Fifth Annual Report on Canada's State of Trade

Trade Update

MARCH 2004

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Updates to the data appearing in the Statistical Annex of this publication are available at www.dfait-maeci.gc.ca/eet/trade/state-of-trade-en.asp

About This Document

This fifth Annual Report on Canada's State of Trade has been prepared by the Trade and Economic Analysis Division (EET) of the Department of Foreign Affairs and International Trade under the general supervision of John M. Curtis, Senior Economic Advisor and Coordinator. This year's report was prepared under the direction of Rick Cameron, Deputy Director and Senior Research Coordinator. The report was written by Rick Cameron, with statistical assistance from Suzanne Desjardins, Björn Johansson, and Mira Patel. Special features were prepared by Rick Cameron, Shenjie Chen and Aaron Sydor of EET, and by Bruna Santarossa of the International Trade Division of Statistics Canada.

This report reflects data up to March 15, 2004.

Your comments concerning this year's report are welcome. Please direct them to Rick Cameron at:
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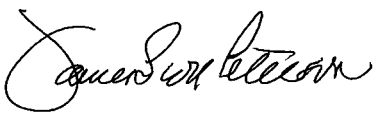
A Message from the Honourable James S. Peterson, Minister of International Trade

This annual report on Canada's State of Trade reflects the impact in 2003 of a series of extraordinary challenges for the Canadian economy. The year just past will be remembered for the severe acute respiratory syndrome epidemic, the bovine spongiform encephalopathy case, the power blackout that affected Ontario and much of the northeastern United States, forest fires and an uncertain international economy.

Yet even with all of these circumstances combined, exports of electricity and natural gas continued their dramatic increase. Commercial services such as engineering, environmental and management services continued to increase as a proportion of our overall trade in services; international prices for commodities rose and our current account—the broadest measure of Canada's economic relationship with the world—remained both positive and increased over the course of the year.

I am optimistic about the year to come. The underlying strength of the Canadian economy means we are well-positioned to benefit as the global economy regains strength. The 2004 KPMG Competitive Alternatives international business cost study has reaffirmed that Canada is the lowest-cost G7 country in which to do business, even in the context of a rising dollar. The newly created Department of International Trade, will take a highly focussed, innovative, and aggressive approach to promoting Canadian trade and investment and international business development.

Enhanced trade and investment are intrinsic to our government's strategy to build a 21st century economy in Canada. I look forward to working closely with all Canadian trade and investment stakeholders as we seek out creative ways to maximize Canadian prosperity and opportunity in a rapidly changing global market place.



Trade and Economic Highlights, 2003

- **Exports of goods and services** fell for the third straight year, down $14.8 billion, or 3.1 per cent, to $457.8 billion.
  - Losses in goods exports were widespread as six of the seven major commodity groupings registered declines, most notably in automotive products, machinery and equipment, and industrial goods and materials. Only energy products posted a gain.
  - Services exports decreased by $2.0 billion, to $56.3 billion last year.
- **Imports of goods and services** also fell in 2003, posting a $14.0 billion or 3.3 per cent decline to $409.1 billion. Merchandise imports fell $15.1 billion while services imports rose by $1.2 billion. All major commodity groups imports were down from the previous year, with the exception of energy products.
- Canada's **current account balance** expanded $2.4 billion to $25.8 billion as improvements to the deficit on investment income ($4.0 billion) were only partially offset by falling balances to trade and current transfers (down $0.8 billion, each).
- Canadian **gross domestic product** at current prices expanded to just over $1.2 trillion in 2003, or $38,401 on a *per capita* basis.
- Growth in **real GDP**, or gross domestic product adjusted for inflation, decelerated to 1.7 per cent last year, almost half the 3.3 per cent rate recorded in 2002.
- **Employment** in 2003 grew by 334,200 jobs, just a notch below the 335 thousand jobs created in 2002. Continuing job creation helped bring down the unemployment rate to 7.6 per cent last year, from 7.7 per cent a year earlier.
- **Inflation**, as measured by the annual change in consumer prices, registered a 2.8 per cent increase last year, compared to 2.2 per cent in 2002. Core inflation, which excludes food and energy, rose by 2.2 per cent last year, from 2.3 per cent the year before.

Total trade

The year 2003 was a difficult one for Canada as a series of international events, many beyond our control, spilled over into Canada and negatively affected Canadian economic activity and our trade performance for 2003. As a result, real growth in the economy was nearly halved to 1.7 per cent last year. It was, nonetheless, the twelfth year of uninterrupted growth. This subdued performance was also reflected in Canada's international trade statistics where, for example, total trade fell almost $28.8 billion last year.

- Canada's exports of goods and services fell 3.1 per cent to $457.8 billion in 2003 as the pace by which these exports slowed accelerated from the two previous years. With exports of goods and services falling while the economy continued to expand, the share of exports of goods and services in Canada's GDP thus declined, falling 3.2 percentage points from 40.9 per cent in 2002 to 37.7 per cent last year.

- Imports of goods and services into Canada were also lower in 2003 than they were in 2002, posting a 3.3 per cent decline. Accordingly, the share of imports of goods and services in Canadian GDP also fell last year, down almost 3 full percentage points, from 36.6 per cent to 33.7 per cent.

- Canada's current account balance nevertheless expanded by $2.4 billion last year, from $23.4 billion to $25.8 billion. Although the goods and services trade surplus shrank by $0.8 billion as did the current transfers surplus, a $4.0 billion narrowing of the investment income deficit was more than enough to offset the declines.

Trade by regions

- A disproportionate share of the decline in Canada's total trade in 2003 came because of declines in Canada-U.S. trade. Exports of goods and services fell $17.3 billion (or 4.5 per cent) to $364.8 billion while imports were off by $15.9 billion, or 5.4 per cent. The U.S. was the destination of 79.7 per cent of total Canadian exports, compared with 80.8 per cent a year earlier. Likewise, the U.S. was the source of 68.4 per cent of total Canadian imports, down from 69.9 per cent the year before.

    - Goods exports to the United States fell 4.5 per cent (down $15.6 billion) to $331.4 billion while exports of services declined $1.8 billion (or 5.0 per cent) to $33.4 billion.

    - Goods imports from the U.S. fell 6.2 per cent (or $15.7 billion) while services imports declined 0.4 per cent (or $0.1 billion).

- Exports of goods and services to the EU advanced 5.1 per cent to $33.6 billion last year as goods exports were up $1.4 billion (6.2 per cent) and services exports advanced $0.2 billion (2.4 per cent). At the same time, imports of goods and services from the EU were down by $0.8 billion (or 1.7 per cent) as a $1.3 billion (or 3.5 per cent) decline in merchandise imports more than offset a $0.5 billion (or 4.6 per cent) advance in services imports.

- Total exports to Japan fell 6.2 per cent (almost $750 million) to $11.3 billion in 2003. At the same time, imports of goods and services from Japan plunged 10.1 per cent (or $1.4 billion) to $12.6 billion.

    - Exports of goods fell 3.8 per cent (or $0.4 billion) while exports of services plummeted 20.2 per cent (or $0.4 billion).

    - Imports of goods from Japan were down 9.1 per cent (or $1.1 billion), while imports of services declined by 15.0 per cent (or $0.3 billion).

Trade by commodities

<u>Exports</u>

- Exports of automotive products fell the most in 2003, down $9.1 billion, or 9.4 per cent, to $87.9 billion. Car exports were down $6.3 billion, truck exports were off by $1.7 billion, and parts exports suffered a $1.2 billion decline. Automotive products accounted for 21.9 per cent of total merchandise exports last year, down from 23.4 per cent a year earlier.

- Machinery and equipment suffered the second largest export decline last year, at $8.1 billion, or a decline of 8.3 per cent. At $89.2 billion, they accounted for 22.2 per cent of merchandise exports, down from 23.5 per cent in 2002.

- Industrial goods and materials experienced a $3.6 billion decline in exports in 2003, as their share in total merchandise exports slipped from 17.0 per cent in 2002 to 16.6 per cent last year. Canada exported $66.6 billion worth of these products in 2003.

- Energy products rose in importance as a share of Canadian exports, from 12.0 per cent of total exports in 2002 to 15.3 per cent last year. Exports of these products rose dramatically by $11.7 billion over the year, or 23.7 per cent, to $61.3 billion.

Imports

- Widespread losses in imports were also observed in 2003, most notably for machinery and equipment, where imports fell $7.7 billion, or 7.2 per cent. Machinery and equipment accounted for 28.8 per cent of merchandise imports, down from 29.7 per cent one year earlier.

- Imports of automotive products also fell substantially last year, down $5.1 billion to $76.4 billion, a 6.3 per cent decline. At this level, the share of these products in total imports edged down from 22.8 per cent to 22.4 per cent from 2002 to 2003.

- Industrial goods and materials imports posted a $3.8 billion decline from 2002, a 5.5 per cent decrease, to $65.1 billion. The share in total imports of this sector slipped from 19.3 per cent two year's ago to 19.1 per cent last year.

- Imports of energy products advanced 18.3 per cent, or slightly over $3.0 billion, to $19.6 billion last year.

Foreign direct investment

- FDI inflows into Canada fell dramatically (to $8.3 billion) in 2003, down nearly three-quarters from their levels only one year earlier. It was the third straight year of decline.

    - Inflows to Canada from all major trading partner areas were down in 2003.

- FDI outflows from Canada fell by a third to just over $30.0 billion this past year.

    - Outflows were down to most major trading partners, except for the E.U.

- As has been the case for the past few years, the outflow of Canadian direct investment abroad exceeded the inflow of foreign direct investment in Canada in 2003.

Trends

- Over most of the 1990s, both exports and imports of goods and services grew faster than GDP. As a consequence of these developments, their respective ratios relative to GDP climbed steadily to reach 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, trade levels have fallen off somewhat while overall Canadian economic activity has continued to expand, 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 are now at 37.7 per cent while the corresponding share for imports is 33.7 per cent.

- Exports of goods and services to the U.S. increased more rapidly than total Canadian exports over the 1990s (11.9 per cent *vs.* 10.3 per cent) while the importance of the United States in Canadian exports increased to 80.8 per cent. Since the year 2000, exports of goods and services to the U.S. have fallen faster than overall exports (-2.5 per cent *vs.* -2.2 per cent) and the U.S share in Canada's overall exports has started to shrink — to 79.7 per cent in 2003.

- Imports of goods and services from the U.S. also increased more quickly than total imports of goods and services over the past decade. In 2000, they represented 72.1 per cent of total imports. Since then, imports of goods and services from the U.S. have also fallen faster than total imports (-3.1 per cent compared to -1.4 per cent) while the share of imports from the U.S. in total imports has fallen to 68.4 per cent, a decline of 3.7 percentage points.

- With exports growing faster than imports over the 1990s, Canada's trade balance moved from deficits in the early 1990s to surpluses by the late 1990s. With total exports falling faster than total imports since the year 2000, the overall trade surplus, while still strongly positive, has begun to narrow.

- Similarly, with exports to the U.S. growing more quickly than imports from that country, the bilateral trade surplus expanded from $1.1 billion in 1991 to $86.9 billion in 2000. However, since then, with exports falling faster than imports from that country, the bilateral surplus has begun to diminish. Canada's bilateral trade surplus with the U.S. stood at $84.9 billion last year.

Canada's Trade and Investment over 2001-2003, in millions of dollars

	2001	2002	2003	2001	2002	2003	2001	2002	2003
	Exports of Goods and Services			*Imports of Goods and Services*			*Goods and Services Balance*		
World	480,404	472,628	457,848	417,908	423,112	409,123	62,496	49,516	48,725
U.S.	387,108	382,101	364,753	296,400	295,734	279,866	90,708	86,367	84,887
EU-15	33,886	31,983	33,621	45,847	46,754	45,966	-11,961	-14,772	-12,345
Japan	11,929	12,082	11,334	12,692	13,990	12,579	-763	-1,908	-1,244
ROW	47,481	46,462	48,140	62,969	66,634	70,712	-15,488	-20,171	-22,573
	Exports of Goods			*Imports of Goods*			*Goods Balance*		
World	421,519	414,305	401,527	350,632	356,459	341,317	70,887	57,846	60,210
U.S.	352,082	346,991	331,403	254,953	254,929	239,204	97,129	92,062	92,199
EU-15	23,872	22,735	24,150	35,166	36,175	34,898	-11,294	-13,440	-10,748
Japan	10,228	10,292	9,906	10,572	11,732	10,659	-344	-1,441	-753
ROW	35,337	34,287	36,068	49,941	53,623	56,556	-14,604	-19,335	-20,488
	Exports of Services			*Imports of Services*			*Services Balance*		
World	58,885	58,323	56,321	67,276	66,653	67,806	-8,391	-8,330	-11,485
U.S.	35,027	35,110	33,351	41,448	40,805	40,662	-6,421	-5,695	-7,312
EU-15	10,014	9,246	9,471	10,681	10,578	11,068	-667	-1,332	-1,596
Japan	1,701	1,790	1,428	2,120	2,257	1,919	-419	-467	-491
ROW	12,143	12,177	12,071	13,027	13,013	14,157	-884	-836	-2,086
	Canadian Direct Investment Abroad			*Foreign Direct Investment in Canada*			*Balance of Outward less Inward*		
Flows:									
World	56,737	45,217	30,035	44,608	32,342	8,253	12,129	12,875	21,782
U.S.	29,044	13,967	6,379	40,816	24,710	4,370	-11,772	-10,743	2,009
EU-15	7,814	14,673	15,096	1,332	4,030	2,042	6,482	10,643	13,054
Japan	1,670	1,538	335	379	998	821	1,291	540	-486
ROW	18,209	15,039	8,225	2,081	2,604	1,020	16,128	12,435	7,205
Stocks:									
World	389,660	431,819	*n.a.*	333,635	349,388	*n.a.*	56,025	82,431	*n.a.*
U.S.	188,791	201,792	*n.a.*	214,227	224,330	*n.a.*	-25,436	-22,538	*n.a.*
EU-15	81,349	99,853	*n.a.*	91,158	93,973	*n.a.*	-9,809	5,880	*n.a.*
Japan	7,033	9,203	*n.a.*	7,909	8,600	*n.a.*	-876	603	*n.a.*
ROW	112,487	120,971	*n.a.*	20,341	22,485	*n.a.*	92,146	98,486	*n.a.*

*ROW: Rest of the World

I. Merchandise trade

Overview

Since the downturn in the global economy in early 2000, recovery world-wide has been patchy, uneven, and, until very recently, has failed to gather significant momentum. Fiscal and monetary policy world-wide has become increasingly accommodative, but this has been counterbalanced by persistent "headwinds" to recovery; these include the macroeconomic imbalances that built up during the boom-period of the late 1990s in the U.S., the sharp decline in world equity prices from early 2000, structural problems in the euro area, the continued fallout from a general asset price collapse in Japan, weakness in several emerging market economies, and more recently, the persistence of heightened geopolitical tensions. While Canada has fared relatively well over this period, its heightened exposure to international markets made it particularly vulnerable to a series of shocks that affected output destined for foreign markets and, consequently, dampened economic activity over 2003.

The strong global economic growth experienced over the late 1990s relied heavily on strong and continued domestic demand in the U.S., which was reflected in a sizeable and growing U.S. current account deficit, bolstered by large-scale capital inflows which generated significant US dollar appreciation. Such was the reliance on the U.S. as a driver, or locomotive, of global growth in recent years that the rest of the international economy has not been able to grow at or above trend growth (See Box A for a discussion on Canada-US business cycle synchronization).

However, the strong U.S. domestic demand growth over the late 1990s involved "excessive exuberance" regarding economic prospects, leading firms to over-invest and consumers to over-spend. This, in turn, was reflected in and further driven by over-valuation of equity prices. On top of these economic imbalances, rising geopolitical tensions early this decade provided a further drag on global economic growth. The situation with regard to Iraq raised uncertainty, with the effect of depressing consumer and business confidence, causing further declines in equity prices and resulting in substantial risk *premia* in oil prices through the latter part of 2002 and into 2003.

Throughout this period, monetary policy was highly accommodative, with Canadian, U.S., and most other countries interest rates falling to recent-historical lows. Likewise, fiscal policy has also contributed to economic growth through a series of tax-lightening measures, particularly in the United States but also, to some extent, in Europe and Japan.

After the sub-par economic growth of the past three years, strong signs of improvement in the international economic environment became more evident through the latter part of 2003. This is most apparent in the US, where the recovery picked up momentum over the first three quarters and locked the gains in place with a strong fourth quarter showing for GDP growth, and in Japan where, after a decade-long period of stagnation, growth has picked up. The improved performance of Japan is being assisted by robust growth in other Asian economies, most especially China, which registered a 9.1 per cent rate of growth in 2003. Economic activity in the euro area remained torpid, however, as Germany in particular continued to drag on Europe's economic health.

Inflation in most economies in 2003 was fairly stable. This was the reflection of, on the one hand, sharp increases in energy prices that were exerting inflationary pressures in the short-term and, on the other, the persistence of subdued economic growth and weak labour markets dampening inflation and inflationary expectations. Nonetheless, the rate of inflation in services remained high throughout the year in most countries, resulting in inflation rates of over 2 per cent. The main exception to these developments was Japan, where deflation remained embedded in the economy, although oil price developments slowed the annual rate of decline in consumer prices in that country.

The pick-up in global economic activity is still at a preliminary stage, and the strength and particularly the durability of the recovery remain uncertain. The long-standing imbalances are still present in the US, in particular the large current account and fiscal deficits, which could have a disruptive effect on future exchange rates and international developments in the months ahead.

The Canadian macro situation in 2003

While during much of the downturn early in the decade, Canada had managed rather successfully to lean into these headwinds, all this changed in 2003 as a series of international events, many beyond its control, spilled over into Canada and negatively affected Canadian trade performance and economic activity over the course of 2003.

