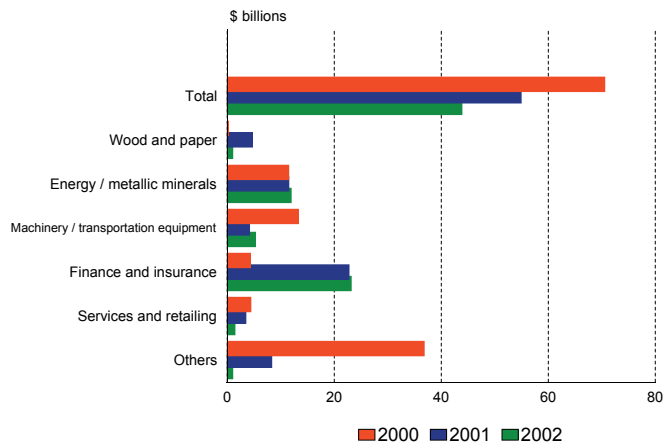


Figure 4-3

Outflows of direct investment by sector, 2000-2002



Outflows of direct investment, or Canadian direct investment abroad (CDIA), peaked in the year 2000 and have fallen by 22.1 per cent and 20.1 per cent in 2001 and 2002, respectively. At \$43.9 billion, Canadian investment outflows remain the fourth highest on record, trailing only the levels registered for 2000, 2001, and 1998 in that order. Similar to the case for FDI in Canada, it was the level of mergers and acquisitions that led CDIA outflows lower in 2002: net outward M&A flows fell \$16.9 billion between 2001 and 2002 while total outward investment flows declined by a more modest \$11.1 billion over the same period.

Canadian outward investment for 2002 was widely spread geographically, much more so than in the previous four years. Last year, a little over a third of CDIA flows (35.2 per cent) were placed in the United

States compared to well over a half (56.8 per cent) over the 1998-2001 period. A number of accounting/auditing irregularities, particularly with respect to U.S. corporations, along with disenchantment concerning new technology firms, many also U.S.-based, appeared to contribute to Canadian investors looking further abroad for investment opportunities. All other major regions gained at U.S. expense, most notably the EU, which captured 30.4 per cent of CDIA flows in 2002 compared to their average of 17.5 per cent over 1998-2001, and the other OECD region (12.1 per cent vs. 7.7 per cent and, the non-OECD rest of the world (18.7 per cent vs. 15.1 per cent).

Canadian direct investment abroad went largely to the financial and the energy/metallic minerals industries, at \$23.2 billion and \$11.9 billion, respectively; when combined, they accounted for about 80.0 per cent of total outflows. Machinery and transportation equipment was next in importance, accounting for a further 12.0 per cent of the total.

Portfolio investment

Portfolio investment typically refers to international transactions in stocks and bonds (both foreign and Canadian) in addition to transactions of Canadian money market instruments between residents of Canada and non-residents. Foreign money market instruments are included in other assets because of difficulties in their measurement.

In 2002, the flow of Canadian portfolio investment abroad declined for the second year running — from \$62.3 billion in 2000 to \$37.7 billion in 2001 to \$24.7 billion last year. Not surprisingly, given the bearish market conditions, the mix of Canadian portfolio outflows shifted dramatically in 2002. In 2001, only one dollar of every twenty dollars invested abroad was placed in foreign bonds: last year it was one dollar of every four dollars invested offshore. In effect, Canadian purchases of foreign stocks were held in check, off some \$17.3 billion (or down 48 per cent) from the previous year while bond holdings shot up 230 per cent (or \$4.3 billion).

The skittishness caused by jittery markets also showed up in inward portfolio statistics. The flow of foreign portfolio investment into Canada tumbled \$13.0 billion

to \$17.9 billion in 2002. Investors looked less favourably at Canadian stocks and bonds for the year, cutting bond holdings by over half from 2001 levels, from \$33.6 billion to \$15.8 billion, and selling off Canadian stocks to the amount of \$1.8 billion for 2002. On the other hand, foreign investors bought \$3.9 billion of Canadian money market paper in the year.

Overall, it was the fourth consecutive year that the flow of Canadian outward portfolio investment exceeded the flow of portfolio investment into Canada. At \$6.86 billion last year, the overall outflow was marginally higher than the \$6.85 billion registered in 2001, but considerably lower than the \$48.2 billion recorded in the year 2000.

