Sixth Annual Report on Canada's State of Trade

Trade Update

APRIL 2005

This publication and it's Statistical Annex is available on-line at www.international.gc.ca/eet

About This Document

This sixth 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 (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 Susan Maloney. Special features were prepared by Shenjie Chen, Aaron Sydor, Jean Bosco Sabuhoro, David Boileau, and Gáspár Csete of the Trade and Economic Analysis Division, as well as by Rick Cameron, and by Eugene Beaulieu, Visiting Professor and the 2004-2005 Norman Robertson Fellow of the Department of Foreign Affairs and International Trade.

Your comments concerning this year's report are welcome. Please direct them to Rick Cameron at:
<< richard.cameron@international.gc.ca >>

ISBN 0-662-40077-1-5

Catalogue no. ITI-3/2005E-PDF

Table of Contents

A Message From the Honourable James S. Peterson, Minister of International Trade

The year 2004 was a good year for Canada in international markets. Canada took advantage of stronger and more balanced growth internationally to post a substantial increase in overall exports last year. Together with improvements in our terms of trade as prices of our exported goods and services increased relative to the prices of our imports, this contributed to a record current account surplus for Canada of $33.8 billion, $10 billion more than in 2003.

As I reported in last year's State of Trade, our economy and particularly all those involved in every aspect of our international commerce weathered a difficult period in the early years of this decade which featured slow and inconsistent international economic growth, a cascade of economic shocks both domestic and international, and a steep rise in the international value of our dollar. With our economic fundamentals solidly based on balanced budgets, low inflation, declining domestic and international debt loads, a highly profitable corporate sector, and sound microeconomic policies that make Canada one of the best places in the world to do business, I am confident that Canada is poised for further solid performance in 2005.

But we cannot afford to be complacent. The reward for success in the global economy is that markets raise the bar. As our companies know full well, the international marketplace is constantly throwing up new challenges from old and from new quarters. The strong growth of Canadian exports particularly to our key US market shows that Canadian exporters are adjusting to the tougher competitive situation created by the appreciation of the Canadian dollar and heightened competition from other US trading partners. But China, India, and Brazil are growing forces in global production, trade, and foreign direct investment. This and other significant developments abroad emphasize the need for Canadian companies to take advantage of growth opportunities everywhere in the world, especially those beyond our traditional markets.

To respond to these changing circumstances, my Department has recently set up a World Markets Branch, and developed as well within that context an Emerging Markets Strategy, to reinforce Canada's focus on dynamic new markets. In addition, Canada is currently negotiating both improved air transportation protocols and Foreign Investment Promotion and Protection Agreements with China and India to assist Canadian businesses to protect their investments and to seize opportunities in these economies. And, as a prime beneficiary of and advocate for the multilateral rules-based system, Canada is an active participant in the current Doha Round of multilateral trade negotiations aimed at the further opening up of global markets, promoting economic development, and strengthening the world-wide trade rules-based system.

Trade, investment and all aspects of international commerce represent a cornerstone of Canada's economic success. They are vital to the continued development of Canada's economy as a flexible, adaptive, 21st century economy. I look forward to working with all Canadians in shaping our trade and investment policies and programs of support to contribute to Canada's prosperity and improved standard of living in an ever-challenging global environment.

HIGHLIGHTS OF THE 2004 TRADE PERFORMANCE:

- **Exports of goods and services** rebounded sharply in 2004, reversing a three year decline. They were up $32.6 billion, or 7.1 per cent, to $492.6 billion.
    - » Most of the gains came from **goods exports,** which increased $30.3 billion, or 7.6 per cent.
        - ◊ Advances in goods exports were widespread as all seven of the major commodity groupings posted increases. Industrial goods and energy products led the way.
        - ◊ Geographically, exports of goods were up to all major trading partners, especially to the United States — which absorbed over 70 per cent of the increase.
    - » **Services exports** were up $2.4 billion, or 4.0 per cent, to $62.3 billion.
        - ◊ Travel and transportation services led the services increases, while a decline in commercial services exports partially offset the gains.
        - ◊ Services exports were up to all major trading partners. Broadly speaking, the EU accounted for two-fifths of the gains, while the U.S., Japan, and the other OECD countries each accounted for one-fifth of the gains. Gains to non-OECD countries were marginal, but positive.
- Imports of goods and services were also up strongly in 2004, registering a $23.8 billion, or 5.8 per cent, increase to $436.5 billion.
    - » Increased **imports of goods** accounted for most of the advance, as they climbed $21.1 billion, or 6.2 per cent.
        - ◊ Imports in six of the seven major commodity groupings were up in 2004, led by industrial goods, machinery and equipment, and energy products. Only imports of agricultural and fishing products posted a loss.
        - ◊ Goods imports were up from most major trading partners, with the exception of Japan. Imports from the United States accounted for roughly one half of the total increase in goods imports.
    - » **Services imports** rose 3.8 per cent, or $2.7 billion, to $73.5 billion.
        - ◊ Travel and transportation services led the services increases, while a decline in commercial services imports partially offset the gains.
        - ◊ Imports of services from the U.S. fell by 1.1 per cent in 2004. Of the remaining major trading partners, non-OECD countries accounted for about half of the overall increase in services imports, while Japan accounted for roughly a further 40 per cent of the total.
- For 2004, Canada's current account balance, the broadest measure of transactions with foreigners, widened by $10.0 billion to a record $33.8 billion surplus. Improvements to the goods and investment income balances were only partially offset by falling balances for services and current transfers.
- The **gross domestic product** for Canada, at current prices, was just below $1.3 trillion in 2004, or nearly $40,500 on a *per capita* basis.

- Growth in **real GDP,** or gross domestic product adjusted for inflation, accelerated to 2.8 per cent in 2004, up from 2.0 per cent registered a year earlier.

- **Employment** in 2004 grew by nearly 285,000 jobs, all in full-time employment. This was about 80 per cent of the jobs created in 2003 and contributed to bringing the annual unemployment rate down to 7.2 per cent last year from 7.6 per cent the year before.

- Inflation, as measured by the annual change in consumer prices, came in at 1.9 per cent last year, down from 2.8 per cent a year earlier. Core inflation, which excludes food and energy, fell to 1.5 per cent for the year, compared to 2.2 per cent in 2003.

Total trade

The year 2004 might best be characterized for Canada as the year of the rebound as the economy recovered from its *annus horribilis* the year before. Real growth in the economy recovered, accelerating to 2.8 per cent for the year, as Canada registered its thirteenth year of uninterrupted growth. The rebound was also seen in Canada's international trade performance where both exports and imports of goods reached record levels in 2004, as did services imports, while services exports were within two and a half percentage points of their previous high.

- Canadian exports of goods and services climbed 7.1 per cent to $492.6 billion in 2004, reversing three years of decline. With exports of goods and services rising faster than the rate of expansion in the economy, the share of exports of goods and services in Canada's GDP thus increased, rising 0.4 percentage points from 37.7 per cent in 2003 to 38.1 per cent last year.

- Imports of goods and services into Canada posted a 5.8 per cent increase in 2004. This trailed the 6.1 per cent rate of expansion in the nominal economy. Accordingly, the share of imports of goods and services in Canadian GDP fell last year, down two-tenths of a percentage point, from 33.9 per cent to 33.7 per cent.

- Canada's current account balance expanded by $10.0 billion last year, from $23.8 billion to $33.8 billion. The goods and services trade surplus grew by $8.9 billion and the investment income deficit improved by $1.3 billion, partially offset by a slight deterioration in the current transfers surplus.

Trade by regions

- At roughly four-fifths of exports and two-thirds of imports, the United States is Canada's principal trading partner. It thus should come as no surprise that much of the gains in trade over 2004 originated with this country. Exports of goods and services to the U.S. increased $21.9 billion (or 6.0 per cent) to $387.9 billion, while imports rose $9.7 billion (or 3.4 per cent) to $291.8 billion.

  » Exports of goods to the U.S. advanced $21.5 billion (or 6.5 per cent), while exports of services nudged ahead $0.4 billion (or 1.1 per cent).

  » Imports of goods from the United States were up $10.2 billion (4.2 per cent), while services imports were off $0.4 billion, or 1.1 per cent.

- Total exports to the EU climbed 11.3 per cent (or $3.9 billion) to $38.3 billion as goods exports led the way (up 12.3 per cent, or $3.0 billion) while services exports grew 8.9 per cent (or $0.9 billion). Imports from the EU also increased last year, up 4.9 per cent (or $2.3 billion). Goods imports were up 4.4 per cent (or $1.5 billion); services imports rose 6.6 per cent (or $0.7 billion).

- Exports of goods and services to Japan increased $0.7 billion, with much of the advance coming from services (up $0.5 billion, or 36.1 per cent). Goods exports edged ahead $0.2 billion, or 1.8 per cent. Total imports from Japan were also up in 2004, by $0.4 billion, or 3.1 per cent. A $1.0 billion (or 40.9 per cent) increase in services imports was partially offset by a $0.6 billion (or 5.8 per cent) decline in goods imports.

Trade by commodities

Exports

- Gains were widespread as all seven of the major commodity groupings posted increased exports in 2004.

- Industrial goods reported the largest gains in exports over 2004, at $11.0 billion, or an increase of 16.6 per cent over the previous year's level. At $77.6 billion, exports of these goods represented about 18.0 per cent of total goods exports last year, up from 16.6 per cent in 2003.

- Energy products registered the next largest gain in exports last year, at $8.4 billion. This was a 13.9 per cent increase over 2003 exports. The share of energy products in total goods exports rose to 16.0 per cent last year from 15.1 per cent a year ago.

- Forestry products also rose in importance as a share of Canadian goods exports last year — up half a percentage point to 9.1 per cent. At $39.2 billion, exports of these products were $4.7 billion (or 13.8 per cent) higher than in 2003.

- Machinery and equipment is the largest export category of Canadian goods, accounting for 21.3 per cent of all goods exports. This was down from a 22.2 per cent share just one year ago. Machinery and equipment exports advanced by $3.2 billion last year, to $91.8 billion, representing a 3.6 per cent increase over the year.

- Exports of automotive products were up $2.9 billion, or 3.4 per cent, between 2003 and 2004, to $90.3 billion. Automotive products were the second largest export category in 2004, accounting for 21.0 per cent of total goods exports, down from 21.8 per cent in 2003.

Imports

- Gains were broadly based as six of the seven of the major commodity groupings posted greater imports last year.

- Imports of industrial goods posted an $8.3 billion gain in 2004, to $73.4 billion. Industrial goods accounted for 20.2 per cent of total goods imports, up from 19.1 per cent one year earlier.

- Machinery and equipment imports rose in 2004, up $5.5 billion to $103.7 billion. They represented 28.6 per cent of all goods imports last year, down marginally from the 28.7 per cent share recorded in 2003.

- Energy products imports were up $5.1 billion, to $24.7 billion, last year. These products accounted for 6.8 per cent of total goods imports in 2004, compared with a 5.7 per cent share the previous year.

- Imports of agricultural and fishing products registered the only decline in 2004, as they edged down $0.1 billion to $21.4 billion.

Foreign direct investment

- Following three years of declines, foreign direct investment outflows rebounded sharply in 2004, to $57.5 billion.

  » Some 70 per cent of the outflows were placed in the United States, perhaps reflecting the relatively strong US economic performance last year as well as the appreciation of the Canadian dollar *vis-à-vis* the American dollar.

- Foreign direct investment inflows into Canada fell for the fourth consecutive year, to $8.5 billion.

  » Re-acquisition, or repatriation, of Canadian firms from European investors was the principal reason for the low overall net inflows.

- The cumulative stock of Canadian direct investment abroad rose 9.8 per cent, or $39.3 billion, to $438.4 billion in 2004.

  » Some $191.2 billion, or 43.6 per cent of the total CDIA, is placed in the United States.

- Total foreign direct investment in Canada edged up 2.9 per cent, to $367.9 billion last year.

  » About two-thirds (or 65.1 per cent) of the total is held by American investors.

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 45.4 per cent of GDP for exports and from 25.6 per cent to 39.7 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 in 2004 are now at 38.1 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 80.9 per cent. Since the year 2000, exports of goods and services to the U.S. have fallen while total exports have risen. As a result, the U.S share in Canada's overall exports of goods and services has declined — to 78.7 per cent in 2004.

Imports of goods and services from the U.S. also increased more quickly than total imports of goods and services over the previous decade. In 2000, they represented 72.0 per cent of total imports. Since then, imports of goods and services from the U.S. have also fallen while total imports have risen. Thus, the share of imports from the U.S. in total imports has fallen to 66.9 per cent, a decline of 5.1 percentage points.

With exports growing more quickly than imports over the 1990s, Canada's trade balance moved from deficits in the early 1990s to surpluses by the late 1990s. However, total exports have been rising more slowly than total imports since the year 2000. As a result, the overall trade surplus, while still strongly positive, has narrowed.

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 $87.4 billion in 2000. However, since then, annual imports have fallen nearly three times faster than exports from that country (-1.4 per cent *vs.* -0.5 per cent), the bilateral surplus has thus expanded. Canada's bilateral trade surplus with the U.S. stood at $96.0 billion last year, a record high.

Canada's Trade and Investment over 2002-2004, in millions of dollars

	2002	2003	2004	2002	2003	2004	2002	2003	2004
	Exports of Goods and Services			*Imports of Goods and Services*			*Goods and Services Balance*		
World	477,694	459,974	492,618	427,382	412,688	436,481	50,312	47,287	56,137
U.S.	385,425	365,999	387,880	297,407	282,117	291,833	88,018	83,882	96,047
EU	33,173	34,447	38,346	47,400	46,062	48,333	-14,226	-11,615	-9,987
Japan	11,985	11,157	11,832	14,672	13,141	13,546	-2,687	-1,983	-1,713
ROW*	47,111	48,371	54,560	67,903	71,368	82,769	-20,793	-22,997	-28,210
	Exports of Goods			*Imports of Goods*			*Goods Balance*		
World	413,795	400,010	430,279	356,581	341,833	362,952	57,214	58,177	67,328
U.S.	347,069	330,375	351,860	255,093	239,871	250,031	91,976	90,505	101,829
EU	22,557	24,119	27,097	36,040	34,810	36,337	-13,483	-10,691	-9,239
Japan	10,152	9,786	9,965	11,733	10,645	10,029	-1,580	-859	-64
ROW	34,017	35,730	41,357	53,715	56,507	66,555	-19,699	-20,778	-25,198
	Exports of Services			*Imports of Services*			*Services Balance*		
World	63,899	59,964	62,338	70,801	70,855	73,529	-6,903	-10,891	-11,191
U.S.	38,356	35,624	36,020	42,314	42,246	41,802	-3,958	-6,623	-5,782
EU	10,616	10,329	11,248	11,360	11,253	11,996	-743	-924	-749
Japan	1,832	1,372	1,867	2,939	2,496	3,516	-1,107	-1,124	-1,649
ROW	13,095	12,639	13,203	14,188	14,860	16,215	-1,095	-2,220	-3,011
	Canadian Direct Investment Abroad			*Foreign Direct Investment in Canada*			*Balance of Outward less Inward*		
Flows:									
World	41,472	30,191	57,453	33,026	9,222	8,548	8,446	20,969	48,905
U.S.	15,444	7,692	41,328	28,083	5,896	10,168	-12,639	1,796	31,160
EU	11,975	14,136	4,813	2,989	1,476	-12,667	8,986	12,660	17,480
Japan	1,777	473	1,340	816	763	1,023	961	-290	317
ROW	12,276	7,890	9,972	1,138	1,087	10,024	11,138	6,803	-52
Stocks:									
World	429,633	399,134	438,439	348,917	357,548	367,907	80,716	41,586	70,532
U.S.	197,128	164,874	191,158	223,217	228,383	239,444	-26,089	-63,509	-48,286
EU	89,241	99,077	n.a.	95,128	96,725	n.a.	-5,887	2,352	n.a.
Japan	9,514	9,123	n.a.	8,904	9,686	n.a.	610	-563	n.a.
ROW	133,750	126,060	n.a.	21,668	22,754	n.a.	112,082	103,306	n.a.

*: ROW = Rest of the World

I. Goods

Overview

A characteristic of the world economy in recent years has been the somewhat uneven nature of the global economic recovery. Since the downturn at the beginning of this decade, growth in the global economy has ebbed and flowed somewhat, with periods of rising growth tending to be followed by periods where growth has moderated. As a result, a feature of the current global economic recovery is that it has not evolved in a smooth and sustained fashion. This pattern remains evident, with the pace of global growth moderating over the second half of last year.

Global growth continues to be led by the United States and China. Year-end data for the US confirmed that the economy in that country is expanding at a good pace and is generating solid gains in employment. China's economy has become an increasingly important driver of world growth, with last year's growth approaching 10 per cent, exceeding most expectations. In other parts of the world, including Japan and the euro area, the economic recovery is continuing, though at a slower pace than during the first half of 2004. Despite some slowing, growth remains quite strong in most of the smaller East Asian economies. The tsunami disaster of late 2004 is unlikely to have a major impact on aggregate GDP in the Asian region but will reduce growth in the short term in Indonesia and Thailand, as well as in some smaller economies on the Indian Ocean rim.

The strong global economy has contributed to upward pressure on commodity prices in the past couple of years. One important aspect of this level of activity was the sharp rise in oil prices, which peaked in October of last year. This increase was seen as primarily a consequence of strong global demand, although supply disruptions also played a role. While a slowdown after a sustained period of above trend growth would be a normal occurrence in a typical growth cycle, the rise in oil prices through the autumn likely was a significant additional factor dampening growth. However, so far, the global economy has weathered the rise in oil prices reasonably well. Prices of a range of other mineral commodities have generally remained firm or increased further over recent months.

Overall, it is likely that growth of the world economy, though not as strong as last year, will continue in 2005. Underpinning this is the continued strong expected rate of expansion of the US economy. Growth in the US continues to be supported by accommodative financial conditions — low short term and long term interest rates and a depreciating dollar — as well as by expansionary fiscal policy. This also focuses attention on some other issues. Connected to concerns about US fiscal sustainability, the combination of strong US economic growth in combination with slower growth elsewhere has resurfaced concerns about global current account imbalances. In recent months, this has contributed to a relatively broad-based decline in the US dollar, which fell sharply against the euro, the yen and the Canadian dollar in the final quarter of 2004. Moreover, concern about the potential for a disruptive adjustment of global imbalances remains a downside risk for global growth in 2005.

The Canadian macro situation in 2004

The year began on a weak note as cold weather put the freeze on job growth and GDP suffered setbacks in January and February. However, the economy picked up significantly in the spring as output and jobs strengthened; the momentum carried on through much of the summer. The rapid rise in the exchange rate resulted in output stalling in the autumn, with manufacturing exports bearing the brunt of the weakness. Output and job growth resumed however, at year-end. From an international perspective, sustained growth in Canada and the United States contrasted with marked slowdowns in Europe and Japan.