The year 2003 was marked by the onset of the coldest winter in Canada in a decade. This, combined with fears over Middle-Eastern oil supplies and reinforced by the lapsing of Ontario's rebate for the cost of electricity, caused both energy demand and energy prices to surge to record levels. The rising energy prices, in turn, sent inflation to decade highs in the "4-point-plus" range over the first few months of the year, triggering the Bank of Canada to tighten monetary policy. It would not be until July when uncertainty over war with Iraq had effectively dissipated and the return of warmer weather had provided for general easing of energy prices and a curbing of inflation, that the Bank of Canada would respond with the first of two interest rate cuts, adding some stimulus back into the economy.

U.S. industries had a tough time making a go of things throughout the first half of 2003. Continued shedding of jobs, in particular in the U.S. manufacturing sector, and the war with Iraq held consumer confidence in check. U.S. firms continued to cut spending, holding back on purchases of machinery and equipment while consumers shied away from big ticket purchases, such as autos. In the second quarter, U.S. economic growth overtook Canadian economic growth. However, it was only in the third quarter when U.S. GDP soared to an annualized 8.2 per cent that confidence in the recovery in the United States firmed. Consumers, flush with a $US 100 billion (8 per cent) cut in taxes, were the driving force behind the advance. Fourth quarter U.S. growth fell back to a more sustainable 4.1 per cent, and the U.S. is now firmly driving global growth once more.

The aerospatial sector was rocked in March of 2003 as various U.S. and Canadian carriers including Air Canada and US Airways sought bankruptcy protection. Bombardier laid off 10 per cent, or 3,000 workers, from its aerospace workforce. These and related actions would have repercussions throughout the year, likely contributing to the decline in the other transportation equipment component of machinery and equipment trade.

In May, most countries banned imports of Canadian beef after a single cow in Alberta was found to have bovine spongiform encephalopathy (BSE), commonly referred to as mad cow disease. With foreign borders shut down at that point, Canadian exports of live animals and of meat and meat preparations fell significantly. It would not be until August that the U.S. would partially re-open its borders to Canadian beef, by accepting only boneless beef processed in plants dedicated to cattle under 30 months of age. A month later, in September, the U.S. agreed to accept Canadian beef slaughtered at plants that process both older and younger cows.

Later in the year, on August 14, a massive power outage left much of Ontario and the north-eastern U.S. without electricity for a day. A state of emergency was declared in Ontario with industrial sectors requested to cut power consumption by 50 per cent in the following week. Non-essential government workers were sent home for up to a week as soaring temperatures placed further strain on the recovering power supply. At the other end of the country, over 900 forest fires were burning throughout the southern interior of British Columbia, damaging the forestry, tourism and agricultural industries. Output for the month fell sharply, down 0.7 per cent; trade flows were sharply curtailed as imports posted their largest drop in over a decade, outstripping the loss in exports.

The story of 2003's natural disasters was only to end at the end of September, when Hurricane Juan knocked out power in most of Nova Scotia with accompanying damage to both that province and to Prince Edward Island.

Labour markets, which had enjoyed increases in February and March following a flat January, dipped in April for the first time in over a year and a quarter. The severe acute respiratory syndrome (SARS) crisis appeared to have been at the root of the decline as the job losses were concentrated in Ontario, in health care and in accommodation and food. The World Health Organization (WHO) issued a travel advisory on Toronto during the month, before lifting it at month-end, accelerating the decline in the tourism and related sectors. Travel advisories were also issued for Hong Kong and the Chinese province of Guangdong, where SARS is thought to have originated. However, another outbreak of SARS occurred in Toronto in May, prompting the WHO to re-list the city as a SARS-infected area. Real GDP generated by tourism in the second quarter fell 4 per cent, the largest quarterly drop on record since 1986, and the equivalent of 0.1 per cent of total Canadian GDP. Virtually all of the drop originated in spending by visitors to Canada, especially on air transportation and accommodation. Labour markets were weak for much of the following five months or so, before resuming growth over the final four months of the year.

Box A: How Does International Trade Affect Business Cycles Synchronization in North America?

This feature article examines the synchronization of business cycles between Canada and the U.S. in recent decades, investigating whether increased trade between the two countries has led to a measured increase in similarity in economic activities between the two countries.

Have the correlations changed?

Business cycle synchronization across countries refers to the timing and magnitudes of major changes in economic activities appearing increasingly similar. There are two main approaches to measure the synchronization of business cycles. One is the concordance correlation that calculates the number of periods during which national cycles are in the same phase. The other is the output correlation that measures the similarities in both the timing and magnitude of output changes. According to the latter measure, national cycles are synchronized if they are positively and significantly correlated with each other. The higher are the positive correlations, the more synchronized are the cycles. Output correlation has been the most frequently used measure, and will be the main instrument used in this article.

Figure A-1 shows the changes of Canadian and U.S. real GDP over 1950-99[1]. The GDP figures are de-trended so as to focus on business cycle fluctuations. A quick visual examination of this graph tells us that, from the 1950s to the 1970s, changes of Canadian real GDP consistently lagged behind that of the U.S. by about one year. The delayed response of the Canadian economy to changes in economic activity south of the border implied that Canadian policymakers did not have to follow the policy changes in the U.S. immediately; they could maintain their policy course until the U.S. business cycles started to affect the Canadian economy a year later. From 1980 onward, however, a new trend emerged that saw the timing of business cycles between the two countries becoming increasingly similar; the Canadian economy fluctuated almost concurrently with the U.S., though the magnitude of changes in two countries remained substantially different. To measure this observation, we construct a concordance index over two sub-periods: before 1980 and after 1980[2]. Our calculations show that the number of years during which Canadian and the U.S. were in the same phase of business cycles as a fraction of the total number of years increased from 0.8 over 1951-79 to 0.85 over 1980-99.

Figure A-1
Changes in Canadian and U.S. GDP

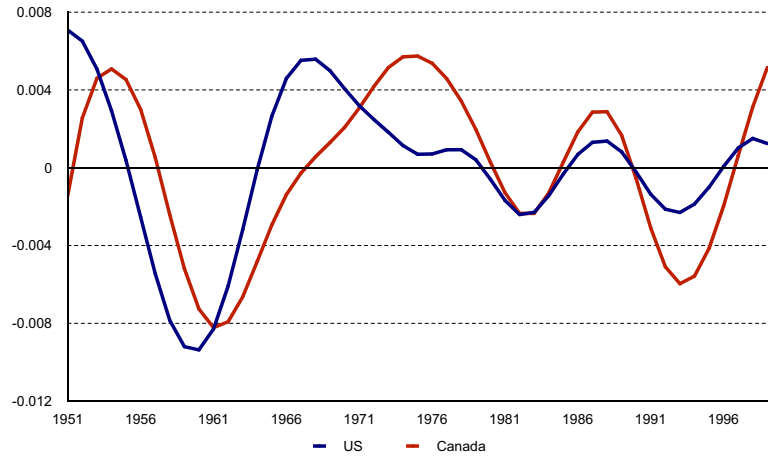


Figure A-2
Correlation of changes in real GDP between Canada and the U.S., 1950-99

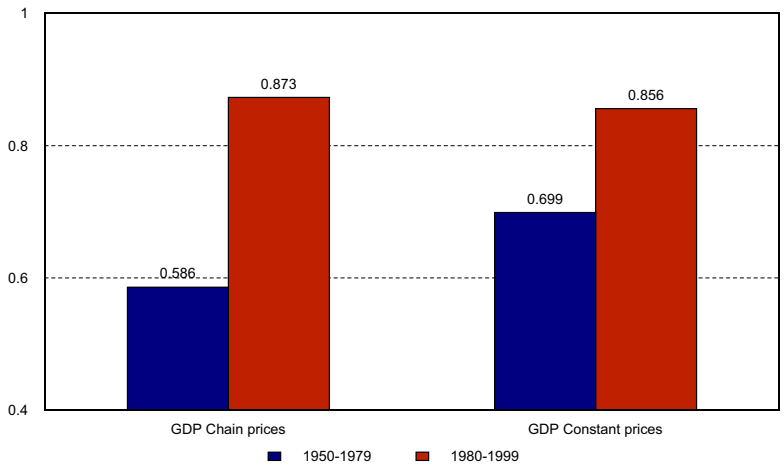


Figure A-2 introduces the second measure of business cycle synchronization—the correlation coefficients between changes in U.S. real GDP and that of Canada over the two sub-periods, 1950-79 and 1980-99. Real GDP data are calculated using the two different price indexes: the chained-price and constant-price indexes. In both cases, the results support the conclusion of a secular increase in business cycle synchronization between the two countries during the last half-century. During the first sub-period (1950-79), the estimated correlation coefficients were 0.586 for the chained price data and 0.699 for the constant-price data; however, the correlations were considerably higher in the second sub-period (1980-99), rising to 0.873 and 0.856, respectively.

Why has the situation changed?

The standard argument about why a rise in international trade would imply a closer relationship in economic activities between countries is straightforward: the expansion of international trade increases the magnitude of the transmission of shocks between countries. In reality, the impact of trade integration on business cycle correlations could go either way. On the one hand, openness to trade could lead to an increasing specialization in production following each country's comparative advantage relative to its trading partners, leading to inter-industry trade. If different types of production are subject to different kinds of shocks, higher trade integration by bringing about deeper specialization could lead to decreasing business cycle correlations. On the other hand, if patterns of specialization in production and trade are dominated by intra-industry trade, specialization could have a synchronizing effect on the business cycles, since the pattern of specialization occurs mainly within the industries subject to common shocks. In particular, production fragmentation and resulting intensive "back-and-forth" intra-industry trade could significantly increase the similarity in the "timing" of business cycles between countries.

Our estimation results show that increased trade, particularly intra-industry trade, between Canada and the U.S. has resulted in a greater synchronization of business cycles between the two countries.

[1] The GDP numbers are expressed in local currency, at the constant 1997 or chain prices. The numbers are transformed in the following way: first, we take natural logarithms of GDP. Second, we de-trend the variables using the well-known Hodrick Prescott ("HP") filter.

[2] The concordance index calculates the number of periods during which national cycles are in the same phase as a fraction of the total number of periods in the sample. If two cycles are perfectly synchronized, in the sense of being in the same state, the concordance correlation coefficient is 1. If the two cycles are uncorrelated, the correlation is 0.

Concurrently, a number of important shifts in prices were taking place. In particular, the terms of trade (i.e., the ratio of export to import prices) returned to near-peak highs in March (of 110.3), its highest level since January 2001, a result of the rising exchange rate as well as rising energy prices. The appreciation of the exchange rate had a significant impact on the prices of tradeable goods. Export prices climbed as gains for energy outweighed the moderating impact of the exchange rate on other exports. Import prices were down as all non-energy prices were pushed down by the dollar. This drop in prices, in turn, fed through to consumer prices by April, as the inflation rate fell sharply to 3.0 per cent.

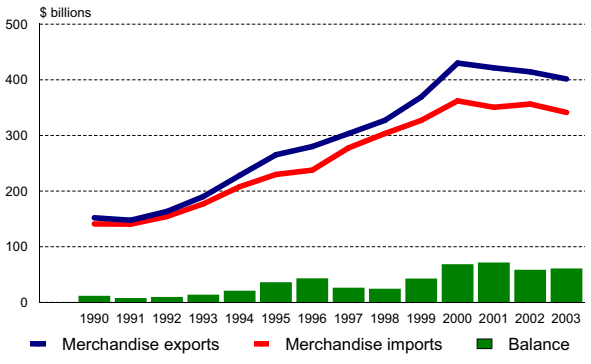
The rising Canadian exchange rate in terms of the US dollar had the overall effect of lowering prices and nominal values of transactions in many sectors (see Box B); export receipts thus fell and import values declined. Trade was definitely on the decline.

Canadian merchandise trade in 2003

These events, in concert with the weak global situation, were reflected in Canada's merchandise trade performance. For the third consecutive year, merchandise exports were down, falling 3.1 per cent ($12.8 billion) to $401.5 billion (Figure 1-1). The declines were restricted to trade with the United States and Japan, as exports fell 4.5 per cent ($15.6 billion) and 3.8 per cent ($0.4 billion), respectively. Partially offsetting the losses were advances to the European Union (up 6.2 per cent or $1.4 billion), to other OECD countries (up 3.3 per cent or $0.4 billion), and to all other countries (up 6.3 per cent, or almost $1.4 billion).

Figure 1-1

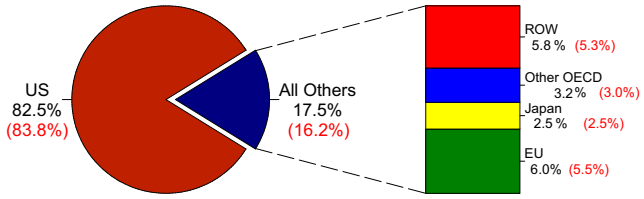
Merchandise trade, 1990-2003



Notwithstanding the sizeable decline in exports to the U.S. in 2003, that country remained Canada's principal export destination, accounting for slightly over 82.5 per cent of Canada's merchandise exports (Figure 1-2). However, this share was down roughly one-and-one-quarter percentage points from the previous year. The EU and Japan accounted for nearly half the remainder of Canada's exports, at 6.0 per cent and 2.5 per cent, respectively. It is possible that the U.S. statistics are overstated and those of other countries are under-reported. Please see Box C for a more complete discussion on this.

Figure 1-2

Merchandise export shares by region, 2002 and 2003



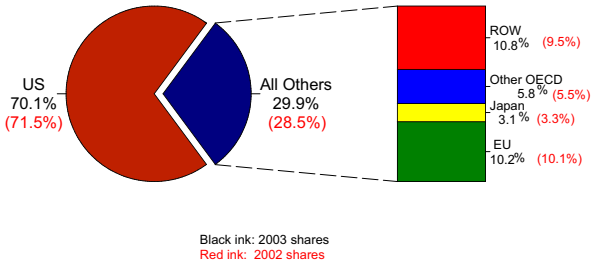
Black ink: 2003 shares
Red ink: 2002 shares

Canada's merchandise imports also fell in 2003, declining 4.2 per cent (or $15.1 billion) to $341.3 billion. Like the situation with respect to exports, the United States accounted for more than the total of the reduction, as imports from that country fell 6.2 per cent (or $15.7 billion). Imports from Japan (down $1.1 billion or 9.1 per cent) and the EU (down $1.3 billion or 3.5 per cent) were also lower while imports from the other OECD countries and from all other countries were higher. In particular, imports from non-OECD sources shot up 8.4 per cent, or $2.9 billion, last year.

With these developments, the U.S. share of Canada's merchandise imports fell almost 1.5 percentage points to 70.1 per cent in 2003 (Figure 1-3). Japan's share in total merchandise imports also slipped last year — from 3.3 per cent a year earlier to 3.1 per cent. Even though imports from the EU were down, the EU's share in Canadian imports increased one-tenth of a percentage point to 10.2 per cent. This is because imports from the EU fell less quickly than did overall imports. The other OECD countries collectively increased their share in Canada's merchandise imports to 5.8 per cent from 5.5 per cent last year, while the share for all other countries advanced by one-and-one-quarter percentage points to 10.8 per cent in 2003.

Figure 1-3

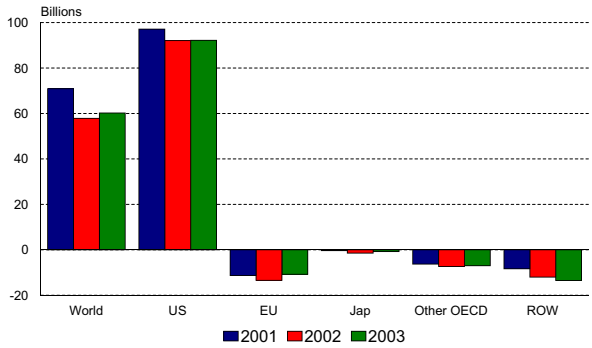
Merchandise import shares by region, 2002 and 2003



Black ink: 2003 shares
Red ink: 2002 shares

Figure 1-4

Merchandise trade balances by region, 2001-2003



In spite of the overall lower level of trade activity brought about by exports falling but imports falling by more and more quickly, the merchandise trade surplus with the world widened by $2.4 billion to $60.2 billion in 2003 (Figure 1-4). It was the third largest surplus on record, behind those of 2001 ($70.9 billion) and 2000 ($67.8 billion).

With respect to the United States, however, Canada runs a merchandise trade surplus. Notwithstanding the rather sizeable reductions in Canada's exports to and imports from the U.S. last year, the bilateral trade surplus with that country edged down only marginally to $92.2 billion, a $0.1 billion reduction from the 2002 level.

Canada imports more merchandise from its non-U.S. trading partners than it exports, thus running deficits with its other principal trading partners. In 2003, these trade deficits narrowed, with the exception of that with all other (non-OECD) countries. For the EU, it was a combination of rising exports and falling imports that resulted in a $2.7 billion decline in the trade deficit, to $10.7 billion. For Japan, however, the situation was that imports fell more than exports, with the result that the bilateral deficit was nearly halved (down $688 million) to $753 million. Both exports and imports were up, but exports were up more from the other OECD countries as the deficit with these trading partners diminished by $336 million to $7.0 billion. Finally, for all other countries, Canadian merchandise exports increased but imports increased more, and the trade deficit widened by $1.5 billion to $13.5 billion.

With both falling exports as well as falling imports in 2003, this meant that Canada's overall level of merchandise trade fell last year. In other words, two-way trade (i.e., the sum of total exports and total imports) was lower in 2003 than in 2002. Two-way merchandise trade fell $27.9 billion to $742.8 billion from $770.8 billion, a 3.6 per cent reduction. Lower trade flows between Canada and the United States were the principal cause of the reduction: Canada-U.S. two-way trade was down $31.3 billion, or 5.2 per cent, to just about $570.6 billion for 2003.