International investment position

A change in Statistics Canada's reporting procedure has delayed the release of Canada's international investment position statistics for 2002. Thus, unlike our three previous annual Reports, we are unable to set out

Canada's performance in this area for 2002. Canada has traditionally relied on inflows of foreign capital to finance domestic investment and to acquire technologies from abroad. As a result, Canada's foreign accumulated liabilities have traditionally exceeded its corresponding assets. However, Canada's net foreign indebtedness as a share of gross domestic product has fallen from 44.7 per cent of GDP in 1993 to 18.8 per cent in 2001, reflecting improvements in the foreign direct investment (FDI) account associated with the switch from a traditional debtor position to one of a creditor beginning in 1997, in addition to the surge in foreign stock holdings resulting from the relaxation of foreign-content limits for tax-sheltered Canadian investment funds. We note that the FDI account has further improved for the year 2002.

¹ Derivatives are financial instruments providing payoffs that depend or are contingent on the values of other assets, such as commodity prices, bond and stock prices, or market index values. The coverage of derivatives in Canadian statistics is currently limited to options and traded financial futures.

V. DIRECT INVESTMENT (STOCKS)

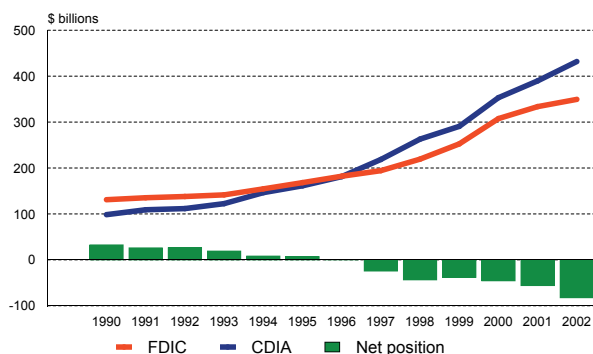
Up to now, this Report has examined the annual flows of capital and financial transactions and of goods and services between Canadians and foreigners. However, on the investment side, there is an additional dimension that can be addressed — the holdings, or stocks, of outward and inward foreign investment that have accumulated through time. This chapter examines the stock of Canadian holdings of direct investment abroad as well as the stock of foreign direct investment holdings in Canada.

Foreign direct investment (FDI) is an investment by an investor from one country involving a long-term relationship, reflecting a lasting interest and a significant influence on the management of an enterprise residing in another country. It usually requires a holding of 10 per cent or more of voting equity, but does not have to imply control of the foreign firm. Direct investments made by Canadians abroad, or outward investment, is called Canadian direct investment abroad, or CDIA, while direct investment made by foreigners in Canadian enterprises is referred to as foreign direct investment in Canada, or FDI in Canada.

In 2002, Canadian direct investment abroad amounted to \$431.8 billion, up 10.8 per cent from the \$389.7 billion registered for 2001. The growth of foreign direct investment into Canada slowed to 4.7 per cent in 2002, down from 8.5 per cent one year earlier. FDI in Canada stood at \$349.4 billion last year. With the stock of outward investment exceeding that of inward investment, Canada is now a net exporter of direct investment capital. Canada has been in this net exporter position since 1997, when the stock of CDIA exceeded that of FDI in Canada for the first time since records of this data were kept.

Figure 5-1

CDIA, FDI in Canada, and net direct investment position, 1990-2002



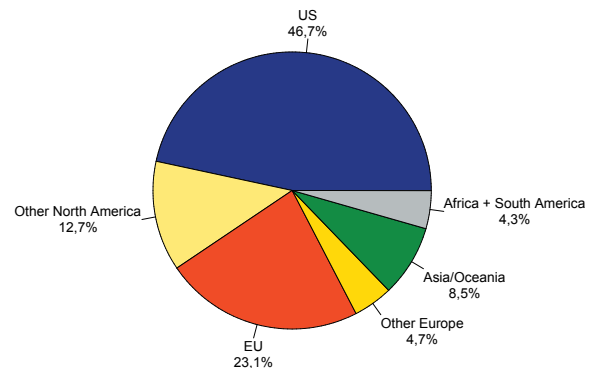
Outward direct investment

Investment by region

The largest portion of Canadian FDI holdings is placed within North America, which accounted for almost six-tenths (59.4 per cent) of the total outward stock of investment. The bulk of the North American holdings are in United States-based companies, which accounted for 78.7 per cent of the total North American investment, or \$201.8 billion. The U.S. is also the single largest country for CDIA, accounting for just below half (46.7 per cent) of total Canadian outward investment. At \$23.9 billion and \$9.4 billion, the Barbados and Bermuda account for almost two-thirds of the remaining stock of CDIA in North America. The Barbados is, in fact, the third largest single-country destination of CDIA, after the United States and the United Kingdom. Canadian investment in NAFTA-partner Mexico edged up 2.0 per cent to \$3.3 billion in 2002.

