Industry Canada Industrie Canada

Micro

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Micro-Economic Policy Analysis Branch Bulletin

A REPORT CARD ON CANADA'S TRADE AND INVESTMENT RECORD

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FEATURED RESEARCH

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The world is being transformed by a chain of events, the likes of which have never been experienced before. Trade and investment barriers are gradually being eliminated, and the labour advantages of one country or region can now be combined with the technological strengths of another. The outcome is the creation of many new economic opportunities that, for the first time ever, are truly global in conception, administration and delivery. Businesses are reorganizing operations to be complementary, giving rise to stronger investment linkages and increased intra-firm trade flows. And the pace of change is accelerating as advances in computing and telecommunications remove the constraints of distance and time. Canadian producers must compete in this highly competitive environment and Canada must remain an attractive place in which to invest.

This special edition of *MICRO* analyses the trade and investment developments in Canada over the past decade or so. It is a follow-up to last year's special issue on "*Measuring Canada's International Trade and Investment Performance*." This year's special issue reviews Canada's recent export, import and foreign investment performance. It also discusses the main factors underlying these trends. Lastly, it compares Canada's relative performance in these areas with that of other industrialized countries.

INDUSTRY CANADA RESEARCH AND PUBLICATIONS PROGRAM

RECENT RELEASES

WORKING PAPER SERIES

No. 24: *Canadian Government Policies Toward Inward Foreign Direct Investment*, Steven Globerman and Daniel Shapiro.

This paper evaluates the importance of formal and informal barriers to foreign investors in Canada, as well as analyses the net benefits to Canada of selectively restricting inward FDI. The authors also draw upon case studies and existing theoretical and empirical literature in economics and international business to draw their conclusions.

No. 25: *A Structuralist Assessment of Technology Policies - Taking Schumpeter Seriously on Policy*, Richard G. Lipsey and Kenneth Carlaw.

This study examines the conditions that favour the success or failure of technology policies and programs as opposed to trying to measure directly their impact on output.

No. 27: *Recent Jumps in Patenting Activities: Comparative Innovative Performance of Major Industrial Countries, Patterns and Explanations*, Mphammed Rafiquzzaman and Lori Whewell.

This monograph analyses the nature, pattern, and causes of the changes in patenting activities among the G7 countries, with an emphasis on Canada's performance.

FORTHCOMING

WORKING PAPER SERIES

No. 26: *Intrafirm Trade of Canadian-Based Foreign Transnational Companies*, Richard A. Cameron.

No. 28: *Technology and the Demand for Skills: An Industry-Level Analysis*, Surendra Gera, Wulong Gu, and Zhengxi Lin.

No. 29: *The Productivity Gap Between Canadian and U.S. Firms*, Frank C. Lee and Jianmin Tang.

ANNOUNCEMENTS

UPCOMING DISTINGUISHED SPEAKERS LECTURES

April 9, 1999: Quality Improvements and Productivity, Jack Triplett.

April 30, 1999: Computers and Work, Frank S. Levy.

May 21, 1999: An Economists' Manifesto on European Unemployment, Franco Modigliani.

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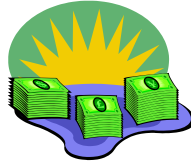


Over the 1990s, strong export growth has shifted the balance of trade to a surplus and made a sizable contribution to overall GDP expansion.

CANADA'S FOREIGN TRADE ENVIRONMENT IN 1998

Canada is a trading nation and trade is its lifeblood. We are one of the world's leading trading nations. We were the sixth-largest exporter of goods and services in the world, and the seventh-largest importer.

Our prosperity and well-being are linked to trade. Canada exports more than four of every ten dollars' worth of the goods it produces. Countless Canadian jobs depend on export trade, as well as imports.

Increased trade means a lot to Canadians. More exports mean more production and more jobs. It also enhances gains in productivity through longer production runs and scale economies, resulting in lower production costs. These factors in turn improve Canada's competitive position and raise our living standards.

To protect and expand its exports, Canada needs free and secure access to foreign markets. This is why Canada has vigorously promoted an open world trading system, and why we have negotiated international trade agreements at both the bilateral and multilateral levels.

As the trade winds blow, so too go Canada's fortunes. Exports have continued to benefit from the United States' cyclical lead, supported by efficiency gains from domestic deregulation, greater internal market integration and improved overall cost competitiveness. The financial crisis in Asia so far has had only limited impact on Canada's overall economic growth, although slower growth in Asia has substantially reduced shipments of Canadian goods and services to the region. Still, a protracted crisis could have significant indirect effects on our economy, and commodity prices have already fallen on a broad range of export products.

TRADE PATTERNS: THE OVERALL PICTURE

Canada's export performance has been strong throughout the 1990s. Over much of the decade, real exports surpassed imports into Canada. Between 1990 and 1997, real exports grew at an average annual rate of 8.7 percent, while real imports grew on average by 8.1 percent per year. With such growth in real net exports, the balance of trade shifted from a deficit at the beginning of the decade to a surplus, thus making a sizable contribution to overall GDP expansion.