Overall, the United States accounted for 76.8 per cent of Canada's total (two-way) trade last year, down from 78.1 per cent the previous year. Still, this means that U.S. merchandise exchanges amounted to more than $1 million per minute for each and every day of the year just past.

Merchandise trade by major commodity groupings

As noted above, total goods exports fell $12.8 billion (or 3.1 per cent) in 2003, as six of the seven major commodity groupings posted losses (Figure 1-5). Energy products was the only commodity group to record an increase in exports during 2003, posting a 23.7 per cent gain, to $61.3 billion. Declines were most notable in automotive products (down $9.1 billion, or 9.4 per cent), machinery and equipment (down $8.1 billion, or 8.3 per cent), and industrial goods and materials (down $3.6 billion, or 5.2 per cent).

Box B: Effects of a Stronger Canadian Dollar

Global markets are in the midst of substantial change as the value of the US dollar corrects against the currencies of other economies. This exchange rate realignment has meant a run-up in the relative value of a number of the world's currencies, including the Canadian dollar of some 20 per cent in 2003 alone. This special feature examines the impact of the currency appreciation on Canadian economic sectors.

So what are the effects?

The conventional wisdom is that a rise in the valuation of the Canadian dollar makes Canadian exports more expensive for foreigners to buy (i.e., our exports become less competitive) or the appreciation forces Canadians to cut prices to stay competitive.

What this assumes is that Canadian companies immediately raise their US dollar export prices by the full amount of the appreciation, leaving their profit margins intact. Thus, faced with higher prices, foreign buyers cut back on or cancel their orders and exports fall. But this is hardly the way Canadian companies operate in today's environment. Instead, they generally price to their foreign market, and take the adjustment of the Canadian dollar in the form of a lower profit margin[1]. Then, over time, they look for ways to restore their profit margins.

Indeed, this is likely happening already. Consider that a substantial share of Canada's exports are commodities and other resource-based products, and these goods are priced on world markets in US dollars. Yet most of the inputs required to produce these exports, for example, labour, materials, and services, are sourced from within Canada and, as a result, are priced in Canadian dollars. Thus, with no change in their US dollar selling price and inputs costed in Canadian dollars, company profits are squeezed. This is because the US dollar revenues received from their exports are worth less when converted into Canadian dollars at higher exchange rates.

However, looking at only the exports side does not provide a complete picture. Canadian companies import a relatively large share of the materials they use in their business — about 34 per cent to 40 per cent on average[2]. This indicates that with an appreciation of the Canadian dollar many firms will see a significant portion of their import costs decline[3].

This would suggest that the vulnerability to the appreciation of the Canadian dollar will be determined in part by the export intensity of the company or sector and in part by the use of imported intermediate inputs. The former increases exposure, the latter reduces it. A recent study by TD Economics has taken this approach[4]. The study looked at the manufacturing sector in detail for exposure to currency appreciation. It adjusted the export dependency of various manufacturing industries for the effects of imported intermediate input use, leaving a net export reliance measure. The study found that accounting for imported inputs significantly altered the ranking of sectors most exposed to currency appreciation. While the transportation equipment industry is the most export dependent, the study found that paper products and wood products were most vulnerable to currency appreciation, followed by furniture and transportation equipment. Machinery and primary metals were also found to be above average in their exposure.

The stronger Canadian dollar is, however, not good news for the Canadian travel and tourism sectors. For years, the low Canadian dollar has tended to keep Canadians at home and lured travellers from other countries, especially the United States. With a stronger exchange rate, Canadians are expected to increase their foreign travels while foreigner travellers will no longer see Canada as a bargain place to visit.

Similarly, the rising dollar will raise production costs for U.S. film and TV productions. This is because Canadian dollar costs incurred during shooting become higher when converted back into cheaper US dollars. The likely effect will be less U.S. filming activity in Canada.

However, the rising value of the dollar will also bring benefits to Canadian producers. First, the appreciation of the Canadian dollar can help all Canadian companies with debt denominated in US dollars. A firm with US-dollar debt would, in effect, see the size of its liability shrink as the Canadian currency rises. If the currency appreciation happens when the debt comes due, the company could end up paying out a significantly smaller amount of Canadian dollars. Also, often overlooked is that Canadian companies import much of the machinery and equipment used to produce their goods and services. The stronger Canadian dollar changes the relative price of foreign machinery vis-à-vis other inputs, making it relatively cheaper. It additionally makes investment in new foreign machinery and equipment less expensive as fewer dollars need to be exchanged into foreign currency to pay for these acquisitions. The potential for increased investment augurs well for future increases in Canadian productivity and, hence, competitiveness. This, in turn, will help to dampen the impact of the currency appreciation.

And the evidence?

The November 2003 EDC survey of exporters asked how companies would respond to the higher dollar. Only 18 per cent indicated that they would be attempting to raise export prices. A further one quarter of those surveyed said they would simply ride out the storm. Another quarter stated that they would be seeking to cut costs or increase productivity, while 12 per cent stated that they would be increasing production volumes. That is, most are pricing to the foreign market, accepting a lower profit margin for now, and are looking for ways to improve upon those profit margins. Moreover, more than one-third are expecting to hire additional staff in the next six months and slightly under half expect their foreign sales to increase. The survey reached 1,000 exporting companies.

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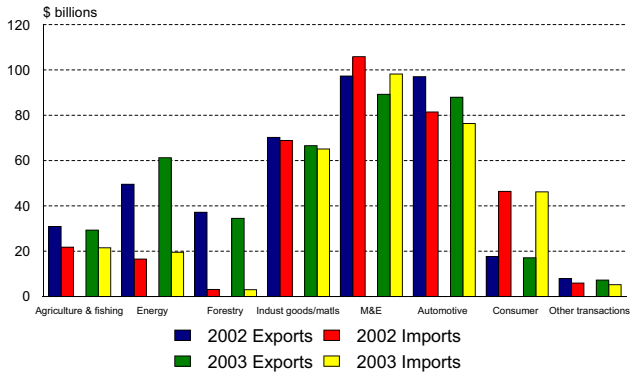
[1] S. Poloz, "The Economic Effects of Exchange Rate Fluctuations", Export Development Corporation, Oct. 21, 2003.
[2] Poloz (*alt cite*) pegs the Canadian content of exports at just over 60 per cent, leaving 40 per cent for imports, while T. Evans, ("Which Industries Are Most Exposed To The Rising Dollar" Export Development Corporation, May 15, 2003) pegs the import content of exports at 34 per cent.
[3] Evans, *alt cite*.
[4] Marc Levesque, "Uncovering the hidden effects of the rising Canadian dollar", TD Waterhouse Investor Insights, Nov/Dec 2003.

On the import side, the situation was nearly identical to that of exports; namely, all commodity groups were down from the previous year, with the exception of energy products. However, imports of machinery and equipment posted the largest decline (down $7.7 billion, or 7.2 per cent), followed by automotive products (down $5.1 billion, or 6.3 per cent), with industrial goods and materials posting the third largest decline (down $3.8 billion, or 5.5 per cent). Imports of energy products advanced 18.3 per cent, or slightly over $3.0 billion.

Figure 1-5

Merchandise trade by major categories, 2002-2003



Machinery and equipment

For the fourth consecutive year, machinery and equipment was the largest major category of exports from Canada, amounting to $89.3 billion in 2003. However, as noted previously, these exports were down 8.3 per cent from a year earlier. It was the third consecutive annual decline; exports of this category are now 19.1 per cent below their peak of $110.3 billion, recorded for the year 2000.

Exports of machinery and equipment fell across the board in 2003. That is, exports in each sub-category (*industrial and agricultural machinery*; *aircraft and other transportation equipment*, and *other machinery and equipment*) as well as for the individual products that make up the sub-categories were down.

Within the *other machinery and equipment* sub-category, there was a notable decline in exports of ***other equipment and tools***. Exports of these products fell $2.3 billion. Also contributing to the losses were exports of ***television, telecommunications and related equipment***, which fell for the third consecutive year, albeit at a slower pace than the first two years of decline. Exports of these products fell $1.5 billion to $10.8 billion and are now some 43-to-44 per cent of their level for the year 2000.

Almost all of the declines in *industrial and agricultural machinery* exports were due to lower ***industrial machinery*** exports. Exports of these products were off by almost $1.4 billion from a year earlier. Similarly, more than five-sixths of the declines in exports of *aircraft and other transportation equipment* came from reductions in ***aircraft, aircraft engines and parts*** exports, which fell by slightly more than $1.4 billion.

Machinery and equipment imports also fell in 2003, with all four sub-components experiencing declines compared to the previous year. Overall, imports of machinery and equipment were off $7.7 billion, or 7.2 per cent. Imports of *aircraft and other transportation equipment* fell $2.7 billion as imports of ***aircraft, aircraft engines and parts*** fell $2.9 billion, while imports of ***other transportation equipment and parts*** advanced $188 million to partially offset the losses. Imports of *other machinery and equipment* fell the most — $2.9 billion — as imports of ***other communication and related equipment*** were down $1.7 billion while those for ***other equipment and tools*** were off by $1.3 billion. Imports of *office machines and equipment* fell $1.2 billion last year. Finally, imports of *industrial and agricultural machinery* declined $841 million.

Overall, machinery and equipment accounted for 22.2 per cent of merchandise exports and 28.8 per cent of merchandise imports in 2003, down from 23.5 per cent and 29.7 per cent, respectively.

Automotive products

Automotive products are the second largest major category of Canadian exports and imports. At $87.9 billion for exports and $76.4 billion for imports in 2003, they accounted for 21.9 per cent and 22.4 per cent of total merchandise exports and imports last year, respectively, down from 23.4 per cent and 22.8 per cent, respectively, a year earlier.

Total automotive exports fell $9.1 billion in 2003 as *car*, *truck*, and *parts* exports all experienced declines. The lion's share of the reductions came from reduced *car* exports. Car exporters sold only $7 of their products last year for every $8 of their products sold a year earlier; that is, *car* exports were down $6.3 billion, or 12.6 per cent. *Truck* exports suffered a $1.7 billion decline, while *parts* exports were off by $1.2 billion in 2003.

Fewer exports of cars and trucks meant less demand for imports of motor vehicle parts; imports of these products fell $4.6 billion last year. Imports of *cars* were also down $1.8 billion last year while *truck* imports advanced $1.3 billion for the year.

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*. On the import side, *metal ores* and *metals and alloys* are combined to form *metals and metal ores*.

Given that these products serve largely as intermediate inputs in other products and that 2003 was a period of overall anaemic global recovery, it comes as no surprise that exports of industrial goods and materials declined by $3.6 billion last year.

Slightly over half of the decline in these exports, or $1.9 billions-worth, originated in the *metals and alloys* sub-component. Exports of most metals and their alloys were down last year, with the exception of ***nickel and alloys*** (up $190 million) and of ***primary iron and steel*** (up $2 million). Losses were widespread in *chemicals, plastics and fertilizers*, most notably in ***fertilizers*** (down $470 million), ***inorganic chemicals*** (down $243 million), and ***synthetic rubber and plastics*** (down $219 million). Exports of *other industrial goods and materials* also experienced widespread declines, in particular those of ***metal fabricated basic products*** (down $564 million), ***textile fabricated products*** (down $225 million) and ***non-metallic mineral basic products*** (down $154 million), while a $436 million advance in exports of ***other crude non-metallic minerals*** helped limit the losses. Finally, increased exports of ***iron ores*** (up $134 million) and ***copper in ores*** (up $33 million) were completely offset by declines in ***zinc in ores*** (down $174 million) and in all other types of ores as total exports of *metal ores* fell $59 million last year.

With respect to imports, those of industrial goods and materials fell $3.8 billion in 2003. Imports of *metals and metal ores* fell by slightly more than $1.5 billion as did imports of *other industrial goods and materials*, with imports of *chemicals and plastics* falling by $701 million). Notable declines were observed for ***precious metals, including alloys*** (down $974 million), ***metal fabricated basic products*** (down $940 million), and ***textile fabricated materials*** (down $528 million).

Industrial goods and materials accounted for 16.6 per cent of total merchandise exports in 2003 and 19.1 per cent of total merchandise imports. These shares were down from 17.0 per cent and 19.3 per cent, respectively, one year earlier.

Energy products

As noted earlier, geopolitical uncertainties surrounding the situation with Iraq resulted in substantial risk *premia* in oil prices through the latter part of 2002 and into 2003. This drove energy prices in a strong upward direction. The result of this strong price effect was that imports and exports of energy products were both up in 2003 over their values a year earlier. Thus, energy products as a share of Canadian exports rose in importance (from 12.0 per cent of total exports in 2002 to 15.3 per cent in 2003) and as a share of Canadian imports (from 4.6 per cent in 2002 to 5.7 per cent a year later). Exports of these products jumped up $11.7 billion in 2003, as gains in *natural gas* (up $8.2 billion), *crude petroleum* (up $1.9 billion), and ***petroleum and coal products*** (up $1.5 billion) led the advances.

Imports of energy products advanced $3.0 billion last year. *Crude petroleum* imports were responsible for about half of the gains (up $1.6 billion) while ***coal and other related products*** as well as ***petroleum and coal products*** were each responsible for about one-quarter of the gains (up $703 million and $756 million, respectively).

Forestry products

Forestry product exports fell for the third consecutive year, down $2.7 billion in 2003. Nearly half of the decline came from *lumber and sawmill products* and the other half of the decline came from *newsprint and other paper and paperboard*. Exports of *wood pulp* also fell last year (by $134 million). Within the *lumber and sawmill products* category, declines in ***lumber*** exports (down $1.9 billion) were partially offset by a $704 million advance in ***other wood fabricated materials***. ***Lumber*** exports have fallen each year since 1999. Forestry products accounted for 8.6 per cent of total Canadian merchandise exports in 2003, down slightly from the 9.0 per cent share they held in 2002.

Canada imports few forestry products; they account for less than one per cent of total commodity imports. Imports of these products fell slightly last year — down $115 million.

Box C: Misallocation and Undercoverage in Merchandise Trade Statistics

In theory, the merchandise trade statistics produced by one country should be the mirror image of the statistics published by its trading partners. After all, at the most fundamental level of any trade there is only one transaction: goods leave one country and they arrive in another.

However, this is rarely the case. If the goods are crossing international borders, this trade also generates many other documents—transportation, warehousing, and customs documents to name a few. For the most part, customs documents are used to generate trade statistics.

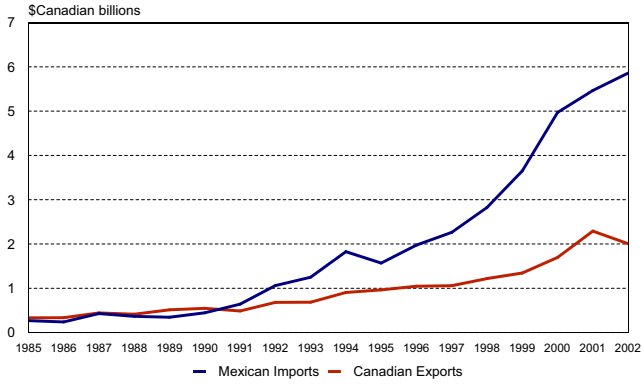
Partner country trade balance discrepancies are a world-wide problem. They reflect the various data collection and recording practices of countries as well as legitimate conceptual differences. Other factors which contribute to partner country trade data differences include time of recording, valuation, coverage and possible recording errors.

Thus, for example, Canada's recorded exports to Mexico should be close to Mexico's recorded imports from Canada. However, they are not. Figure C-1 below compares published statistics for Canada's exports to Mexico with Mexican statistics for imports from Canada. The difference between the two has been growing since the early nineties. In 2002, Canada's published exports to Mexico were only one third of Mexico's published imports from Canada.

Statistics Canada depends on the administrative records of the Canada Border Services Agency (CBSA), formerly the Canada Customs and Revenue Agency, for most of its import statistics and non-U.S. export statistics. Statistics on Canada's exports to the United States are derived from the administrative records of the United States Bureau of Customs and Border Protection as part of the Canada-U.S. Data Exchange Agreement[1].

Figure C-1

Canadian exports to Mexico: Canadian statistics vs. Mexican statistics



Source: OECD

Data derived from import documents tend to be more accurate and complete than those based on export documents because they are used for the management of tariffs and compliance with trade agreements. Export documents are usually not subject to the same rigorous control. Consequently, the published export statistics for all countries that use customs based data, is likely to be understated.

To come to a better understanding as to the causes and degree of differences in Canada's merchandise trade statistics with that of a partner country's, Statistics Canada has undertaken reconciliation studies with a number of Canada's major trading partners. These studies are a bilateral comparison of the trading partner countries' published trade statistics with the objectives of providing an explanation for the differences and a number of 'estimates' that better reflect the actual trade occurring between the two countries. These exercises have been useful in quantifying two major probable causes for discrepancies between the published figures: country misallocation and export undercoverage.

Country misallocation

Country misallocation is the allocation of trade to a country that is not the final destination of goods, resulting in the situation where the two partner countries credit trade to different countries.

For most countries, export trade statistics are allocated to the country of final destination as known at the time of shipment across an international border. However, trade and transportation patterns can be complex and can involve one or more intervening countries en route to a final destination. The exporter might not know the final destination or else might confuse the intermediate country with the final country. Imports, on the other hand, are attributed to the country of origin, not to the country of shipment.

The ease of reporting, combined with tariff treatments, might also contribute to country misallocation. It is administratively easier to declare export shipments as U.S. consumption rather than as in-transit through the United States to a third country. Whereas once import duties were an incentive to accurately report exports this is no longer the case.

Prior to the Canada-U.S. Free Trade Agreement, goods entering the United States for consumption would have been subject to tariffs; those going in-transit would not have been. Consequently, even though the reporting requirements for in-transit trade were more cumbersome to deal with, the financially punitive nature of the tariff treatment encouraged accurate reporting. However, since tariffs on imports into the U.S. are now, for the most part, non-existent, import duties are no longer deterrents. And ease of reporting is often a determining factor when making customs declarations.