Figure 5-2

Distribution of CDIA by region, 2002



At a little over one-quarter of the total, Europe is Canada's second largest destination for CDIA. Direct investment holdings in Europe grew at twice the pace of total CDIA in 2002 — 22.4 per cent vs. 10.8 per cent. The bulk of Canadian direct investment holdings in Europe is in the European Union, which accounted for nearly \$100 billion of the approximate \$120 billion invested in Europe, or five-sixths of total CDIA in Europe.

The stock of CDIA in the EU grew 22.7 per cent, an increase of \$18.5 billion, from 2001 to 2002. Investment levels were up for all EU countries, except for Italy where the stock nearly halved from \$4.9 billion in 2001 to \$2.6 billion last year. Elsewhere in the EU,

advances were led by a \$7.7 billion increase in stock levels to Ireland and a \$5.5 billion increase in stock levels to the U.K. Germany (up \$3.1 billion) and the Netherlands (up \$2.1 billion) also registered notable increases in their levels of CDIA in 2002.

Outside of the EU, there are sizeable Canadian direct investment holdings in Hungary (\$11.4 billion) and Switzerland (\$6.5 billion). CDIA in Hungary climbed a further 25.6 per cent in 2002 after having more than doubled the previous year.

The Asia/Oceania region is the next largest region for CDIA at 8.5 per cent of the total outward stock of investment. Investment holdings jumped 31.1 per cent in 2002, from \$27.9 billion to \$36.6 billion. Japan, at \$9.2 billion, is the principal destination of CDIA to the region followed by Australia at \$8.5 billion and Singapore at \$4.5 billion. CDIA in Australia rocketed 87.6 per cent last year, coming on the heels of a 45.9 per cent increase a year earlier.

South and Central America was the destination of slightly over \$15.0 billion of CDIA in 2002. Chile and Brazil are the chief destinations for CDIA in this region, accounting for \$5.8 billion and \$4.3 billion, respectively. Peru and Argentina account for almost two-thirds of the remaining \$5.0-or-so billion after accounting for Chile and Brazil, with CDIA levels of \$2.0 billion and \$1.4 billion, respectively, in 2002.

At \$3.6 billion in 2002, Canadian direct investment in Africa was again the smallest of any region. This amounts to less than one per cent of total CDIA. Because investment levels are not high, much of the data on CDIA in Africa is considered confidential by Statistics Canada. Public data on CDIA is available for only 9 African nations, and cover only 20 per cent of the total. Consequently, little of any specific nature can be said about CDIA in Africa.

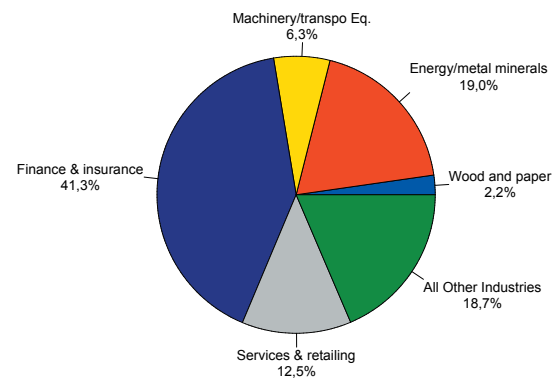
Investment by sector

Direct investment data are available for six industrial groupings and three major regions — the United States, the European Union, and Japan-and-the-rest-of-the-world. Canadian direct investment abroad (CDIA) is concentrated in the financial and insurance sector, which accounted for 41.3 per cent of the stock of CDIA.

Investment in the energy and metallic minerals sector is next in importance at 19.0 per cent of CDIA, closely followed by miscellaneous industries at 18.7 per cent. Services and retail is the fourth most important sector for CDIA, accounting for 12.5 per cent of the total stock of investment abroad. Machinery and transportation equipment (6.3 per cent) and wood and paper (2.2 per cent) are the last two sectors for which data are available.

