

Canada's State of Trade

Trade and Investment Update - 2008

ABOUT THIS DOCUMENT

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

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A Message



from

The Honourable David Emerson,
Minister of Foreign Affairs and International Trade and
Minister for the Pacific Gateway and
the Vancouver-Whistler Olympics

As Canada's Minister of International Trade, it gives me great pleasure to present the 2008 edition of *Canada's State of Trade*.

This publication is now in its ninth year, and judging by its continuing popularity with Canadian and international audiences alike, it is fast becoming a trusted and informative gauge of Canadian trade and investment trends in the global context.

The Canadian economy achieved another year of solid growth in 2007, weathering turbulence in international financial markets and a slowing US economy. While these factors tempered Canada's growth performance towards the end of last year — and will likely continue to slow growth in 2009, both in Canada and internationally — the Canadian economy is well-positioned to withstand these pressures, thanks to strengths like low unemployment, the strongest fiscal situation in the G7 and our endowment of natural resources, which continue to be in demand the world-over.

The high Canadian dollar presents a special challenge for our economy. While its strength increases the spending power of Canadians and keeps inflation low, it also means that Canadian exporters' receipts are reduced in Canadian-dollar terms. The challenge for exporters is compounded by slowing demand in the United States, our number-one market.

At the same time, Canadian exporters are showing a great determination to adapt to these challenges. Exports continued to grow in 2007, and while this growth was concentrated in resource-based products, we also saw strong growth in manufactured goods going to non-US markets. Canadian firms have also shown a renewed flexibility to expand into faster-growing markets and adapt to new cost conditions.

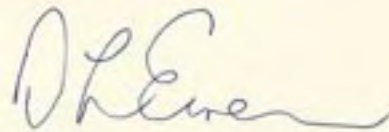
While these achievements are remarkable, we cannot become complacent. Global competitive challenges will continue to increase in the years ahead. The same emerging economies that have driven the global boom in commodities are moving up the value chain and establishing themselves as fierce competitors in a widening range of sectors.

A competitive business environment that fosters innovation is key to our economic future. Through Advantage Canada, our Government is putting in place a comprehensive plan to create a more competitive and resilient Canadian economy.

As part of these efforts, my department is implementing Canada's Global Commerce Strategy, a plan to help Canadian businesses and investors compete and succeed in the global marketplace. Through it, we are helping Canadian firms build their linkages to global value chains, increase inward and outward investment, foster innovation partnerships and improve Canada's overall international market access.

This year, we achieved two significant milestones towards this goal: two new free trade agreements, one with Peru, and one with the European Free Trade Association nations of Switzerland, Liechtenstein, Iceland and Norway. Moving forward, we will continue to pursue an aggressive strategy of free trade negotiations with other strategic partners, as well as negotiations covering investment, air services and science and technology co-operation. We will also continue supporting Canadian businesses and investors abroad, by expanding our network of Trade Commissioners in key global markets, including India, China and Brazil.

Through this Strategy and the continued efforts and energy of Canadian businesses, I have every confidence that Canada will not only adapt to the competitive global economy, but thrive and prosper within it, and continue supporting the prosperity and quality of life upon which every Canadian depends.

A handwritten signature in blue ink, appearing to read 'D. Emerson', with a stylized flourish at the end.

The Honourable David L. Emerson, P.C., M.P.

Executive Overview

Real world economic output continued to perform well in 2007, edging down only marginally from 5.0 percent in 2006 to 4.9 percent. However, global economic activity began to decelerate in the second half of the year and is continuing on this trajectory as we enter into 2008, particularly in the developed economies. This reflects the downturn in the U.S. economy and ongoing dislocation in global financial markets.

For the third straight year, real activity in the United States slowed, posting growth of only 2.2 percent in 2007. The economy weakened sharply in the fourth quarter as it expanded by a mere 0.6 percent on an annualized basis. In the euro area, growth slipped to 2.6 percent last year from 2.8 percent in 2006. Again, signs of strain have appeared as GDP growth in the fourth quarter slowed to 1.5 percent at an annual rate. The same story unfolded for the United Kingdom. The Asian economies, however, seemed to be less affected. Japan, for instance, remained largely resistant to the global slowdown and picked up momentum in the second half of the year. China, which had been posting double-digit rates of expansion, experienced an acceleration in growth to 11.9 percent last year from 11.6 percent the year before. India, while slowing over the second half of the year, achieved a fairly strong 8.7 percent growth for the entire year.

In light of the global strains, Canada's economic performance last year was testament to the resilience of the economy. Real GDP growth continued more-or-less apace with that of 2006, at 2.7 percent growth compared to 2.8 percent the year earlier. All major expenditure categories advanced, with the exception of net exports. Inflation came in just above the

target of 2.0 percent, at 2.2 percent for the year. Employment creation was at a three-decade high, bringing the unemployment rate down to 6.0 percent for 2007, its lowest level since 1974. Within Canada, those provinces endowed with an abundance of natural resources performed the best, led by Newfoundland and Labrador whose economy grew at over 9 percent, followed by the western provinces which all had growth rates closer to 3 percent. The slowdown in the U.S. combined with the 5.5 percent appreciation of the Canadian dollar vis-à-vis the American dollar were sources of weakness for central Canada, leading to GDP growth somewhat below the national average.

On a global basis, world merchandise trade grew by 14.8 percent in U.S. dollar terms in 2007 and world services trade grew by 17.8 percent. On this basis, Canadian merchandise exports grew at roughly half the pace as world trade, or by 7.8 percent, while Canadian services exports grew by one-third the world average. However, these metrics are based on data converted into U.S. dollars and, consequently, include the appreciation of the Canadian dollar against its U.S. counterpart.

