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CANADA'S TRADE POLICY AND ECONOMIC RELATIONSHIP WITH CHINA

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4 October 2004

PARLIAMENTARY INFORMATION AND RESEARCH SERVICE
SERVICE D'INFORMATION ET DE RECHERCHE PARLEMENTAIRES

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INTRODUCTION

From modest beginnings, economic relations between Canada and China have evolved considerably. In the early 1960s, the sole economic contact between the two countries consisted of Canadian exports of wheat. Foreign investment was essentially non-existent and development assistance funding was 20 years away.

Fast-forward 40 years and the picture has changed dramatically. China is now Canada's fourth-largest export destination and second-largest source of imports worldwide. Total two-way merchandise trade between Canada and China reached $23.4 billion in 2003 – $4.8 billion in Canadian exports and $18.6 billion in imports into Canada. Canadian companies are investing in China and, increasingly, Chinese enterprises are taking advantage of opportunities in Canada. China is also Canada's fourth-largest destination for Official Development Assistance (ODA).

Much has changed since the Communist Party assumed control of the country, declaring the People's Republic of China (PRC) in 1949.(1) This paper examines the progress in Canada's economic relationship with China and the policies that accompanied that evolution. Specifically, it offers a detailed examination of the current trade and investment relationship between the two countries, as well as an overview of how that relationship came to be established.

(1) References to China throughout this paper are to the mainland People's Republic. Taiwan and Hong Kong are excluded unless otherwise stated.

CANADA'S HISTORIC RELATIONSHIP WITH CHINA

A. Pre-1970

The PRC was officially proclaimed in October 1949 after a short but violent civil war. At that time, China's involvement with the outside world was limited. Most countries initially refused to recognize the authority of the Communist government; for its part, China imposed severe restrictions on foreign trade and investment.

In the early years of the Communist regime, Canada did not have an official trade policy with regard to China. While there was some support for the promotion of trade with China, the issue of Canada's trade policy was closely tied to a long internal debate through the 1950s and 1960s over whether or not to grant official recognition to Chairman Mao's government. Canada generally recognized that there were opportunities for gains from establishing formal trading relations with China, but a number of factors delayed the establishment of official political or economic linkages until the 1970s. Significant among these was the concern that extending official recognition to China would be poorly regarded in the United States.(2) Several Canadian government officials at the time believed that, given its lack of foreign currency reserves (necessary to buy foreign goods), the PRC offered limited prospects for increased trade – certainly not sufficient to risk Canada's economic relationship with its largest trading partner.(3) As a result of these and other circumstances, Canada's trade with China through the 1950s was limited. Rarely did Canadian exports to China exceed an annual value of more than a few million dollars.(4)

Despite the lack of formal economic or political ties, Canada's trade relationship with China began to expand in the early 1960s. At that time, the Canadian government was actively seeking new international markets for wheat and other grains in order to help the embattled Canadian farmer. Recalling that in 1958 China had purchased a small amount of wheat from Canada, the Department of Trade and Commerce sent representatives to China in 1960 to see if there was any interest in additional sales.

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(2) See, for example, S. Beecroft, "Canadian Policy Towards China, 1949-1957: The Recognition Problem," in *Reluctant Adversaries: Canada and the People's Republic of China, 1949-1970*, ed. P. Evans and M. Frolic, University of Toronto Press, Toronto, 1991; and N. St. Amour, "Sino-Canadian Relations, 1963-1968: The American Factor," in the same publication.

(3) St. Amour (1991), p. 110.

(4) Z. Deyan, "Economic and Trade Relations Between Canada and China," Department of Economics, Wuhan University, working paper #24, 1983, p. 5.

As it turned out, two successive years of poor harvests in China – related to the policies of the Great Leap Forward – had created a profound food shortage in that country.(5) By early the following year, Canada officially announced the sale of about $60 million in wheat and barley to China. As the food shortage became more apparent, China was forced to become more active on international grain markets. Due almost exclusively to increased sales of wheat and barley, Canadian exports to China grew from about $9 million in 1960 to over $147 million only two years later. Until the end of the 1960s, Canada's total exports to China were volatile, but generally remained between $100 million and $185 million annually. These shipments consisted almost entirely of wheat.