Canadian Exports and Imports of Goods and Services
($ billions)

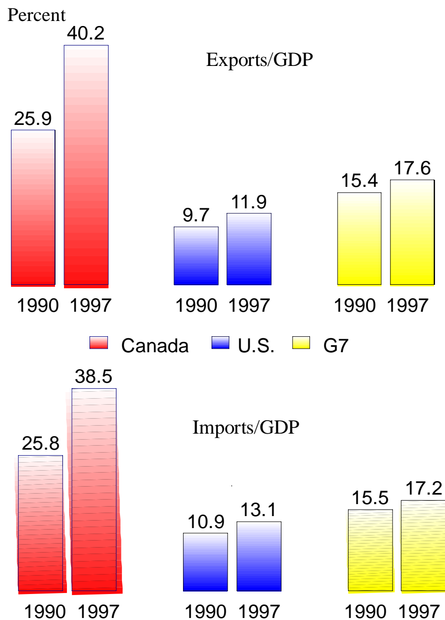
	1990	1996	1997
Goods			
Exports	152	280	301
Imports	141	238	277
Balance	11	42	24
Services			
Exports	22	40	42
Imports	33	49	50
Balance	-11	-9	-8
Goods & Services			
Balance	–	33	16

Canada's stands out among the G7 for its trade orientation in both imports and exports.

Since 1997, however, imports have been growing at a much faster than exports, causing a sharp drop in net exports. Domestic demand has surged strongly while the Asian crisis has weakened overseas markets, with the overall result that our trade surplus has narrowed. The growth in merchandise imports continued to outpace exports by a significant margin in 1998.

Canada's reliance on open markets is underscored by our country's dramatically increasing trade orientation. In the 1990s, real exports of goods and services have increased by more than 50 percent as a share of gross domestic product (GDP). Over the same period, import penetration (the ratio of real imports to GDP) also rose dramatically. This trend was pervasive in all manufacturing industries and across all provinces and regions.

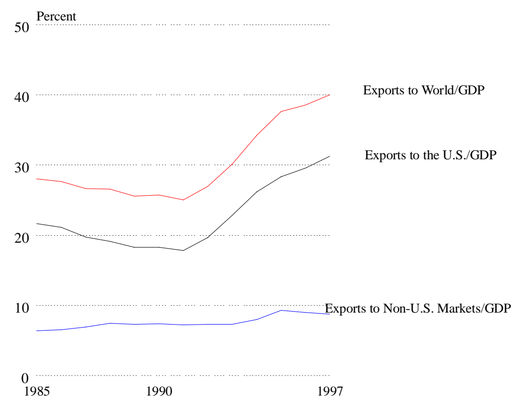
Share of exports and imports of goods and services in GDP, Canada, U.S. and the G7



Canada's trade orientation is significantly stronger than that of other G7 countries, and it is deepening. In 1997, some 40 percent of our goods and services were exported on the international market. This is well over three times the U.S. average, and about two and a half times that of the G7 countries; moreover, the gap has widened considerably during the 1990s. Canada now stands out among the G7 countries for its trade orientation in both imports and exports.

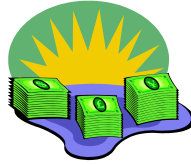
The marked increase in two-way trade is a sign of increased product specialization, thanks largely to the implementation of the Canada–U.S. Free Trade Agreement (FTA) and its successor, the North American Free Trade Agreement (NAFTA). Between 1990 and 1997, Canada's export orientation was increasingly centered on the United States, rising by some 13 percentage points to 31 percent, and accounting for 91 percent of the growth in our overall export orientation during the period. In contrast, Canada's export orientation toward non-U.S. markets edged up by only about 1 percentage point, to reach almost 9 percent in 1997.

Canada's exports to the world, the U.S. and other countries relative to GDP



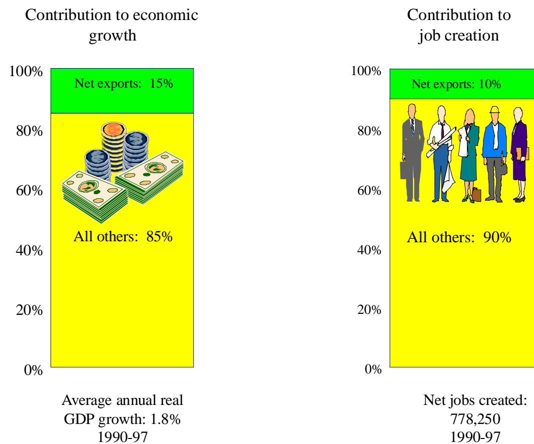
The increased trade activity and, more specifically, the growth in net exports have fuelled economic prosperity and job creation in Canada. Rising net exports directly accounted for 15 percent of economic growth

The faster pace of expansion of Canadian exports over imports has contributed close to 80,000 net new jobs.