Thus, for example, Canada might ship goods destined for Mexico through the United States. A statistical imbalance will likely occur if the goods are landed and declared for consumption in the United States and subsequently re-exported to Mexico with no transformation. As a result of the Canada-U.S. data exchange agreement, the Canadian exporter does not need to file an export document for trade to the United States if the goods are destined for U.S. consumption; Canadian exports to the United States equal U.S. imports from Canada. Canada's export trade with the United States will be overstated. Correspondingly, Canada's export trade with Mexico understated. However, Canada's total trade will not be affected. U.S. imports from Canada and U.S. exports to Mexico will be overstated. Mexican imports will show the goods as coming from Canada since they report imports on a country of origin basis.

Export undercoverage

Export undercoverage refers to the situation where the export trade is not reported to the compiling country and consequently does not appear in the country's officially published trade statistics.

In some cases, goods exported directly from Canada to another country may not be reported at all. Canada's exports will be understated since the export trade will not be captured. The situation is further complicated by the possibility of in-bond movements through the United States. As mentioned earlier, because of the Canada-U.S. data exchange agreement, Canadian exporters do not have to file export documentation if the goods are destined for consumption in the United States. Exporters may fail to report the outbound movement of goods to a non-U.S. destination in Canada if the goods are travelling in-bond through the United States.

For example, goods passing through the United States to other final destinations such as Mexico may be placed in-bond for the portion of the travel through the United States. Exporters may treat the export

to Mexico via the United States in the same way they treat an export to the United States: that is, the supporting customs documents will not be filed. A U.S. import document will not be needed since the ultimate destination of the goods is Mexico. Hence, U.S. Customs will not capture the import. However, Mexico will capture the import trade of the good from Canada. There will again be a statistical imbalance; Canada's trade with Mexico will be understated. However, unlike the example given in the country misallocation section (above), U.S. imports from Canada and U.S. exports to Mexico are not overstated.

Reconcilition estimates

Reconciliation studies derive a number of estimates to balance the import/export numbers of partner countries. While the data do not permit a firm estimate of the discrepancies per se, they do provide an upper limit as to what these values might be.

The estimate which provides a measure of misallocation is known as the indirect trade value. This estimate is based on the available import records of the partner countries. Instances in which import records show the country of origin as the other partner country and the country of shipment or seller as another country are shown as indirect trade in the reconciliation studies. The assumption is that in most cases this indirect trade results in country misallocation with the intermediate country being attributed as the trading partner in the officially published statistics of the exporting country.

The estimate which provides a measure of undercoverage is known as the residual. This estimate is calculated as the difference between the published import figure and the sum of the reconciliation adjustments. Reconciliation adjustments could include estimates for indirect trade, freight and insurance, re-exports, price mark-ups, etc. The residual therefore largely comprises two main aspects: export undercoverage and errors or deficiencies in the other reconciliation estimates. In all likelihood, the bulk of the residuals comprise export undercoverage but the two aspects cannot be definitively separated.

Table C-1 shows the estimated partner country difference attributed to misallocation and undercoverage, as a percentage of the partner countries' reconciled imports (which equal Canada's reconciled exports). The reconciliation estimates are from recent studies with Mexico, China and South Korea[2]. For the purpose of misallocation/undercoverage comparisons it is assumed that the reconciliation residual comprises 100 per cent of undercoverage.

Table C-1: Estimated misallocation and undercoverage for selected countries: as a percentage of reconciled imports

Year	Mexico		China*		South Korea*	
	Misallocation	*Undercoverage*	*Misallocation*	*Undercoverage*[1]	*Misallocation*	*Undercoverage*
1996	27	26	*n.a.*	*n.a.*	*n.a.*	*n.a.*
1997	35	25	*n.a.*	*n.a.*	*n.a.*	*n.a.*
1998	30	33	19	-1	*n.a.*	*n.a.*
1999	33	34	25	-5	*n.a.*	*n.a.*
2000	29	42	20	15	12	9
2001	41	28	20	10	16	11
2002	*n.a.*	*n.a.*	22	9	17	13

*The 2002 reconciliation data for China and all the South Korean figures are preliminary.

[1] The negative numbers indicate that some reconciliation adjustments were too large.

It is apparent that Canadian export statistics do understate export trade with Mexico, China and South Korea. The problem, however, is more serious in the case of exports to Mexico where on average, from 1996 to 2001, almost two thirds of exports to Mexico were either allocated to another country or not reported at all.

Statistics Canada, together with the Canada Border Services Agency, has conducted a number of studies over the last several years in order to get a better understanding of the rate of undercoverage to non-U.S. export destinations at road, marine and air ports. In order to detect undercoverage, these studies compare the Canadian Customs documents with either transportation documents for goods directly from Canada to non-U.S. destinations, or U.S. Customs documents for goods shipped through the United States to a third country.

In 2002, the amount of undercoverage via marine ports was 18 per cent; by air it was 16 per cent. A brief, *ad hoc* study, conducted in 2003, indicated that almost 93 per cent of the non-U.S. exports via road were not reported; this compares to previously reported undercoverage via road of 71 per cent (1994), 75 per cent (1995) and 81 per cent (2000).

It is evident that the published export statistics do indeed understate the true value of Canada's exports. It follows that this will impact other statistics such as a partner countries' share of Canadian exports, as well as the merchandise trade balances of Canada with its trading partners.

Table C-2 compares the shares in Canada's total domestic exports of three partner countries from published data to those from reconciliation studies-based data. The reconciliation estimates are from recent studies with Mexico, China and South Korea.[3] In order to account for export undercoverage in the estimation of the reconciliation studies based shares, the balance-of-payments statistics are used for total exports since they include an adjustment for undercoverage; the partner countries' reconciled imports (or Canadian reconciled exports) are used as Canadian exports to the partner countries.

Table C-2: Selected countries share of Canadian exports: published data vs. reconciled data

Year	Mexico		China*		South Korea*	
	Reconciled	*Published*	*Reconciled*	*Published*	*Reconciled*	*Published*
1996	0.94	0.47	*n.a.*	1.11	*n.a.*	1.07
1997	10.2	0.44	*n.a.*	0.84	*n.a.*	1.07
1998	1.14	0.47	0.93	0.83	*n.a.*	0.60
1999	1.25	0.45	0.84	0.76	*n.a.*	0.59
2000	1.48	0.50	1.17	0.85	0.64	0.60
2001	1.69	0.71	1.34	1.05	0.63	0.53
2002	*n.a.*	0.63	1.26	1.00	0.67	0.54

*The 2002 reconciliation data for China and all the South Korean figures are preliminary.

For each country, the reconciled data show considerable gains in terms of that country's share in Canada's total exports. This is particularly true for Mexico. Since 1996, the share of exports to Mexico as determined by the reconciled data has been more than double that of the share of exports as determined by the published data.

Table C-3 compares Canada's merchandise trade balance as reported in the published statistics with that of reconciliation studies-based data. For each of the selected countries and years, regardless of which data set was used, Canada experienced a merchandise trade deficit. However, in all cases, the merchandise trade deficit determined using the reconciliation based data was less than that determined using the published data.

Table C-3: Canadian merchandise trade balance with selected countries: published data vs. reconciled data *(millions of Canadian dollars, customs basis)*

Year	Mexico		China*		South Korea*	
	Reconciled	*Published*	*Reconciled*	*Published*	*Reconciled*	*Published*
1996	-3,414	-4,777	*n.a.*	*n.a.*	*n.a.*	*n.a.*
1997	-3,931	-5,691	*n.a.*	*n.a.*	*n.a.*	*n.a.*
1998	-3,941	-6,212	-4,613	-5,158	*n.a.*	*n.a.*
1999	-5,034	-7,996	-5,799	-6,261	*n.a.*	*n.a.*
2000	-5,711	-10,127	-6,234	-7,615	-2,389	-2,958
2001	-4,991	-9,758	-7,044	-8,507	-1,935	-2,619
2002	*n.a.*	*n.a.*	-10,740	-11,885	-2,076	-2,863

*The 2002 reconciliation data for China and all the South Korean figures are preliminary.

The difference between the figures was most evident concerning trade with Mexico. Since 1996, the discrepancy between the published and reconciled balance of trade with Mexico has increased steadily; in 2001, the deficit estimated from the reconciled numbers was half of that reported in the officially published statistics.

In some cases, the reconciliation results are of such magnitude as to affect the trade surplus/deficit standing of Canada and some of its trading partners.

While all attempts are made to ensure that Canada produces the most accurate trade statistics this is often difficult to accomplish. The bilateral comparison of our published data with that of our trading partner countries makes this obvious.

In general, import data are more accurate than export data. The results from reconciliation studies confirm that exports are often understated. This can be traced, in large part, to country misallocation and undercoverage. While reconciliation studies offer a rough measure of country misallocation and undercoverage, the estimates are not sufficiently 'strong' to permit adjustments to the officially published numbers of either country. They do, however, help improve the understanding of the trade statistics of the two countries.

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[1] In July 1987, Canada and the United States signed a Memorandum of Understanding to exchange import statistics starting with January 1990 data. Each country now uses the other country's import data to derive their export statistics.

[2] The data are customs based and have been adjusted to take into account conceptual differences such as re-exports, geography, and insurance and freight.

[3] The data are customs based and have been adjusted to take into account conceptual differences such as re-exports, geography, and insurance and freight.

Agricultural and Fishing Products

Exports of agricultural and fishing products accounted for 7.3 per cent of total merchandise exports in 2003, down from 7.5 per cent a year earlier. Exports of these products fell $1.6 billion in 2003, the second consecutive year of decline. The largest decline in exports came in the ***live animals*** and ***meat and meat preparations*** categories, the direct result of foreign markets closing their markets to Canadian beef following the discovery of a BSE-infected cow in May 2003. ***Live animal*** exports fell by $1.2 billion while ***meat and meat preparations*** exports fell by $623 million. About a half-dozen categories recorded increased exports last year, most notably ***rapeseed*** (up $311 million) and ***other food, feed, beverages and tobacco*** (up $144 million).

Imports of agricultural and fishing products were down slightly last year, falling $263 million. Imports of *fruits and vegetables* were off by $152 million, as all four product categories that make up this sub-component experienced declines. Imports of *Other agricultural and fishing products* were down by $112 million as gains largely offset losses posted by individual product categories. For example, ***beverage*** imports, the product to register the largest increase, advanced $266 million, but were slightly more than offset by declines in ***shelled corn*** (down $136 million) and ***fish and marine animals*** (down $124 million), the products to register the largest decreases. Overall, imports of agricultural and fishing products accounted for 6.3 per cent of total commodity imports, up 0.2 percentage points from a year earlier.

Consumer goods

Consumer goods are the smallest of Canada's major export commodity groupings. Exports of consumer goods fell by $545 million last year, to account for 4.3 per cent of total merchandise exports in 2003, unchanged from 2002.

Consumer goods are much more important on the import side — accounting for 13.5 per cent of total merchandise imports and up half a percentage point from the share one year earlier. Overall, imports of consumer goods edged down $221 million in 2003. Most of the decline came from reduced imports of *apparel and footwear* (down $198 million). The remaining decline of $23 million came from *miscellaneous consumer goods*. The declines were split fairly evenly between ***apparel*** (down $96 million) and ***footwear*** (down $103 million) in the *apparel and footwear* category. Within *miscellaneous consumer goods*, declines in imports of ***watches, sporting goods and toys*** (down $125 million), ***television and radio sets and phonographs*** (down $123 million), and ***photographic goods*** (down $76 million) more than offset the $309 million advance in ***inedible miscellaneous end products***.

Merchandise trade by principal trading regions

The United States

At 86.1 per cent of total merchandise exports on a Customs basis[1], the United States is the principal destination for Canadian exports, bar none. This is true at the aggregate level as well as for each of the seven major sub-categories of trade, where the U.S. export shares in total merchandise exports run from a low of 65.0 per cent for exports of agricultural and fishing products to a high of 98.0 per cent for exports of automotive products.

Canada's total merchandise exports to the U.S. fell $17.7 billion, or 5.1 per cent, to $327.7 billion on a Customs basis in 2003. It was the third consecutive year of decline and Canada's merchandise exports to the U.S. are now 8.8 per cent lower than their peak of $359.3 billion recorded in the year 2000.

Exports to the United States fell in six of the seven major categories, led down by declines in automotive products, as exports of motor vehicles (HS chapter 87) fell $8.7 billion, or 10.5 per cent. Exports of machinery and equipment to the U.S. were also down substantially in 2003, falling some $5.8 billion, or 10.1 per cent. Exports of mechanical (or non-electrical) machinery and equipment declined $3.2 billion (down 11.6 per cent) and exports of electrical machinery and equipment fell $2.6 billion (down 16.4 per cent), to account for the bulk of the declines. Falling exports of medical, scientific, and technical instrument (HS chapter 90) — down $0.5 billion, or 14.9 per cent — also contributed to the losses. Advances were led by bilateral exports of aircraft (HS chapter 88) and rail transportation equipment (HS chapter 86), which posted gains of $0.6 billion (or 7.3 per cent) and $128 million (or 24.8 per cent), respectively.

Exports of forestry products to the U.S. were down across the board. The long-standing dispute over softwood lumber remained unresolved through 2003 and, as a result, most Canadian production of these products remained subject to anti-dumping and countervailing duties at the border. Thus, exports of wood and articles of wood to the U.S. fell $1.2 billion, or 7.4 per cent, last year. However, notwithstanding this barrier, the main contributor to the reduction in Canadian forestry exports to the United States was not lumber products; rather it was reduced exports of paper and paperboard products (HS chapter 48), which fell $2.0 billion (or 13.4 per cent), that accounted for the bulk of the loss in forestry product exports to the U.S. Pulp exports also fell some $200 million (down 6.6 per cent) for the year.

Industrial goods and materials comprise a wide range of products that are primarily used in the production of other goods, though not always. They range from things like chemicals and fertilizers, to textiles and rubber, to metals, stone and glassware. About 80 per cent of these products are exported to the United States in proportion to their total exports. In 2003, Canadian exports to the U.S. of these products fell, as exports of iron and steel, copper, aluminum, nickel, zinc and other base metals, as well as the miscellaneous articles made of these base metals, declined, as did exports of chemicals, fertilizers, and rubber products, to account for the bulk of the declines.

Imports from the United States fell 7.0 per cent, or $15.2 billion, to $203.1 billion in 2003. The majority of the declines occurred in machinery and equipment (down $8.0 billion), industrial goods and materials (down $3.8 billion), and automotive products (down $2.9 billion). As was the case for exports to the U.S., the only sector to experience an increase was energy, which advanced $1.5 billion in 2003.

Notable declines in imports were observed in mechanical machinery and equipment (HS chapter 84), which fell $4.2 billion, electrical machinery and equipment (HS chapter 85), which fell $2.9 billion, and motor vehicles (HS chapter 87), which fell $2.9 billion. Energy products (HS chapter 27) posted the only sizeable gain in imports from the U.S. in 2003: they advanced $1.5 billion, or 36.2 per cent, over 2002 levels.

The European Union

The European Union accounted for 4.9 per cent and 11.6 per cent of Canada's merchandise exports and imports, respectively, on a Customs data basis. These shares were up 0.5 percentage points and 0.3 percentage points, respectively, from their 2002 share levels. Roughly one-third of Canadian exports to the EU are in machinery and equipment (32.6 per cent) and another third is in industrial goods and materials (31.8 per cent). Forestry products (14.6 per cent) and agricultural and fishing products (11.1 per cent) make up most of the remaining third of exports to the EU.

Machinery and equipment also accounted for approximately one-third of Canadian merchandise imports from the EU (35.3 per cent) last year. However, the remainder of the import commodity groups are more widely spread out than was the case for exports: industrial goods and materials were next in importance at 21.6 per cent of EU merchandise imports, followed by consumer goods at 14.3 per cent, energy products at 10.1 per cent, automotive products at 9.2 per cent, and agricultural and fishing products at 7.0 per cent, with the final 2.5 per cent belonging to forestry products.

Merchandise exports to the EU advanced $1.3 billion, or 7.6 per cent, to $18.8 billion in 2003, partially reversing the $1.7 billion decline that had taken place over the two previous years. Merchandise imports from the EU, on the other hand, fell $0.2 billion, down 0.6 per cent, last year. With exports rising and imports falling, the bilateral Canada-European Union merchandise trade deficit thus narrowed $1.6 billion for the year, to $19.9 billion.

About half the gains in exports came from industrial goods and material. A $1.0 billion jump in exports of pearls and precious stones, along with a $0.2 billion increase in inorganic chemical exports, drove the gains, while a $0.4 billion decline in ore, slag and ash exports and a $0.2 billion decline in aluminum exports helped cap the advances.

Agriculture and fishing products also saw their exports to the EU rise in 2003 — by nearly $0.5 billion. A $0.4 billion (or 152.3 per cent) jump in cereal exports accounted for the bulk of the gains. Widespread gains in exports of consumer products (up $0.2 billion) and gains in automotive products (also up $0.2 billion) also helped to push up Canadian exports to this region.

A large ($0.6 billion) decline in aircraft exports (HS chapter 88) more than offset smaller gains in all other components of machinery and equipment as total machinery and equipment exports to the EU fell $0.1 billion. Likewise, declines in exports of pulp (down $0.1 billion) and paper and paperboard products (down $0.1 billion) helped bring total exports of forestry products down by $0.1 billion, to limit total Canadian exports to the EU.

On the import side, increased imports of consumer products (up $0.7 billion), agricultural and fishing products (up $0.2 billion), and energy products (up $0.1 billion) were more than offset by declines in machinery and equipment (down $1.1 billion) and industrial goods and materials (down $0.2 billion). Of particular note, imports of aircraft from the EU plunged 43.7 per cent, or down $1.4 billion, to $1.9 billion last year. Sectors experiencing large increases in imports from the European Union included beverages, spirits and vinegar (up $0.2 billion), mechanical machinery and equipment (up $0.3 billion), and pharmaceuticals (up $0.7 billion).