B. 1970: Official Recognition

The 1970s brought significant developments to the economic and political relationship between Canada and China. As the trading relationship between the two countries became more firmly established, the Canadian government signalled, in 1968, its intent to officially recognize the Communist government in China.

However, establishing official diplomatic relations proved to be a complicated task. The official treatment of Taiwan had been a long-standing irritant between China and the western world. China had insisted that countries formally recognize Taiwan as part of Chinese territory, while Canada had maintained that Taiwan should be treated in a parallel fashion. In bilateral negotiations, this issue proved to be a major stumbling block. It took 22 months of negotiations before an agreement was reached. Canada eventually recognized that the PRC made a claim to the island of Taiwan "without either challenging or endorsing" it.(6) Canada and China established formal diplomatic relations in October 1970.

This event ushered in a new era of Sino-Canadian trade. With the foundation of diplomatic recognition in place, the two countries turned to their economic relationship. From the Canadian perspective, China had transformed from a diplomatic challenge into an economic opportunity and began to garner more attention from a trade policy standpoint. In 1973, Canada and China signed the Canadian-Chinese Trade Agreement, which allowed for the mutual

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(5) Canadian officials, like those across the world, were unaware at the time of the severity of the shortage.

(6) M. Frolic, "The Trudeau Initiative," in Evans and Frolic (1991), p. 203. Many other countries followed Canada's example in establishing diplomatic relations, with similar caveats with respect to Taiwan.

extension of “most-favoured nation” status – each country agreed to apply import tariffs against one another that were as low as those applied against other “most-favoured nations.” That same year, a Canadian trade fair was held in Beijing, attracting about 600 Canadian officials and business leaders. It was the first such foreign trade fair attended by Chinese Premier Zhou Enlai. In addition, the two countries established a Joint Economic and Trade Committee that provides a forum for discussion of economic and trade-related concerns between Canadian and Chinese officials.

These events contributed to a tremendous acceleration in trade between the two countries. By 1973, only three years after the initiation of diplomatic relations, Canadian exports to China had already doubled. So too had Chinese exports to Canada. With the establishment of “most-favoured nation” status, two-way trade grew further still. As the Chinese market became more accessible, Canada began to export a wider variety of products. In the late 1960s, wheat had accounted for over 97% of Canadian exports to China. The value of wheat exports remained strong through the decade, but by 1978, wheat’s share of Canada’s total exports to China had fallen to 69%. Sulphur, wood pulp, newsprint and metals such as aluminium and copper all emerged as significant exports to China in the late 1970s.

C. China’s 1978 Economic Reforms

The death of Chairman Mao in 1976 brought an end to China’s Cultural Revolution (1966-1976) and opened the door for more moderate party members to assume control. In December 1978, these moderates approved an ambitious series of agricultural and economic reforms. The economic reforms, known as the Open-Door Policy, were aimed at reforming the national economy and lifting the restrictions on foreign commercial relations.(7) The Open-Door Policy was made up of four components: the creation of special investment zones; the attraction and efficient investment of foreign capital; increasing foreign trade; and the import of modern technology and management techniques.(8) Reforms were phased in through the remainder of the 1970s and into the 1980s.

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(7) Deyan (1983), p. 6.

(8) R. Carson, *Comparative Economic Systems Part II: Socialist Alternatives*, M. E. Sharpe, Inc., Armonk, New York, 1990, p. 303.

From the perspective of Sino-Canadian trade, China's 1978 economic reforms were a watershed development that had a tremendous impact on formal economic relations and trade between the two countries. The Open-Door Policy led not only to further improvements in Canadians' access to Chinese markets, particularly for non-wheat exports, but also to a considerable increase in the number of formal trade policy initiatives between the two countries.

Among these initiatives, in 1978 the Canadian Department of External Affairs established the Canada-China Trade Council (CCTC) – later renamed the Canada China Business Council (CCBC). The purpose of the organization was to act as a link between the two countries to further trade relations.(9) To that end, shortly after its inception, the CCTC opened a Representative office in Beijing.