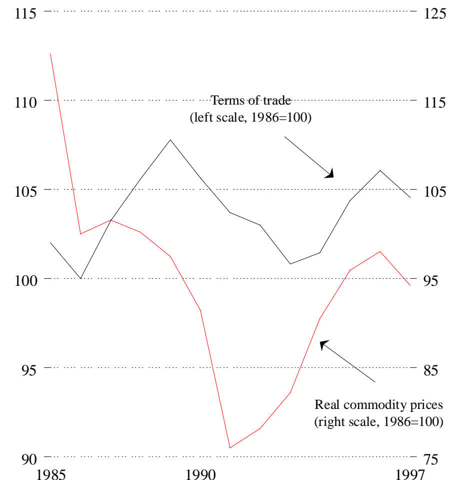
and 10 percent of net job creation in Canada between 1990 and 1997 — a net contribution of close to 80 000 new jobs. Furthermore, our expanding trade contributed indirectly to higher real incomes and job creation via product specialization and productivity improvements. This is in sharp contrast with the significant negative impact of trade in the second half of the 1980s. But the situation has reversed once more, and in 1997 and 1998 net exports again became a drag on economic growth and job creation.

Contribution of net exports to economic growth and job creation: 1990-97



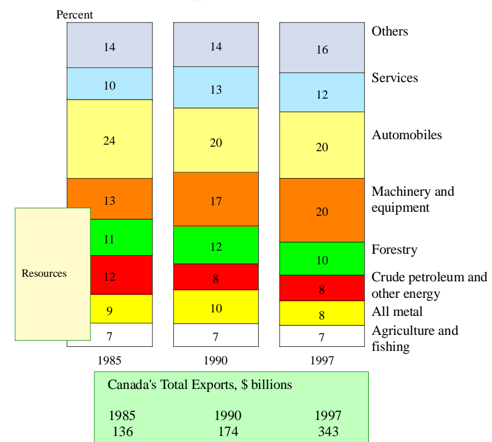
The faster pace of expansion of Canadian exports over imports was accompanied by a number of key developments on the trade front. First, there was a concomitant improvement in the relationship between the prices received by Canadian exporters and those paid by Canadian importers. Our terms of trade improved by about 3 percent between 1993 and 1997, largely as a result of a rise in real commodity prices. However, a declining demand for resources worldwide, especially in Asia, has triggered a sharp fall in commodity prices, particularly since the second half of 1997.

Trends in Canada's terms of trade and real commodity prices

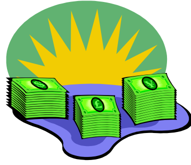


Second, exports of high value–added products, such as machinery and equipment (M&E), have been gaining in importance during the 1990s. Since the beginning of the decade, exports of M&E products have added three percentage points in the distribution of Canadian exports, rising from 17 to 20 percent. This advance has come about at the expense of resource exports. The shift largely reflects the fact that Canadian exports are increasingly concentrated in the U.S.. market, where we ship relatively more high value–added products. But in reality, this trend goes back to the mid-1980s.

Distribution of Canada's exports by industry

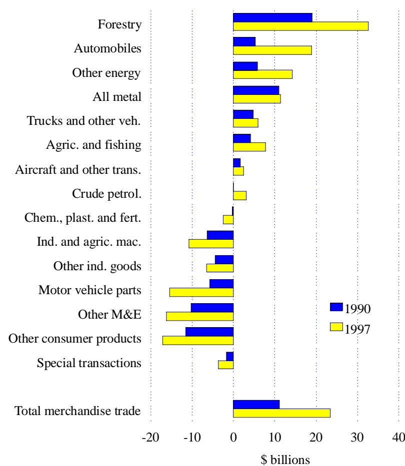


Were it not for the significant depreciation of the Canadian dollar, unit labour costs would have grown faster in Canada than in the U.S., and eliminated this country's cost advantage.



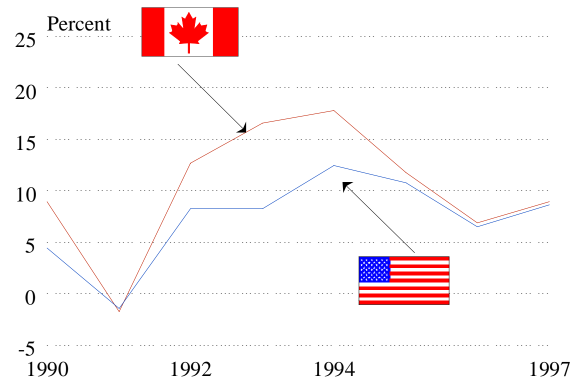
A third development is that our exports have moved up the high value–added chain. Over the 1990s, Canada's export structure has shifted toward high value–added items. Capital goods and finished products now make up the bulk of Canada's merchandise exports, accounting for more than half of total exports in 1997, up from about 45 percent in 1990. Despite the declining importance of low value–added exports, however, raw materials and semi-finished goods continue to post increasing positive trade balances. The trade in finished products ran a modest surplus in 1997, up from a modest deficit in 1990, while the trade deficit in capital goods widened over the decade. This more or less implies a consolidation of the industrial structure of merchandise trade balances: sectors traditionally enjoying trade surpluses have run increasingly large surpluses, while the reverse is true for sectors generally showing trade deficits.