The year 2004 began on a subdued note as the coldest January in years helped curtail economic activity, especially those where work is done outdoors — building construction, mining and other primary industries, and auto sales. Employment growth was flat and monthly real GDP edged down over the first two months. January's housing starts fell to 200,000 units, their lowest levels in 8 months. Against this backdrop, the Bank of Canada injected monetary stimulus into the economy in January and again in March, lowering the Bank Rate by one quarter of a percentage point each time, to 2.5 per cent and then to 2.25 per cent. Merchandise exports fell in January, before commencing a string of five consecutive increases starting in February. In March, the declines in GDP were reversed and the first of a string of monthly increases for the remainder of the year was recorded; it was also the strongest monthly increase for the year, at 1.1 per cent. Housing starts shot up to 250,000 units (annualized), its highest level since early in 2003. With the March performance, GDP registered a 2.8 per cent increase (annualized) for the quarter.

Job growth picked up in the Spring, especially in April, led by full-time positions. Indeed, 120,000 jobs were added to payrolls over the second quarter of the year; economic activity thus accelerated. Crude oil prices began to rise. In April, these prices closed above $US 37 a barrel, their highest level since the 1991 Gulf war. They were up by $US 2 more in May. By June, they hit a 21-year high of $US 43 a barrel over geopolitical concerns about supply in the face of strong global demand. At the same time, the Canadian exchange rate began to fall in April, falling nearly US 3.4¢ to US 73¢ for the month before making its way down to US 71.6¢ by mid-May. It recovered somewhat over the rest of the month and through June, closing that month at US 74.6¢. Overall, second quarter GDP registered an annualised 4.5 per cent rate of growth.

The exchange rate remained more-or-less steady over July and August before rising US 2.6¢ over September. At the same time, crude oil prices continued upwards. By mid-August, the price nearly hit $US 50 a barrel; it reached that level at the end of September. Commodity prices in general continued to rise throughout the summer, as they had most of the Spring, nevertheless, beginning in July, merchandise exports began to fall. Housing starts dipped slightly in July, recovered strongly in August, and returned normal levels in September. The net result was that third quarter GDP slowed to an annualized 2.9 per cent.

In September and again in October, the Bank of Canada began to remove stimulus from the economy, raising the Bank Rate by a quarter of a percentage point each time. Exchange rates and oil prices were moving upwards in tandem. For crude oil, the price reached a record $US 55 a barrel in October, before subsiding to below $US 50 a barrel in November. A cold snap in the US Northeast helped send prices back above $US 50 a barrel in December. The exchange rate rose US 2.7¢ and US 2.2¢ in October and November, respectively. On November 26, it reached its high for the year, at US 84.9¢. It fell dramatically over the next three and a half weeks, to US 80.6¢, before recovering US 2.5¢, to close the year at US 83.1¢. Overall, by year-end, the exchange rate rose US 5.6¢ over the year from its January 2, 2004 value. Job creation picked up over much of this period, except for November, again mostly in full-time positions. Merchandise exports reversed its recent string of declines with an increase in December. Real GDP stalled in October, before recovering somewhat over the last two months of the year (in conjunction with falling oil prices and a lower value for the Canadian loonie). However, fourth quarter GDP grew by only 1.7 per cent compared to much higher levels over the three previous quarters.

For the year as a whole, real GDP expanded by 2.8 per cent and annual employment grew by almost 285,000, mostly in full-time positions. The unemployment rate, which began the year at 7.4 per cent, declined to 7.0 per cent in December. Inflation for the year came in at 1.9 per cent.

Canadian goods trade in 2004

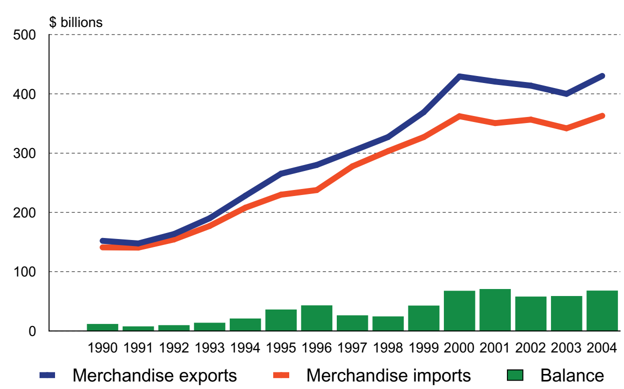
The global economic recovery of 2004 was reflected in Canada's trade performance for that year. Canada's total trade in goods rebounded, reversing three years of decline. Total goods trade (exports + imports) in 2004 grew 6.9 per cent over the previous year, as both exports and imports established new record levels.

As was the case for Canada's overall or total trade, the rebound in goods exports last year halted a three year slide: goods exports grew 7.6 per cent, or $30.3 billion, to $430.3 billion (Figure 1-1). The advance amounted to an increase of more than $900 million over the previous record for goods exports which had been established in the year 2000. The gains were widespread as exports to all major trading partners increased. Higher exports to the United States accounted for about 70 per cent of the overall gain, as goods exports to that country were up $21.5 billion. Next in importance to the overall increase in goods exports was the non-OECD region, where exports to the countries of this region grew by $4.1 billion. The EU followed, as exports advanced $3.0 billion. Gains to the other OECD countries were up $1.5 billion in 2004, while those to Japan increased only $0.2 billion.

Notwithstanding the sizeable increase in exports to the U.S. last year, that country's share in Canada's total goods exports fell to 81.8 per cent, from 82.6 per cent the previous year. At this degree of importance, the United States is far and away the principal export destination for Canadian goods exports (Figure 1-2). The eight-tenths of a percentage point share loss on the part of the United States was accounted for by the non-OECD region (up 0.5 percentage points to a 6.3 per cent share of total goods exports) and by the EU (up 0.3 percentage points to a 6.3 per cent share of the total). Japan's share of the

Figure 1-1

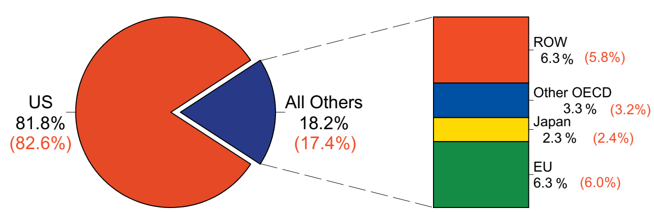
Merchandise trade, 1990-2004



total slipped one-tenth of a percentage point (to 2.3 per cent), while that of the other OECD countries picked up one-tenth of a percentage point (to 3.3 per cent of the total).[1] of total goods imports, while the increase in imports from the other OECD region meant that this region's share grew to 6.1 per cent from 5.8 per cent a year ago.

Figure 1-2

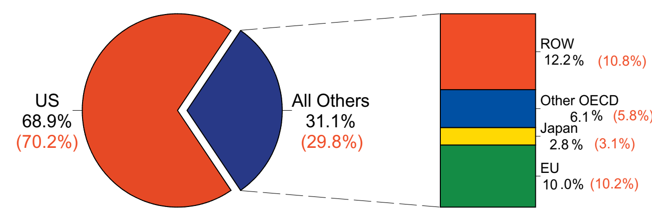
Merchandise export shares by region, 2003 and 2004



Black ink: 2004 shares
Red ink: 2003 shares

Figure 1-3

Merchandise import shares by region, 2003 and 2004



Black ink: 2004 shares
Red ink: 2003 shares

Imports of goods into Canada were also up in 2004, rising 6.2 per cent (or $21.1 billion) to almost $363.0 billion. Like the situation with respect to exports, the United States was, once again, the most important trading partner when examining the advances in goods imports by region. Canadian imports of goods from the U.S. increased by $10.2 billion to account for almost half of the increase. At $7.5 billion, the non-OECD countries accounted for just over a third (or 35.6 per cent) of the increase in imports last year, followed by the other OECD countries (up $2.5 billion, or 12.0 per cent of the total increase), and the EU (up $1.5 billion, or 7.2 per cent of the total). Imports from Japan fell $0.6 billion in 2004, representing a reduction of 2.9 per cent from the total increase for goods imports.

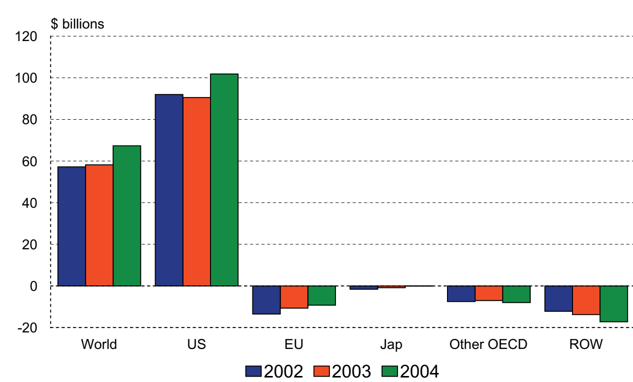
As imports from Canada's major trading partners increase at different amounts and at differing rates, their relative share in total Canadian imports of goods changes from year to year. In 2004, for example, the U.S. share of Canada's imports of goods fell 1.3 percentage points to 68.9 per cent (Figure 1-3). Falling imports from Japan caused that country's share in the total imports of goods to decline, as the share fell 0.3 percentage points (to 2.8 per cent of the total). At the same time, slower growing imports from the EU meant that the EU share in total goods imports also edged down from 10.2 per cent to 10.0 per cent last year. The strong increase in imports from the non-OECD countries caused this region's share to rise 1.4 percentage points, to 12.2 per cent

With exports rising more quickly than imports, Canada's goods balance moved $9.2 billion further into surplus, to $67.3 billion in 2004 (Figure 1-4). It was the second largest surplus on record, lagging behind only that of 2001 ($70.0 billion). With the increase in goods exports to the U.S. outweighing the increase in imports last year, the goods surplus widened by $11.3 billion, to break through the $100-billion mark to reach $101.8 billion for the year.

With the goods surplus higher for the United States than for the entire world including the United States, the result was that Canada ran goods deficits with all its other (non-U.S.) principal trading partners.

Figure 1-4

Merchandise trade balances by region, 2002-2004



[1]Because of trans-shipments, it is possible that the U.S. statistics are overstated and those of other countries are under-reported.

For 2004, these trade deficits narrowed, however, for two of Canada's four other partners (the EU and Japan) and widened for the other two. For the EU, both exports and imports were up, but exports were up more, with the consequence that the Canadian goods trade deficit shrank with the EU by $1.5 billion to $9.2 billion. In the case of Japan, the combination of rising exports and falling imports served to narrow the bilateral goods deficit by $0.8 billion, almost wiping out that deficit in the process (to stand at only $64 million for 2004). Exports and imports were also up for both the other OECD countries and for the non-OECD region. In both instances, however, goods imports grew more (and slightly faster) than exports, resulting in widening trade deficits. For the other OECD countries, the goods deficit grew by $1.0 billion to $8.0 billion, while for the non-OECD region, it expanded by $3.4 billion to $17.2 billion.

As mentioned above, both Canadian exports and imports of goods climbed to record levels in 2004. Thus, two-way goods trade (or the sum of goods exports and imports) was at its highest level ever. Two-way, or total, trade increased $51.4 billion in 2004, to $793.2 billion. Increased trade flows to the U.S. accounted for over 60 per cent of the total increase, or $31.6 billion.

Overall, the United States accounted for 75.9 per cent of Canada's total (two-way) trade in 2004, down a full percentage point from the share recorded the previous year. Thus, Canada-U.S. goods exchanges exceeded $1.1 million for every minute of every day of last year.

Box A: Emergence of China, India and Brazil in Global Production, Trade and FDI

An emerging market is a country, region, or sector that is characterized by high growth, accompanied by high risk, resulting in high potential reward. Although many countries fit this definition, three stand out from the rest: China, India, and Brazil. Identified in the 2004 Speech from the Throne as key emerging markets, these countries are transforming the global economy by redirecting flows of trade and investment, and becoming local economic powers within their respective geographic regions.

China	
Area	9,551,000 km
GDP Growth	9.1% (2003)
Population	1,298,847,624
Inflation	1.2% (2003 est)
Population Growth	0.57% (2004 est)
Unemployment Rate	10.1% (2003 est)
GDP:	1,601,015 (million US$ 2004)

India	
Area	3,287,263 km
GDP Growth	8% (2003)
Population	1,065,070,607
Inflation	3.8% (2003 est)
Population Growth	1.44% (2004 est)
Unemployment Rate	9.5% (2003)
GDP:	654,822 (million US$ 2004)

Brazil	
Area	8,547,403 km
GDP Growth	-0.2 (2003)
Population	184,101,109
Inflation	14.7% (2003 est)
Population Growth	1.11% (2004 est)
Unemployment Rate	12.3% (2003 est)
GDP:	558,418 (million US$ 2004)

Size

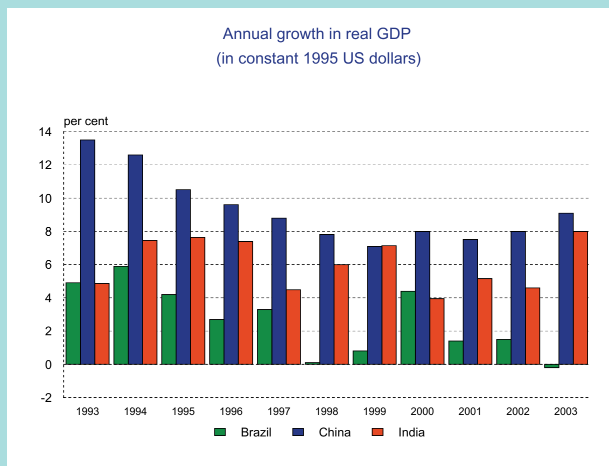
As can be seen from the above tables, these three countries are very large; China, India, and Brazil are the 1st, 2nd, and 5th most populous countries in the world, respectively. China and India alone account for one third of the world's population. But population alone is not what really matters; economic size is why these countries are becoming so important in the global economy. The best indicator for looking at how a country's economy sizes up is Gross Domestic Product (GDP), a measurement of an economy's total domestic output. When measured in a common currency —in this case in US dollars — we see that China, India, and Brazil rank in the top 20 of the largest economies in the world in 2003.[1] As a percentage of total world GDP, China accounts for 3.9 per cent, India 1.6 per cent, and Brazil 1.4 per cent of total world output. Although these countries are of significant economic size, on a GDP *per capita* (or GDP per person) basis these countries' rankings drop drastically. China falls to 133rd, India 160th, and Brazil falls to 95th place. This is important because it indicates that although these countries have large absolute output, their output per person is very low. For example, Chinese output per person[2] was about $US1,100 ($CAD 1,340) in 2003, whereas in Canada it was $US 26,380 (about $CAD 37,000). Thus, size alone is not the only reason these markets are attractive, it is their size along with their rapid economic growth that matters.

Total GDP 2003

Ranking	Economy	(millions of US dollars)
1	United States	10,881,609
2	Japan	4,326,444
3	Germany	2,400,655
4	United Kingdom	1,794,858
5	France	1,747,973
6	Italy	1,465,895
7	China	1,409,852
8	Spain	836,100
9	Canada	834,390
10	Mexico	626,080
11	Korea, Rep.	605,331
12	India	598,966
13	Australia	518,382
14	Netherlands	511,556
15	Brazil	492,338
16	Russian Federation	433,491
17	Switzerland	309,465
18	Belgium	302,217
19	Sweden	300,795
20	Austria	251,456

Rapid Growth

These economies are growing at fast rates. Between 1993 and 2003 China's real GDP grew at an average rate of 9.3 per cent, India averaged 6.1 per cent, and Brazil 2.6 per cent. Brazil's growth has not been as spectacular as that of China and India, due to the recent currency crises and economic slowdown in the country; it is now recovering from this downturn and is forecast to have higher growth in the near future. The chart below shows annual growth in real GDP from 1993 to 2003 for the three countries.

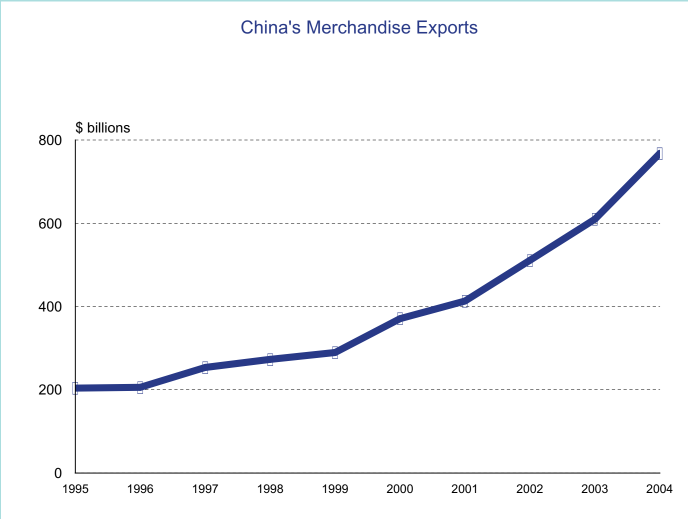


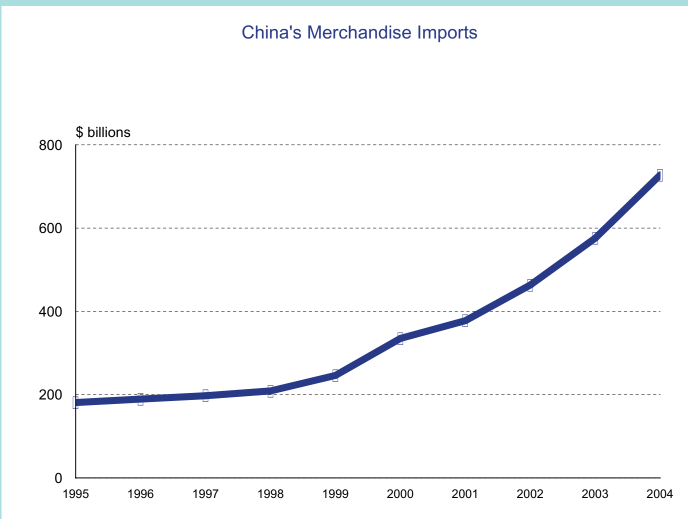
Trade Flows

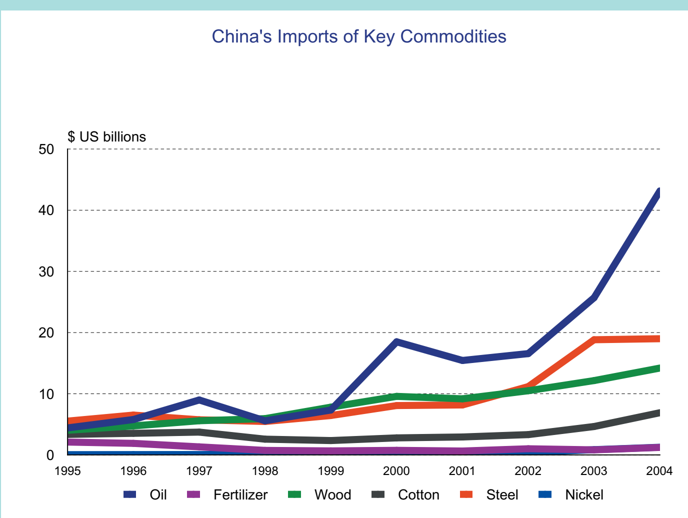
As these three economies grow, their trade flows are also increasing. Not only does higher output increase their ability to export, but also the higher incomes of the country's residents push up their demand for imports.