The following year, the Canadian-Chinese Trade Agreement was revised for the second time,(10) and a Treaty of Chinese-Canadian Economic Co-operation was signed. This latter treaty defined the potential contribution that Canada could make to Chinese economic development in a number of high-tech goods and services, notably in the areas of light industry, communications, the construction of power stations, petroleum and coal exploration, and various mining projects.(11)

In 1980, Canada granted "preferential" trade status to China, reducing tariffs on imports from China by over one-third from the regular "most-favoured nation" tariff rate.(12) However, many products were excluded from this agreement, meaning that the actual effects of "preferential" status were relatively minor.(13) Four years later, in an effort to support Canadian marketing efforts in China, the Export Development Corporation concluded an agreement with the Bank of China for a $2-billion financing facility to support the purchase of Canadian

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(9) Deyan (1983), p. 6.

(10) The agreement was subject to renewal every three years.

(11) Deyan (1983), p. 6.

(12) Normally, WTO rules forbid member countries from levying different tariff rates on imports based on the country of origin (unless a bilateral or regional free trade agreement is in place). However, in the early 1970s, industrialized countries were permitted to offer preferential tariff and market access treatment to developing countries on a non-reciprocal basis to encourage the latter to use trade as a means to promote economic growth. Canada introduced its own General Preferential Tariff (GPT) in 1974.

(13) Deyan (1983), p. 7.

equipment and services.[14] In 1986, the two countries signed a double-taxation agreement, ensuring that goods produced in one jurisdiction and sold in the other would not be subject to overlapping taxation in both.

The implementation of China's economic reforms through the late 1970s and early 1980s, along with the formal linkages and agreements established between Canada and China over the same period, had a significant effect on trade between the two countries. Chinese exports to Canada grew exponentially between 1978 and 1988, averaging an increase of 26% per year. While Canadian exports to China did not match this growth rate, the increase was still considerable. From 1978 to 1988, Canadian exports to China grew by an average of nearly 18% per year.[15] In 1980, two-way trade had grown to just over $1.0 billion. By 1987, that figure had more than doubled to $2.2 billion; one year later, it had increased to $3.6 billion. By 1988, China was Canada's sixth-largest trading partner worldwide.

D. Economic Partnership and Human Rights

One of the ongoing policy challenges Canada faced throughout this period was finding a balance between economic and trade policies on one hand and human rights and freedoms on the other. This balance was put to the test by the Tiananmen Square massacre in 1989, which caused the Canadian public to question its support for Canada's economic and trading relationship with China and brought the issue of human rights to the fore.

Although relations between Canada and China were strained for a number of years following the violence in Tiananmen Square, trade between the two countries continued to grow. By 1994, two-way trade exceeded $6.1 billion in value. That same year, to support long-term relations with the country, Canada introduced its four-pillar policy on China, comprising the following elements: economic partnership; peace and security; sustainable development; and human rights, good governance and the rule of law.

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(14) Prime Minister Brian Mulroney's visit to Asia, 1986 – background document, p. 42.

(15) This growth rate was affected by a particularly large shipment of wheat in 1988. Not including this spike, Canadian exports grew by an average of 12.4% per year from 1978 to 1987.

CANADA'S TRADE POLICY TODAY

China's economic potential is considerable. With the world's largest population, a fast-growing economy, continued market-based reforms, recent accession to the World Trade Organisation (WTO), and a middle class that could reach 500 million people by 2010,(16) China is a virtually irresistible export market. In recognition of this fact, the federal government has continued to actively promote China as an export destination through a variety of means.

Perhaps the most significant of these are Canada's official trade missions to China. The first Team Canada trade mission to China took place in 1994. Each year from 1998 to 2001, Canada sent trade delegations to China accompanied by government ministers. The 2001 Team Canada mission was the largest such endeavour in Canadian history. It included the Prime Minister, two cabinet ministers, eight provincial premiers, the three territorial leaders and nearly 600 business participants.

Canada has also continued to pursue formal economic ties with China. The two countries signed a bilateral agreement in 1999 that committed China to reduce its tariffs on Canadian goods and to improve market access to Canadian firms as part of its accession to the WTO. With China granted entry to the WTO in December 2001, these tariff reductions have now begun to be implemented.