Trade balance by industry



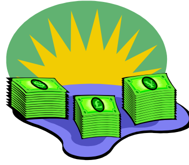
Fourth, the recent export boom has been driven by strong U.S. demand for imports. Three major factors appear to have contributed to Canada's export performance over the 1990s: strong growth in U.S. domestic demand, improved cost competitiveness and the implementation of the two free trade agreements (FTA/NAFTA). Over the 1990s, U.S. merchandise imports grew at an average annual rate of 8 percent, while Canadian merchandise exports to that country expanded at an average pace of 10 percent per year.

Growth rates of U.S. merchandise imports and Canadian merchandise exports to the U.S.



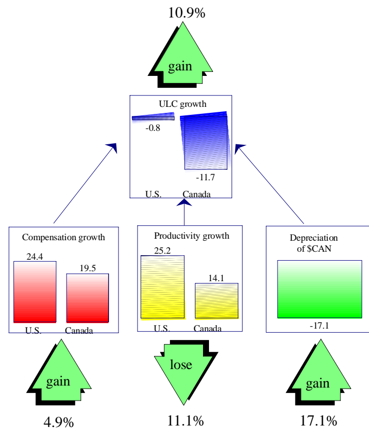
Finally, Canada's competitive cost position improved, especially vis-à-vis the United States. The chart below shows that the depreciation of the Canadian dollar was entirely responsible for Canada's improved cost position. The lower rate of growth in Canada's hourly labour compensation in manufacturing was more than offset by its poor productivity performance. Were it not for the significant depreciation that occurred in the value of the Canadian dollar, unit labour costs would have risen faster in Canada than in the United States and eliminated this country's cost advantage. Canada's export expansion and improved trade performance will not be sustainable in the longer run without substantial improvements in our relative productivity performance.

Overall, these developments have combined to improve the current account balance over the 1990s,



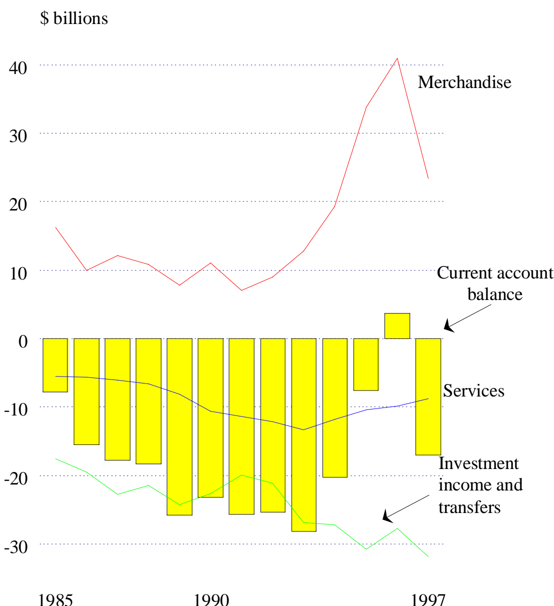
Since the inception of the FTA, Canada's dependence on the United States as a source of imports and destination for exports has risen markedly.

Cumulative Change in the Components of Unit Labour Costs (ULC) in Manufacturing: Canada and the U.S., 1990-97 (Percent)



a trend that has continued until quite recently. Between 1993 and 1996, the merchandise trade surplus rose sharply, from a bit over $10 billion to more than $40 billion. As a result, the current account balance has improved, from a record deficit of $28.2 billion to a surplus of $3.8 billion over the same period. In 1997, however, the current account posted a deficit of about $17 billion, precipitated by a massive drop

Current account balance by category



in the merchandise trade balance. Primarily responsible for this fall were stronger domestic spending and investment, along with slower U.S. economic growth.

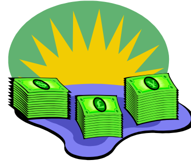
A SPECIAL LOOK AT CANADA–U.S. TRADE

A key feature in Canada's overall trade picture is the bilateral flow of exports and imports with it's southern neighbour. In the mid- to late 1980s, Canada and the United States negotiated and signed a free trade agreement. This agreement, the Canada-U.S. Free Trade Agreement, or FTA — along with its successor, the North American Free Trade Agreement, or NAFTA — has set in motion a dynamic process that resulted in even closer trading relationships between the two partners than the strong links that were already in place in the earlier part of the 1980s.