[1]GDP Rankings from World Bank, World Development Indicators.

[2]World Bank, World Development Indicators.







China:

Chinese global exports have grown from $204 billion in 1995 to $767.9 billion in 2004. In 2003, its share of world exports was 5.8 per cent, considerably higher than that for 1995 when its share stood at 2.9 per cent. China is now the third largest exporter in the world.

China's exports to Canada have also risen over this time, from $2.1 billion in 1995 to $10.5 billion last year.

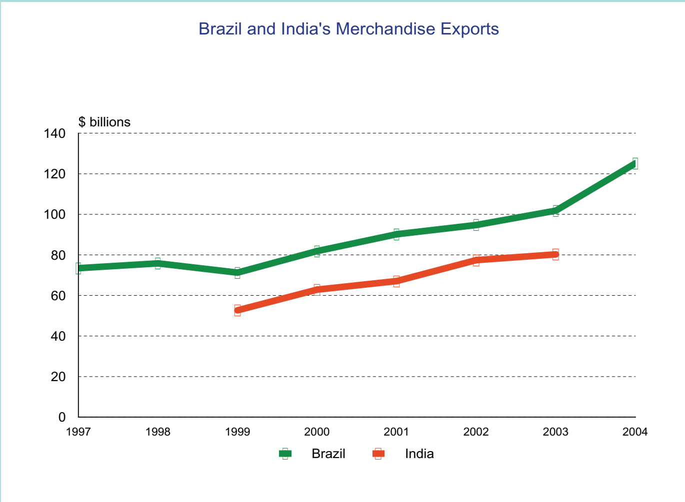
Chinese imports have risen almost as much as exports — from $180.9 billion in 1995 to $727.7 billion in 2004. As China's economy continues to develop, its demand for imports will rise. This will be to the benefit of Canada, especially in the resource sector.

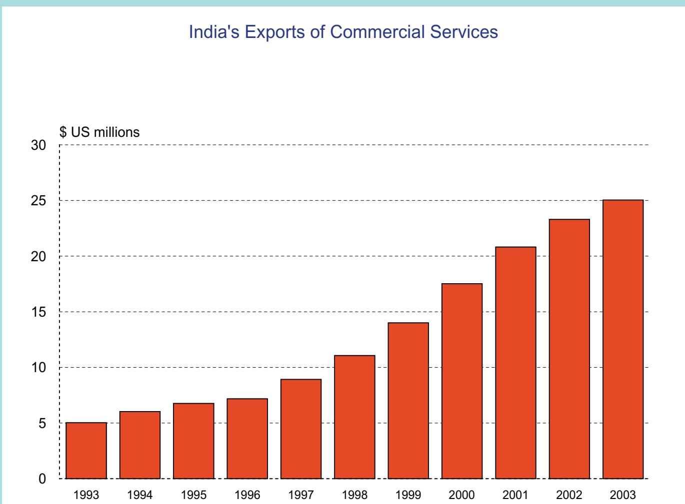
Chinese imports of Canadian goods have risen from $3.7 billion in 1995 to $9.5 billion in 2004.

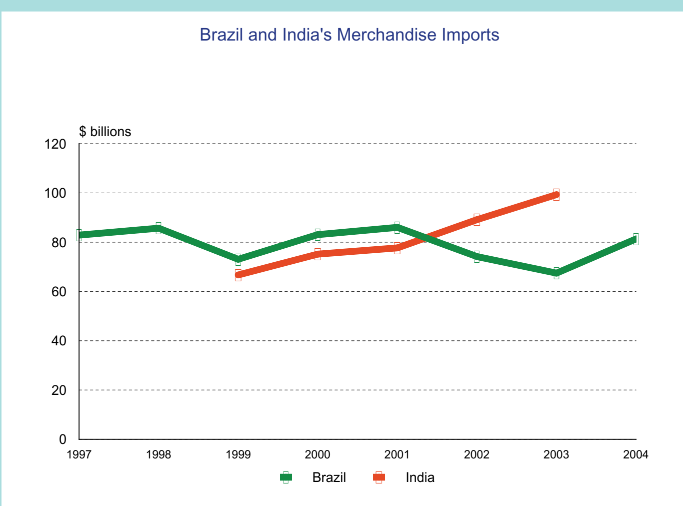
Canada has had a great deal of success in exporting resources and raw materials to China. For example, Canada exported $US 111 million (about $CAD 136 million) worth of nickel to China, or about 17 per cent of China's total nickel imports. Canada also supplied 87 per cent of China's wood pulp in 2003, worth $US 236 million (or $CAD 288 million), fuelled by strong demand from China.

Canada has also seen a booming demand from China for agricultural products. Recently, the Canadian Wheat Board signed its largest deal ever with China to export one million tons of milling wheat during the 2005-06 crop year, a deal worth approximately $250 million at today's prices.[3]

[3]Canadian Wheat Board, News Release, "CWB signs million-tonne new crop sales agreement with China", January 21, 2005.







Brazil and India:

Although not on the same scale as that in China, export growth for India and Brazil has been no less impressive. Indian exports grew from $52.6 billion to $80.2 billion over 1999-2003. Brazil's export growth has been more moderate, up from $73.4 billion in 1995 to $125.1 billion in 2004.

Both India and Brazil have expanded their exports to Canada. Indian exports to Canada rose from $832 million to $984 million over 1999-2003 while those from Brazil doubled from $809 million in 1997 to $1.6 billion in 2004.

India's export growth is being led by the service sector, which grew by 7.5 per cent per annum[4] over the 1990's. Growth in services is being led by information, communications, technology (ICT), and financial services.

Indian imports rose from $66.7 billion to $99.3 billion between 1999 and 2003.

India's imports of Canadian goods increased at the same pace as total imports, going from $520.5 million in 1999 to $774.25 million in 2003.

2003 Brazilian total imports remain below 1997 levels, at $81.3 billion. As noted above, slow growth and currency depreciation, making imports more expensive, have been the main causes of this performance. As Brazil begins to recover from the currency crises and economic slowdown, imports look to be back on track.

Brazil's imports from Canada have experienced the same slump. Imports of Canadian goods were $1.1 billion in 2004 down from $2.0 billion in 1997. But as total imports begin to rise, Brazil's imports of Canadian goods should pick up too.

[4] Jim Gordon and Poonam Gupta, "Understanding India's Service Revolution", IMF, 2003

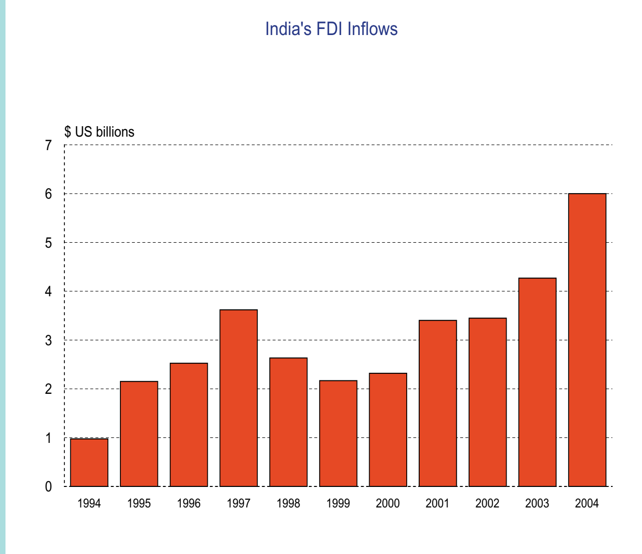
FDI inflows

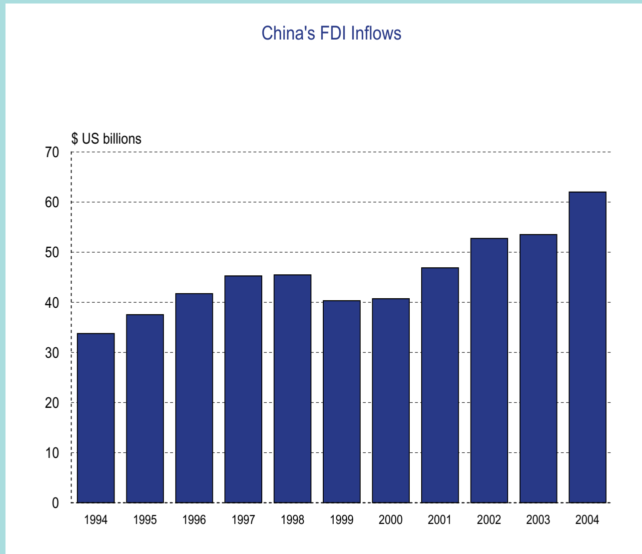
Because of their large domestic markets and continuing economic growth, all three of these countries have seen foreign direct investment (FDI) into their countries rise over the past years.

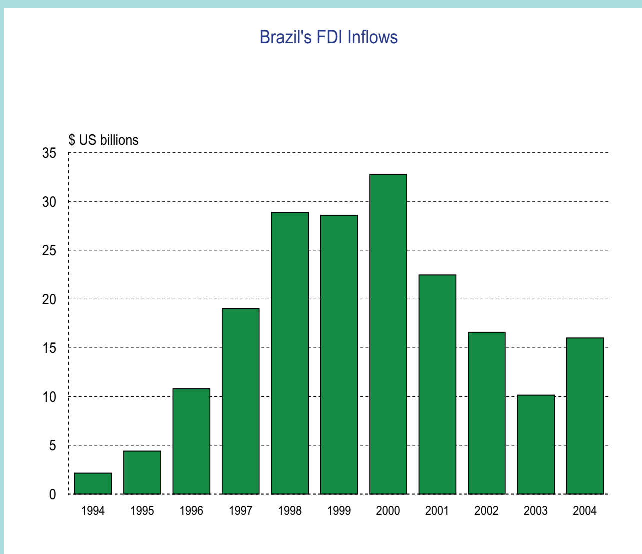
China in particular has experienced a large amount of FDI inflows over the past decade. In 2004, China received $US 62 billion ($CAD 75.7 billion) of FDI, making China the second largest FDI recipient in the world after the United States. Foreign investors have been attracted to China for its low labour costs, as well as for its growing supply of domestic consumers.

Considering its size and economic growth, India attracts relatively small amounts of FDI, often attributable to excessive government regulation and lack of infrastructure in that country. However, India also has significant advantages, including highly skilled workers, competitive wages, and a large domestic market. India might be better placed, in fact, than China to attract future investment since India is addressing its bureaucratic obstacles and infrastructure problems.

Since a record $US32.7 billion ($CAD 39.9 billion) in FDI in 2000, Brazil has seen a downturn in FDI inflows. Two factors may help explain this: many multinational corporations investing in Brazil have seen deteriorating conditions in their home countries, limiting their ability to invest abroad, and much of the FDI in Brazil's past was fuelled by privatization of many Brazilian industries. With this privatization over, FDI flows have receded back to more normal levels — they were $US 16 billion ($CAD 19.5 billion) in 2004.







Conclusions

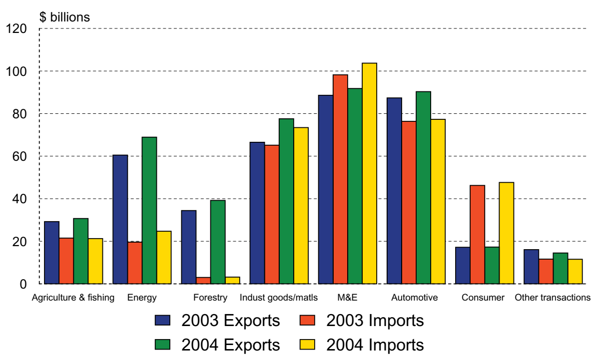
These three major economies — China, Brazil, and India — offer a great opportunity for Canada to increase its trade and foreign investment. Already Canada is experiencing dramatic increases in flows of exports, imports, and FDI with these countries. As mentioned, these countries are very large and growing rapidly, but still have fairly low GDP *per capita*. As their economies continue to develop, they will exert greater economic and political influences within their regions and within the world.

Merchandise trade by major commodity groupings

Along with total goods exports increasing, as reported above, Canadian exports of all seven of the major commodity groupings posted gains in 2004 (Figure 1-5). The advances were led by industrial goods, where exports increased $11.0 billion (up 16.6 per cent), and energy products (up $8.4 billion, or 13.9 per cent). Consumer goods posted the smallest increase in 2004, up $0.1 billion, or 0.7 per cent.

Figure 1-5

Merchandise trade by major categories, 2003-2004



On the import side, all but one of the major commodity groupings posted increases last year. The lone exception was agriculture and fishing products imports, which fell 0.7 per cent, or $0.1 billion. On the other hand, notable gains were recorded for industrial goods (up 12.7 per cent, or $8.3 billion), machinery and equipment (up 5.6 per cent, or $5.5 billion), and energy products (up 26.0 per cent, or $5.1 billion).

Machinery and equipment

Machinery and equipment is the largest major category of Canadian goods exports and imports. Sales of machinery and equipment abroad advanced $3.2 billion, or 3.6 per cent, to $91.8 billion in 2004. At this level, these products accounted for 21.3 per cent of total Canadian goods exports.

Exports of machinery and equipment were up across the board for the year. The only exception was a $1.1 billion decline for ***aircraft, aircraft engines and parts*** exports which resulted in overall exports in the *aircraft and other transportation equipment* sub-category of machinery and equipment falling over the year. The decline for ***aircraft, aircraft engines and parts*** was partially offset by a $0.5 billion increase in ***other transportation equipment*** exports as *aircraft and other transportation equipment* recorded an overall $0.7 billion decline in exports.

Both ***industrial machinery*** and ***agricultural machinery*** contributed equally to the overall $0.4 increase in exports of *industrial and agricultural machinery*. The gain for the former was $215 million, while it was $216 million for the latter.

The final sub-category that makes up machinery and equipment is *other machinery and equipment.* Exports of these products increased $3.4 billion last year. Gains were largest for ***television, telecommunications and related equipment,*** at $1.1 billion, followed by ***other inedible end products,*** at $0.9 billion. Exports of ***office machinery and equipment*** and ***other equipment and tools*** both contributed $0.7 billion to the gains for this sub-category.

Machinery and equipment imports also rose in 2004, as all four sub-components posted increases when compared to the previous year. Overall, imports of machinery and equipment were up $5.5 billion to $103.7 billion, or 28.6 per cent of total goods imports.

Imports of *industrial and agricultural machinery* were up $0.5 billion in 2004. Most of the products falling under this sub-category registered gains in imports, most especially ***excavating machinery,*** up $0.4 billion, and ***engines, turbines, and electrical motors,*** up $0.2 billion; however, there were small declines — of $0.1 billion each — in imports of ***drilling mining machinery*** and ***other industrial machinery.***

Imports of *other machinery and equipment* advanced $3.4 billion in 2004 as ***other communication and related equipment*** and ***other equipment and tools*** recorded increases of $1.7 billion each.

Elsewhere within machinery and equipment, imports of *office machines and equipment* grew by $0.9 billion and those of *aircraft and other transportation equipment* expanded by $0.6 billion in 2004.

With exports of machinery and equipment rising less than imports, the trade deficit for these products widened by $2.3 billion, from $9.6 billion to $11.9 billion in 2004. It was the second consecutive year that the deficit expanded. Nonetheless, the 2004 deficit for these products is roughly half that observed in 1997, when the trade deficit in machinery and equipment peaked at $22.4 billion.

Automotive products

For the fifth consecutive year, automotive products were the second largest category of Canadian traded goods.[2] Exports of these products amounted to $90.3 billion, while imports were $77.3 billion. These levels represented gains of $2.9 billion and $0.9 billion, respectively, over 2003 levels. The automotive trade surplus thus expanded by $2.0 billion for the year. Automotive products accounted for 21.0 per cent of total goods exports and 21.3 per cent of total goods imports last year, down from 21.8 per cent and 22.3 per cent, respectively, a year earlier.

Car exports accounted for all the gains in automotive exports in 2004 as *truck,* and *parts* exports fell. *Car* exports were up $3.8 billion for the year, while *truck* exports and *parts* exports suffered declines of $0.6 billion and $0.2 billion, respectively.

Increased *car* exports raised the demand for motor vehicle parts; accordingly, auto *parts* imports climbed $2.1 billion last year. At the same time, *truck* imports increased $1.1 billion, while *car* imports fell by twice as much, or $2.2 billion.

Canada has run a trade surplus in automotive products since 1988. The surplus peaked in 1999 and has declined steadily over the 2000-2003 period. Last year's $2.0 billion addition to the surplus ended, at least temporarily, the four-year slide in the automotive trade balance. The surplus amounted to $13.0 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.*

As these products serve largely as intermediate inputs in other products and given that global economic activity picked up strongly last year, it comes as no surprise that exports of industrial goods and materials increased rather dramatically in 2004. In fact, they increased by one-sixth, or $11.1 billion, for the year.

All four sub-components, and virtually every product making up these sub-components, experienced an increase in their level of exports last year. Over forty per cent of the increase originated from *metals and alloys* where exports advanced $4.7 billion. Exports of all *metals and their alloys* were up in 2004, with the exception of ***primary iron and steel,*** which registered a marginal $13 million decline. Gains in *chemicals, plastics and fertilizers* were widespread, with notable increases in ***organic chemicals*** (up $1.6 billion), and ***synthetic rubber and plastics*** (up $1.0 billion). Total exports of *chemicals, plastics and fertilizers* were up $3.6 billion for the year. Exports of *metal ores* grew by $1.6 billion in 2004, as all principal ores — nickel, iron, copper, and zinc — registered gains. Lastly, exports of *other industrial goods and materials* increased by $1.2 billion last year. ***Metal fabricated basic products, other fabricated materials,*** and ***other crude non-metallic minerals*** accounted for the bulk of the gains, while ***textile fabricated products*** and ***non-metallic mineral basic products*** suffered slight setbacks to limit the advance.

Metals and metal ores accounted for nearly three-quarters of the increase in industrial goods and materials imports in 2004, as they rose $6.0 billion. Imports of all products falling under this sub-category were up last year. *Chemicals and plastics* imports grew by $1.8 billion, led by a $1.1 billion increase in ***organic chemicals*** imports. Finally, imports of *other industrial goods and materials* were up $0.5 billion last year. Performance was mixed as ***other fabricated materials, non-metallic minerals,*** and ***metal fabricated basic products*** recorded gains and ***textile fabricated materials*** and ***crude animal products*** registered declines.

The $11.1 billion advance in exports and $8.3 billion advance in imports produced and overall $2.8 billion improvement in the trade balance for industrial goods and materials. It was the fifth straight improvement in the trade balance for these products, as they have

[2]Automotive products had been the largest category of Canadian traded goods for most of the 1960s, 70s, and 80s.

climbed out of a deficit of $2.3 billion in 1999 to reach a $4.1 billion surplus last year — levels not seen since 1995-1996. Overall, industrial goods accounted for 18.0 per cent of total goods exports in 2004 and 20.2 per cent of total goods imports. These shares were up from 16.6 per cent and 19.1 per cent, respectively, one year earlier.