Recently, the Department of Foreign Affairs and International Trade introduced its 2002 China and Hong Kong Trade Action Plan, designed to help Canadian companies take advantage of market opportunities and to compete successfully in those areas. This strategy document outlines Canada's key goals with respect to economic and trade policy regarding China. In addition to specific sectoral strategies, the objectives of the Trade Action Plan are:(17)

- To raise Canada's profile as a valuable trade and investment partner and to foster support for closer economic and commercial cooperation in China and Hong Kong by:
  - Continued high-level visits by government leaders, accompanied by business representatives to the greatest extent possible;

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(16) Department of Foreign Affairs and International Trade, *Opening Doors to the World: Canada's International Market Access Priorities 1998*, 1998, p. 47.

(17) Department of Foreign Affairs and International Trade, *Dragon at your Door: China and Hong Kong Trade Action Plan 2002*, pp. 8-9; available at http://www.infoexport.gc.ca/docs/cn_chhktap02-e.pdf.

  - Encouraging increased visits by business delegations;
  - Monitoring and disseminating economic information and market intelligence on China and Hong Kong to Canadian businesses;

- To improve market and investment access in China for Canadian products by:

  - Strengthening trade policy dialogue and negotiating a Foreign Investment Protection Agreement (FIPA);
  - Maintaining close cooperation and information-sharing with business associations and all levels of government, reflecting private-sector interests;

- To increase sales of Canadian products in China and Hong Kong by:

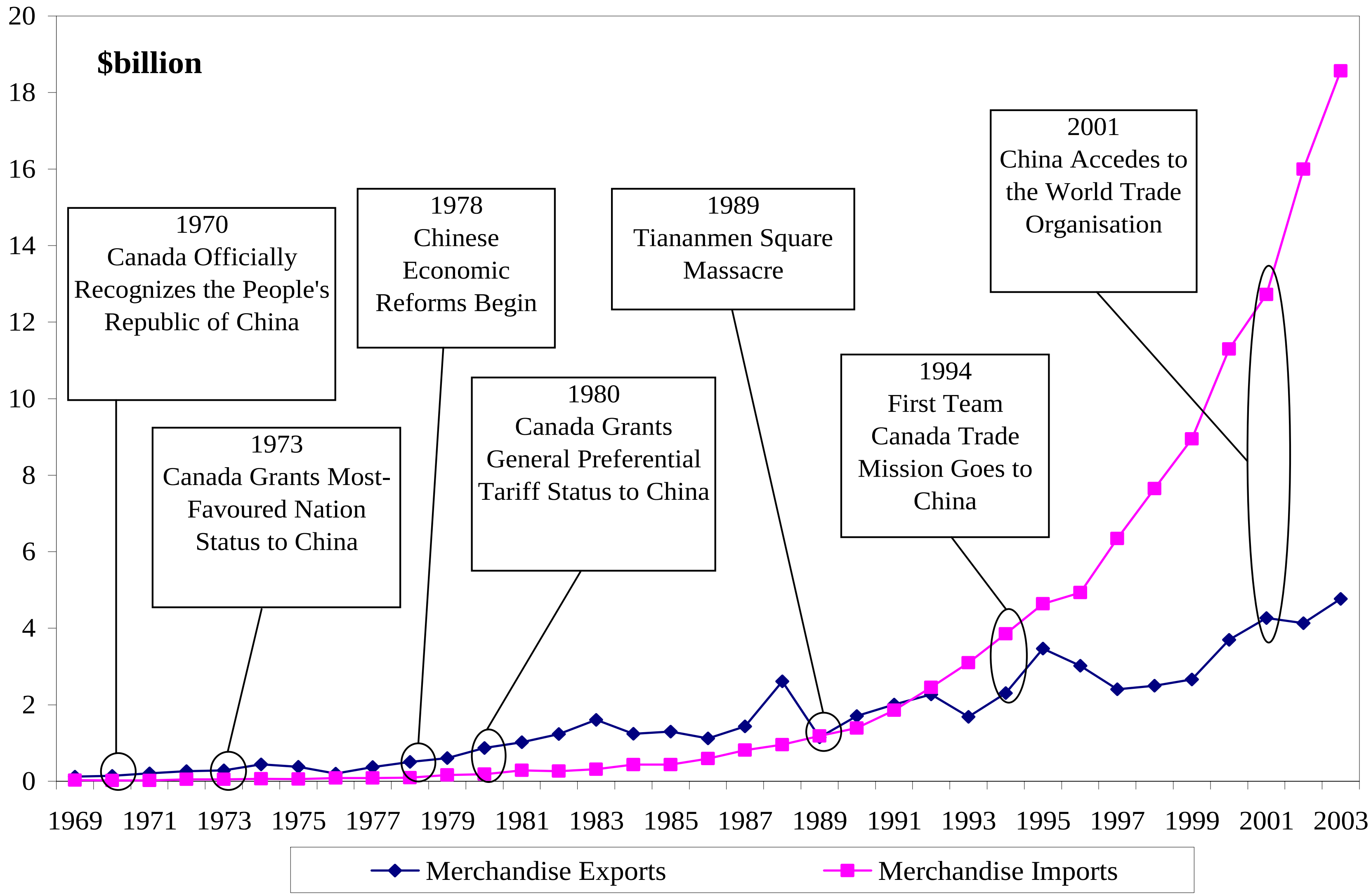
  - Promoting exports of high value-added products, especially in areas where Canadian technologies are well-established and well-known;
  - Sustaining and strengthening Canada's role as a reliable supplier of agricultural and resource-based goods;
  - Supporting Canadian businesses' efforts to expand their presence in China and Hong Kong, especially through joint-venture and wholly-owned Canadian business investments;
  - Helping specialized small and medium-sized enterprises (SMEs) penetrate those markets;
  - Maximizing economic benefits of other initiatives such as multilateral development banks, bilateral development assistance projects, or provincial/municipal government linkages;