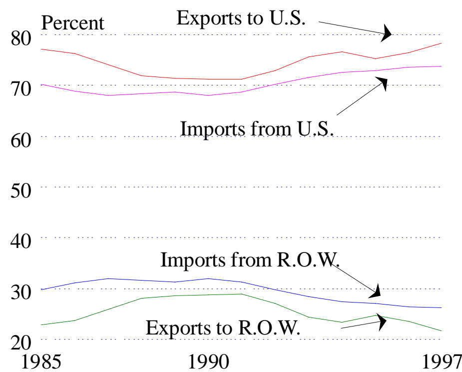
Since the inception of the FTA, Canada's dependence on the U.S. market for its export business has risen markedly, as has our dependence on imports from the United States. Between 1990 and 1997, the proportion of Canada's exports of goods and services bound for the United States increased by seven percentage points, to reach just under 80 percent. Similarly, the U.S. share of Canada's total imports of goods and services rose — from 68 percent in 1990 to 74 percent in 1997. The increased two-way trade between the two countries reflects increased product specialization and rising integration of production by multinational enterprises, facilitated by the FTA/NAFTA. These trends bode well for Canada's future competitive position.

The benefits of these strong linkages are already showing up in Canada's relative performance vis-à-vis its major competitors in the U.S. market. The United States represents the largest consumer market in the world and, accordingly, should be seen as a priority

Canada's share of G7 exports to U.S. markets has increased steadily over the 1990s, thanks largely to the depreciation of our dollar and to the FTA.



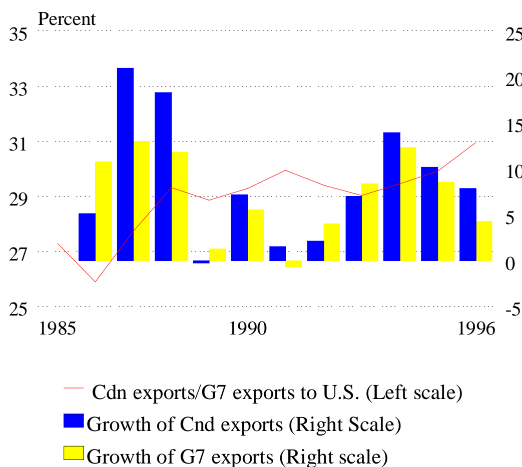
Geographic distribution of Canada's exports and imports



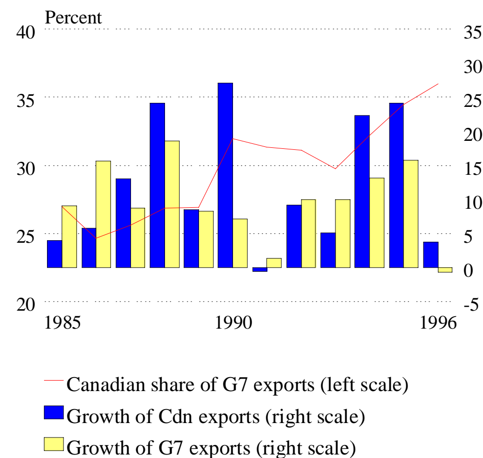
target for our exports. Among the many factors facilitating Canadian exports to the United States are the FTA and the NAFTA, and the depreciation of the Canadian dollar against the U.S. dollar and against the currencies of other G7 countries. In fact, Canada's share of G7 exports to the all-important U.S. market rose steadily from about 33 percent in 1987 to some 41 percent in 1995.

While Canadian gains in U.S. markets have been widespread, efforts have focussed on certain sectors. First are the high-growth sectors. Areas showing strong demand growth offer Canadian exporters an opportunity to gain a foothold in U.S. markets, to establish their reputation as high-quality suppliers at fair prices and, of course, to grow and expand. High-growth sectors include high-tech products, such as electrical machinery, office machines and data processing equipment, telecommunications and sound recording apparatus, professional and scientific equipment, and medicinal and pharmaceutical products; medium-tech products, such as general industrial machinery, organic chemicals, resins, plastics and cellulose esters, other chemical products, and rubber products; and low-tech products, including pulp and papers, sugars, leathers, and wood products. Worldwide, imports of high-growth sector products expanded at an average rate of about 12 per cent per year in the 1990–95 period, almost 50 percent faster than total world imports. In 1995, Canada accounted for over one third of G7 exports to the United States in high-growth sectors, up from 25 per cent in 1986.

Canada's share of G7 merchandise exports to the U.S.