Energy products

As noted above, global energy prices have risen dramatically over the past few years. As a net exporter of energy, this upward trend has been to the overall benefit of Canada. It has also resulted in the values of exports and imports of energy products rising rapidly — they have grown at an annual average rate of about 18.2 per cent between 1999 and 2004.

Exports of energy products increased by $8.7 billion in 2004, largely because of *crude petroleum* (up $5.6 billion) and *natural gas* (up $1.8 billion). Exports of *other energy products* were also up over the year, increasing by $1.3 billion.

Imports of energy products rose $5.3 billion last year. Sixty per cent of the gain came from increased imports of *crude petroleum* (up $3.3 billion) and the remaining forty per cent from other *energy products* (up $2.0 billion).

Energy products accounted for 16.1 per cent of total goods exports in 2004, up a full percentage point from its 2003 share level. On the import side, energy imports amounted to almost 6.9 per cent of total goods imports last year, an increase of 5.7 per cent a year earlier.

The energy trade surplus widened $3.3 billion in 2004, to a record $44.3 billion. It was the second consecutive increase in the surplus.

Forestry products

At $39.2 billion, Canadian forestry product exports are about twelve-and-a-third times larger than forestry product imports (of nearly $3.2 billion); thus, Canada is a significant net exporter of forestry products. Exports of these products grew by $4.7 billion in 2004, reversing three years of losses. Some 85 per cent of the gain, or $4.0 billion, came from *lumber and sawmill products,* while *wood pulp* (up $0.4 billion) and *newsprint and other paper and paperboard* (up $0.3 billion) accounted for the remainder of the increase. Within *lumber and sawmill products,* **lumber** exports were up by $2.6 billion, while those for ***other wood fabricated materials*** increased $1.5 billion for the year. Forestry products accounted for 9.1 per cent of total Canadian goods exports in 2004, up half a percentage point from the share held one year earlier.

Canada imports few forestry products; they account for less than one per cent of total commodity imports. Imports of these products, such as ***crude wood products*** and ***wood fabricated materials,*** rose slightly last year — up $156 million.

As a net exporter of forestry products, the trade surplus in this sector stood at $36.0 billion in 2004. It was the fourth highest surplus on record, trailing only those over the 1999-2001 period.

Agricultural and Fishing Products

Exports of agricultural and fishing products grew by $1.4 billion in 2004, nearly reversing the $1.6 billion decline recorded a year earlier. Just under half the increase came from *wheat,* while the remainder came from *other agricultural and fishing products.* Within this latter category, exports of ***live animals*** fell by over $0.4 billion — the ongoing result of restricted borders following the discovery of one case of BSE in Canadian cattle in May 2003. Other declines were observed for ***fish and fish preparations, alcoholic beverages,*** and ***other crude vegetable products*** (each down $0.1 billion). On the other hand, exports of ***meat and meat preparations*** rebounded $0.8 billion from their decline of a year earlier.

As mentioned above, the lone category of exports and imports to record a decline in 2004 was imports of agricultural and fishing products: imports of these products fell by over $0.1 billion for the year. Most of the losses were concentrated in imports of ***meat and meat preparations*** (down $0.3 billion) and ***shelled corn*** (down $0.2 billion) while gains to *fruits and vegetables* (up $0.1 billion) and ***cocoa, coffee, tea and other food preparations*** (up $169 million) helped to limit the losses.

With the increase in exports and the slight decline in imports, the agricultural and fishing products goods surplus widened by $1.6 billion in 2004, reversing a two year slide. At $9.3 billion, it was the second largest surplus recorded for these products, just behind the $10.7 billion registered in 2001.

The share of agricultural and fishing products in total goods exports fell from 7.3 per cent in 2003 to 7.1 per cent last year. On the import side, the corresponding shares were 6.3 per cent and 5.9 per cent, respectively.

Consumer goods

Consumer goods are the smallest of Canada's major export commodity groupings. Although exports of consumer goods increased by $0.1 billion last year, their share in total goods exports fell 0.3 percentage points, to just over 4.0 per cent.

Consumer goods are much more important on the import side — accounting for 13.1 per cent of total merchandise imports — and though down from 13.5 per cent in 2003. Imports of consumer goods expanded $1.4 billion last year. The largest increase came from ***apparel*** as imports of *apparel and footwear* increased by $0.5 billion. ***Home furnishings*** imports also advanced (up $0.4 billion), as did those for ***miscellaneous end products*** (up $0.3 billion), ***photographic goods*** (up $0.1 billion), and ***television and radio sets*** and ***phonographs*** (also up $0.1 billion), to account for the remainder of the increase.

The combination of a slight increase in exports and a much larger increase in imports meant that the negative trade balance for consumer goods grew by $1.3 billion in 2004. It was the eighth consecutive widening of the trade deficit for consumer goods and, at $30.4 billion, the largest deficit ever.

Box B: Merchandise trade by key trading partners

Trade statistics are provided in two forms — Customs basis and Balance of Payments basis — at the level of total exports and total imports. The trade balance (surplus or deficit) is published by principal trading area and, at the total level, on a Balance of Payments basis only. Detailed commodity and geographic information is presented on a Customs basis only. Elsewhere in this Report, the trade figures are provided on a Balance of Payments basis, along with the rest of the current account, which includes services transactions, investment income, and transfers.

***For this boxed section,** the analysis is based on the Customs information in order to highlight developments at the commodity and specific geographic level. As such, various shares and growth rates will often differ from those reported in the remainder of this Report. The reader is urged to use caution when making comparisons or when combining data from this box with data found in the body of the Report. To reinforce this distinction, we have used the term "merchandise" trade to refer to commodity trade on a Customs basis and "goods" trade to reference trade on a Balance of Payments basis. This Customs data is produced on an internationally harmonized commodity classification (or HS) system that is broken down into chapters numbered from 1 to 99. Chapters 98 and 99 of the HS system represent special transactions and are excluded from the analysis, while Chapter 77 has been withheld for possible future use.*

The United States

Canada's total merchandise exports to the United States climbed to $348.2 billion in 2004 from $326.7 billion a year earlier. This represented an increase of 6.6 per cent for the year, or $21.5 billion. Despite this increase, the U.S. share in total merchandise exports fell 1.1 percentage points last year, from 85.8 per cent to 84.6 per cent.

Canadian merchandise exports to the U.S. are dominated by motor vehicles and mineral fuels (Table B-1). Together, they accounted for about 45 per cent of all commodity exports to the U.S. The eight (8) next-largest exports were responsible for a further third of all merchandise exports to Canada's southern neighbour, bringing the share of Canada's top 10 exports to over three-quarters of all exports to the U.S., or exports of over $250 billion.

Table B-1

HS #	Description	2004 Exports ($ millions)	Share (%)
87	Motor Vehicles	77,587.7	23.5
27	Mineral Fuels	66,524.0	20.2
84	Mechanical M&E	26,103.9	7.9
44	Wood	19,189.0	5.8
85	Electrical M&E	14,215.0	4.3
48	Paper and Paper Products	13,360.6	4.1
39	Plastics and Plastic Products	12,254.4	3.7
76	Aluminum and Aluminum Products	7,825.8	2.4
94	Furniture and Furnishings	7,684.7	2.3
88	Aircraft and Spacecraft	7,065.4	2.1
	TOP 10	**251,810.5**	**76.4**
	ALL OTHERS excluding 98 & 99	77,674.6	23.6
	SUBTOTAL	**329,485.1**	**100.0**
98 + 99	Special transactions	18,701.2	
	TOTAL	**348,186.3**	

It was mentioned earlier that rising global energy prices have been driving the recorded value of Canadian exports and imports up over the past few years. Mineral fuels exports to the U.S. grew by $6.8 billion last year, the largest gain in exports. Wood products were also up strongly last year, as their exports increased $4.1 billion over 2003 levels. Together, these two products combined to account for nearly half the total $21.5 billion increase in exports to the U.S.

Hand-in-hand with the strong increases observed for exports of industrial goods and materials were notable gains in many of the sub-commodities of this group. For example, exports to the U.S. of nickel (HS 73) were up 124.4 per cent, those of tin (HS 80) also more than doubled (up 102.0 per cent), lead (HS 78) exports increased by more than half of their previous years' levels (up 51.9 per cent), those of copper (HS 74) increased by 40.4 per cent, and those of other base metals (HS 81) advanced by nearly a third (up 31.5 per cent).

Exports of aircraft and spacecraft (HS 88) to the U.S. experienced the largest decline in 2004, as they fell $1.8 billion, a decline of nearly 20 per cent. Exports of live animals (HS 01) to the U.S., at $836 million in 2004, are only one-third of what they were only two years ago, falling by a third in 2004 after declining by half in 2003. Restricted border closures, because of the BSE re-occurrence, are behind these declines.

On the import side, Canadian merchandise imports from the U.S. advanced by over $5.1 billion, or 2.5 per cent, to $208.9 billion last year. At this level, the U.S. accounted for 58.8 per cent of all merchandise imports, down 1.9 percentage points from the 60.7 per cent share recorded in 2003.

Motor vehicles and machinery and equipment (M&E) — both mechanical and electrical — accounted for nearly half of all merchandise imports from the U.S. in 2004 (Table B-2). Other key imported products from the U.S. include plastics, mineral fuels, precision instruments and the like, paper, iron and steel, and organic chemicals.

Combined, the top 10 merchandise imports at the HS 2-digit, or chapter, level accounted for about 70 per cent of total merchandise imports from the U.S., or $143.3 billion of the $208.9 billion total.

Like the case for exports above, mineral fuels (HS 27) recorded the largest gain for bilateral imports in 2004, at $1.4 billion. Iron and steel imports also advanced strongly, up $1.3 billion. Next in terms of gains were imports of organic chemicals, which rose $0.6 billion last year.

Although the largest declines in imports from the U.S. at the HS chapter level were not as robust as the gains at this level — the largest decline came in inorganic chemicals (HS 28), at $260 million — some 47 of the 96 commodity chapters experience fewer imports from the U.S. in 2004 than in 2003.

Table B-2

HS #	Description	2004 Imports ($ millions)	Share (%)
87	Motor Vehicles	49,214.0	24.0
84	Mechanical M&E	35,795.1	17.5
85	Electrical M&E	16,092.3	7.8
39	Plastics	10,452.5	5.1
27	Mineral Fuels	7,258.6	3.5
90	Precision Instrumentation	6,787.1	3.3
48	Paper Products	5,099.7	2.5
73	Iron or Steel Articles	4,541.8	2.2
72	Iron and Steel	4,263.5	2.1
29	Organic Chemicals	3,790.6	1.8
	TOP 10	**143,295.2**	**69.9**
	ALL OTHERS excluding 98 and 99	61,761.9	30.1
	SUBTOTAL	**205,057.2**	**100.0**
98 + 99	Special transactions	3,815.9	
	TOTAL	**208,873.1**	

The European Union

Canadian merchandise exports to the EU accelerated last year, up 13.6 per cent compared with growth of 11.4 per cent a year earlier. This was an increase of $2.7 billion, to $22.6 billion, for the year. The top 10 exporting sectors accounted for some two-thirds of all merchandise exports to the EU. Precious stones/ metals and jewelry, mostly in the form of diamonds, were Canada's top exports to the EU, at $3.3 billion, or 15.0 per cent of all merchandise exports to the region. Several other high value added sectors, such as mechanical machinery and equipment, precision instruments, aircraft, and automotive products, were also amongst the largest exports to this region (Table B-3).

Diamonds and other precious stones/metals and jewelry were responsible for about one-third of the increase in EU-bound merchandise exports, as they grew by $830.8 million. Electrical machinery and equipment exports also expanded noticeably in 2004, up $566.5 million, or just over one-fifth of the total increase in exports, while mineral fuels, works of art (HS 97), and nickel combined to account for another third. These five largest growing sectors accounted for 91.4 per cent of the overall $2.7 billion increase in exports to the EU last year.

Exports of aluminum (HS 76) and pulp (HS 47) registered the largest reductions in merchandise exports to the EU in 2004, as they fell $324.8 million and $123.0 million, respectively. These two products were the only ones to experience declines in excess of $100 million. However, some 34 of the 96 HS chapters experienced falling exports to the EU in 2004.

Canadian merchandise imports from the EU grew more slowly than exports, rising by 4.8 per cent in 2004, to $42.0 billion. Mechanical machinery and equipment was the largest imported product at $7.5 billion, or almost 20 per cent of all imports from the EU. Other key import products included mineral fuels, pharmaceuticals, and motor vehicles, each accounting for about 10 per cent of imports last year (Table B-4).

Increases in imports were led by pharmaceuticals (up $446.0 million), mineral fuels (up $418.9 million), motor vehicles (up $346.5 million), iron and steel (up $300.2 million), electrical machinery and equipment (up $257.1 million), and precision instruments (up $148.3 million). Partially offsetting the gains were declining imports of ships and boats (HS 89), at $256.0 million, organic chemicals (HS 29), at $133.8 million, and aircraft (HS 88), at $129.5 million.

Table B-3

HS #	Description	2004 Exports ($ millions)	Share (%)
71	Precious Metals/Stones and Jewellery	3,275.8	15.0
84	Mechanical M&E	2,680.0	12.2
85	Electrical M&E	2,025.5	9.2
88	Aircraft and Spacecraft	1,464.2	6.7
47	Wood Pulp	1,396.2	6.4
75	Nickel and Nickel Products	1,084.8	5.0
27	Mineral Fuels	865.9	4.0
90	Precision Instrumentation	713.0	3.3
26	Ores, Slag and Ash	695.8	3.2
87	Motor Vehicles	638.4	2.9
	TOP 10	**14,839.6**	**67.7**
	ALL OTHERS excluding 98 and 99	7,068.9	32.3
	SUBTOTAL	**21,908.6**	**100.0**
98 + 99	Special transactions	690.5	
	TOTAL	**22,599.1**	

Table B-4

HS #	Description	2004 Imports ($ millions)	Share (%)
84	Mechanical M&E	7,529.1	18.2
27	Mineral Fuels	4,363.6	10.5
30	Pharmaceutical Products	4,186.2	10.1
87	Motor Vehicles	3,988.0	9.6
85	Electrical M&E	2,738.8	6.6
88	Aircraft and Spacecraft	1,822.3	4.4
90	Precision Instrumentation	1,811.3	4.4
29	Organic Chemicals	1,543.7	3.7
22	Beverages and Spirits	1,265.9	3.1
72	Iron and Steel	1,129.4	2.7
	TOP 10	**30,378.4**	**73.4**
	ALL OTHERS excluding 98 and 99	11,000.4	26.6
	SUBTOTAL	**41,378.8**	**100.0**
98 + 99	Special transactions	605.3	
	TOTAL	**41,984.1**	

Japan

Japan was the destination of 2.1 per cent of Canadian merchandise exports in 2004, roughly similar to the share recorded in 2003. For the year, merchandise exports increased 4.7 per cent, or $385.0 million, to $8.5 billion.

The ten largest products exported to Japan accounted for slightly more than three-quarters of total merchandise exports to that country. Wood, at one-fifth of all exports, was the largest export commodity. Japan is an important market for Canadian agricultural and agri-food products, with several of these products appearing in the top ten Canadian exports to Japan (Table B-5).

Not only was wood the largest export commodity to Japan, it also increased the most between 2003 and 2004, rising by $152.2 million for the year. Consistent with the overall increase in industrial goods and materials exports, the three next largest increases in exports to Japan came from aluminum (up $123.0 million), other base metals (HS 81 — up $102.1 million), and nickel (HS 75 — up $87.6 million). The former registered an export increase of over 40 per cent, while the latter two more than doubled (rising 142 per cent and 121 per cent, respectively).

There were three notable declines in exports to Japan in 2004: mineral fuels (HS 27) exports fell by a fifth (21.5 per cent), or $102.4 million; those for mechanical machinery and equipment declined by 31.9 per cent, or $99.0 million; and, those for motor vehicles plummeted 62.4 per cent, or $85.4 million.

Merchandise imports from Japan fell for the second consecutive year in 2004, declining 3.3 per cent, or $451.9 million, to $13.4 billion. Although Canadians import a wide variety of products from Japan, imports from that country are highly concentrated in only a few sectors. The top 10 imports were responsible for almost 93 per cent of total merchandise imports from Japan. Automotive products and machinery and equipment (both mechanical and electrical) accounted for over three-quarters of these imports last year (Table B-6).

Canada imported $118.9 million more in aircraft (HS 88) from Japan in 2004, an increase of over 80 per cent from 2003 levels. Electrical machinery and equipment imports increased $111.7 million, while those for precision instruments (HS 96) advanced $63.4 million. Also of note, pharmaceutical imports (HS 30) from Japan almost doubled in 2004, rising $30.6 million.

The largest reduction in merchandise imports from Japan occurred in motor vehicles (down $534.8 million). Other notable declines were registered for mechanical machinery and equipment (down $177.4 million) and for toys, games, and sporting goods (HS 95), which fell $99.3 million last year. These declines, along with declines in 39 other HS chapters, helped pull overall imports from Japan down last year.

Table B-5

HS #	Description	2004 Exports ($ millions)	Share (%)
44	Wood	1,701.1	20.1
12	Oil Seeds, etc.	979.1	11.6
2	Meat	777.0	9.2
47	Wood Pulp	550.5	6.5
26	Ores, Slag and Ash	514.3	6.1
3	Fish and Seafood	488.6	5.8
76	Aluminum and Aluminum Products	426.9	5.1
27	Mineral Fuels	372.9	4.4
10	Cereals	334.2	4.0
85	Electrical M&E	297.0	3.5
	TOP 10	**6,441.8**	**76.3**
	ALL OTHERS excluding 98 and 99	2,005.2	23.7
	SUBTOTAL	**8,447.0**	**100.0**
98 + 99	Special transactions	82.0	
	TOTAL	**8,529.0**	

Table B-6

HS #	Description	2004 Imports ($ millions)	Share (%)
87	Motor Vehicles	5,104.0	38.2
84	Mechanical M&E	2,865.9	21.5
85	Electrical M&E	2,295.5	17.2
90	Precision Instrumentation	893.8	6.7
40	Rubber and Rubber Products	342.3	2.6
88	Aircraft and Spacecraft	267.3	2.0
73	Articles of Iron or Steel	259.6	1.9
39	Plastics and Plastic Products	139.5	1.0
72	Iron and Steel	115.7	0.9
82	Tools and Utensils of Base Metals	102.8	0.8
	TOP 10	**12,386.4**	**92.8**
	ALL OTHERS excluding 98 and 99	958.3	7.2
	SUBTOTAL	**13,344.7**	**100.0**
98 + 99	Special transactions	20.9	
	TOTAL	**13,365.6**	

China

Canadian merchandise exports to China increased 38.8 per cent, or $1.8 billion, to $6.6 billion in 2004. It was the second consecutive increase in exports to that country. The top ten exporting sectors accounted for nearly three-quarters of all exports last year. Wood pulp exports were the largest, and the only one to exceed one billion dollars. Exports of these products were up almost a quarter over previous year levels. The second largest export category — organic chemicals — doubled exports last year (up 104.7 per cent), while cereals exports vaulted into 3rd spot, as they grew by over one thousand per cent. Also of note, Canadian exports of automotive products and machinery and equipment amounted to nearly one-fifth of total exports to China in 2004 (Table B-7).