Figure 5-3

Distribution of CDIA by sector, 2002



In total, just under half of all CDIA (46.7 per cent) has gone to the United States. Canadian investment is most heavily placed, relatively speaking, in the U.S. services and retailing sector, with 71.6 per cent of total sectoral CDIA (or \$38.6 billion). U.S. wood and paper (\$5.5 billion) and miscellaneous industries (\$45.7 billion) accounted for 56.7 per cent of CDIA each in their respective sectors while the U.S. energy and metallic minerals sector has absorbed \$35.4 billion of Canadian direct investment, about 43.1 per cent of the total sectoral CDIA. U.S.-placed CDIA in the machinery and transportation equipment sector stood at \$7.0 billion in 2002, about one-quarter of the total CDIA in this sector.

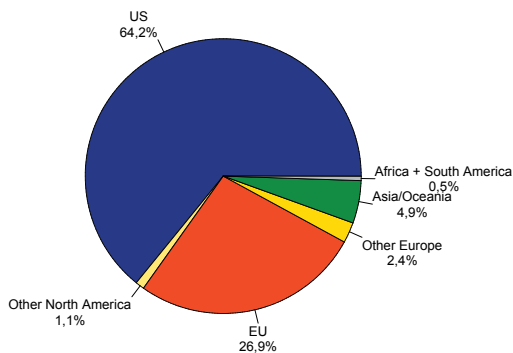
CDIA in the machinery and transportation equipment sector in the EU was \$10.1 billion in 2002, the only sector in which CDIA in the EU exceeds that in the U.S. Elsewhere in the EU, CDIA levels are notable in finance and insurance (\$41.8 billion), miscellaneous industries (\$18.5 billion), and energy and metallic minerals (\$17.0 billion). The stocks of CDIA in the EU are below \$10 billion in services and retailing (\$9.9 billion) and wood and paper (\$2.5 billion).

Inward direct investment

Investment by region

Almost two of every three dollars of direct investment in Canada comes from other North American countries. And with over 98 per cent of that investment originating from the United States, for all intents and purposes two-thirds of all foreign direct investment in Canada comes from the U.S. That is, \$224.3 billion of the \$228.1 billion total North American FDI in Canada originates from the United States.

Figure 5-4
Distribution of FDI in Canada by region, 2002



Europeans are the second largest investors in Canada. Some 29.3 per cent of FDI in Canada holdings in 2002 were placed by European investors. Over 90 per cent of the stock of European direct investment in Canada originates from EU investors. Within the EU, France is the largest investor at 34.3 per cent of total EU FDI in Canada (\$32.2 billion), followed by the U.K. at 28.0 per cent (\$26.3 billion). The Netherlands is in third place at about half the British levels — 14.7 per cent of the EU total, or \$13.8 billion. Germany (7.2 per cent, or \$6.7 billion) and Belgium (4.1 per cent, or \$3.8 billion) round out the top 5 inward European investors in Canada over time. In total, these five countries accounted for 88.3 per cent of the total stock of EU direct investment in Canada in 2002.

Jointly, North America and Europe accounted for 94.6 per cent of the total stock of FDI in Canada last year. Asian/Oceanic investors accounted for some 90 per cent of the remaining 5.4 per cent. Asian/Oceanic investors held \$17.2 billion in FDI assets in Canada last year, up almost \$2.0 billion from 2001 levels. At \$8.6 billion, Japan is the largest investor in Canada,

followed by Hong Kong (\$5.0 billion) and Australia (\$2.0 billion). These three countries accounted for over 90 per cent of the stock of FDI from this region last year. Hong Kong investment was especially noteworthy last year, rising \$1.1 billion from its 2001 level of \$3.9 billion — nearly a 30 per cent increase.

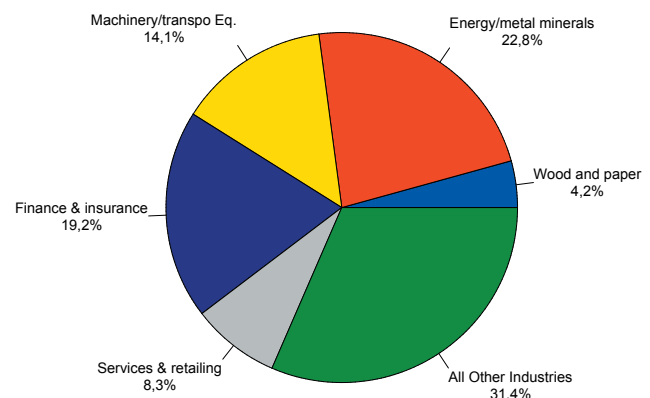
South and Central Americans had \$1.4 billion in FDI holdings in Canada in 2002, or 0.4 per cent of total FDI in Canada. Brazil, at \$1.3 billion, and Panama, at a little less than \$0.1 billion, account for virtually all of the stock of FDI in Canada from this region.