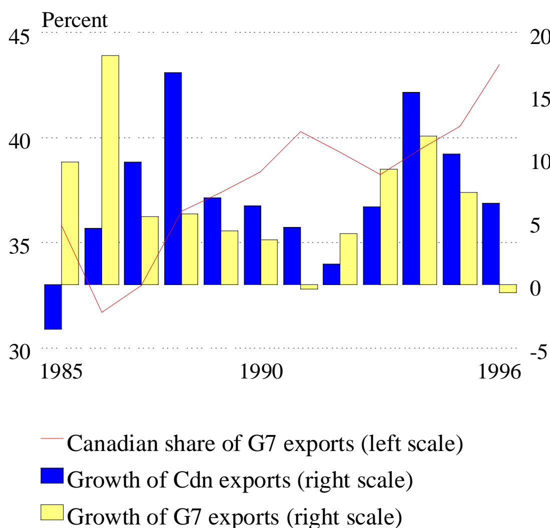
Canadian share of G7 exports in high-growth sectors in the U.S. market: 1985-1996



Canadian exporters are making real gains in key markets and priority sectors.

Exports are also especially encouraged in other key sectors. For lack of a better definition, we will refer to these as "priority" sectors. Priority sectors are fast growing trade sectors. They account for an increasing share of world imports, rising from 36 per cent of total world imports in 1985 to nearly 41 per cent in 1995. Priority sectors include wood products, pulp and papers, office machines, and telecommunications and sound recording apparatus, mentioned earlier. Other priority sectors include road vehicles, aerospace and defence products, furniture, electricity and power-generating machinery and equipment, and a bevy of agricultural and agri-food products.

Canadian share of G7 exports in priority sectors in the U.S. market: 1985-1996



Between 1990 and 1995, Canada's share of G7 exports of priority sectors to the United States surged five percentage points to 44 per cent, largely as a result of strong growth in auto exports. Moreover, since 1988, Canadian exports of priority sectors to the United States have consistently outpaced exports of these sectors from other G7 countries.

In summary, over the 1990s, Canada's export orientation increasingly focussed on the United States. Canada's merchandise imports from the United States grew at an average annual rate of 8 percent, while our merchandise exports to the United States expanded at an average rate of 10 percent per year. This strong export performance has been achieved largely by concentrating on high-growth and priority sectors. Three other major factors appear to have contributed to the phenomenon: strong growth in U.S. domestic demand, improved cost competitiveness and the two free trade agreements (FTA / NAFTA).

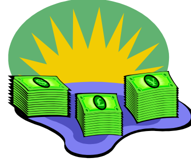
THE FOREIGN INVESTMENT ENVIRONMENT IN 1998

Our ties to world markets neither begin nor end with trade. Canada has international assistance programs as well as special programs to promote development around the world. And then there are the ties that bind us through foreign investment.

Canada is both a source and a recipient of foreign investment. Ours is a high-income country, and so it should come as no surprise that Canadians are major global investors seeking out opportunities throughout the world. On the other hand, Canada has a well-educated and productive work force, a strategic location, and state-of-the-art telecommunications and transportation infrastructures. These make it an attractive place in which to invest and create high-quality jobs.

Canada depends on foreign direct investment (FDI) to finance a significant proportion of its economic development. Estimates are that one job in ten and about 50 percent of total exports derive from inward FDI. Moreover, over a five-year period, a $1-billion increase in new inward FDI generates about 45,000 jobs and $4.5 billion in output (GDP). And FDI

The FTA and NAFTA have spurred cross-border investment between Canada and the United States.

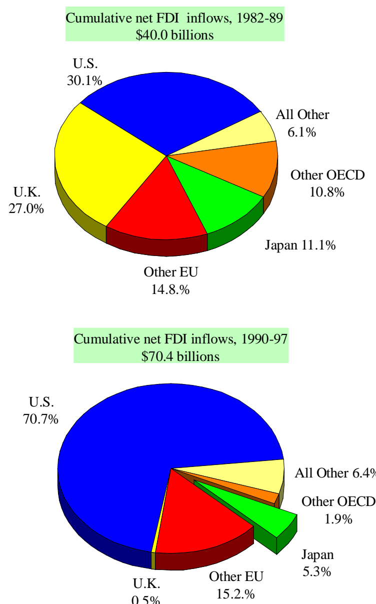


inflows have offered a sure way of improving Canada's competitive position. But in spite of all this, Canadian firms have been actively pursuing business opportunities abroad as well as at home. And for the first time in history, Canada has become a net exporter of capital.

INWARD FOREIGN DIRECT INVESTMENT

The 1990s have been marked by a significant resurgence of inward FDI flows to Canada. Over the 1991–97 period, average FDI inflows were up almost a third from their level between 1984 and 1990. Over the past 10 years, the stock of inward FDI more than doubled, reaching $188 billion in 1997. Along with this renewed foreign investment activity, the importance of inward FDI stock in the Canadian economy has increased considerably. The ratio of inward FDI stock to GDP reached 21.9 percent in 1997, up from 19.3 percent in 1990 and 18.6 percent in 1985.