With the strong growth reported above, it is not surprising that cereals exports grew the most amongst Canadian exports to China in 2004 — increasing $698.1 million. Organic chemicals (HS 29) also experienced a sizeable increase in exports to that country, rising $442.0 million, as did pulp (HS 47), at $200.7 million, and nickel (HS 75), at $139.9 million. On the other hand, automotive products exports fell $247.1 million in 2004, giving up most of the gains accrued in 2003. Electrical machinery and equipment exports also fell, by some $31 million, to register the second largest decline in commodity exports to China last year.

Canadian merchandise imports from China were also up strongly in 2004, but not as fast as for exports — they grew by 29.6 per cent. This was an increase of $5.5 billion for the year. Machinery and equipment (at 37.6 per cent of the total), miscellaneous consumer goods, such as furniture and toys and games (at 15.3 per cent), and footwear and apparel (at 12.2 per cent) were amongst the largest import categories (Table B-8).

The large import categories above also led the gains in merchandise imports from China, as the advances were led by mechanical (up $1.7 billion) and electrical machinery and equipment (up $1.1 billion), followed by iron and steel and their articles (HS 72 + HS 73 — up some $443 million, together), and furniture and furnishings (up $380 million).

Table B-7

HS #	Description	2004 Exports ($ millions)	Share (%)
47	Wood Pulp	1,038.8	15.9
29	Organic Chemicals	864.2	13.2
10	Cereals	764.2	11.7
87	Motor Vehicles	479.6	7.3
84	Mechanical M&E	363.3	5.5
85	Electrical M&E	338.2	5.2
03	Fish and Seafood	297.7	4.5
31	Fertilizers	274.9	4.2
75	Nickel and Nickel Products	232.6	3.6
26	Ores, Slag and Ash	159.4	2.4
	TOP 10	**4,813.0**	**73.5**
	ALL OTHERS excluding 98 and 99	1,734.9	26.5
	SUBTOTAL	**6,547.9**	**100.0**
98 + 99	Special transactions	66.4	
	TOTAL	**6,614.3**	

Table B-8

HS #	Description	2004 Imports ($ millions)	Share (%)
84	Mechanical M&E	4,704.7	19.6
85	Electrical M&E	4,325.2	18.0
95	Toys, Games & Sporting Goods	2,047.5	8.5
94	Furniture and Furnishings	1,637.2	6.8
62	Woven Apparel	1,119.9	4.7
64	Footwear	913.3	3.8
61	Knitted or Crocheted Apparel	886.9	3.7
73	Articles of Iron or Steel	755.4	3.1
39	Plastics and Plastic Products	720.8	3.0
90	Precision Instrumentation	679.6	2.8
	TOP 10	**17,790.4**	**73.9**
	ALL OTHERS excluding 98 and 99	6,268.3	26.1
	SUBTOTAL	**24,058.7**	**100.0**
98 + 99	Special transactions	25.7	
	TOTAL	**24,084.4**	

BOX C: THE GROWING IMPORTANCE OF NORTH-SOUTH TRADE

In 2002, world merchandise exports amounted to US$6.5 trillion and exports of commercial services were US$1.7 trillion. High-income industrial economies accounted for the lion's share of this trade, which is hardly surprising given that these economies also produced more than 70 per cent of world's GDP that year. These countries traded extensively among themselves (North-North trade), accounting for a half of world merchandise exports in 2002. Trade among developing countries (South-South trade) represented less than 15 per cent of world merchandise exports, while the rest, about one third, represented trade between industrial and developing countries, or North-South trade.

The past several decades, particularly the 1990s, have witnessed, however, an expansion of North-South trade. By 2002, the North-South share in world merchandise exports rose in precise terms to 37 per cent from 30 per cent in 1970; at the same time, the share of South-South trade was up to 14.1 per cent from 5.6 per cent, while that of North-North trade fell to just under 50 per cent from more than 60 per cent (Table C-1). The expansion of North-South trade was mainly led by increased imports from the South by the industrial countries in the North. Northern countries' imports from the South increased substantially from only 3 per cent of Northern countries' GDP in the early 1970s to nearly 7 per cent of GDP in 2001.

This note attempts to point out the underlying forces driving the expansion of North-South trade over the past several decades.

Table C-1: The Shares of Merchandise Exports by North and South, 1970-2002 (in per cent)

	1970	1980	1990	2000	2002
Exports by industrial countries:					
to industrial countries (North-North)	64.2	59.5	61.3	49.7	48.9
to low- & medium-income countries (North-South)	18.4	18.9	15.9	17.5	17.3
Total North exports	82.6	78.4	77.2	67.2	66.2
Exports by low- and medium-income countries					
to industrial countries (North-South)	11.8	13.6	14.5	19.7	19.8
to low- & medium-income countries (South-South)	5.6	8	8.3	13.1	14.1
Total South exports	17.4	21.6	22.8	32.8	33.9
Total North-South trade	30.2	32.5	30.4	37.2	37.1

Sources: IMF Direction of Trade Statistics

North-South trade

The expansion of North-South trade over the past decade has been shaped by several historical events that took place particularly in the early 1990s, including the transformation of formerly socialist economies into market economies following the end of the Cold War, the emergence of China as an important global economic force, and the signing of NAFTA that brought Mexico into the North American free trade area. These events fundamentally changed the structure of the global economy and set the stage for the expansion of North-South trade.

Table C-2 reports on the changes in regional shares of merchandise imports by industrial countries from various Southern countries. It shows a significant increase of industrial countries' imports from China; its share in industrial countries' total imports from the South increased significantly from 2.1 per cent in 1970 to more than a quarter in 2001. Equally impressive, though to a lesser extent than is the case for China, is Mexico. This country increased its share in total industrial countries' imports from southern countries from 5 per cent in 1970 to 16 per cent in 2001. On the other hand, the African, Latin American and Oceanic countries experienced declines in their shares in total industrial countries' imports from the South, while imports from other Asian (mainly South Asia), Central and Eastern countries and Russia remained stable.

Regional influences on the North-South trade pattern underpin these trends. For example, Japan's imports from the South were completely dominated by China, which accounted for more than a half of Japanese imports from the South. In Europe, imports from Central and Eastern European countries represented 37.5 per cent of total EU imports from southern countries. And in North America, both Canadian and American imports from the South came largely from Mexico and China.

Table C-2: Regional shares of industrial countries merchandise imports from low- and medium-income countries (per cent), 1970-2001

	Total industrial			
	1970	1980	1990	2001
Africa	24.6	21.1	13.4	7.3
China	2.1	4.8	15.9	25.8
ASEAN	8.5	10.1	13.0	12.5
Other Asia	9.3	7.9	10.3	9.1
Oceania	2.1	2.4	0.9	0.6
Mexico	4.8	9.1	10.8	15.6
Other American	28.6	21.1	17.6	10.4
CEE & Russia	19.9	23.5	18.1	18.7

Sources: OECD

With respect to exports from the North to the South, the picture looks somewhat similar to that of imports, with Central and Eastern Europe, Mexico and China taking the lead. The exception was that Central and Eastern Europe and Russia stood far ahead of all other regions as the destination of industrial countries' exports to the South. At nearly a quarter of Northern exports to southern countries, this region was a larger recipient than either China or Mexico. On the other hand, the African, Oceanic and Latin American countries lost relative importance in industrial countries' total exports to the South.

As in the case of imports, regional influences lie behind these trends. EU exports to central and Eastern European countries accounted for 44 per cent of total EU exports to the South. EU exports to China and Mexico were less significant. In fact, the EU exported more to Africa than to Mexico and China combined. In Japan, exports to the Southern were dominated by two economies — China and ASEAN. For the U.S., the main destination of U.S. exports was Mexico, at 46 per cent of total U.S. exports to the South. For Canada, the main markets for Canadian exports to southern countries were China, the other Western Hemisphere countries, particularly Mexico.

Table C-3: Regional shares of industrial countries merchandise exports to low-and medium-income countries (per cent), 1970-2001

	Total Industrial			
	1970	1980	1990	2001
Africa	24.6	21.9	16.4	9.9
China	3.5	6.2	7.8	12.3
ASEAN	6.9	7.0	13.1	11.3
Other Asian	13.0	12.4	13.1	9.6
Mexico	6.5	9.4	12.8	17.5
Other American	22.3	19.2	15.6	14.7
Oceania	2.6	1.5	1.2	0.8
CEE & Russia	20.6	22.4	20.0	23.8

Sources: OECD

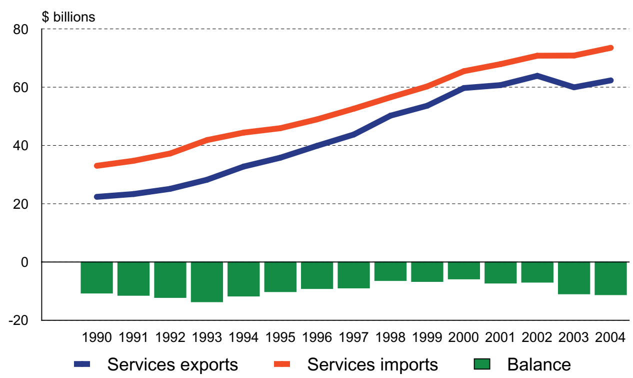
Overall, several historical events, particularly during the 1990s, have helped reshape the structure of global trade and continue today — especially, the fall of the Iron Curtain, the opening of China, and the addition of Mexico to the Canada-US Free Trade Agreement to form NAFTA — leading to the expansion of trade between East and West Europe, between China and Japan, between China and the U.S., and between Mexico and Canada and the U.S., leading to the increasing importance of North-South trade.

II. Services

Canadian services exports trailed Canadian goods exports in terms of performance last year. For 2004 as a whole, Canadian services exports increased $2.4 billion, up 4.0 per cent, to $62.3 billion (Figure 2-1). At this level, services exports amounted to 12.7 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, 1990-2004



Canadian services imports also rose last year, increasing $2.7 billion to $73.5 billion, a 3.8 per cent rise from the level of one year ago. Services imports thus represented 16.8 per cent of total imports of goods and services, or almost one dollar of every six dollars of total Canadian imports.

Since the increase in the value of services exports ($2.4 billion) was less than that of services imports ($2.7 billion), Canada's services deficit widened by $0.3 billion, to $11.2 billion, in 2004. It was the second consecutive increase in the deficit.

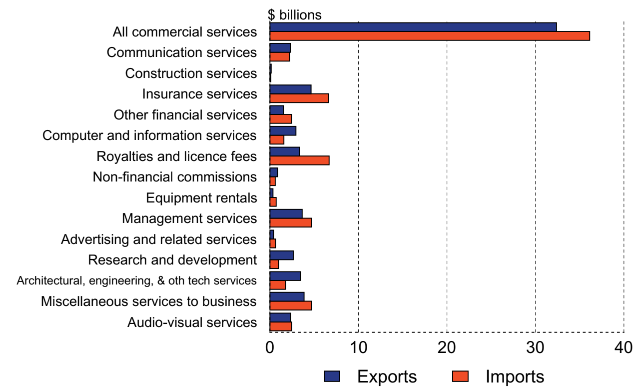
There are four sub-components to services trade — commercial services, travel services, transportation services and government services. Each of these categories is discussed in greater detail below.

Commercial services

Accounting for about half of all services trade, commercial services are the largest component of services. These services include such activities as accounting, legal, insurance, financial, architectural, computer, communications, and advertising services, to name but a few. In 2004, commercial services was the only major component of services to register declines. On the export side, total commercial services fell by $1.2 billion to $32.4 billion, a 3.5 per cent decrease in these exports (Figure 2-2). With this drop, the share of commercial services in total services exports slipped from 56.0 per cent two years ago to 51.9 per cent last year. It was the second consecutive decline in annual commercial services exports.

Figure 2-2

Commercial services trade, 2004



For 2004, nine of the fourteen categories that comprise commercial services experienced declining exports when compared to 2003 levels. Notable declines, of a quarter of a billion dollars or more, were registered for *management services* (down $387 million, or 9.6 per cent), *research and development* (down $262 million, or 9.0 per cent), *royalties and licence fees* (down $254 million, or 7.1 per cent), and *computer and information services* (down $251 million, or 7.9 per cent). Rising export receipts for *non-financial commissions* (up $129 million, or 17.8 per cent) and *insurance services* (up $120 million, or 2.7 per cent) helped to limit the losses to commercial services exports.

Imports of commercial services into Canada also declined in 2004, down $1.0 billion to $36.1 billion. This was a 2.7 per cent decline from 2003 levels. With the decline, the share of commercial services in total services imports dropped from 52.4 per cent in 2003 to 49.1 per cent last year.

Similar to commercial services exports, nine of the fourteen component categories had lower levels of imports in 2004 than in 2003. The largest declines occurred in *research and development* (down $410 million, or 29.8 per cent), *management services* (down $404 million, or 8.0 per cent), and *insurance services* (down $371 million, or 5.3 per cent). Limiting the overall decline were advances in *miscellaneous services to business* (up $264 million, or 6.0 per cent) and *computer and information services* (up $144 million, or 10.0 per cent).

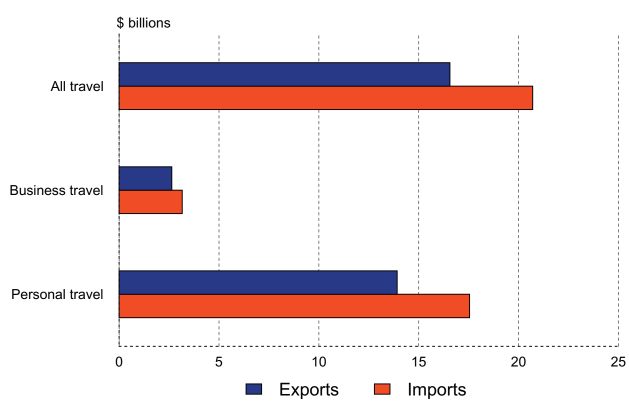
With Canadian commercial services exports falling more than imports, commercial services experienced an overall decline in its trade balance last year, posting a $0.2 billion deterioration in its trade deficit. This deficit rose to $3.7 billion for the year.

Travel services

Travel services are the next largest category of Canadian services exports after commercial services. After reaching a peak of $16.7 billion in 2002, travel services exports (i.e. Foreigners buying Canadian goods and services) suffered a setback in 2003 because of the SARS outbreak in the Toronto area and, arguably, because of the fast appreciation of the Canadian dollar with respect to the U.S. currency. Last year, travel services exports rebounded to $16.6 billion, about $190 million below its previous high. This represented a $1.8 billion turn-around, or a 12.3 per cent increase in these exports. The two sub-categories that make up travel services — *business travel and personal travel* — both experienced double-digit growth in their export levels. *Business travel services*, the smaller of the two sub-categories, saw exports rise 10.4 per cent, or $248 million, to $2.6 billion while *personal travel services* exports grew 12.6 per cent, or $1.6 billion, to $13.9 billion. Overall travel services represented 26.6 per cent of total services exports in 2004, up from 24.6 per cent one year earlier (Figure 2-3).

Figure 2-3

Travel services trade, 2004



Imports of travel services registered an overall 11.3 per cent increase in 2004, as they rose $2.1 billion to $20.7 billion. However, unlike the export side, both sub-categories did not register increases last year: imports of *business travel services* fell $228 million, or 6.7 per cent, to $3.2 billion, while imports of *personal travel services* increased 15.3 per cent, or $2.3 billion, to $17.5 billion last year.

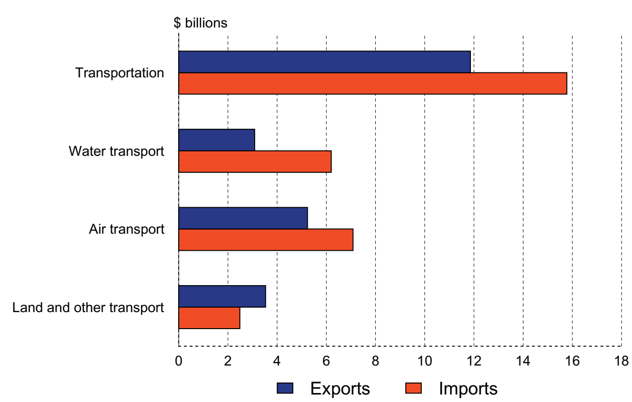
Despite the strong dollar *vis-à-vis* the U.S. dollar, spending by Canadian travellers grew almost twice as fast for overseas destinations as for travel to the United States. Payments advanced more quickly than revenues and the 2004 travel deficit, at $4.1 billion, surpassed the 2003 deficit, which was, at that time, the highest since the 1990-1994 period. Overall, the deficit in *personal travel services* widened by a further $0.8 billion, to $3.6 billion, while that for *business travel services* was halved from $1.0 billion in 2003, to $0.5 billion last year.

Transportation services

At about one-fifth of total services trade, transportation services are the third largest of the four major services sub-categories. In 2004, trade in transportation services was robust: total transportation services exports grew by 15.3 per cent, or $1.6 billion, to $11.9 billion, while imports advanced 10.9 per cent, or $1.5 billion, to $15.8 billion (Figure 2-4).

Figure 2-4

Transportation services trade, 2004



All three sub-components of transportation services experienced increased exports in 2004. *Air transport services,* the largest of the three sub-groups, accounted for about 60 per cent of the total $1.6 billion increase in transportation services exports, or $0.9 billion. Exports of these particular services jumped 21.6 per cent to $5.2 billion last year. *Water transport services* also contributed to the overall advance, climbing 19.8 per cent to $3.1 billion, an increase of over $0.5 billion. Lastly, *land and other transportation services* added the final $0.1 billion contribution to the overall increase as exports of these types of transportation services rose 3.9 per cent to $3.5 billion.

On the import side, gains in *air transport services* (up $0.9 billion, or 14.9 per cent) and *water transport services* (up $0.6 billion, or 11.5 per cent) were partially offset by a marginal decline in *land and other transportation services,* which fell $9 million, or 0.4 per cent.

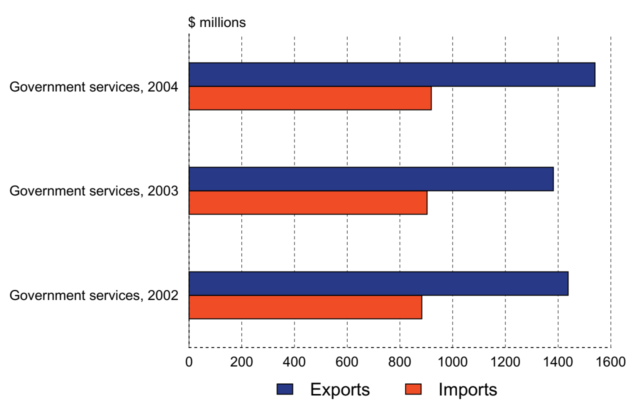
With transportation services exports rising faster (and slightly more) than imports, there was a slight improvement of $24 million in the overall transportation services deficit in 2004, to $3.9 billion. Both the *air transport* and *land and other transport* sub-categories contributed to reducing this deficit, while *water transportation services* added to the deficit.