- To increase foreign direct investment from China and Hong Kong.

As China continues its gradual process of economic and financial reform, the opportunities in that country for Canadian businesses will continue to grow. However, Canada has not been successful to date in increasing its export focus on the Chinese market. China accounted for about 1.3% of Canadian exports worldwide in 2003, about the same level as in the early 1990s.

Nevertheless, expanding Canada's presence in China is an ongoing policy goal for the federal government. In its 2003-2004 *Report on Plans and Priorities*, the (former) Department of Foreign Affairs and International Trade identified China as one of 11 priority countries for enhancing bilateral trade and investment ties.

Figure 1 – Significant Events in Canada's Trade Relationship with China



Sources: Library of Parliament; Statistics Canada.

CANADA'S CURRENT ECONOMIC RELATIONSHIP WITH CHINA

Rapid economic growth and ongoing market-based reforms have transformed China into a major trading nation. In the early 1990s, China accounted for about 2% of global exports and 1.8% of imports. Trade grew through the 1990s and accelerated even further once China became a member of the World Trade Organisation in 2001. Following WTO accession, Chinese exports grew by 65% in only two years while imports grew by 70%. By 2003, China accounted for 5.9% of global exports and 5.3% of imports.

The rapid development of the Chinese economy and its increasing focus on international trade has dramatically affected Canada's trade and investment relationship with that country since the early 1990s. Gone are the days when wheat represented a major portion of Canadian exports to China. Similarly, the composition of Canadian imports from China has changed dramatically as production in that country moves away from clothing and textiles towards electronics and other manufactured goods.

A. Merchandise Trade

China is Canada's fastest-growing major trading partner. Since 1990, bilateral trade between the two countries has increased by an average of 16.8% annually. By comparison, Canada's total two-way trade with all other countries grew by 7.2% over the same period. As mentioned in the introduction, merchandise trade between Canada and China reached $23.4 billion in 2003. Chinese exports comprised $18.6 billion of that total, while Canadian exports accounted for the remaining $4.8 billion.

Trade between the two countries shows no signs of abating through 2004. From January to July, exports to China were 42.6% higher compared to the same period last year. For their part, imports from China were 24.7% higher. As a result, China has solidified its position as Canada's second-largest source of imports worldwide and could surpass the United Kingdom to become Canada's third-largest export destination by year-end.