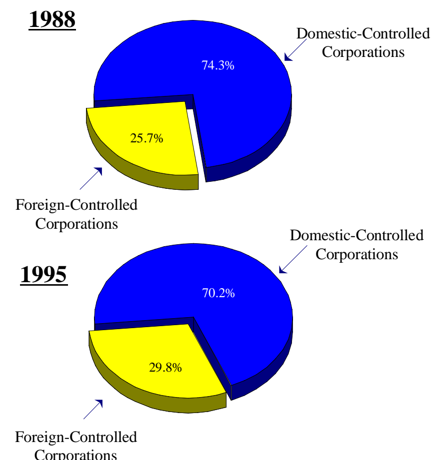
Distribution of net FDI inflows to Canada, by source countries/regions

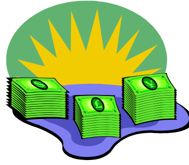


The Free Trade Agreement of 1989 and the NAFTA have spurred cross-border investment between Canada and the United States. Inward FDI flows from the United States have climbed dramatically in the 1990s. Over the decade, our southern neighbours provided approximately three quarters of the cumulative FDI inflows, compared to only a third of FDI inflows during the 1980s. On the other hand, the British virtually withdrew from investing in Canada from one period to the other, as did the other OECD countries, while Japanese investment fell by half. Much of this activity occurred in the form of mergers and acquisitions.

The importance of these FDI inflows should not be underestimated. Over the 1990s, FDI flows have been a significant component of business investment in Canada. They are estimated to have accounted for over 11 percent of business capital formation over the decade. The share of corporate revenues earned by foreign-controlled firms in Canada rose from about 25 percent at the start of the decade to around 30 percent in 1995. Contributing to this rise were relatively stronger revenue expansion in the foreign sector as well as foreign takeovers, plus privatization of gov-

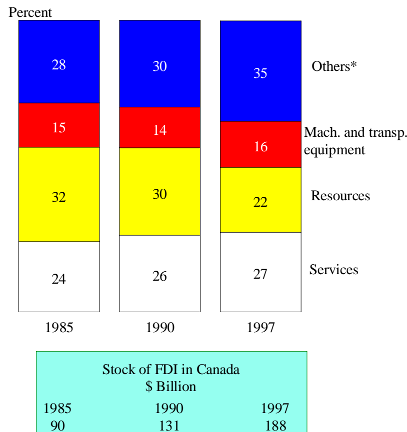
Share of Foreign-Controlled Corporate Operating Revenues in Canada





Canada's comparative stature as a host economy has declined among the G7 economies.

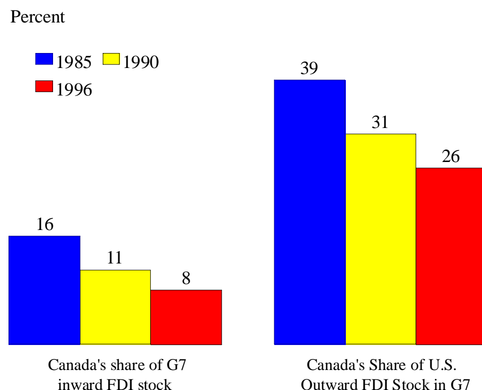
Industry distribution of inward FDI stock



* Includes food, beverages and tobacco; chemicals, chemical products and textiles; electrical and electronic products; construction and related activities; and communications.

ernment business enterprises. Moreover, foreign-controlled firms are concentrated mainly in high knowledge– and high technology–intensive industries. Over the mid-1980s and into the 1990s, the importance of resource-based industries in Canada's inward FDI stock diminished by 10 percentage points, to the benefit of services and other manufacturing industries. The increasing importance of FDI inflows to the service sector in Canada is consistent with global direct investment trends.

Canada's share of G7 inward FDI stock and U.S. outward FDI stock in G7 countries



However, despite the increased importance of inward FDI stock in the Canadian economy, Canada's comparative stature as a host economy has declined among the G7 countries: its share of G7 inward FDI stock shrank by nearly half between 1985 and 1996. Moreover, over the same period, Canada's share of U.S. outward FDI stock in the G7 shrank by 13 percentage points — from 39 to 26 percent. The decline, however, should not be interpreted as a failure of Canadian policies to promote Canada as an investment destination. Rather, it merely reflects the fact that FDI in other G7 countries is increasing at a faster pace than in Canada.

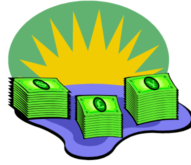
OUTWARD FOREIGN DIRECT INVESTMENT

Much like inward FDI, net outward FDI flows from Canada have been buoyant over the 1990s. They averaged $11 billion per year between 1991 and 1997, compared to $6.3 billion over the 1984–90 period; in 1997, they reached a record $18 billion. In fact, the outward FDI stock surpassed the inward FDI stock in 1996, making Canada a net exporter of FDI for the first time in the country's history. The ratio of Canada's outward to inward FDI stock rose from 75 percent in 1990 to slightly over 103 percent in 1997. The share of outward FDI stock in Canada's GDP was also up dramatically, reaching 22.6 percent in 1997 from 14.5 percent in 1990 and 12.4 percent in 1985.