Government services

The smallest of the four services sub-categories, government services, cover international transactions arising largely from official representation and military activities. Theses services experienced a relatively large increase in exports (11.3 per cent, or $156 million) and a slight increase in imports (1.8 per cent, or $16 million) last year. For 2004 as a whole, the overall effect was a $140 million widening in the trade surplus for this category of services trade, to $620 million (Figure 2-5).

Figure 2-5

Government services trade, 2002-2004



Services trade by region

As is the case for goods, the United States is Canada's largest trading partner for services, accounting for nearly six of every ten dollars of services trade (57.3 per cent in 2004). This is as true for services exports, where the U.S. share of total services exports was 57.8 per cent last year, as it is for services imports, where the U.S. share of total services imports was 56.9 per cent.

Services trade with the United States

Services exports to the United States grew by $0.4 billion, or 1.1 per cent, to just over $36.0 billion in 2004. The expansion only partially offset the $2.7 billion decline experienced in 2003. Gains came as exports of transportation services grew by $292 million and those of government services increased by $118 million. A $646 million increase in travel services exports was offset by an equally large ($659 million) reduction in commercial services exports to the U.S.

Services imports from the U.S. fell by $0.4 billion, or 1.1 per cent, to $41.8 billion last year. A $0.9 billion increase in travel services imports and a $0.4 billion increase in transportation services imports were more than eliminated by a $1.7 billion decline in commercial services imports.

With services exports rising by $0.4 billion and services imports falling by $0.4 billion, the services trade deficit with the United States narrowed by $0.8 billion, to $5.8 billion, in 2004.

Services trade with the European Union

Canadian services exports to the EU grew the most in absolute terms with respect to the various geographic regions in 2004, advancing $0.9 billion, or 8.9 per cent, to $11.2 billion. At this level of increase, the EU accounted for almost 40 per cent of the total $2.4 billion gain in services exports last year. Both travel and transportation services exports grew by more than 20 percent over the year, accounting for all of the gains. Travel services exports were up 20.5 per cent, or $0.5 billion, to $2.9 billion and transportation services exports grew by 22.3 per cent, or $0.6 billion, to $3.2 billion. A slight 3.0 per cent, or $0.2 billion, decline in commercial services exports to the EU partially offset the gains, however.

Services imports from the EU were also up in 2004, rising $0.7 billion, or 6.6 per cent, to $12.0 billion. The bulk of the increases came from travel services, where imports jumped 18.8 per cent, or $0.6 billion, to $3.8 billion. Transportation services imports also rose last year, up 8.4 per cent, or $0.3 billion, to $3.8 billion. As was the case for services exports to the EU above, there was a decline in commercial services imports from the EU. These imports fell 3.6 per cent, or $0.2 billion, to $4.1 billion to limit the gains in services imports from the EU.

Overall, the Canada-EU services deficit narrowed $0.2 billion, falling from $0.9 billion in 2003 to $0.7 billion last year.

Services trade with Japan

Services exports to Japan took off in 2004, climbing by more than a third, or $0.5 billion, to $1.9 billion. The three biggest sub-categories of services — travel, transportation and commercial — increased by 56.2 per cent, 35.9 per cent, and 23.4 per cent, respectively. Government services exports were unchanged at $32 million for the year.

A $32 million increase in travel services imports from Japan (up 15.9 per cent) was matched by a $32 million decline in transportation services imports (down 6.7 per cent). As a result, the level of overall gains to services imports from Japan was determined by gains to imports of commercial services. These imports rose by just over $1.0 billion (or 57.5 per cent). Thus, imports of services from Japan rose by just over $1.0 billion, to $3.5 billion in 2004.

With services imports from Japan rising by $1.0 billion and services exports increasing by only half that amount, the bilateral services deficit between Canada and Japan widened by $0.5 billion in 2004, to $1.6 billion.

Services trade with the other OECD countries

Service exports to the other OECD countries advanced $0.5 billion in 2004, as the three major categories of services all registered increase. Exports of transportation services were up slightly more than $0.2 billion (or 30.3 per cent), while those of commercial services were up slightly less than $0.2 billion (or 13.7 per cent). Travel services exports were also up — by $0.1 billion, or 8.4 per cent.

Canadian imports of services from the other OECD countries rose $0.1 billion, or 1.3 per cent last year. Gains in transportation services imports (up $75 million) and travel services (up $6 million) were partially offset by a $29 million decline in commercial services imports from these countries.

With services exports rising by over half a billion dollars and services imports up some $53 million, the services deficit with the other OECD countries shrank by $467 million, to $127 million in 2004.

Services trade with the non-OECD countries

Canadian exports of services to the non-OECD countries were up only marginally ($44 million, or 0.5 per cent) in 2004. Gains in travel services (up $0.4 billion) and transportation services (up $0.3 billion) were slightly more than offset by a $0.7 billion decline in commercial services. A $49 million increase in government services exports accounted for the positive increase in services exports to this region.

On the import side, gains in travel services (up $0.6 billion) and transportation services (up $0.8 billion) were only partially offset by a $0.1 billion decline in commercial services imports. The overall result was that Canadian imports of services from the non-OECD region increased by $1.3 billion, or 11.9 per cent, to $12.2 billion in 2004.

Overall, the services trade deficit with this region slipped another $1.3 billion further into deficit, falling to $2.9 billion last year.

III. Current Account

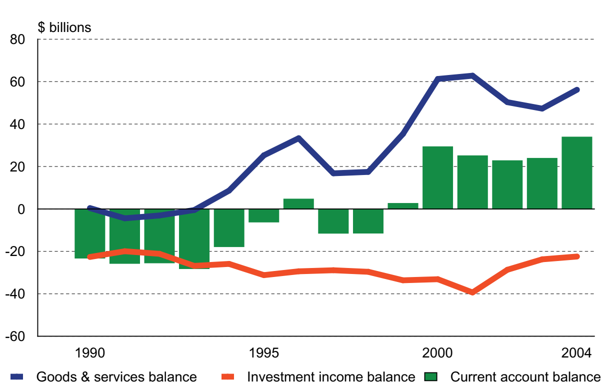
The current account is one of the two major accounts that make up the balance of payments: the other is the capital account. The current account records the flow of goods, services, investment income, and transfers between Canada and other countries. The capital and financial account, on the other hand, 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 a record $33.8 billion current account surplus in 2004, as the surplus expanded by $10.0 billion from its level a year earlier. It was the sixth consecutive surplus (Figure 3-1). The current account surplus of 2004 stood some $61.9 billion higher than its lowest recorded level, which occurred in 1993.

For 2004, the goods surplus stood at $67.3 billion, the highest in three years and second highest ever. As noted in Chapter I above, both exports and imports reached record levels helped by higher values of trade in industrial goods and energy products. Further, the deficit for services increased by $0.3 billion for the year. Travel and commercial services contributed to the increased deficit.

Figure 3-1

Current account balance and key components, 1990-2004



The deficit on investment income was reduced by $1.3 billion in 2004, as receipts grew more than payments. Last year's deficit was the lowest since 1992 and comes only three years after registering the largest investment income deficit ever recorded (of $39.4 billion). The bulk of the advance came from the portfolio investment balance. While portfolio investment income receipts from abroad fell $0.2 billion, payments to foreign investors declined $1.4 billion, with the deficit for this category thus narrowing by $1.2 billion. Both profits earned abroad by Canadians and profits on foreign direct investment in Canada increased significantly over their 2003 levels; however, payments grew slightly more than receipts with the result that the direct investment income deficit widened by $0.3 billion. Slightly more than offsetting this loss was a $0.4 billion improvement in the other investment income balance.

The current transfers balance slipped by almost $150 million to a $125 million surplus in 2004.

Regional analysis

The United States

Up until the year 1993, Canada ran a current account deficit with the United States, except for the six-year period of 1982-1987. In 1994 this long-standing position changed, with a $4.9 billion surplus, and the first of what is now an uninterrupted 11-year string of surpluses was recorded.

The bilateral Canada-U.S. current account balance for 2004 expanded by $12.6 billion to reach $75.3 billion — more than the entire improvement in Canada's current account surplus with the world. The balances for all four major components of the current account — goods, services, investment income, and current transfers — showed improvement for the year. As with Chapter I, the bilateral Canada-US goods surplus broke the $100 billion mark in 2004, as it climbed $11.3 billion to $101.8 billion. Exports rose to within 2 per cent and imports to within 6 per cent of their record levels, which were recorded in the year 2000. Goods exports for the seven major commodity groups rose across the board, led by industrial goods, energy products, and forestry products. Five of the seven major commodity groups increased on the import side. Import advances were led by industrial goods and energy products while imports of agricultural and fishing products and of consumer goods from the United States declined.

Canada's bilateral deficit for services narrowed by over $0.8 billion in 2004 as exports to the U.S. increased 1.1 per cent and imports fell by a similar rate. Sectorally, much of the improvement came from commercial services as payments fell two-and-a-half times more than receipts fell. Trade levels were up for both travel and transportation services; however, the travel and transportation deficits widened as payments increased more than receipts.

The investment income deficit narrowed marginally ($0.1 billion) in 2004 as improvements in the portfolio investment and other investment income balances increased more than the widening of the direct investment income balance ($0.9 billion and $0.5 billion compared against $1.3 billion, respectively).

The European Union

The current account deficit with the EU narrowed for the second consecutive year in 2004, declining to $13.1 billion from $14.6 billion a year earlier and from a peak of $16.1 billion the year before that. Most of the improvement was accounted for by the goods balance as a slight narrowing of the services deficit ($175 million) was more-or-less offset by a slight decline in the current transfers balance ($152 million) and a small widening of the investment income deficit ($10 million).

The goods deficit with the EU fell to $9.2 billion, its lowest level since the year 2000. Bilateral Canada-EU exports and imports both reached record levels. Exports advanced at a pace nearly three times faster than imports — 12.3 per cent versus 4.4 per cent — to account for this performance. Advances on the exports side were led by machinery and equipment and by industrial goods, while industrial goods, automotive products, and energy products headed the import gains.

Receipts for travel services advanced by over 20 per cent in 2004; however, much larger travel payments were also up strongly, by 18.8 per cent. There was, thus, an overall $0.1 billion decline in the travel balance.

The transportation deficit narrowed $0.3 billion as receipts were up some 22 per cent while payments advanced less robustly, at 8.4 per cent. Declines in both commercial services imports and exports were largely offsetting, leaving the surplus in this category to rise from $755 million to $759 million between 2003 and 2004. Overall, the bilateral services deficit narrowed nearly 20 per cent, or $0.2 billion, to about three-quarters of a billion dollars in 2004.

The bilateral Canada-EU investment income deficit was essentially unchanged as overall receipts narrowly trailed payments by around $10 million — $863 million versus $872 million, respectively. Direct investment receipts were $33 million more than payments, portfolio investment income receipts fell $180 million more than payments, and other investment income receipts were $136 million more than payments.

Japan

Canada nearly wiped out its goods deficit with Japan in 2004 as export growth was nearly double that of import growth (6.1 per cent compared to 3.1 per cent). While there remains a $64 million goods deficit, the bilateral services deficit expanded by $0.5 billion to $1.6 billion. The deterioration came from commercial services, where the deficit expanded by $0.9 billion to $2.1 billion. Payments to Japan for commercial services were up by $1.0 billion for the year, while receipts only advanced $0.1 billion. Partially offsetting the losses were gains of $0.2 billion each to the travel and transportation balances. The transportation balance moved from a $0.1 billion deficit in 2003 to a $0.1 billion surplus last year, while the travel balance moved further into surplus, registering a $0.4 billion balance.

Receipts of investment income from Japan jumped 70 per cent, or $0.5 billion, in 2004, while payments were up only 7.2 per cent, or $0.2 billion. Thus, the overall income deficit narrowed $0.3 billion, to $1.4 billion for the year. A $0.2 billion decline in the portfolio income deficit accounted for most of the improvement, while additions to the direct investment income surplus accounted for the bulk of the remaining $0.1 billion gain.

Overall, Canada's current account balance with Japan narrowed $0.6 billion, to a $2.9 billion deficit.

Other OECD countries

Canada's current account deficit with the other OECD countries reached $7.7 billion in 2004, its highest level in four years. The deficit widened by $1.4 billion between 2003 and 2004. The goods deficit grew by $1.0 billion, to $8.0 billion, as exports advanced 12.2 per cent and imports by 12.9 per cent. Also contributing to the overall deficit was a $0.9 billion decline in the investment income balance. Investment income receipts fell across the board (down $0.2 billion in aggregate), while payments increased $0.7 billion in total. Direct investment income payments increased by $0.8 billion and portfolio investment payments declined by $0.1 billion, as other investment income payments remained more-or-less steady.

Improvements to the services balance limited the widening of the overall current account with this region. The services deficit narrowed substantially in 2004, falling $0.5 billion to just over $0.1 billion. Services gains were widespread: the travel deficit narrowed $0.1 billion to $0.4 billion; the transportation surplus grew from a near-balance to $0.2 billion; and the commercial services balance improved $0.2 billion, transforming from a $0.1 billion deficit in 2003 to a $0.1 billion surplus in 2004.

All other countries

The Canadian current account deficit with the remainder of the world slipped $3.2 billion in 2004, to $17.7 billion. Declines in both trade balances (goods and services) outweighed the advance in the investment income balance.

For the year as a whole, the goods deficit expanded $3.4 billion, to $17.2 billion. Exports to this region grew 17.7 per cent in 2004, as they advanced $4.1 billion to $27.1 billion. However, imports from this region were up even more — growing at a 20.4 per cent rate, or $7.5 billion, to $44.3 billion.

The services deficit also expanded, increasing from $1.6 billion in 2003 to $2.9 billion in 2004. With the exception of a small increase in the government services balance, the balances deteriorated for all other services categories. The commercial services balance fell the most, declining $0.6 billion to register a $0.1 billion surplus for the year. Both the transportation and travel services deficits widened, as the former moved $0.5 billion deeper into deficit (to $3.0 billion) while the latter saw its deficit grow $0.2 billion to $1.4 billion for 2004.

As mentioned above, the investment income balance moved further into surplus, by $1.8 billion in 2004, to $6.2 billion. Most of the gains came from a $1.7 billion increase in the direct investment income surplus (to $5.7 billion), while the portfolio investment income was nearly wiped out as it declined from a $304 million deficit in 2003 to just a $9 million deficit last year. Finally, the commercial services surplus narrowed $0.2 billion in 2004, from $0.7 billion to $0.5 billion.

As noted earlier in this Report, Canada has generally run current account deficits over the past thirty years, which coincided with rising levels of government debt. (It is only more recently that Canada has 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 eight 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 2004, the net debt-to-GDP ratio was reduced by 38.2 percentage points to 31.1 per cent of GDP, resulting in Canada's debt burden being now the 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 a share of GDP, 1980s to 2004

	Private			Public	
	Saving (%)	Invest-ment (%)	Excess saving over Invest-ment	Budget sur-plus(+) Budget deficit (-)	Current Account Balance
1981-1985	23.4	18.0	5.5	-5.1	-1.2
1986-1990	21.1	19.3	1.8	-4.0	-3.3
1991-1995	19.9	15.6	4.2	-6.7	-2.8
1996	19.1	15.7	3.4	-2.5	0.5
1997	17.4	18.5	-1.0	0.2	-1.3
1998	17.0	18.2	-1.2	0.0	-1.2
1999	17.1	18.0	-0.9	1.6	0.3
2000	18.5	18.0	0.6	3.2	2.7
2001	18.6	16.6	2.0	1.5	2.3
2002	18.9	17.0	1.8	0.9	2.0
2003	19.0	17.5	1.4	1.2	2.0
2004	19.2	17.9	1.3	2.0	2.6

Source: Statistics Canada, National Income and Expenditure Accounts, Catalogue No. 13-001-PPB, 4th Quarter 2004.

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 net foreign direct investment (FDI) flows expanded in 2004, reflecting the improved global macroeconomic situation and, likely, the higher value of the Canadian dollar. At the same time, net foreign direct investment in Canada contracted last year, largely because of repatriation of Canadian companies from foreign investors.

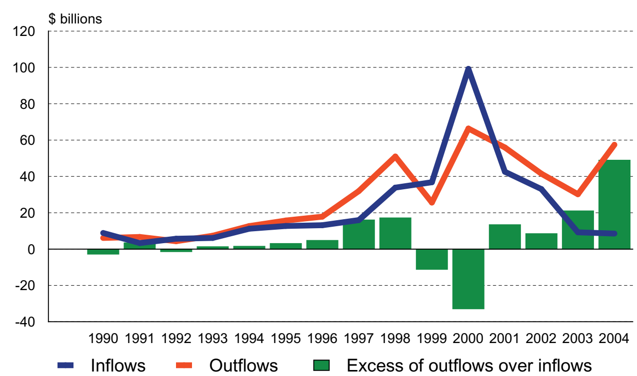
FDI inflows into Canada stood at $8.5 billion in 2004, down $0.7 billion from the $9.2 billion level observed in 2003. It was the fourth straight year of decline, following nine years of uninterrupted expansion of inflows (Figure 4-1). The 2004 level represents only 8.6 per cent of the peak $99.2 billion of inflows registered in the year 2000.

Foreign direct investment acquisitions were negative in two of the four quarters of 2004 and for the fourth time in the past six quarters. Negative acquisition results when Canadians on balance repatriate companies from foreign investors. For the year as a whole, most of the foreign direct investment inflows came from reinvested earnings.

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. For 2004, U.S. direct investment shot up 72.5 per cent, to $10.2 billion.

Figure 4-1

Inflows, outflows, and balance of direct investment flows, 1990-2004



Foreign direct investment inflows from the EU declined last year. In fact, there was an overall negative acquisition of $12.7 billion from this region in 2004. Inflows from UK direct investors were up almost $2.0 billion while the negative acquisitions in the amount of $14.6 billion occurred with investors from the non-UK rest of the EU. According to Statistics Canada, there were two large international mergers that accounted for the reductions in overall EU investment.

Elsewhere, FDI inflows from all other non-OECD countries increased ten-fold from 2003 to 2004, to $7.6 billion; those from other OECD countries increased nearly seven-fold, to $2.4 billion; and those from

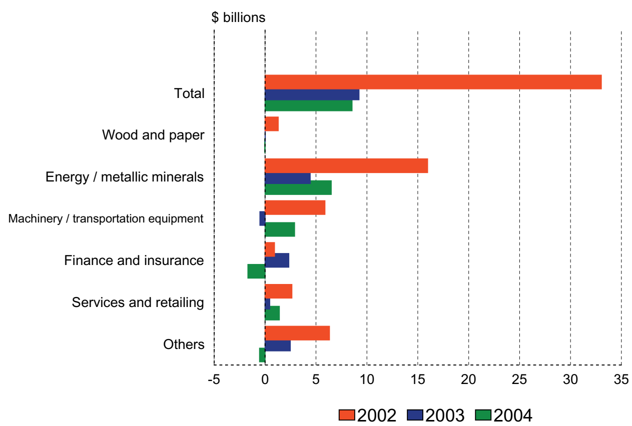
[1]Derivatives are financial instruments providing payoffs that depend or are contingent on the values of other assets, such as commodity prices, bond and stock prices, or market index values. The coverage of derivatives in Canadian statistics is currently limited to options and traded financial futures.