Japan

Exports to Japan fell $0.3 billion, or 3.3 per cent, to $8.1 billion while imports from this country fell $1.6 billion, or 10.3 per cent, to $13.8 billion. With imports falling more than exports, but still remaining larger than exports, Canada's merchandise trade deficit with Japan contracted $1.3 billion to $5.7 billion in 2003.

Exports to Japan were pulled down last year by reduced exports of forestry products, energy products, and agricultural and fishing products, which fell $0.3 billion, $0.1 billion, and $0.1 billion, respectively. Helping to cap the decline was a $0.2 billion increase in exports of machinery and equipment. Exports of industrial goods and materials and consumer goods posted small increases while exports of automotive products posted a small decline. Losses in forestry products exports were widespread as wood and wood products posted a $211 million decline, pulp exports fell $42 million, and paper and paperboard exports were down $65 million.

On the import side, imports of Japanese automotive products fell $0.8 billion last year. Imports of pearls and precious stones (HS chapter 71), iron and steel and their products (HS chapters 72 and 73) and tools and implements made of base metals also fell, leading imports of industrial goods and materials down $0.3 billion. Similarly, fewer imports of electrical and mechanical machinery and equipment and of aircraft helped lower imports of machinery and equipment by $0.3 billion. Toy, game and sporting goods imports from Japan also fell last year as gains and losses elsewhere in the consumer goods category largely offset each other, resulting in a $0.2 billion decline in total consumer goods imports from Japan.

The rest of the world

This region contains all of Africa, Latin America and the Caribbean, and most of Asia (except for Japan), to name much, but not all, of the region. It contains both small and large economies, rich and poor ones, countries that are populous and others that are sparsely populated, fast-growing economies and shrinking economies, as well as developed nations and developing nations. Box D provides a statistical overview of three of the largest economies from this region, while Box E includes Mexico, also a member of this region, in the context of a brief review of the NAFTA trade agreement at ten years.

Merchandise exports to the rest of the world grew more slowly than merchandise imports in 2003 (3.6 per cent against 4.3 per cent), Canada's merchandise trade deficit with the rest of the world expanded $2.4 billion to $53.2 billion. Exports in 2003 were smaller than imports, by about two-thirds — $26.1 billion *vs.* $79.3 billion.

Imports from the rest of the world were up across the board in all major categories, but especially for energy products (up $2.3 billion, or 24.5 per cent), consumer products (up $0.5 billion, or 3.9 per cent), and industrial goods and materials (up $0.4 billion, or 2.9 per cent). Toys, games and sporting goods (HS chapter 95), miscellaneous manufactured articles (HS chapter 96), and woven apparel (HS chapter 62) helped to boost consumer product imports.

Exports to the rest of the world were also up in all major categories, except those for agricultural and fishing products and machinery and equipment. Exports of automotive products (HS chapter 87) surged 35.7 per cent to $2.1 billion, a gain of $0.6 billion, to lead the advances. Forestry product exports also contributed to the advance, rising $0.3 billion (8.8 per cent), as did industrial goods and materials (up $0.2 billion, or 2.8 per cent) and consumer goods (up $0.1 billion, or 19.3 per cent). Declines in agricultural and fishing products (down $0.2 billion, or 3.2 per cent) and machinery and equipment (down $0.1 billion or 1.1 per cent) limited the gains.

[1] This 86.1 per cent share in total merchandise exports is calculated on a *Customs* data basis — in contrast to the 82.5 per cent reported earlier in this Report, which is calculated on a *Balance of Payments* data basis.

Box D: New and Emerging Markets

BRAZIL

Area
8,547,403 km²

Main Metropolitan Areas
(Population in millions in 2000)

São Paulo	10,406
Rio De Janeiro	5,852
Salvador	2,441
Belo Horizonte	2,233

Population
174.6 million (2002)

Population growth rate
1.3% (2002)

GDP
$735.8 billion (2002)

Real GDP growth rate
-0.2% (2002)

GDP per capita
$4,210(2003)

Inflation rate
14.8% (2003)

Unemployment rate
12.3% (2003)

Structure of the Economy (2003 average over 3 quarters)

Agriculture, fishing & forestry	10.2%
Mining & quarrying	3.9%
Manufacturing	22.2%
Construction	6.7%
Public Utilities	3.5%
Services	53.6%

Canadian imports from Brazil
$1.99 billion (2003), including raw cane sugar, motor vehicles and parts, semi-finished products of iron/non-alloy steel, frozen orange juice, and non-monetary gold.

Canadian exports to Brazil
$0.9 billion (2003), including potassium chloride, coal, newsprint, sulfurs, meslin and wheat, and canary seed.

CHINA

Area
9,551,000 km²

Main Metropolitan Areas
(Population in million, in 2000)

Shanghai	9.86
Beijing	7.61
Chongqing	6.61
Tianjin	5.33

Population
1.27 billion (2003 est.)

Population growth rate
0.7% (2001)

GDP
$1.98 trillion (2003)

Real GDP growth rate
9.1% (2003)

GDP per capita
$1,560 (2003)

Inflation rate
-0.8% (2002)

Unemployment rate
7.7% (urban, 2002)

Structure of the Economy (2002)

Primary	15.4%
Industry	44.4%
Construction	6.7%
Services	33.5%

Canadian imports from China
$18.66 billion (2003), including computers and parts ,TV video games, voice reception/transmission equipment, toys, and footwear.

Canadian exports to China
$4.7 billion (2003), including auto parts, wood pulp,, chemicals, shrimps and prawns, and telephone line equipment.

INDIA

Area
3,287,263 km²

Main Metropolitan Areas
(Population in millions in 2001)

Mumbai (Bombay)	16.4
Kolkata (Calcutta)	13.2
Delhi	12.8
Chennai (Madras)	6.4

Population
1.055 billion (2002/03)

Population growth rate
1.7% ((2002/03)/(2001/02))

GDP
$790.1 billion (2002/03)

Real GDP growth rate
4.6% ((2002/03)/(2001/02))

GDP per capita
$750 (2002)

Inflation rate
6.9% (2002)

Unemployment rate
8.8% (2002)

Structure of the Economy (fiscal 2002/03)

Agriculture, fishing & forestry	22.7%
Mining & quarrying	2.7%
Manufacturing	15.6%
Construction	2.1%
Public Utilities	6.2%
Services	50.7%

Canadian imports from India
$1.42 billion (2003), including chemicals, diamonds, clothing, shrimps and prawns, and jewellery.

Canadian exports to India
$0.7 billion (2003), including newsprint, potassium chloride, dried vegetables, aircraft, and wood pulp.

Box E: NAFTA@10

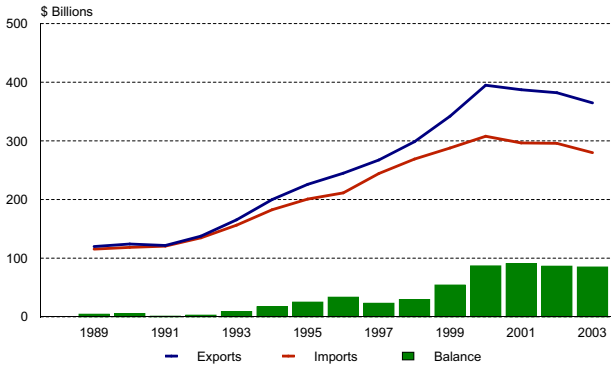
January 1, 2004 marked the 10th anniversary of the North American Free Trade Agreement and the 15th anniversary of its predecessor, the Canada-U.S. Free Trade Agreement. These anniversaries allow for the opportunity to look back and evaluate the effects of these two agreements for Canada's trade and investment patterns.[1]

Between 1989 and 2003, Canadian goods and services exports to the U.S. expanded at an average annual rate of 8.3 per cent (6.9 per cent since 1994), more than tripling to $364.8 billion in 2003. Canadian imports from the U.S. increased almost as rapidly, growing at an average annual rate of 6.5 per cent (4.9 per cent since 1994), to reach $280.0 billion in 2003. The faster growth in exports has resulted in Canada's trade surplus with the U.S. growing from $4.4 billion in 1989 ($17.3 billion in 1994) to $84.9 billion in 2003. The faster pace in export relative to import growth was largely a result of the superior economic performance of the U.S. economy over much of this period, particularly in the early 1990s, as well as Canada's declining exchange rate relative to the U.S. This is also reflected in the rising share of the U.S. in Canadian exports which rose from 71.4 per cent in 1989 (76.6 per cent in 1994) to 79.7 per cent in 2003, as would be expected with U.S. demand growing faster than that of other regions. The U.S. share of Canadian imports rose at a similar pace to exports but began to fall off in 1998 only to return to 68.4 per cent in 2003, roughly the same level as in 1989.

Canada-U.S. merchandise trade[2] followed generally the same patterns as total trade, but was more pronounced. Canadian merchandise exports increased at an average annual rate of 8.7 per cent since 1989 (6.7 per cent since 1994) to reach $327.7 billion in 2003. Similarly, Canadian imports from the U.S. increased by 6.1 per cent (4.4 per cent) over the same periods to reach $203.1 billion in 2003. About 86.1 per cent of Canadian merchandise exports were bound for the U.S. in 2003, compared to 60.6 per cent with respect to imports. In fact, 47.6 per cent of all Canadian manufacturing production was exported to the U.S., up from 35.1 per cent in 1992. For a brief period in 1999,

Figure E-1

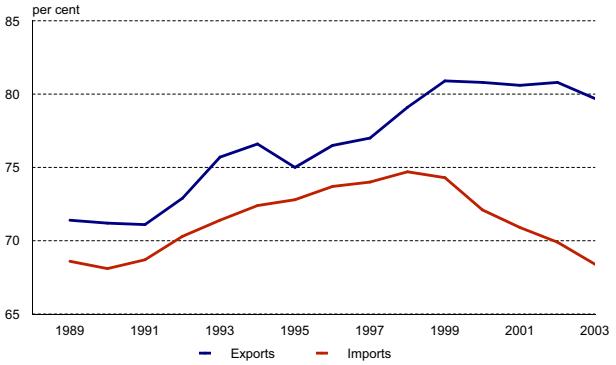
Canada-U.S. Trade in Goods and Services



Data: Statistics Canada, Balance of Payments

Figure E-2

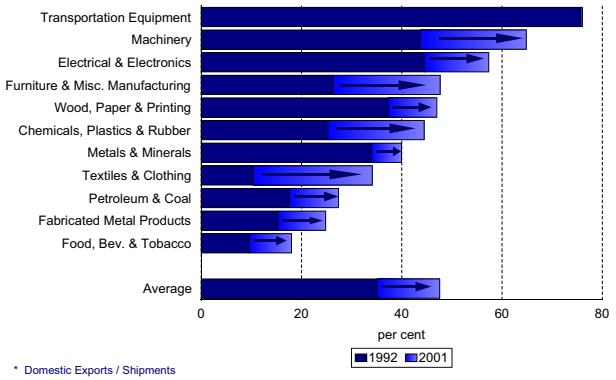
U.S. Share of Canada's Trade in Goods and Services



Data: Statistics Canada, Balance of Payments

Figure E-3

Exports to U.S. Share of Total Canadian Shipments*



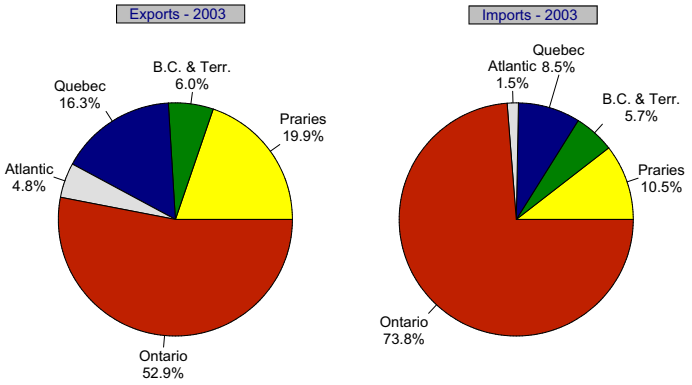
* Domestic Exports / Shipments

Data: Statistics Canada

the U.S. market was an even more important market for Canadian manufacturing than was the domestic Canadian market. Every industry saw an increase in the importance of the U.S. as a market between 1992 and 2001[3]. It is notable that the two industries that witnessed the largest increase in the share of their production going to the U.S. – textiles & clothing and furniture & miscellaneous manufacturing are also those that witnessed the largest decreases in tariffs, in both directions, as a result of the Canada-U.S. FTA. The U.S. was a more important market than the Canadian market for five of eleven industries; more than three-quarters of the output from the transportation equipment sector was exported to the U.S. in 2001.

Figure E-4

Canadian Regional Distribution of Merchandise Trade with the U.S.



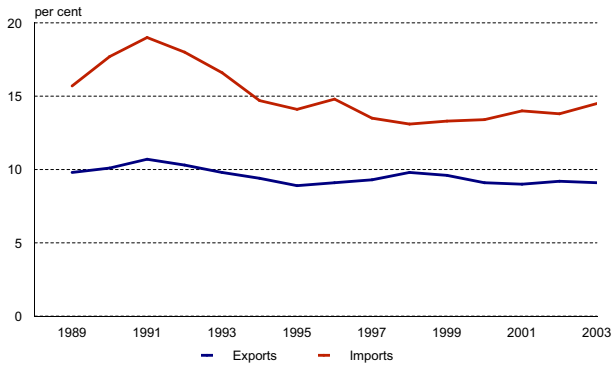
Data: Statistics Canada, Customs Basis

Ontario, amongst the ten provinces, has the strongest linkages with the U.S. accounting for 52.9 per cent of total Canadian exports and 73.8 per cent of total Canadian imports in 2003. The Prairies also stand out for their large share of Canadian exports to the U.S., with the automotive sector accounting for a larger portion of the former and energy exports accounting for an important share of the latter. Quebec stands out for the opposite reason, having relatively weak linkages to the U.S. for both exports and imports.

Canada-U.S. trade in services did not grow as quickly as trade in goods for most of the 1990s but has picked up recently. Between 1989 and 2003, Canadian services exports to the U.S. grew at an average annual rate of 7.7 per cent (6.6 per cent since 1994). As a result, services share of total Canadian exports to the U.S. fell slightly from 9.8 per cent in 1989 to 9.1 per cent in 2003. The trend was even more pronounced for imports, which grew at an average annual rate of 6.0 per cent since 1989 (4.7 per cent since 1994), peaking at 19.0 per cent of total Canada-U.S. trade in 1991 before falling to a low of 13.1 per cent in 1998. The share has rebounded somewhat since then, reaching 14.5 per cent in 2003. The declining share of services in Canada-U.S. trade is more a result of faster growth in goods trade rather than slower performance in trade in services.

Figure E-5

Services as a Share of Total Canada-U.S. Trade



Data: Statistics Canada, Balance of Payments

Foreign direct investment between the two countries grew even more quickly over the FTA/NAFTA period than did trade. The stock of Canadian direct investment in the U.S. grew at an average annual rate of 10.3 per cent since 1989 (12.6 per cent since 1994) to reach $201.8 billion in 2002. Similarly, the stock of U.S. direct investment in Canada reached $224.3 billion, growing 8.2 per cent annually since 1989 (10.3 per cent since 1994). It is not clear what effect the Canada-U.S. FTA and NAFTA have had on bilateral investment, if any, with a large portion of the bilateral FDI in both directions occurring between 1998 and 2001 and

largely in the form of mergers and acquisitions (M&As). There is some indication, however, based on the dramatic fall in FDI flows in 2003, that the growth rate could fall considerably once the complete 2003 investment position data are released.

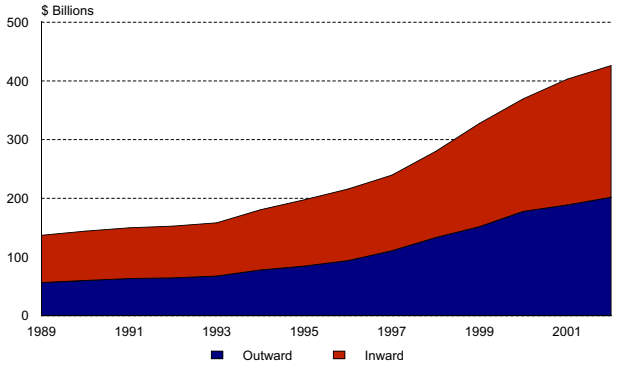
Canadian trade with Mexico remains relatively small, accounting for only 0.7 per cent of total Canadian exports in 2001 and 3.1 per cent of imports.[4] However, Canadian exports to Mexico grew at an average annual rate of 13.1 per cent since 1989 (14.2 per cent since 1994) while imports grew at an even faster 16.7 per cent average annual rate (14.8 per cent) for the same period, significantly outpacing growth with the U.S. It should also be noted that trade with Mexico, particularly Canadian exports to Mexico, may be understated due to transhipments.[5] Thus, while Canada's trade deficit with Mexico grew from $1.3 billion in 1989 ($3.7 billion in 1994) to $9.9 billion in 2001, Mexico also reported a large and growing trade deficit with Canada.

Merchandise trade accounts for the bulk of Canada-Mexico trade. In 2003, Canadian merchandise exports to Mexico reached $2.2 billion, or three-times greater than their 1989 levels (double that of 1994). Merchandise imports from Mexico exceeded exports by a factor of five, reaching $12.2 billion by 2003. Furthermore, growth in imports has vastly outstripped growth in exports having increased nearly seven-fold since 1989 (more than doubled since 1994).

The Prairie Provinces; Alberta, Saskatchewan and Manitoba, however, greatly outpaced national growth in exports to Mexico. Exports by the Prairies were more than 800 per cent higher in 2003 than in 1989. This was driven almost entirely by exports of agricultural products as well as by processed food, beverage and tobacco products. By 2003, more than 80 per cent of exports from the Prairies to Mexico belonged to this category.