Although exports to China have increased considerably in 2004 to date, the bulk of growth in Sino-Canadian trade since the early 1990s has been the result of higher Canadian imports of Chinese goods. From 1990 to 2003, imports from China grew by an average of 22% annually, compared to 8% for exports. As a result, a considerable trade deficit has opened up between Canada and China. In 2003, imports from China exceeded exports to that country by $13.8 billion.

B. Major Export Products

As mentioned above, Canada's export mix to China has changed dramatically since the early 1990s. Whereas wheat was once the principal export product, Canada now exports a wide range of goods including motor vehicle parts, telecommunications equipment and chemical products. However, resource-based goods continue to comprise a significant portion of exports to China.

In particular, exports of metals, minerals and wood pulp are on the rise. The rapid growth of the Chinese economy has created enormous demand for many of these raw materials, contributing to the recent increase in world commodity prices – particularly in metals.(18) In fact, Chinese demand for raw materials is a major factor behind Canada's export growth to that country. Metals and minerals are among the fastest-growing Canadian exports to China and accounted for close to 13% of total exports in 2003.

For their part, wheat exports have declined considerably since the early 1990s, although there has been a substantial spike in wheat shipments in 2004. This increase aside, the general decline in wheat exports reflects the combination of two factors. First, China has become considerably more self-sufficient in agriculture in recent years, producing its own grain and reducing its reliance on imported products. Second, as many Chinese become wealthier, eating patterns in the country are changing. Per capita consumption of grains is falling, while that of meat and seafood is growing.(19)

Canadian exports of agriculture and food products to China have adapted accordingly. Even as wheat exports declined through the 1990s and into the present decade, exports of seafood and oilseeds have increased considerably.

C. Major Import Products

As the Chinese economy has grown and evolved since the early 1990s, so too has the composition of Canadian imports from that country. In 1990, Canadian imports of Chinese goods were concentrated in two areas: clothing, textiles and related products; and toys. The former group accounted for 46% of Chinese exports to Canada that year, while the latter made up an additional 12%.

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(18) F. Roy, "Canada's Trade with China," Feature Article, *Canadian Economic Observer*, Statistics Canada, Ottawa, June 2004.

(19) *Ibid.*

Canadian imports of these products grew rapidly through the 1990s, but were nevertheless eclipsed by other goods that saw even more impressive growth. In particular, China has become a major manufacturing and assembly centre, especially for electronics and telecommunications equipment. Machinery and equipment imports from China grew by an average of 31% per year from 1990 to 2003. As a result, those products now account for 37% of all Canadian imports from China. Other manufactured goods make up an additional 26% of Chinese exports to Canada.

Much of the growth in Canada's imports from China can be attributed to that country's growing attractiveness as a location for foreign companies to locate their assembly-related manufacturing activities. A large, inexpensive labour force along with the easing of economic restrictions has made China a magnet for foreign direct investment. Businesses from around the world, including Canada, are locating in China and re-exporting their products from that country.

Although assembly-based manufacturing is an important factor behind China's export growth, it is also true that, in general, China's exports to Canada are moving up the value-added chain. This is evident in examining one of China's traditional types of exports to North America – toys and games. In the early 1990s, most of China's exports to Canada in this general category of goods were comprised of basic toys and dolls. By 2003, however, console-based video games had become one of China's largest toy/game exports to Canada, and one of Canada's fastest-growing imports from that country.

D. Foreign Direct Investment

As mentioned above, China is becoming an increasingly attractive destination for foreign direct investment (FDI). In 1990, the stock of FDI in China stood at just under US$25 billion, accounting for 1.3% of total investment worldwide. Since that time, however, FDI in China has soared, growing at more than twice the rate of the global average. By 2002, the most recent year for which data are available, FDI stocks in China had reached US$448 billion, equivalent to 6.3% of global inbound investment.