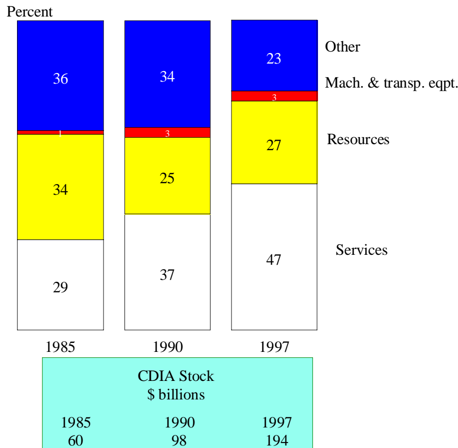
In addition, Canadian-based firms are active players in the globalization of business. And they have been busy in the recent global merger and acquisition boom: acquisitions of foreign companies by Canadian-based corporations set a new record of $6.4 billion in 1997.

Like inward FDI, the share of service industries in Canada's outward FDI stock has been on the rise

Canadian investors are actively pursuing opportunities in developing economies, especially Latin America and the Asia-Pacific region.



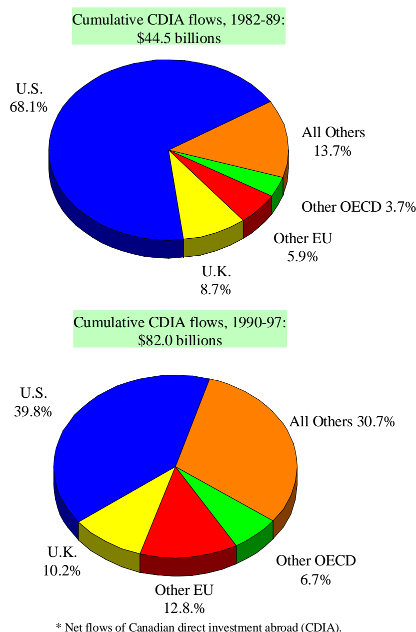
Industry distribution of CDIA stock



* Includes food, beverages and tobacco; chemicals, chemical products and textiles; electrical and electronic products; construction and related activities; and communications.

since the mid-1980s. The importance of services jumped some 18 percentage points between 1985 and 1997, largely at the expense of resource-based and other industries.

Distribution of net outward FDI flows* from Canada, by destination dountries/regions



* Net flows of Canadian direct investment abroad (CDIA).

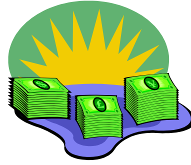
In contrast to the trend observed in inward FDI, Canadian investors are not investing primarily in our FTA partner's market. While the United States is still the dominant venue for Canadian direct investment abroad (CDIA), its importance has dwindled steadily over the past two decades. It was the destination for only two fifths of Canada's outward FDI flows in the 1990s, down from slightly over two thirds in the 1980s. Non-OECD countries, comprising much of the developing world (especially in Latin America and the Asia–Pacific region), more than doubled their share of Canada's outward FDI stock, from 14 to 31 percent.

CONCLUSIONS

The foregoing analysis points to the increased importance of trade policy and trade development in Canada's national economic management. With developments such as the implementation of the FTA and the NAFTA, and the conclusion of the Uruguay Round, Canada has become increasingly trade-oriented during the 1990s. The evidence points to a strong export performance, largely driven by trade and other commercial links with the United States. A related but independent phenomenon is the improved cost competitiveness vis-à-vis the United States, achieved solely through the depreciation of the Canadian dollar against the U.S. currency.

Challenges await on many fronts. Perhaps the most obvious is the need to review our trade focus in order to protect the gains made and to expand in areas where we have the most to benefit. Given the problems that currently plague Asia and Latin America, achieving this is likely to require and increased reliance on the United States as a trading partner.

While challenges await on many fronts, trade policy and trade development will become increasingly important in Canada's national economic management.



Strong imports went hand in hand with strong export performance over the 1990s. This poses another challenge: if strong import growth continues, how can we sustain sufficient export expansion to maintain our balance of payments in good standing? Moreover, how can we increase the number of Canadian exporters and involve more small and medium-sized enterprises in the exporting business?

Cost competitiveness cannot be sustained indefinitely by relying on the depreciation of the national currency. We will have to increase productivity growth both in absolute terms and relative to the United States in order to improve our standard of living.

Next, the evidence points to an ongoing need to diversify our exports across destinations and across industries. There is a strong international demand in the high-technology, high knowledge–based sectors. In terms of human capital and infrastructure, Canada is well placed to tap into this demand. What is needed is to have a few doors opened for our exporters.

Finally, Canada's relative importance as a host country for foreign direct investment has declined among the G7 countries as well as in the North American context. We will need to clearly reverse our position as a relatively less attractive location for FDI, especially in comparison with the United States.

NOTES