Figure E-6

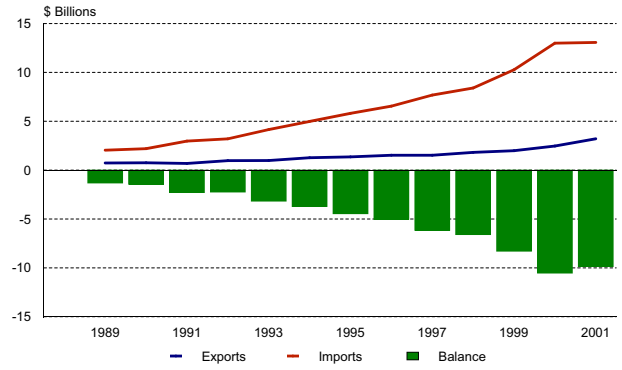
Canada-U.S. FDI Stocks



Data: Statistics Canada, International Investment Position

Figure E-7

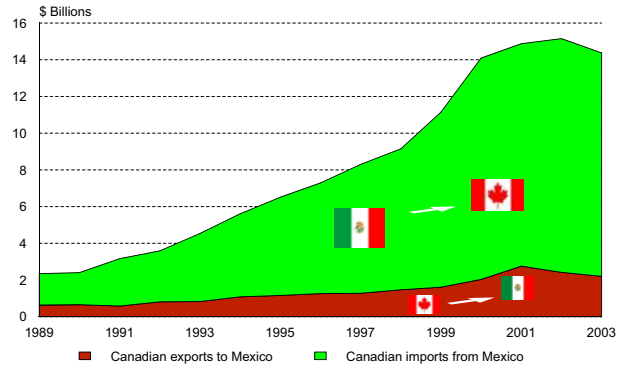
Canada-Mexico Trade in Goods and Services



Data: Statistics Canada

Figure E-8

Canada-Mexico Merchandise Exports & Imports

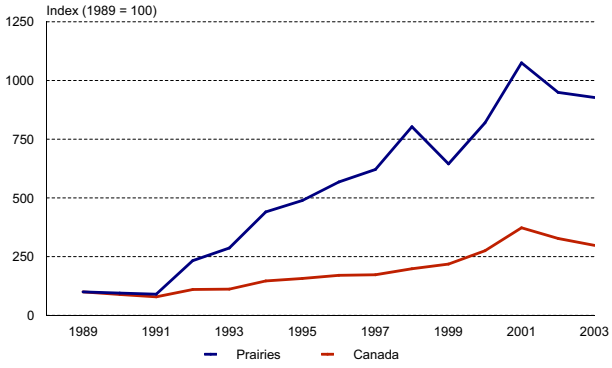


Data: Statistics Canada, Customs Basis

The NAFTA, and the Canada-U.S. FTA before it, along with a booming U.S. economy and declining Canada-U.S. exchange rate all contributed to a rising importance of the U.S. and Mexico for Canada over the past decade-and-a-half. In the last few years, however, we have seen some of these trends show signs of reversing. With the two trade agreements now in place, uncertainty about whether the U.S. will be able to continue to outpace global growth as it had, as well as a change in the direction of exchange rate movements, only time will tell if recent movements are temporary fluctuations or reflect a change in long-term trends.

Figure E-9

Canadian Merchandise Exports Growth to Mexico



Data: Statistics Canada, Customs Basis

[1] "NAFTA@10: A Preliminary Report"

[2] On a customs basis.

[3] 1992 is the earliest data for which data is available for exports by the NAICS industrial classification while 2001 is the most current data available for manufacturing shipments.

[4] 2001 is the most up-to-date balance of payments data available for Mexico.

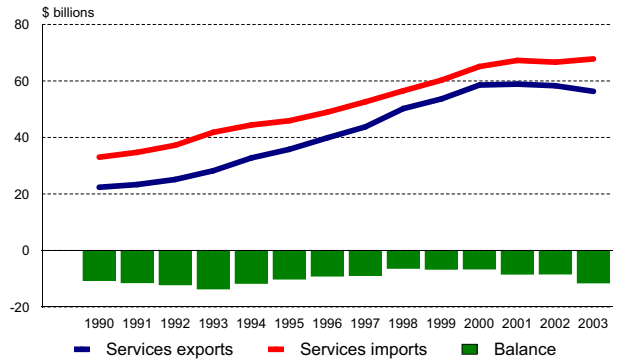
[5] See Box C: Misallocation and Undercoverage in Merchandise Trade Statistics.

II. SERVICES

Services exports performed slightly better than goods exports in 2003, falling less rapidly than was the case for goods (Figure 2-1). With this performance, services exports recorded a $2.0 billion decline, down 3.4 per cent, to $56.3 billion last year. At this level, services exports represented 12.3 per cent of total exports of goods and services. In other words, about one dollar of every eight dollars earned from Canadian exports last year came from services.

Figure 2-1

Services trade, 1990-2003



On the other hand, services imports increased last year, up almost $1.2 billion to $67.8 billion. This was a 1.7 per cent increase over 2002 levels. The increase brought services imports to about 16.6 per cent of total imports of goods and services into Canada, or nearly one dollar of every six dollars of imports.

With services exports falling and services imports on the rise, Canada's traditional services deficit widened last year, returning to levels not seen since the early- to mid-1990's. For the year as a whole, the deficit on services trade expanded to $11.5 billion.

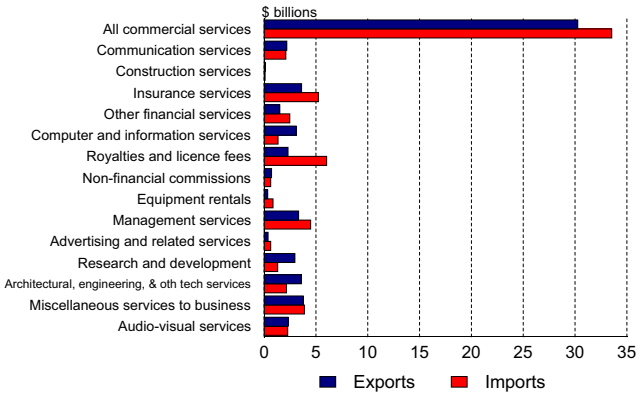
There are four sub-components to services trade — commercial services, travel services, transportation services and government services. Each of these categories is discussed in greater detail.

Commercial services

Commercial services are the largest component of services, accounting for about half of all services trade. These services include such things as accounting, legal, insurance, financial, architectural, computer, communications, and construction services, to name but a few. In 2003, commercial services was the only major component of services to record an increase in exports: total commercial services exports increased by $1.0 billion to $30.3 billion, an increase of 3.2 per cent (Figure 2-2). With this increase, the share of commercial services in total services exports increased to 53.7 per cent last year, up from 50.3 per cent the previous year.

Figure 2-2

Commercial services trade, 2003



Gains in commercial services exports were led by *Management services* (up $665 million, or 25.0 per cent), *Insurance services* (up $357 million, or 10.9 per cent), and *Audio-visual services* (up $275 million, or 13.4 per cent). Falling *Royalties and licence fees* receipts (down $340 million, or 12.8 per cent), and reduced exports of *Miscellaneous services to business* (down $248 million, or 6.2 per cent) were a limiting factor in the growth of commercial services exports.

Commercial services was also the largest services import category in 2003 — at 49.5 per cent of total imports (unchanged from the previous year). Imports of commercial services advanced 1.6 per cent last year, comparable to the 1.7 per cent rate observed for total services imports. Gains were led by *Insurance services* (up $361 million, or 7.4 per cent), *Royalties and licence fees* receipts (up $308 million, or 5.4 per cent), and *Architectural, engineering, and other technical services* (up $274 million, or 14.5 per cent). Putting a cap on the advances were declines in *Management services* (down $195 million, or 4.2 per cent), *Audio-visual services* (down $139 million, or 5.7 per cent), and *Miscellaneous services to business* (down $137 million, or 3.4 per cent).

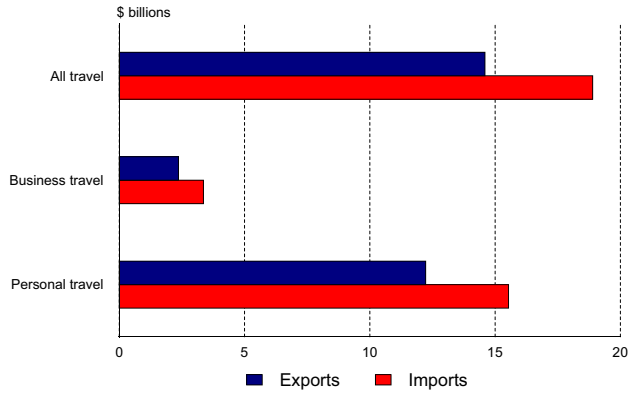
With exports rising more than imports, commercial services posted a $413 million improvement in its trade balance, reducing the deficit to $3.3 billion in 2003.

Travel services

Travel services are Canada's second largest category of services exports. At $14.6 billion in 2003, they were also $2.1 billion (or 12.8 per cent) lower than the $16.7 billion high recorded the previous year. The two sub-categories that comprise travel services — *Business travel* and *Personal travel* — experienced reduced exports last year as the effects of the outbreak of SARS in the Toronto area in the Spring of 2003 and the rising value of the Canadian dollar with respect to the U.S. currency throughout the year impacted negatively on travel services. The bulk of the decline in these exports was concentrated in *Personal travel services*, which fell nearly $1.8 billion (or 12.5 per cent). *Business travel services* were also down, falling almost $0.4 billion, or 14.0 per cent. With the drop in exports, travel services declined to 25.9 per cent of total services exports last year, from 28.7 per cent in 2002 (Figure 2-3).

Figure 2-3

Travel services trade, 2003



Total travel services imports rose by 1.7 per cent in 2003 — the same pace recorded for total services imports. As a result, travel services maintained their 27.9 per cent share of total services imports from 2002 to 2003. Overall, travel services rose $0.3 billion, to $18.9 billion for the year. *Personal travel* imports were up $0.4 billion, or 2.5 per cent, from a year earlier while *Business travel* imports were $0.1 billion (or 2.1 per cent) lower than they were in 2002.

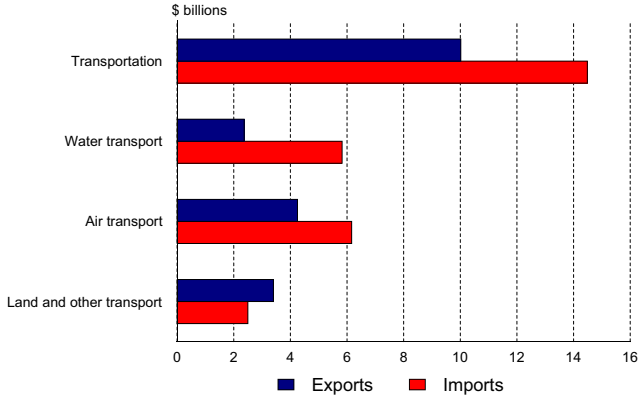
With these developments, the deficit in travel services widened by $2.4 billion, to $4.3 billion in 2003. Both components — *Business travel* and *Personal travel* — contributed to the deterioration in this trade balance.

Transportation services

Transportation services also experienced a fall in their exports last year. This sector, which accounts for slightly less than one-fifth of total services exports (or 17.8 per cent), saw exports fall $0.8 billion to $10.0 billion from 2002 to 2003. The bulk of the decline came in *Air transport services*, as these exports fell 14.6 per cent, from $5.0 billion to $4.3 billion. Also contributing to the losses were fewer exports of *Land and other transportation services*, which declined from $3.6 billion to $3.4 billion, or 4.9 per cent. Partially offsetting the declines was a $0.1 billion (or 4.0 per cent) increase in exports of *Water transport services*. Exports of these particular services rose to $2.4 billion last year (Figure 2-4).

Figure 2-4

Transportation services trade, 2003



On the import side, gains in *Water transport services* (up $0.3 billion, or 5.7 per cent) and *Air transport services* (up $0.2 billion, or 3.1 per cent) were partially offset by a $0.2 billion (or 8.1 per cent) decline in *Land and other transportation services*. Thus, total transportation services imports advanced by $0.3 billion to $14.5 billion in 2003, a 2.0 per cent increase over 2002.

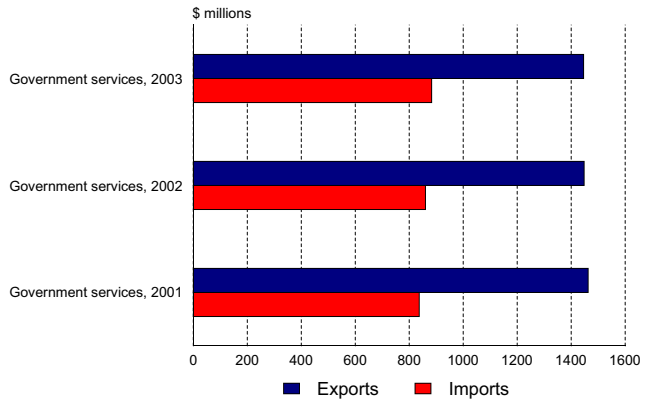
The combination of falling exports and rising imports meant that there was a $1.1 billion widening of the transportation services deficit in 2003, to $4.5 billion. Both the *Air transport* and *Water transport* sub-categories contributed to the increased trade deficit, while *Land and other transportation services* contributed a small surplus, thereby limiting the overall widening of the deficit in transportation services.

Government services

Government services cover international transactions arising largely from official representation and military activities. They showed a marginal ($2 million, or 0.1 per cent) decline in exports and a $22 million (2.6 per cent) increase in imports in 2003. The overall effect was a $24 million decrease in the trade surplus of this category of services trade, from $587 million in 2002 to $563 million in 2003 (Figure 2-5).

Figure 2-5

Government services trade, 2001-2003

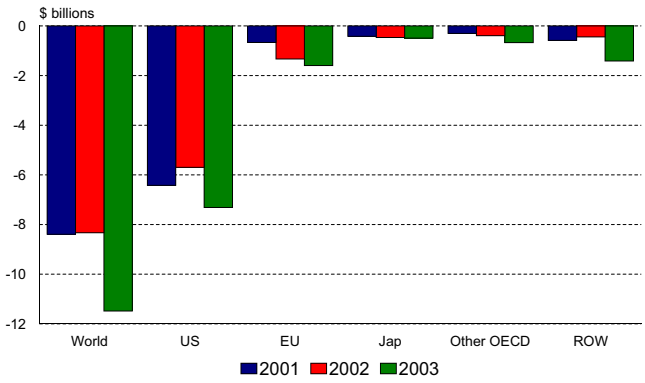


Services trade by region

As is the case for goods, the United States is Canada's principal trading partner for services, accounting for nearly six of every ten dollars of services trade (59.6 per cent). This is as true for exports, where the U.S. share of total services exports is 59.2 per cent, as it is for imports, where the U.S. share of total services imports is 60.0 per cent.

Figure 2-6

Services trade balances by principal regions, 2001-2003



Services trade with the United States

Canadian exports of services to the United States fell $1.8 billion, or 5.0 per cent, to $33.4 billion in 2003. Exports of travel services fell $1.3 billion, accounting for 70 per cent of the decline. Transportation and government services accounted for the remainder of the fall in services exports to this country, declining $0.6 billion. Commercial services exports to the U.S. managed a $0.1 billion increase to partially offset the losses.

Services imports from the U.S. fell by $143 million, or 0.4 per cent, to $40.7 billion last year. As was the case on the export side, declines in travel services (down $116 million) and transportation and government services (down $40 million) were partially offset by a small ($13 million) increase in imports of commercial services.

Overall, the services trade balance slipped another $1.6 billion into deficit, as Canada's services trade deficit with the U.S. expanded to $7.3 billion last year from $5.7 billion a year earlier (Figure 2-6)

Services trade with the European Union

Services exports to the EU advanced $225 million to $9.5 billion in 2003, a 2.4 per cent increase. Commercial services receipts were up $444 million (or 10.3 per cent) to account for the gains, while travel services were off by $228 million (or 8.9 per cent) to account for the setbacks. Transportation and government services exports to the EU were up marginally, by $8 million, last year.

Services imports from the EU were also up last year, rising $490 million (or 4.6 per cent) to $11.1 billion. The bulk of the increases came in commercial services imports, which rose $398 million, supported by advances in travel services (up $79 million) and transportation and government services (up $14 million).

With services imports from the EU rising more than services exports to the EU, the services trade deficit with the EU widened some $264 million, to $1.6 billion in 2003.

Services trade with Japan

Declines in travel receipts (down $315 million) and transportation and government services exports (down $66 million) were only partially offset by a $19 million increase in commercial services exports to Japan, resulting in total services exports to Japan falling by $362 million, or 20.2 per cent, to $1.4 billion in 2003.

Services imports from Japan fell $338 million, or 15.0 per cent, to $1.9 billion last year. The bulk of the decline was in commercial services, which fell $361 million, while transportation and government services declined a more modest $5 million. Travel services imports from Japan were on the rise last year, up $27 million.

With services exports to Japan declining more than services imports from Japan, Canada's bilateral services trade deficit with that country widened by $24 million, to $491 million, in 2003.

Services trade with the rest of the world

Canadian service exports to all countries, excepting the United States, the European Union and Japan, fell $106 million to $12.1 billion in the year just past. A $409 million increase in commercial services exports was offset by the combination of a $330 million decline in travel services exports and a $182 million drop in transportation and government services exports to the rest of the world.

All three components of services imports from the rest of the world posted increases last year over their 2002 levels. The advances were led by commercial services (up $489 million), followed by transportation and government services (up $337 million) and by travel services (up $318 billion). The overall increase in services imports from this region was thus a little over $1.1 billion last year.