Japan were up a third to surpass the $1.0 billion mark. Excluding the negative acquisitions from the other EU region, FDI inflows into Canada would have been about $22.7 billion, almost two-and-one-half times greater than the $9.2 billion of inflows recorded in 2003.

Sectorally, there were overall negative acquisitions, or net withdrawals, in three of the six major direct investment sectors: finance and insurance ($1.7 billion), miscellaneous industries ($0.5 billion), and wood and paper ($26 million). There were overall net foreign direct investment inflows into energy and metallic minerals ($6.5 billion), machinery and transportation equipment ($2.9 billion), and services and retailing ($1.4 billion) (Figure 4-2).

Figure 4-2

Inflows of direct investment by sector, 2002-2004



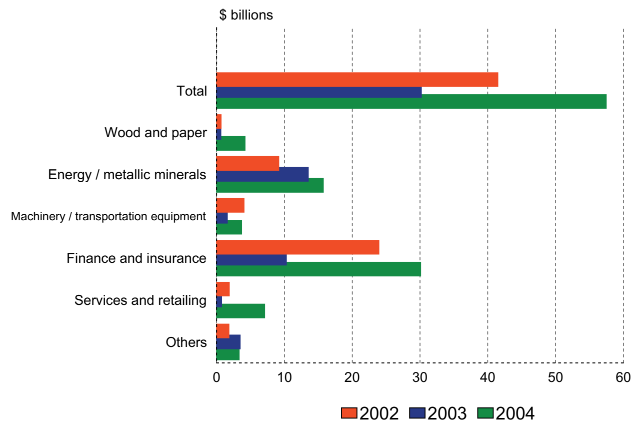
For 2004, Canadian direct investment abroad (CDIA), or outflows, was at its highest level in four years. The annual total of $57.5 billion went in roughly equal measure to acquisitions and to increases in the working capital of foreign affiliates. Geographically, slightly more than 70 per cent of the outflows went to the United States. Of the remainder, over half, or more than 15 per cent of the total, went to non-OECD countries and a further quarter, or 8.4 per cent of the total, went to the EU. Japan and the other OECD countries accounted for 2.3 per cent and 1.6 per cent of the outflows, respectively.

At the industrial level, nearly four-fifths of the total outflows was invested in only two sectors: finance and insurance (52.4 per cent) and energy and metallic minerals (27.4 per cent). Investment outflows in finance and insurance jumped $19.8 billion from 2003 to 2004 while the increase for in energy and metallic minerals was $2.2 billion.

Services and retailing was the third largest CDIA sector at 12.3 per cent of the total, followed by wood and paper (7.3 per cent of the total), and machinery and transportation equipment (6.4 per cent of the total). There was a net withdrawal of CDIA in the amount of $3.3 billion from the miscellaneous industries sector, accounting for a net subtraction equal to 5.8 per cent of the total (Figure 4-3).

Figure 4-3

Outflows of direct investment by sector, 2002-2004



Portfolio Investment

For 2004, over 90 per cent of the $16.2 billion invested by Canadians in foreign securities was in bonds. This investment in bonds was by far the largest ever, almost 90 per cent higher than the previous high established in 2003. According to Statistics Canada, the annual investment of $15.1 billion was roughly split between US corporate bonds, overseas bonds, and US treasuries. Canadian investment in foreign equities stood at about $1.1 billion for the year, the lowest investment in foreign equities since the mid-1980s. However, again according to Statistics Canada, this low net investment marked a shift in composition, as Canadian investors bought some $7 billion in US stocks but sold off some $6 billion in overseas shares.

Foreign investors picked up $20.2 billion in Canadian bonds in 2004; a substantial increase over the $7.0 billion purchased in 2003, but still only half the peak amount purchased in 2001. According to Statistics Canada, virtually all of the buying in 2004 came from US investors while, on a currency basis, the year's investment was roughly split between Canadian and US dollar denominated issues.

Foreign investors also made significant additions to their holdings of Canadian stocks last year as the $35.8 billion invested was a record investment in Canadian equities by foreign investors. There were a number of large deals throughout 2004 that attracted foreign investors and led to the record level of money raised on Canadian equity markets. The year also witnessed the largest takeover of a foreign company in history, where new treasury shares were issued by the Canadian company.

In the market for short-term instruments, foreign investors regularly sold their holdings of money market paper in 2004, culminating in an overall reduction of $2.7 billion for the year. Every sector other than federal government enterprises experienced a decline.

Overall, it was the second consecutive year that foreign portfolio investment into Canada exceeded Canadian outward portfolio investment. However, whereas the difference between the inflows and the outflows was only $6.0 billion in 2003, it exploded to $37.0 billion last year.

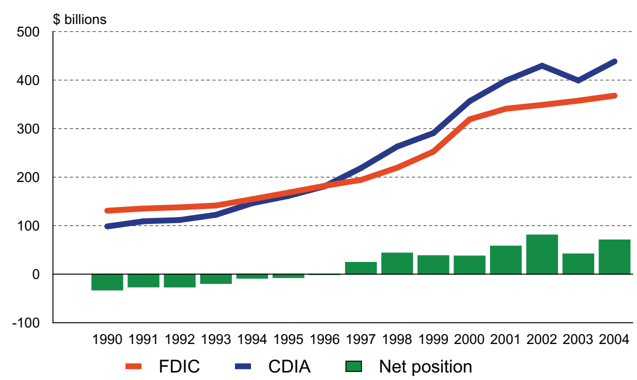
V. DIRECT INVESTMENT (STOCKS)

At the time of the writing, complete 2004 data on the stocks of outward and inward foreign direct investment had not been released by Statistics Canada. Only data for the United States and for total stocks of investment is available. A brief report on this data is included below, along with two special feature boxes. Please check the electronic version of this Report at << http://www.dfait-maeci.gc.ca/eet/trade/state-of-trade-en.asp >> later this year for an update to this section, when the complete direct investment data by country will be released.

In 2004, Canadian direct investment abroad[1], or CDIA, reached $438.4 billion, up 9.8 per cent, or $39.3 billion, from the $399.1 billion level registered one year earlier. On the other hand, the growth of foreign direct investment (FDI) in Canada edged up only 2.9 per cent, from $357.5 billion to $367.9 billion. With the stock of outward investment exceeding that of inward investment, Canada is now a net exporter of direct investment capital. Canada has been in this position since 1997, when the stock of CDIA exceeded that of FDI in Canada for the first time since records of this data were kept (Figure 5-1).

Figure 5-1

CDIA, FDI in Canada, and net direct investment position, 1990-2004



The largest portion of CDIA is placed in United States. The U.S. accounted for some 43.6 per cent of total Canadian outward investment in 2004, or $191.2 billion. This was a 15.9 per cent, or $26.3 billion, increase in holdings in that country. With holdings in the United States up faster than total outward investment, the share of the U.S. in total CDIA rose 2.3 percentage points from 41.3 per cent a year earlier.

Similarly, about two-thirds of the total inward direct investment is held by American investors, or $239.4 billion. Between 2003 and 2004, U.S. investors added $11.1 billion to their total FDI in Canada, which was an amount that was greater than the total net increase in FDI in Canada. As a consequence, the U.S. share of total stock of FDI in Canada increased 1.2 percentage points to 65.1 per cent.

[1]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.

Foreign direct investment (FDI) is an investment by an investor in 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.

Box D: The Geography of Canadian Direct Investment Abroad

The rapid expansion and magnitude of international trade is only part of what has become a global economy. The volume and growth of capital flows in general and Foreign Direct Investment (FDI) in particular is an important component in the broader international commerce story. In 2003, the total size of world international trade flows reached US$ 7.4 trillion while total world FDI stock reached US $8.2 trillion. Canada's foreign investment overseas is an important aspect of Canada's relations with the rest of the world. Canadian direct investment abroad (CDIA) more than tripled since the late 1980s to reach $399 billion by the end of 2003. By comparison, Canada's total exports of goods and services more than doubled (growing 174 per cent) over the same period.

Given the growth and size of Canadian foreign investment and its relationship with international trade, it is important to understand the nature and patterns of CDIA.

The geography

Table D-1 summarizes the geography of CDIA across countries covering two periods (averages over 1987-91 and 1999-03). As seen in the table, the United States remained the most favored location for CDIA, accounting for 47.1 per cent of CDIA in recent years, though its share in total CDIA fell gradually from the recent high of 62 per cent in 1987-91. The remainder of CDIA is geographically dispersed across countries in Europe, the Caribbean, Latin America and Asia. Almost 10 percent of CDIA between 1999 and 2003 went to the United Kingdom.

Table D-1: Top 15 Destinations of Canadian Direct Investment Abroad (millions of dollars)

	Ave(87-91)	Ave(99-03)	% of Total
United States	55,981	176,450	47.1
United Kingdom	11,205	36,307	9.7
Barbados	1,351	23,136	6.2
Ireland	1,173	11,763	3.1
Netherlands	1,188	10,316	2.8
Bermuda	1,769	9,823	2.6
Bahamas	1,872	7,738	2.1
Japan	890	7,023	1.9
Cayman Islands	143	6,827	1.8
Hungary	2	6,807	1.8
Brazil	1,521	6,557	1.7
Germany	800	5,917	1.6
Chile	230	5,704	1.5
France	1,456	5,634	1.5
Australia	2,091	5,131	1.4

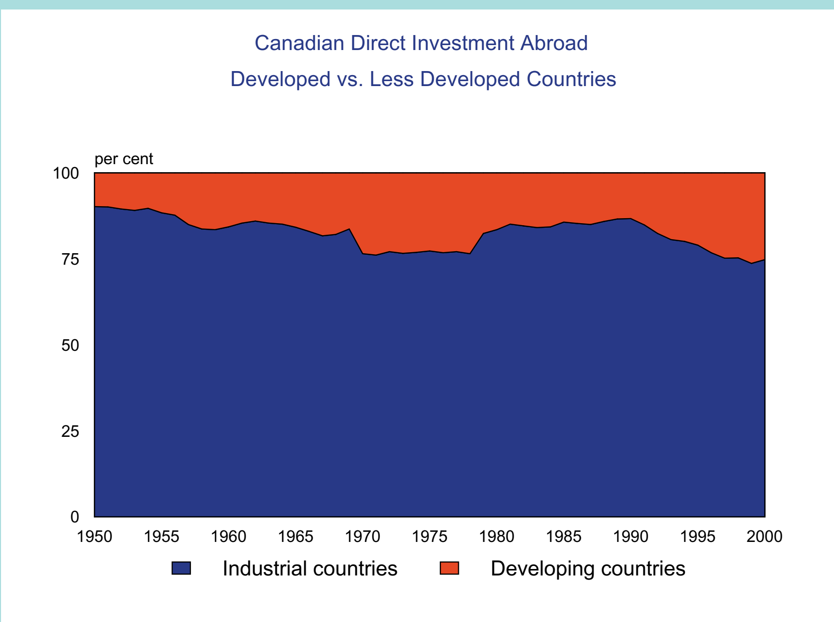
What determines the pattern of what countries CDIA reaches? Recent research examining the bilateral pattern of foreign direct investment has found that the main determinants of the location of CDIA are host country income levels, geographic proximity, and whether the two countries share a common language. This "gravity" relationship has been used extensively in explaining trade flows, and typical findings are that two-thirds of the geographical pattern of trade can be 'explained' by these few variables. Our own analysis shows that a similar finding holds for CDIA. The United States, the U.K., and countries in Non-US North America (mainly Bahamas, Barbados, and Bermuda), Japan in Asia, and Brazil and Chile in South and Central America were among the top destinations of Canadian direct investment abroad.

Adjusting for host country income levels, proximity, and language, a large share of CDIA is headed toward offshore financial centers, the countries with low-taxes, or those endowed with natural resources. For instance, between 1990 and 2003, Canadian investment in official financial centers increased from $11 billion to $88 billion, or more than a quarter of the total increase in CDIA. Barbados, Bermuda, Cayman Islands, and the Bahamas are the top destinations among official financial centers that experienced the strong growth in the past decade. In Europe, Canadian investment concentrated in the Netherlands and two low-tax countries (Ireland and Hungary), rather than in big continental European countries such as Germany and France.

Canadian investment in Central and South America was substantial; particularly in resource-rich Brazil and Chile. Canadian direct investment in these countries was larger than that in Mexico. In non-Japan Asia, Canadian direct investment focused on resource-rich Indonesia and two Asian financial centers, namely, Singapore and Hong Kong. Contrary to the public perception, Canadian direct investment in the two Asian emerging markets of China and India was relatively small. Average Canadian direct investment in China during the period of 1999-2003 was only $602 million, which was smaller than Canadian investment in countries such as Colombia and New Zealand. Canadian direct investment in India over the same period was $178 million, which was similar to Canadian investment in Panama.

Further, there is evidence that the direction of CDIA has shifted in the past several decades, with an increasing share heading toward developing countries.

The figure below shows the share of CDIA in developed and developing countries from 1950 to 2000. In the early 1950s, developing countries accounted for about 10 percent of total CDIA. That share increased throughout the 1960s and reached 23 per cent by the end of 1970s. The 1980s was a lost decade for developing countries as the share of CDIA slipped back to 13-15 per cent of total CDIA. Since 1989, however, the share of CDIA heading toward developing countries came back and surpassed the previous peak in the 1970s to reach 25.2 per cent in 2000 from the low of 13.4 per cent in 1989.



The distribution of CDIA among developing countries was very uneven (Table D-2). Barbados, Bermuda, Bahamas, and Cayman Islands topped Canada's direct investment in developing countries. This was followed by investment in Hungary and resource-based South and Central American economies including Brazil, Chile, and Argentina. These countries plus Mexico, along with Indonesia, Singapore and Hong Kong in Asia accounted for 90 per cent of Canadian direct investment in developing countries.

Table D-2: Top 15 Destinations of Canadian Direct Investment in Developing Countries 1987-03

(Millions of dollars)	Ave(87-91)	Ave(99-03)	Growth (%)
Barbados	1,351	23,136	1,612.7
Bermuda	1,769	9,823	455.2
Bahamas	1,872	7,738	313.4
Cayman Islands	143	6,827	4,674.4
Hungary	2	6,807	340,240.0
Brazil	1,521	6,557	331.2
Chile	230	5,704	2,377.7
Argentina	128	4,924	3,746.7
Singapore	1,795	3,730	107.8
Indonesia	997	3,668	267.9
Mexico	218	3,293	1,413.2
Hong Kong	522	3,134	499.9
Peru	9	1,924	21,282.2
Thailand	33	918	2,724.0
South Korea	28	821	2,867.5

The most surprising development in the recent pattern of Canadian direct investment abroad is the dramatic rise of CDIA in Hungary; investment in that country increased from an average of $2 million in 1987-91 to $6.8 billion in 1999-2003 (Table D-3). CDIA in Peru, Cayman Islands, China, Argentina, Costa Rica, and Colombia also reported very strong growth. It is important to note that the rapid growth of CDIA in many developing countries occurred from a very small base. Moreover, rapid growth of Canadian direct investment didn't occur exclusively in transition economies and developing countries. CDIA also grew rapidly in some advanced industrialized countries including Sweden and Luxembourg.

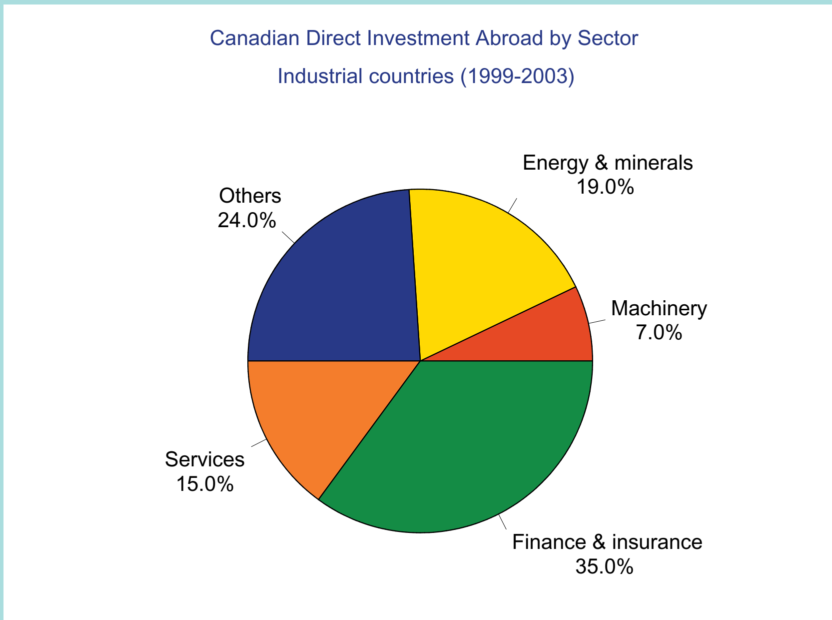
Table D-3: Fastest Growing Canadian Direct Investment Abroad Destinations (Top 20) 1987-03

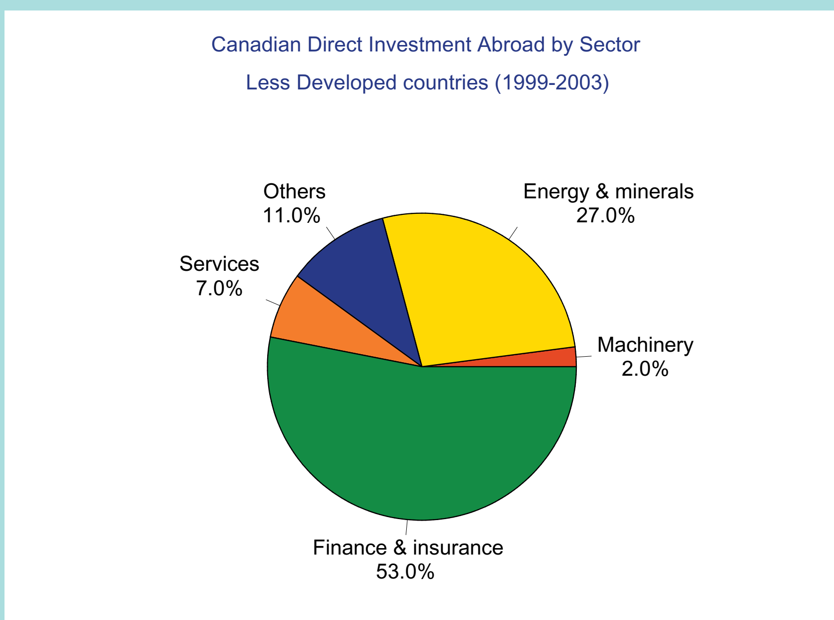
(Millions of dollars)	Ave(87-91)	Ave(99-03)	Growth (%)
Hungary	2	6,807	340,240.0
Peru	9	1,924	21,282.2
Sweden	11	1,268	11,225.0
Luxembourg	9	800	8,788.9
Cayman Islands	143	6,827	4,674.4
China	16	602	3,781.3
Argentina	128	4,924	3,746.7
Costa Rica	3	103	3,320.0
Colombia	25	794	3,050.0
South Korea	28	821	2,867.5
Thailand	33	918	2,724.0
Austria	26	645	2,380.8
Chile	230	5,704	2,377.7
Ecuador	9	212	2,253.3
Barbados	1,351	23,136	1,612.7
Mexico	218	3,293	1,413.2
Norway	32	423	1,228.9
British Virgin Islands	29	313	997.5
Panama	17	187	973.6
Ireland	1,173	11,763	903.1

The structure

With respect to the industrial distribution of CDIA, by far the largest share of CDIA was concentrated in finance and insurance, followed by energy and metallic minerals, services, as well as machinery and transport equipment. The figures below present the sectoral breakdowns of CDIA separately for developed and developing countries. CDIA in industrial countries was more diversified than in developing countries. Nonetheless, 50 per cent of CDIA into industrial economies was in services (35 per cent in finance and insurance and 15 per cent in other services). According to top figure, 24 per cent of CDIA into industrial countries was in "other" sectors and 19 per cent was in energy and metallic minerals; with 7 per cent in machinery and transportation equipment. CDIA in developing countries, on the other hand, was more concentrated in services making up 60 per cent of CDIA going to these countries (with 53 per cent in finance and insurance sector and a further 7 per cent in other services). Within developing countries, 27 per cent of CDIA was in energy and metallic minerals while machinery and transport equipment (representing most of manufacturing activities) accounted for only 2 per cent of total CDIA in developing countries.