Despite the intense international interest in investment opportunities in China, that country is not a major destination for Canadian FDI. China accounts for only 1.5% of Canada's FDI stock in Asia-Pacific, ranking below Thailand and Malaysia. To be sure, the investment relationship between Canada and China has expanded, but at nowhere near the rate of China's overall growth as a destination for foreign investment. In fact, Canada's investment presence in China has receded in recent years. In 2003, the stock of Canadian FDI in China was worth C$542 million. This is up considerably from 1990 levels ($36 million), but is nonetheless the lowest level since 1998.

For its part, China is not a major source of FDI at the global level, accounting for less than 1% of outbound investment worldwide. However, FDI from China is growing rapidly. As with investment into China, outbound FDI from that country has grown twice as fast as global outbound FDI over the 1990-2002 period.

Similarly, the stock of Chinese FDI in Canada is modest, but growing. In 2003, FDI from China reached a record $422 million, accounting for 2.3% of Canada's total FDI from Asia-Pacific that year. By comparison, Chinese investment in Canada was limited to $54 million in 1991.[20]

However, Chinese investment in Canada could increase considerably in the near future. A Chinese state-owned company has recently moved to acquire the Canadian mining company Noranda. If successful, this would represent an investment of about $6.5 billion. As well, in an effort to secure a supply to meet its growing energy demand, China has recently expressed interest in making a major investment in the oil sands in northern Alberta.

E. Development Assistance

China is still considered to be a developing country and as such is eligible to receive Official Development Assistance (ODA) from Canada. Indeed, China is a major destination for Canadian ODA. In 2002-2003, direct aid (excluding debt relief and monies distributed through multilateral assistance programs) from Canada totalled $43.6 million, making China the fourth-largest recipient of Canadian ODA.

That China, a rapidly-growing country and a major economic power in the world, continues to receive foreign aid from Canada is a source of controversy for some observers. Given the rapid growth and development of the Chinese economy in recent years, China is increasingly seen as a competitor for many Canadian industries and certainly not as requiring foreign aid.

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(20) Data for 1990 are not available.

On the other hand, it bears mentioning that China's economic development is far from evenly distributed across the country. Development policy in China has focused on the eastern seaboard and the Pearl River Delta regions of the country. While those regions are expanding quickly, the interior and western portions of China are relatively untouched by the Chinese economic transformation.

Notwithstanding the debate over whether or not China should continue to receive ODA funds, the fact is that in the future, China will likely decline in importance as a destination for Canadian development assistance. Direct ODA funds to China have already fallen well below 1998-1999 levels ($67.1 million). Furthermore, the Canadian International Development Agency (CIDA) – the chief distributor of ODA funds – is changing its policy on how development assistance grants are distributed. Currently, ODA funds are widely spread across many countries. Afghanistan was by far the largest recipient of ODA funds in 2002-2003 at just under $115 million. Even so, that country accounted for less than 5% of total ODA disbursements that year.

In an effort to make more effective use of its resources in the future, CIDA will not spread foreign aid as thinly as in the past and instead will concentrate its efforts in specific priority countries. CIDA has identified a list of nine such priority countries: Bangladesh, Bolivia, Ethiopia, Ghana, Honduras, Mali, Mozambique, Senegal and Tanzania. This suggests that China will not be a major recipient of Canadian foreign aid in the years to come.

CONCLUSION

Economic relations between Canada and China have expanded considerably since the People's Republic was proclaimed in 1949. This has been especially true since the early 1990s as the gradual process of market liberalization in China has increasingly opened that country to the world.

China's accession to the WTO in 2001 signalled that this liberalization process will continue. The acceptance of China as a WTO member was contingent upon a series of market-based reforms that will continue to be phased in over the next few years. Notably, these include financial sector reforms that will eventually allow foreigners greater access to Chinese financial markets. It is hoped that China's participation in the WTO will open the door for even further such liberalization.

In recognition of the potential economic gains that could result from these reforms, China occupies a central position in Canadian trade policy. The new federal trade department – International Trade Canada – has made it a priority to improve the trading relationship between Canada and certain key emerging markets, specifically China, India and Brazil.

Given the rapid economic growth and development taking place in China, along with that country's growing presence on the international stage, the continued increase in Sino-Canadian trade is all but certain. A successful Canadian trade policy initiative would therefore be one that not only resulted in growth in trade between the two countries, but that increased Canada's market share in China as well.