Falling services exports and rising services imports meant that the services trade deficit widened by one and one-quarter billion dollars last year, from a little over $0.8 billion to almost $2.1 billion.

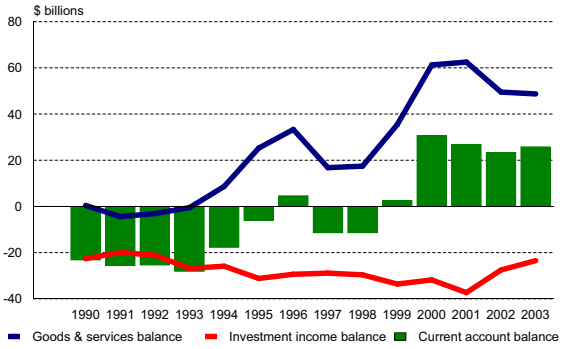
III. CURRENT ACCOUNT

The current account is one of the two major accounts that make up the balance of payments: the other is the capital account. The current account records the flow of goods and services between Canada and countries abroad. 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 account.

Canada recorded its fifth straight current account surplus in 2003, as the balance expanded $2.4 billion to $25.8 billion (Figure 3-1). The goods surplus rose $2.4 billion on the basis of imports falling faster than exports, while the services deficit widened $3.2 billion, as exports of services fell and imports rose. The deficit on investment income also narrowed by some $4.0 billion from a year earlier. Finally, rounding out the balances, the balance on current transfers fell $0.8 billion.

Figure 3-1

Current account balance and key components, 1990-2003



Regional analysis

The United States

Canada continues to run a surplus in its current account balance with the United States; this balance widened by $3.8 billion to $63.9 billion in 2003. A $5.6 billion narrowing of the bilateral investment income deficit was the principal reason for the advance. Profits accruing to Canadian direct investors in the U.S. shot up $3.7 billion while those accruing to U.S. holders of direct investment in Canada fell $0.4 billion to account for the bulk of the gains. The stronger Canadian dollar also likely contributed to a reduction in the deficit in portfolio investment income. This is because a large part of the Canadian securities owned by foreign portfolio investors are issued in US dollars, as is the interest paid on these securities (see Box B on the impact of the rising dollar, particularly the section dealing with debt holdings). In total, the deficit in portfolio investment income improved $0.9 billion as payments to U.S. investors fell $0.8 billion while remittances to Canadian portfolio investors were up by $0.1 billion.

The goods balance also contributed marginally to the improvement in the current account balance with the U.S. — a $15.6 billion decline in exports was slightly more than offset by a $15.7 billion decline in imports, resulting in a net contribution of $0.1 billion to the bilateral balance. However, the services deficit expanded by $1.6 billion as the travel deficit declined by $1.1 billion and the transportation balance fell $0.5 billion (and moved from a small surplus to a deficit position). These sectors were most likely negatively affected by the SARS outbreak in the Spring of 2003 and by the rising value of the Canadian dollar vis-à-vis the US dollar throughout the year. In fact, about 70 per cent of the decline in the travel deficit occurred in the second half of the year, when the dollar averaged nearly US 74.2¢ over July-December compared to a US 63.6¢ average for all of 2002.

The European Union

The current account with the European Union was relatively unchanged in 2003 from 2002, as the deficit narrowed $125 million to $15.1 billion. The goods deficit narrowed by $2.7 billion on the strength of a $1.3 billion increase in exports to the U.K., coupled with a $1.4 billion decrease in imports from the U.K. The goods trade balance with the rest of the EU edged down $75 million. However, offsetting the improvement to the goods balance were further deterioration to the services trade deficit (down $0.3 billion) and to the investment income deficit (down $2.4 billion).

Japan

The deficit in Canada's current account with Japan narrowed by $1.5 billion to $3.0 billion in 2003. The goods deficit contracted $0.7 billion to about three-quarters-of-a-billion dollars last year. Both exports to and imports from Japan were down — the former by $0.4 billion and the latter by $1.1 billion.

Similarly, the investment income deficit narrowed by $0.9 billion as income receipts were off by $0.1 billion and income payments were down by $1.0 billion. The reduction in payments is likely related to the stronger international value of the Canadian dollar, with Japanese investors likely holding Canadian securities issued in US dollars (see Box B on the impact of the rising dollar, particularly the section dealing with debt holdings).

Finally, the services deficit edged down $24 million to $491 million.

The rest of the world

The bilateral current account deficits between Canada and the other OECD countries and between Canada and all other countries moved in opposite directions last year, with the former narrowing slightly (by $0.3 billion to $6.4 billion) and the latter widening (by $3.4 billion to $13.7 billion). In the case of the other OECD countries, Canada's exports to these countries advanced $0.4 billion while imports edged back $0.1 billion resulting in a $0.4 billion narrowing in the goods deficit with this region. Similarly, investment incomes posted gains (up $0.1 billion) while payments fell nearly the same (down $0.1 billion), resulting in a $0.2 billion widening (to $1.3 billion) of the bilateral investment income surplus that Canada enjoys with this region. However, the services deficit expanded from $0.4 billion in 2002 to $0.7 billion in 2003, thereby limiting the overall improvements to Canada's current account balance with these countries.

As regards the all other countries region, each of the principal components experienced a deterioration in their balances over the year: the goods deficit expanded $1.5 billion; that for services grew by nearly $1.0 billion; and the surplus in the investment income balance narrowed by $0.3 billion.

Since the mid-1970s, Canada has mainly run current account deficits, coinciding with rising levels of government debt. (It is only more recently that we have run a series of current account surpluses.) 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, over the past seven fiscal 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 2003, the net debt-to-GDP ratio was reduced by 25.2 percentage points to 43.5 per cent of GDP, resulting in Canada's debt burden being now the second-lowest amongst the G7. 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 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 saving and investment, as share of GDP, 1980s to 2003

Year	Private		Public		Current Account
	Saving (%)	Investment (%)	Excess saving over Investment	Budget surplus(+) Budget deficit (-)	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	17.1	18.0	-0.9	1.6	0.3
2000	18.6	18.0	0.6	3.3	2.9
2001	18.8	16.9	1.8	1.7	2.4
2002	18.8	17.3	1.5	1.3	2.0
2003	18.6	17.5	1.1	1.7	2.1

Source: Statistics Canada, National Income and Expenditure Accounts, Catalogue No. 13-001-PPB, 4th Quarter 2003.

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.

IV Capital and Financial Account

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 instruments[1] — such as financial options, futures and forwards.

For the purpose of this Report, the financial account is of most interest 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. We begin with an examination of direct investment.

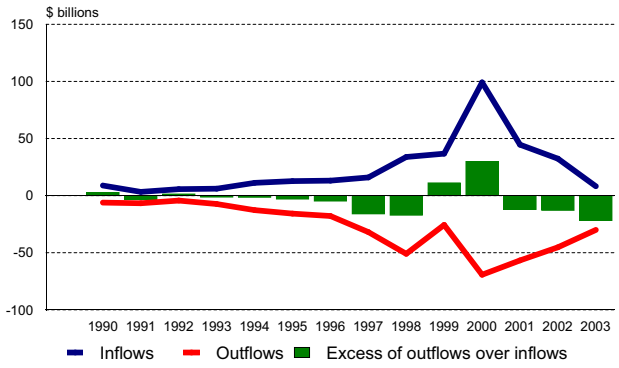
Direct investment (flows)

Canadian foreign direct investment (FDI) flows continued to contract in 2003, as it had in the past few years, reflecting macroeconomic rather than microeconomic developments; this despite the findings of the management consulting firm KPMG that found that Canada is the most cost-competitive nation among the countries of North America, Europe and Japan, with lowest overall costs for labour, land and construction, and electricity, and one of the lowest corporate income tax rates.

For 2003, FDI inflows into Canada fell dramatically (to $8.3 billion) — down to only one-quarter of the $32.3 billion of direct investment that flowed into Canada only one year earlier. It was the third straight year of decline following nine years of uninterrupted expansion of FDI flows into Canada (Figure 4-1). Inbound flows from all major trading partner areas were down last year.

Figure 4-1

Inflows, outflows, and balance of direct investment flows, 1990-2003



Regionally, the United States has accounted for the lion's share of inward investment into Canada over the recent past. (In fact, the U.S. has been a major investor in Canada over the past three-quarters-of-a-century-or-so.) The exception to this was the year 2000 when there was a one-time surge of European investment led by the French takeovers of Seagrams by Vivendi and of Newbridge by Alcatel. While still the dominant investor, the U.S. share of total FDI inflows has slipped from 91.5 per cent in 2001, to 76.4 per cent in 2002, to 53.0 per cent in 2003.

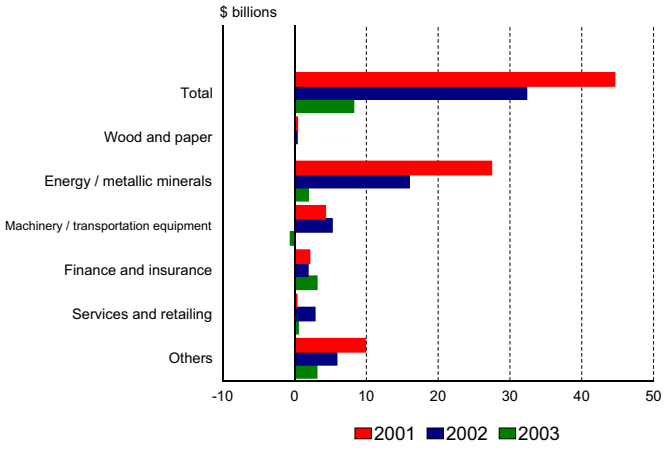
EU investors were next in importance last year, at just under one-quarter of all FDI inflows, or 24.7 per cent. Japanese investors leap-frogged over investors from all other non-OECD countries to place third in importance, representing 9.9 per cent of total FDI inflows in the year just past.

Five of every six dollars of the decline were attributable to U.S. investors: that is, U.S. direct investment into Canada plummeted by 82.3 per cent of their 2002 levels, or by $20.3 billion, to just under $4.4 billion. European investors were responsible for about 8.25 per cent of the decline, as FDI inflows from the U.K. plunged by more than 80 per cent from their 2002 levels, from about $1.25 billion to nearly $0.25 billion. Direct investment inflows from the remainder of the EU were down by more than a third: from $2.8 billion to $1.8 billion. Canada also saw a significant decline in FDI inflows from non-OECD countries; they fell by about two-thirds, from $2.2 billion to $0.7 billion.

Foreign direct investment flows into Canada were down in all sectors, with the exception of the *finance and insurance* sector where investment was up by $1.2 billion to $3.1 billion (Figure 4-2). About 60 per cent of the reduction in FDI inflows came in the *energy/metallic minerals* sector (down $14.1 billion to $1.9 billion). There was a net withdrawal of investment in *machinery and equipment* of $0.6 billion as foreign investors reduced investment by $5.9 billion in the sector from the $5.3 billion level observed last year. Elsewhere, investment flows to *miscellaneous* industries were reduced $2.8 billion to $3.1 billion, those to *services and retailing* declined $2.3 billion to $0.5 billion, and those to *wood and paper* were down $0.3 billion to just $94 million.

Figure 4-2

Inflows of direct investment by sector, 2001-2003



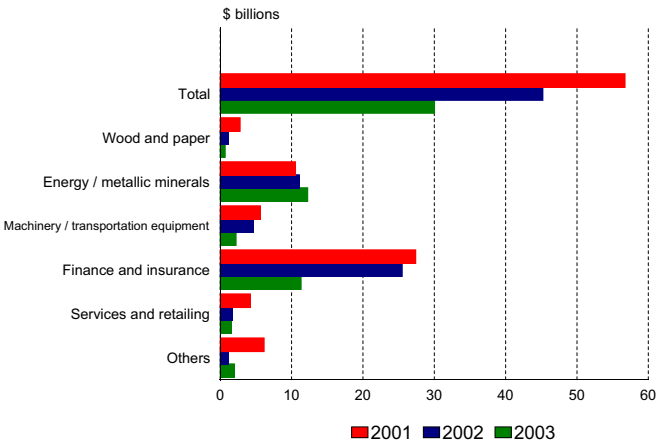
Developments on the Canadian FDI outflow side, or Canadian Direct Investment Abroad (CDIA), were a little less pronounced than on the FDI inflows side, but, nonetheless, quite dramatic. Outward Canadian investment flows fell by a third, or $15.2 billion, to just over $30.0 billion in 2003. These direct investment outflows were down to most major partners, except for the U.K. Half of the decline came from reduced CDIA flows to the U.S. These investment outflows fell by $7.6 billion, slightly more than halving the investment level observed for 2002 ($14.0 billion). Investment outflows to the other OECD countries plunged $5.9 billion, completely erasing the $5.7 billion investment that flowed into that region in 2002; thus, there was a net withdrawal of CDIA of about $236 million from that region over the course of the past two years. CDIA flows to Japan also fell noticeably in 2003, down from about $1.5 billion to a bit over $0.3 billion, or a decline of 78.2 per cent.

Corporate malfeasance, weak consumer confidence, and a multitude of corrections that have been taking place on the U.S. economic front have been reflected in decisions concerning Canadian direct investment abroad. Canadian outward investment has increasingly shifted to Europe, much more so than in the recent past. Just two short years ago, more than half of all CDIA flows were destined to the U.S.; in 2002, the share had fallen to around 31 per cent; by last year, just slightly over 21 per cent of all investment flows found their way to the U.S. The EU has been the prime beneficiary of the shift of CDIA flows away from the U.S., notwithstanding weak economic growth performance in that region. The EU share in direct investment outflows has vaulted from 13.8 per cent in 2001, to 32.4 per cent in 2002, to 50.3 per cent last year.

The bulk of the decline in CDIA outflows occurred in the *finance and insurance* sector, where investment levels plunged 55.5 per cent, or $14.2 billion, to $11.3 billion last year (Figure 4-3). At this level of investment, *finance and insurance* slipped from the largest to second-largest sector for outward investment. The largest sector to receive Canadian outward investment in 2003 was the *energy/ metallic minerals* sector, where direct investment outflows expanded 10.5 per cent to $12.3 billion. Thus, *energy/ metallic minerals* and *finance and insurance* accounted for 40.8 per cent and 37.8 per cent of total CDIA outflows last year. Investment flows to the third largest CDIA recipient sector — *machinery and equipment* — were halved in 2003, from $4.6 billion to $2.2 billion. For the remainder of the sectors, $2.0 billion in foreign investment flows were directed to *miscellaneous* or "other" sectors (up $0.8 billion), $1.5 billion went to the *services and retailing* segment of the market (down $0.2 billion), and $0.7 billion went to *wood and paper* industries (down $0.4 billion).

Figure 4-3

Outflows of direct investment by sector, 2000-2003



Portfolio investment

In 2003, the flow of Canadian portfolio investment, or Canada's international transactions in foreign stocks and bonds, fell for the third consecutive year — from $63.8 billion in 2000, to $37.6 billion in 2001, to $25.0 billion in 2002, to $12.5 billion last year. Over this period, a major restructuring in the portfolio mix of Canadian investors abroad has taken place. From 2000 to 2001, investors withdrew from the stock and bond markets in equal proportions, while maintaining the 1:19 ratio between bonds and stocks that was in place in the year 2000. That is, for every 5 dollars of new foreign bonds held there were new holdings of 95 dollars of foreign equities. Over the course of the year 2002, the investment pattern started to shift towards bonds and out of stocks. This was hardly surprising given the several prominent disclosures of corporate malfeasance and the ongoing correction to stock market prices, particularly in the technology sector. The mix of new foreign holdings of bonds to stocks fell to a 1:3 ratio (i.e., for every 5 dollars of new foreign bonds held there were 15 dollars of foreign stocks held). The shift continued to pick up momentum in 2003 and last year two-thirds of the flow of portfolio investment was directed into the bond market, or a 2:1 ratio (in other words, for every 5 dollars of new bond holdings there was 2 dollars and 50 cents of new investment in foreign equities). Thus, in an overall situation of shrinking portfolio investment, Canadian purchases of foreign stocks were lower by $14.4 billion compared to 2002, while bond holdings increased by $2.0 billion.

The flow of foreign portfolio investment into Canada dropped $5.9 billion to $15.2 billion in 2003. Foreign investors, who had added $3.8 billion in money market instruments in 2002, sold off $8.2 billion of these securities last year. These investors also cut their new bond holdings from $18.7 billion to $6.7 billion between 2002 and 2003. However, they made significant additions (of $14.3 billion) to their equity holdings last year, after having sold off these investments by an amount of $1.4 billion only one year earlier.

Overall, after four consecutive years where the flow of Canadian outward portfolio investment exceeded the flows of foreign portfolio investment into Canada, the situation reversed itself in 2003 and inflows exceeded outflows. The amount of this difference was $2.7 billion last year, compared with outflows exceeding inflows by $3.9 billion in 2002, a $6.6 billion turnaround.

International investment position

Since Statistics Canada's reporting on this data have been delayed this year, we are unable to set out Canada's performance in this area for 2003. The reader is advised to check the electronic version of this Report at << www.dfait-maeci.gc.ca/eet/trade/state-of-trade-en.asp >> later this year for an update to this section.

[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.

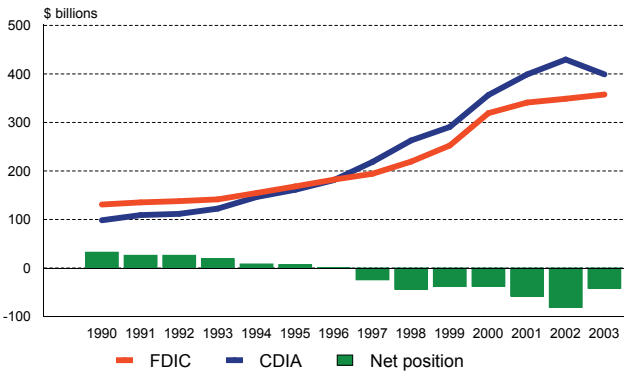
In 2003, the stock of Canadian direct investment abroad (CDIA) amounted to $399.1 billion, down 7.1 per cent from a record high of $429.6 billion at the end of 2002. This decline, the first since 1948, was due to the appreciation of the Canadian dollar against major foreign currencies[1] over the course of 2003, which lowered the Canadian dollar value of Canadian assets abroad denominated in foreign currencies.