Holdings of African FDI in Canada fell 17.2 per cent in 2002, from \$291 million to \$241 million on reduced holdings by South African investors. The stock of South African FDI in Canada fell from \$289 million to \$238 million last year. African FDI in Canada was one-tenth of one per cent of the stock of total foreign direct investment in this country in 2002.

Investment by sector

At the aggregate or overall level, miscellaneous industries, such as food, apparel, and various consumer goods industries, have attracted the largest amount of direct investment from abroad — \$109.5 billion or 31.4 per cent of the total; however, the stock of FDI in this industrial grouping has fallen over the past two years, having declined by 0.4 per cent last year and by 4.2 per cent the year before.

Figure 5-5
Distribution of FDI in Canada by sector, 2002



Energy and metallic minerals are the next largest industrial group with \$79.7 billion in FDI in Canada, or 22.8 per cent of the total. Finance and insurance is the third largest recipient sector for FDI at \$67.2 billion (19.2 per cent of the total), followed by machinery and transportation equipment (\$49.1 billion, or 14.1 per cent of the total), services and retailing (\$29.1 billion, or 8.3 per cent of the total), and wood and paper (\$19.8 billion, or 4.2 per cent of the total).

Americans are the largest investors in all sectors, bar none — accounting for over 50 per cent of the FDI in Canada in all industrial groupings. Their presence is most pronounced in the machinery and transportation equipment sector where they are responsible for 80.3 per cent of the total stock of FDI, or \$39.4 billion. They are also heavily featured in the services and retailing sector and the wood and paper sector where they account for 78.0 per cent and 76.8 per cent of total sectoral FDI, respectively. However, despite their leading positions in these sectors, U.S. investors have been concentrating their investment activity in the energy and metallic minerals sector over the past couple of years. In 2001, the U.S. stock of FDI increased by \$22.4 billion in total across all sectors — \$15.2 billion, or about two-thirds of the increase, came in the energy and metallic minerals sector. Last year, the U.S. stock

of FDI in Canada increased by \$10.1 billion, led by a \$7.7 billion increase in the stock of the energy and metallic minerals sector, or slightly over three-quarters of the total increase.

EU investors were the second largest group of investors in Canada in 2002: this is true in aggregate and in each sector, except for the machinery and transportation equipment sector where the stock of FDI from a combined Japan-and-the-rest-of-the-world is slightly larger than that for the EU (\$4.9 billion vs. \$4.8 billion). Nearly half the stock of EU FDI in Canada is in the miscellaneous industries group, at \$44.9 billion. Finance and insurance is the next largest recipient of EU FDI at \$25.4 billion. Energy and metallic minerals, at \$13.2 billion, is the only other sector where the stock of EU FDI in Canada exceeds \$10 billion.

The energy and metallic minerals sector is also the only other sector where the stock of FDI in Canada from Japan-and-the-rest-of-the-world exceeds \$10 billion, at \$10.7 billion, or just over a third of total FDI from this aggregate region. Miscellaneous industries (\$6.3 billion), finance and insurance (\$5.0 billion), and machinery and transportation equipment (\$4.9 billion) were the three other major recipient sectors of FDI from this region.

VI. WRAP UP

Canada outperformed its major trading partners in 2002, marking the eleventh consecutive year of economic growth in the process. This performance was made all that more impressive given the challenging external environment characterized by the intertwining of weak business investment, financial market and exchange rate volatility, corporate governance issues, and enormous geopolitical uncertainties. Indeed, Canada has led the other major economies, particularly the United States in output growth since 1999, with our performance gap widening to around a full percentage point over the past two years.

Canada's performance in 2002 was buoyed by a competitive exchange rate, fiscal stimulus, and strong demand for consumer durables. The economy posted robust job gains at a time when many of our international competitors, including the United States,

were shedding jobs. The relatively strong expansion of Canadian economic activity relative to the other countries was reflected in Canada's international statistics, as exports of goods and services fell, imports increased, and investment opportunities, both inward and outward, declined, as set out in some detail in this Report.

Looking forward to 2003, mediocre growth prospects in the Eurozone, the U.K., and Japan will limit prospects for trade expansion to these areas. The recent (and further expected) tightening of the monetary stance by the Bank of Canada will likely support an appreciation of our currency, which will also likely dampen Canadian trade growth prospects over the coming year.

Lingering geopolitical anxiety and uncertainty about global economic prospects could also affect direct investment flows around the world, including those to and from Canada, in the months ahead.