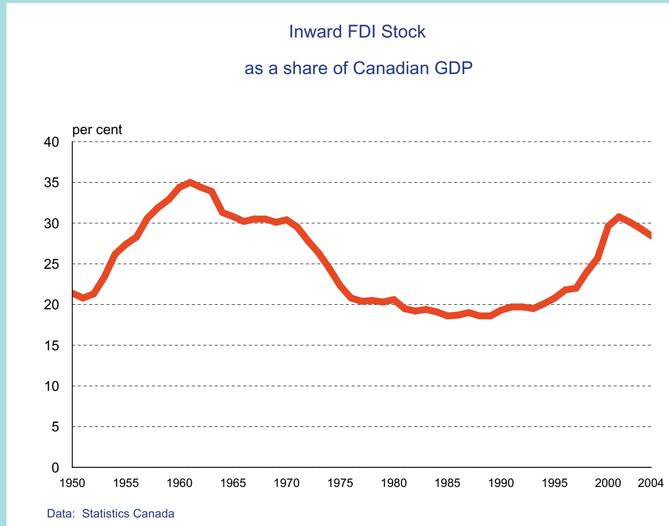
Canadian investment abroad is a large and growing component of Canadian activity in the global economy (and is what is increasingly being referred to as global supply chains). Similar to the pattern of international trade, most CDIA activity is with the United States but also occurs across a broad cross section of countries. Also, as is the case with respect to international trade, the main determinants of CDIA activity are host country income levels, geographic proximity, and whether the two countries share a common language. Most CDIA is in other industrialized countries but the fastest growing destination of CDIA is in developing countries. Although the rapid growth in CDIA in developing countries and emerging markets occurred on a very small base, the share of CDIA going to these countries increased to a quarter of total CDIA in recent years. Canadian direct investment abroad is heavily concentrated in the services sector and to a lesser extent in the energy and minerals sector.



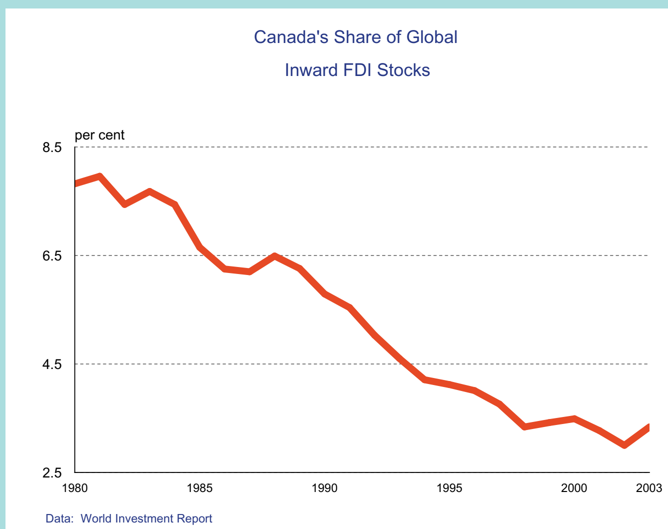


BOX E: CANADA'S DECLINING SHARE OF GLOBAL INWARD FDI: MYTH OR REALITY?

In recent years, the reported decline in Canada's share of inward FDI has generated concern amongst many observers both for the lost benefits as well as for the underlying causes of the decline.[1] In this box, we argue that FDI stock measures, which show Canada as having a declining share of global inward FDI, are not the appropriate measure and when flows, the more accurate measure is used, neither Canada's declining share of global inward FDI nor the underlying assumption by some that Canada has become a less attractive destination for global investment appear to hold.



Inward FDI stocks peaked as a share of the Canadian economy in 1961 at 35.0 per cent of GDP. From that point until 1989 they fell sharply, particularly over the mid 1970s. The early 1990s witnessed a turn-around in this trend and the share rose substantially, from 19.5 per cent in 1993 to 30.8 per cent in 2001, just 4.2 percentage points below the 1961 peak. It has subsequently fallen-off again in recent years, to stand at 28.4 per cent in 2004.



Since 1980, when data on international FDI stocks were first collected, other countries have seen their stocks of inward FDI expand faster than Canada, resulting in the Canadian share of global inward FDI stocks falling steadily from 7.8 per cent in 1980 to 3.0 per cent in 2002, a trend that has led some to conclude that Canada has become a less attractive destination for international direct investment. In 2003, Canada's share increased somewhat to 3.3 per cent.

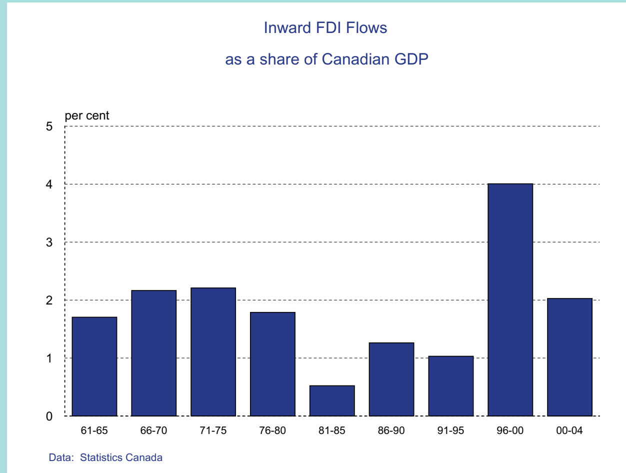
This above analysis is based on FDI stocks. However, FDI can be measured as either a stock or a flow. Stocks measure the value of all investments on the books of the foreign enterprise while a flow is the market value of the investment made in a given time period.[2]

FDI stocks, as a share of GDP, showed a clear trend in Canada: peaking in the early 1960s, declining

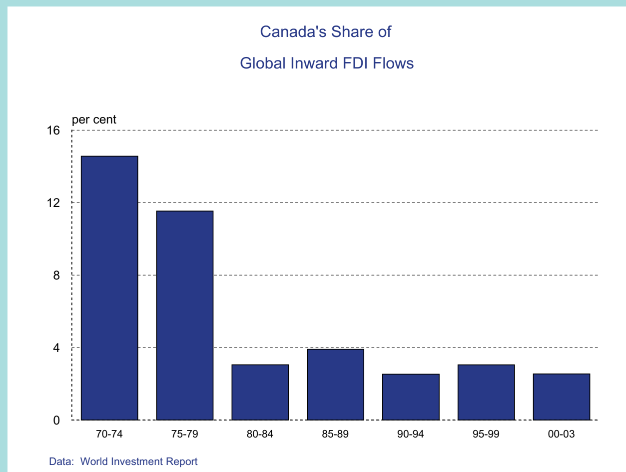
[1]For example, the Conference Board of Canada's annual Performance and Potential report for 2004, identifies Canada's declining share of global inward FDI as potentially contributing to the Canada-U.S. productivity gap. Similarly, in an article entitled "As direct foreign investment wanes, Canada's search for new deals grows" by Jeff Sanford appearing in the March 31st issue of Canadian Business also notes Canada's declining share of global inward FDI and links this to Canada becoming a relatively less attractive global investment location.International Investment Position" Statistics Canada Cat. No. 67-202-XPB for a detailed description of the differences between FDI stocks and flows.

[2]The stock value, in some respect, is a summation of all previous flows adjusted for changes in ownership, and adjustments to its book value as a result of depreciation or other revaluations. Please see "Canada's

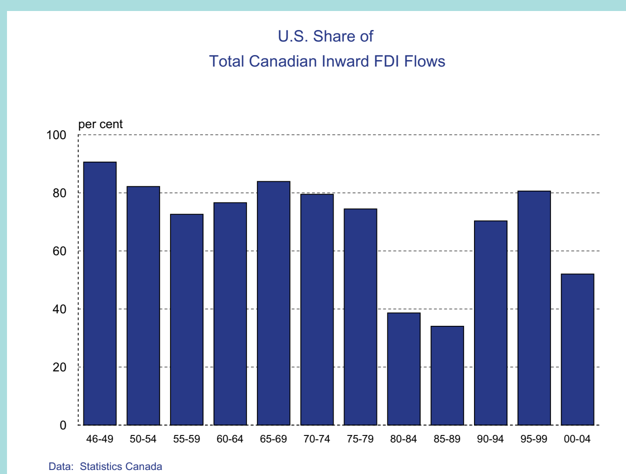
until the early 1990s, and then accelerating until 2000. FDI flows show a somewhat similar, but more muted trend. FDI inflows as a share of Canadian GDP fluctuated between a range of one-and-a-half and three-and-a-half per cent of GDP for the 1960s and 1970s and between zero and two per cent until 1997.[3] A global merger and acquisition (M&A) boom propelled FDI inflows above three per cent of GDP between 1998 and 2001 with a sharp peak of 9.2 per cent in 2000 before falling off to more historic levels in the post 2000 period.



While Canada's share of global inward FDI stocks shows a steadily declining trend since 1980, the picture from the perspective of direct investment flows is substantially different. Canada's share of global inward FDI flows declined sharply after the 1970s but has remained relatively stable, in the two to four per cent range, for the two decades since. This substantial difference in trends between Canada's share of global inward FDI stocks and global inward FDI flows is easy to reconcile. The observed downward trend in Canada's share of global inward FDI stocks is simply the long and slow adjustment to the fall in Canada's share of global inward FDI flows in the early 1980s. For those interested in tracking Canada's relative attractiveness as a destination for global inward FDI, the amount of FDI invested in Canada from year to year is clearly the more appropriate measure to use.

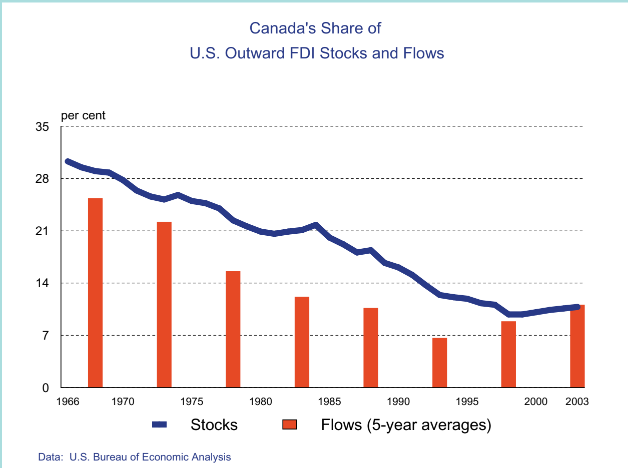


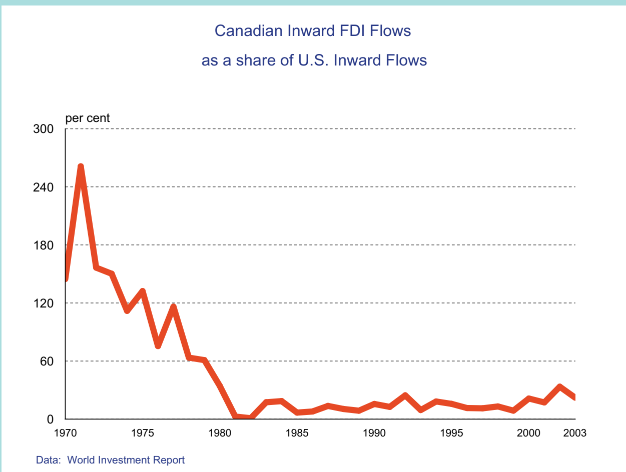
There are three explanatory reasons for the sudden drop-off in Canada's share of global inward FDI flows. First, inflows from the U.S., the single largest foreign investor in Canada, declined in the early 1980s. For the previous three decades, the U.S. accounted for, on average, well above 70 per cent of Canadian FDI inflows. In the 1980s, their share averaged about half of that, at just above 35 per cent.

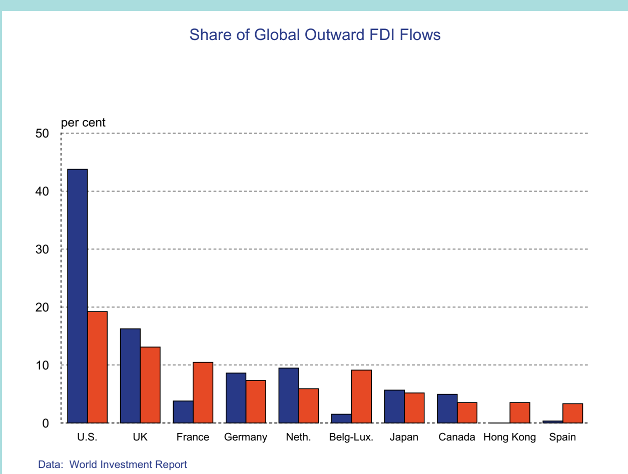


The drop in U.S. FDI going to Canada in the 1980s is the result of an overall decline in U.S. outward investment as well as a gradual decline in the share destined for Canada. The over-all decline in U.S. outward FDI in the early 1980s was likely a result of the slowdown in the U.S. economy in those years. The steady decline in Canada's share of U.S. outward FDI, on the other hand, could potentially be interpreted as

[3]Because inflows are more volatile than stocks, they are presented as averages over 5 year periods as data permits.







a decline in the Canada's relative attractiveness for U.S. investment. However, it could be argued that the U.S. was investing disproportionately more in Canada than Canada's economic size would have suggested prior to the 1980s and this fall in Canada's share of U.S. outward FDI was to be expected as alternate destinations for FDI emerged.

In 1966, the first year for which data are available, just under one-third of all U.S. outward investment was located in Canada. The flow figures match the stock figures closely, with Canada accounting for a much higher share of U.S. outward FDI than Canada's share of global GDP, even excluding the U.S., would warrant. Canada's share of U.S. outward FDI fell steadily until the 1990s, as one would expect, reversing first for flows, before being reflected in the stock figures.

The second reason for the drop in Canada's share of global inward FDI flows in the 1980s was the emergence of new global investors for whom Canada was a less significant investment location. In 1970, the U.S. accounted for more than half of all outward FDI flows, and as already mentioned, a disproportionately large portion of this went to Canada. By 2003, their share had fallen to less than one-quarter, not because of a decline in U.S. outward investment but instead due to a rise in the importance of other investors. To illustrate this point, prior to 1975, Canada consistently received more FDI than did the U.S., an economy more than ten times the size of the Canadian economy.[4] With the emergence of new global investors in the early 1980s, Canada's share of North America-bound inward FDI flows has fallen more in line with the relative size of the two economies, although Canada's share remains slightly above what a gravity model of FDI flows would suggest and has been rising slowly since.

The third possible contributor to the recorded fall in Canada's share of global inward FDI may have been Canadian economic policies in the late 1970s and early 1980s, specifically the National Energy Program (NEP) and the Foreign Investment Review Act (FIRA). As well, the general view toward FDI by many policy makers in Canada at the time may have contributed to the rapidness of the decline in Canada's share of global FDI flows.[5]

[4]U.S. investment in itself is by definition not considered FDI, but is when it is invested in Canada.

[5]Hejazi, Walid and Safarian, A.E. "Explaining Canada's Changing FDI Patterns" Paper delivered to Canadian Economic Association Conference 2003 and Shapiro, Daniel and Globerman, Steven "Foreign Investment Policies and Capital Flows in Canada: A Sectoral Analysis" Journal of Business Research, Vol. 56, 2003.

In summary, FDI stocks carry with it years of history from previous investment decisions as well as exchange rate movements and other changes in market value. FDI flows are therefore the more relevant and meaningful measure of a country's attractiveness as an investment destination. While Canada's share of inward FDI stocks has been declining steadily for more than two decades, Canada's share of inward FDI flows sharply fell off in the 1980s but has remained relatively constant since then. FDI stocks are simply, slowly, approaching this level.

Neither the investment trends themselves nor the driving factors behind the trends appear to imply that Canada's attractiveness as an investment destination has changed significantly over the past two decades or more. Instead, the recorded trends are likely more a reflection of the rising importance of competing destinations for global FDI flows.

VI. Wrap Up

The global economic recovery from the downturn earlier this decade is well underway. In fact, global growth was strong last year — the fastest in more than 30 years, according to the IMF. This has clearly been of benefit to an open economy such as Canada's, as evidenced by the record or near-record levels of trade in goods and services. For 2004 as a whole, Canadian economic growth accelerated — the thirteenth year of uninterrupted growth, trade increased, and employment was up. Inflation in Canada came in close to target, at 1.9%, and there was a budgetary surplus for the eighth time in a row. A relatively strong economic performance to be sure, although GDP growth tailed off over the second half of the year.

Looking forward into the current year, concerns about U.S. fiscal sustainability and current account imbalances remain unresolved, so further appreciation of the euro, the yen, the Canadian dollar and other key trading currencies is a possibility. The Canada-U.S. exchange rate closed out the year 2004 at US 83.19¢, up 7.9 per cent from its level at the end of 2003. This follows on the heels of a 21.7 per cent increase one year ago. Although there was only a US 5.6¢ difference between the noon exchange rate of January 2 and December 31, 2004, there was a US 13.3¢ difference between the peak (or highest value) exchange rate and the trough (or lowest value) exchange rate last year. This suggests that there is much volatility in exchange rates, potentially to the harm of cross-border and, to a lesser extent, to overseas trade. Thus, any further appreciation of the Canadian dollar — either as part of the structural adjustment to the U.S. current account situation or as part of an upward run on the Canadian dollar because of volatility in exchange markets — could put downward pressure on exports.

Oil prices have the ability to shave off a few tenths of a percentage point from growth in the U.S. With that country still the locomotive of world growth, the negative consequences of higher oil prices on the U.S. economy — slowing growth, removing purchasing power from consumers (via higher gasoline and home heating costs), thereby reducing demand and lowering imports, both direct and indirect — could have negative repercussions on Canadian exports to that country, although increased energy exports might go some way to offsetting the overall effect.

Overall, it is likely that growth prospects for Canadian trade will continue to be led by the United States and, to a lesser extent, China and the non-OECD rest of the world. However, oil prices and exchange rate movements are thus significant factors that could influence Canadian trade performance as the year evolves.