At the same time, the stock of FDI in Canada rose to $357.5 billion in 2003, up 2.5 per cent from $348.9 billion at year-end in 2002. This rate of expansion was marginally higher than in 2002 (2.3 per cent), but substantially lower than the record 26.4 per cent growth attained in 2000.

Canada's net direct investment position—the difference between CDIA and FDI in Canada—decreased to $41.6 billion at the end of 2003, down from a revised $80.7 billion a year earlier. With the stock of CDIA exceeding that of FDI in 2003, Canada continued to be a net exporter of direct investment capital—a position it has maintained since 1997 (Figure 5-1).

Figure 5-1

CDIA, FDI in Canada, and net direct investment position, 1990-2003



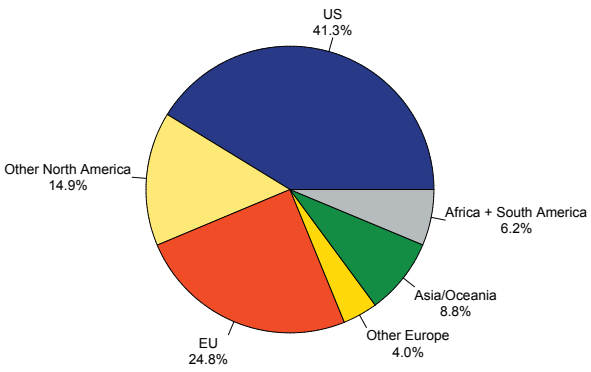
Outward direct investment (CDIA)

Investment by region

North America accounted for $224.4 billion, or 56.2 per cent of the stock of CDIA in 2003, down sharply from 60.7 per cent in 2002 (Figure 5-2). The bulk of these holdings (73.5 per cent) were in the United States, which historically has been the single largest destination for Canadian outward direct investment. Canadian direct investment in the U.S. was valued at $164.9 billion, or 41.3 per cent of total CDIA in 2003, down markedly from $197.1 billion, or 45.9 per cent of total CDIA in 2002. The decline reflected the appreciation of the Canadian dollar vis-à-vis the U.S. dollar in 2003. The offshore banking centres of Barbados ($24.7 billion), Bermuda ($10.8 billion) and the Cayman Islands ($10.6 billion) accounted for almost four fifths of the remaining stock of CDIA in

Figure 5-2

Distribution of CDIA by region, 2003



North America. In fact, Barbados was the third largest single-country destination of CDIA, after the U.S. and the United Kingdom. The stock of CDIA in NAFTA-partner Mexico fell by 13.2 per cent to $2.8 billion in 2003; this decline was also due to the appreciation of the Canadian dollar, in this case against the peso.

Europe accounted for the second-largest regional stock of CDIA in 2003, at $114.9 billion; this represented an increase of $7.1 billion over 2002. Europe's share of the total stock of CDIA rose from 25.1 per cent in 2002 to 28.8 per cent in 2003.

The European Union (EU)[2] accounted for 86.2 per cent of Canadian direct investment assets in Europe. The stock of CDIA in the EU grew by 11 per cent in 2003, an increase of $9.8 billion. Investment levels were up in most EU countries, with the biggest increase occurring in France where the stock of CDIA rose by $7.1 billion, largely due to a major takeover of a French company by a Canadian multinational[3]. In other developments of note, the stock of CDIA rose by $2.3 billion in Ireland and by approximately half a billion dollars in both Sweden and the U.K.

Non-EU European countries with sizeable Canadian direct investment holdings included Hungary ($9.5 billion) and Switzerland ($4.0 billion). However, CDIA fell in both Hungary and Switzerland in 2003 by 28 per cent and 12 per cent, respectively.

Asia/Oceania was the next largest region for CDIA. It accounted for 8.8 per cent of the total outward stock of investment in 2003—virtually the same share as in 2002. Total Canadian direct investment holdings in this region fell by one per cent to $35 billion in 2003. Japan, at $9.1 billion, accounted for the largest stock of CDIA in the region, followed by Australia at $7.8 billion and Indonesia at $5.5 billion. Among the major investment destinations, Australia registered the largest expansion in the value of CDIA, at 10.1 per cent.

South and Central America accounted for $22.3 billion of CDIA in 2003. Brazil and Chile together accounted for some 60 per cent of Canada's direct investment in this region, with $7.6 billion and $5.9 billion of CDIA, respectively. Argentina and Peru together made up an additional 31 per cent of Canada's direct investment in this region, with $5.2 billion and $1.8 billion of CDIA in 2003, respectively.

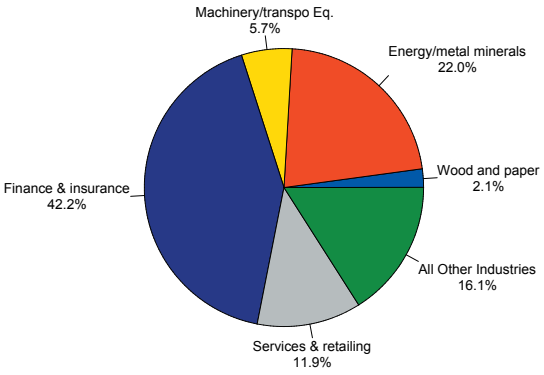
Africa's share of CDIA was by far the smallest of any region. With $2.4 billion of CDIA in 2003, Africa accounted for less than one per cent of Canada's direct investment holdings abroad. The stock of CDIA in the region declined by 13.3 per cent in 2003—about twice the rate of the drop in overall CDIA. Given that investment levels are not high, much of the data on CDIA in Africa is considered confidential by Statistics Canada. Consequently, little can be said about the distribution of CDIA within Africa.

Investment by sector

Direct investment data are available for six industrial groupings and three major regions: the U.S., the EU, and Japan-and-the-rest-of-the-world. Canadian direct investment abroad (CDIA) is mostly concentrated in the financial and insurance sector, which accounted for 42.2 per cent of the stock of CDIA in 2003, virtually unchanged from the previous year (Figure 5-3). Investment in the energy and metallic minerals sector is next in importance at 22.0 per cent of the total. Services and retail accounted for 11.9 per cent of CDIA, followed by machinery and transportation equipment (5.7 per cent) and wood and paper (2.1 per cent). All other sectors combined—a mix of manufacturing and service industries—accounted for 16.1 per cent of total CDIA.

Figure 5-3

Distribution of CDIA by sector, 2003



It is not surprising that, with just over two fifths of CDIA (41.3 per cent) in the U.S., investments there figured prominently in Canadian direct investment in most industries. In 2003, the U.S. services and retailing industries ($30.9 billion) accounted for 65.1 per cent of total CDIA in this sector. Investment in

U.S. wood and paper ($4.6 billion) and miscellaneous industries ($32.8 billion) were responsible for 55.2 per cent and 51.1 per cent, respectively, of CDIA in these sectors. The U.S. also accounted for significant shares of total sectoral CDIA in energy and metallic minerals (38.2 per cent) and finance and insurance (34 per cent).

Machinery and transportation equipment was the only sector in which CDIA in the EU exceeded that in the U.S. In 2003, CDIA in the EU machinery and transportation equipment sector amounted to $9.0 billion, or 39.7 per cent of Canadian direct investment in that industry. By comparison, the U.S. machinery and transportation equipment industry accounted for $5.7 billion, or 25 per cent of total CDIA in that sector. CDIA levels were also substantial in finance and insurance ($43.0 billion), in energy and metallic minerals ($20.8 billion), and in miscellaneous industries ($15.3 billion). The stocks of CDIA in the EU were below $10 billion in services and retailing ($8.5 billion) and wood and paper ($2.4 billion).

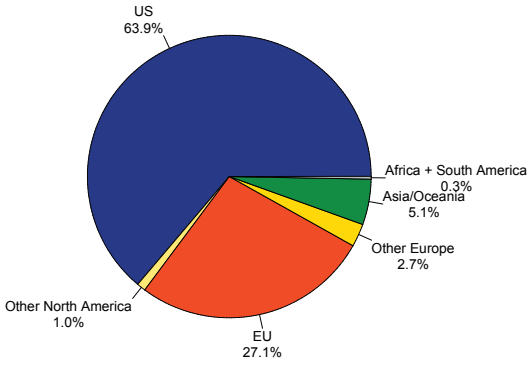
Inward direct investment

Investment by region

Almost two of every three dollars of FDI in Canada came from other North American countries, almost all of it (over 98 per cent) from the U.S. In 2003, $228.4 billion of the $232.0-billion total North American FDI in Canada originated in the U.S. (Figure 5-4).

Figure 5-4

Distribution of FDI in Canada by region, 2003



Europe was the second-most important investor region for FDI in Canada, accounting for almost 30 per cent of the FDI stock in Canada in 2003, with about 90 per cent of that held by EU investors. Within the EU, France was the largest investor ($31.6 billion, or 32.7 per cent of total EU FDI in Canada), followed by the U.K. ($27.1 billion, or 28 per cent of total EU FDI in Canada) and the Netherlands ($15.3 billion, or 15.8 per cent of total EU FDI in Canada). Of the non-EU European countries, Switzerland was the most important investor in Canada.

North America and Europe together accounted for the overwhelming share (94.6 per cent) of the total FDI stock in Canada in 2003. Investors from Asia/Oceania accounted for 90 per cent of the remainder, with holdings valued at $18.2 billion, or 5.1 per cent of total FDI in Canada, up $1.7 billion from 2002 levels. Japan is the largest Asian investor in Canada with $9.7 billion in 2003, followed by Hong Kong ($4.7 billion) and Australia ($2.0 billion). These three economies accounted for 90 per cent of the stock of FDI from this region in 2003. Hong Kong investment was especially noteworthy last year, rising $0.7 billion from its 2002 level of $4.0 billion—an 18.4 per cent increase.

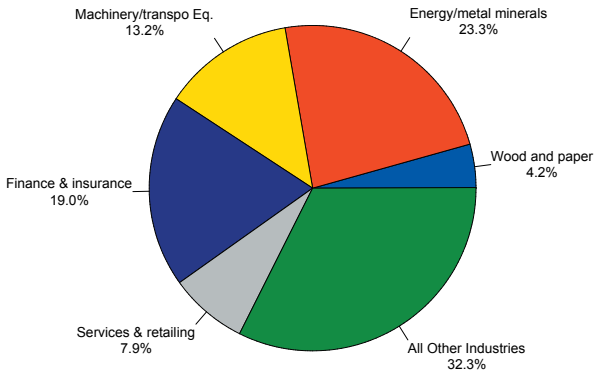
The stock of FDI from South and Central America totalled only $831 million in 2003, or 0.2 per cent of total FDI in Canada. Brazil, with $770 million, and Panama, with $50 million, accounted for virtually all of the stock of FDI in Canada from this region.
The stock of FDI in Canada sourced from Africa fell almost 25 per cent in 2003, from $294 million to $221 million, reflecting reduced holdings by South African investors. The stock of South African FDI in Canada fell from $287 million to $213 million in 2003. African FDI accounted for only one tenth of one per cent of the stock of total FDI in Canada in 2003.

Investment by sector

FDI in Canada was dispersed across a broad range of industries. Indeed, the category "miscellaneous industries," representing a mix of consumer goods and service industries including food and beverages, apparel, electrical equipment and electronics, chemical products and communications, accounted for almost one third ($115.6 billion or 32.3 per cent) of total FDI in Canada in 2003 (although this is down from a 38.7-per cent share in 2000) (Figure 5-5).

Figure 5-5

Distribution of FDI in Canada by sector, 2003



Among the individual industrial sectors, energy and metallic minerals led the way, accounting for $83.5 billion, or 23.3 per cent of total FDI in Canada in 2003, followed by finance and insurance ($67.9 billion, or 19.0 per cent of the total), machinery and transportation equipment ($47.2 billion, or 13.2 per cent of the total), services and retail ($28.3 billion, or 7.9 per cent of the total), and wood and paper ($15.2 billion, or 4.2 per cent of the total).

U.S. sources accounted for over 50 per cent of FDI in Canada in every industrial sector. The U.S. presence was most pronounced in services and retail, accounting for just over three quarters of the total FDI stock in this sectoral grouping, or $22.2 billion; in energy and metallic minerals (75.5 per cent of sectoral FDI); and in machinery and transportation equipment (70.7 per cent). The energy and metallic minerals sector has accounted for the bulk of the increase in the stock of U.S. direct investment in Canada since 2000. Indeed, of the total $34.7-billion increase in U.S. FDI in Canada over the period of 2000 to 2003, this sector accounted for $25.5 billion. Finance and insurance was the next most-favoured sector, accounting for an expansion of $2.9 billion in the stock of U.S. FDI in Canada during this period.

EU investors accounted for the second-largest share of the stock of FDI in Canada in 2003. This was true in terms of aggregate FDI and in each sector, except for wood and paper products (in that sector, the stock of FDI from Japan and the rest of the world, at $2.6 billion, was slightly larger than that from the EU at $2.4 billion). Nearly half of the stock of EU FDI in Canada ($45.0 billion, or 46.5 per cent) was in the miscellaneous industries group. Finance and insurance was next with $25.5 billion, or 26.4 per cent of total EU FDI, followed by energy and metallic minerals with $13.5 billion, or 14 per cent of EU FDI in Canada.

The stock of FDI in Canada from Japan and the rest of the world exceeded $10 billion in only one sector, energy and metallic minerals (at $10.9 billion, or just over one third of total FDI from non-U.S./non-EU sources in 2003). Miscellaneous industries ($7.0 billion), machinery and transportation equipment ($5.2 billion) and finance and insurance ($4.6 billion) were the three other major recipient sectors of FDI from this region.

[1] In 2003, the Canadian dollar gained 17.8 per cent against the U.S. dollar, 9.0 per cent against the pound sterling, 9.1 per cent against the Japanese yen, and 1.7 per cent against the Euro, based on year-end closing rates.

[2] Includes only the 15 member countries of the EU prior to May 1, 2004.

[3] In December 2003, the Canadian firm Alcan acquired the French firm Pechiney in a hostile takeover bid for $6.4 billion

VI. Wrap Up

Canada marked its twelfth year of uninterrupted growth in 2003, though this growth decelerated significantly from previous years rates of growth. It was, nonetheless, a solid economic performance under difficult circumstances. At the start of the year, the case for global recovery was unclear as the pending war with Iraq was generating huge amounts of uncertainty in consumer and business circles. Then SARS hit, followed by mad-cow disease, summer forest fires, floods, power outages and, finally, a hurricane: a Canadian "*annus horribilis*". Fingers could easily be pointed at any one of these events as the cause for our subdued performance and the accuser would be right, or at least partially right. Truth be told, they all contributed, in one way or another, to reduced domestic Canadian economic activity.

On the trade front, these factors above certainly affected our ability to buy and sell our goods and services to foreigners. Their effects, however, were amplified by the rising value of the Canadian dollar *vis*-à-*vis* the US dollar, which rose some 21.7 per cent over 2003. Not only did the SARS briefly make Canada a less attractive place to visit, but the rising exchange rate made it a more expensive place to visit, thereby reinforcing the SARS effect. And the simple mathematics behind a rising exchange rate reinforces the tendency for trade performance to fall: when much of what we sell is priced in world or US markets (such as resources and automobiles), export values fall because the transactions are restated in Canadian dollars, which go further as the exchange rate rises. As well, fewer Canadian dollars are needed to purchase imported intermediate goods and services than before an exchange rate increase. When viewed in this light, it is not at all surprising that Canada's trade performance indicators, in Canadian dollar terms, were not as robust as in previous years.

It is, perhaps, too soon to tell what, if any, impact the rising exchange rate has had on Canadian economic performance. On the one side, with trade still representing a large share of gross domestic product, one can point to the continued strong job creation and argue that there has been little impact. Indeed, most economists had pegged an equilibrium exchange rate at about US 72¢ to US 74¢, and so we should have seen very little impact to date. On the other side, one can point to the disappointing inflows of foreign direct investment into Canada last year as an indicator of the impact of the rising dollar. Then again, with all the turmoil in international markets and given that direct investment is "lumpy" (i.e., investors usually buy "all", or "most", of the equity, or "none" of it, but rarely do they buy "some" of it), 2003 may have simply have been an off year for investment.

2003 saw the United States economy pick up momentum, reaching an annualized rate of growth of 8.2 per cent in the third quarter, before settling down to a more sustainable 4.1 per cent (annualized) growth in the final quarter. As the U.S. moved towards firmer recovery ground, Canada was knocked off the perch of fastest growing G7 nation. Nonetheless, Canada's performance within this group of industrialized nations is still relatively strong, we are sitting in fourth-overall spot in terms of growth, behind the U.S., Japan, and the U.K.

Looking forward to 2004, mediocre growth prospects throughout much of the Eurozone and the U.K. and Japanese growth very much dependent on their ability to export, suggest limited prospects for trade expansion to these areas. The recent relaxing of the monetary stance by the Bank of Canada should help stimulate domestic demand and, perhaps, influence exchange rate behaviour. Similarly, with the U.S. appearing headed for a sustainable recovery, U.S. consumer demand may pick up. These events will stimulate trade prospects over 2004. However, how much further and how quickly the U.S. currency moves as it seeks to re-balance against other major currencies, including the Canadian dollar, is uncertain at this time. The overall impact will likely have a dampening effect of Canadian trade. The net effect of these two opposing forces on Canada's trade for 2004 will play out during the year.