In Canadian dollar terms, exports of goods and services increased by 1.9 percent. Canadian merchandise exports expanded by 2.1 percent in 2007 and Canadian services exports were up by only 0.3 percent. On the imports side, imports of goods and services into Canada advanced 3.2 percent, as merchandise imports were up by 2.8 percent and services imports increased by 5.5 percent. Simply put, these have been trying times for Canadian exporters. However, even with the relatively higher value of the Canadian dollar against other key

currencies, Canadian exporters have demonstrated strength and flexibility by posting positive growth in difficult conditions.

The downturn in the U.S. went hand-in-hand with a slight 1.6 percent decline in Canadian exports of goods to that country. In turn, Canadian exporters found new opportunities in Europe and elsewhere abroad (excluding Japan). Goods exports to the EU vaulted some 20.6 percent in 2007, while those to destinations outside the US, the EU, and Japan jumped 17.1 percent. For Japan, Canadian exports of goods fell by 3.4 percent last year. Clearly, Canadian exporters are shifting to a more global focus from a regional one.

Further evidence for this trend to diversification is found in the pattern of trade at the firm level and the activities of foreign affiliates of Canadian firms. Throughout the early to middle part of this decade, there was a significant decline in the number of firms exporting only to the United States and an almost as large increase in the number of firms exporting globally. Canadian firms are also offering more of their goods and services directly in markets abroad, particularly in overseas markets — with growth in sales by foreign subsidiaries outstripping the pace of exports in recent years.

Nonetheless, the United States is still far and away our largest trading partner and our economies are highly integrated. For example, Canada is a safe and reliable partner for trade in energy products. Many U.S. builders and renovators continue to rely on high quality Canadian lumber to meet their needs. Then there are integrated supply chains, particularly in the auto sector, where inputs travel back and forth across the border before the final product is assembled. Fully thirty percent of our trade with the U.S. is between related companies — slightly more than one-third of our exports and about one-quarter of our imports. The share of intra-firm trade has declined over the past two decades, but that should be seen as evidence of growing ease of trade and diminishing need for cross-border commercial presence to facilitate trade.

The trends and events unfolding across the globe also help to explain the sectoral pattern of Canada's trade. All major categories of exports increased, with the exception of forestry and automotive products. The U.S. accounted for 71.5 percent of Canadian exports of forestry products and 95.3 percent of exports of automotive products, so conditions in that country have affected our exports of these products. Specifically, the deep and ongoing correction in the U.S. housing market has led to a sharp fall in Canadian exports of forestry products (down 12.8 percent). Likewise, falling wealth, tighter credit conditions, and moderating labour market conditions along with rising gasoline costs and a weaker U.S. dollar are all factors reducing U.S. demand for Canadian automobiles and trucks, resulting in a 6.5 percent decline in Canadian exports of automotive products.

Industrial goods and materials led the advances in Canadian exports last year, as they increased by 11.1 percent. This category of goods includes products like metal ores, chemicals, plastics, and fertilizers, and metals and alloys. Growth in industrial goods exports was fuelled by the continued strength in prices for metal ores and alloys, brought about by the strong demand for primary metals emanating from the Asian emerging economies and the EU.

Exports of agricultural and fishing products grew by 10.0 percent in 2007. The resumption of cattle exports to the United States and new markets for wheat and canola helped push exports up. Exports of energy products have continued to benefit from rising prices for crude petroleum. While the United States remained the largest consumer of Canada's energy products, new demand for crude oil from China and Singapore helped to raise Canada's energy exports by 6.8 percent last year. Two remaining categories — consumer goods and machinery and equipment — also posted positive export growth rates, at 5.9 percent and 0.6 percent, respectively.

The small increase in services exports (0.3 percent) was due to a decline in commercial services exports, which fell by 0.6 percent. This partly offset gains in transportation services exports (up 2.9 percent) and travel services exports (up 0.3 percent).

With the strength of the domestic economy, the growth of imports of goods and services, at 3.2 percent, outpaced that of exports. Imports increased from all major trading partners, in particular from the United States (up 1.0 percent), Japan (up 2.6 percent), the EU (up 3.1 percent), and the rest of the world (up 5.5 percent). Gains were recorded across-the-board by major categories, with the exception of a decline of 3.0 percent for forestry products. However, as forestry products accounted for only 0.7 percent of all goods imports, the decline was small in absolute terms.

Rising food and energy prices found their way into the Canadian import performance as these two categories posted the strongest rates of import growth, at 8.7 percent and 4.5 percent, respectively. Imports of consumer goods also posted strong growth, at 5.3 percent, while machinery and equipment, industrial goods, and automotive products registered increases of 1.7 percent, 1.4 percent, and 0.1 percent, in that order.

Services imports posted a strong 5.5 percent increase last year. The strong Canadian dollar boosted Canadian imports of travel services up by 15.5 percent, as Canadians took advantage of their currency's rise against the U.S. dollar to travel to the United States. Both business travel and personal travel registered strong increases. The higher cost of oil also helped push transportation services imports up, as they rose by 5.3 percent. Partly offsetting the advance, commercial services imports into Canada edged down 0.3 percent over the previous year.

The appreciation of the Canadian dollar caused major downward revaluations of Canadian foreign direct investment abroad in 2007, especially for those holdings valued in U.S. dollars, but also for those valued in euros and in British pound sterling. Canadian direct investors' holdings abroad

amounted to \$514.5 billion in 2007, some \$15.4 billion less when compared to 2006. The change in holdings for 2007 can be broken down into substantial outward investment flows of just over \$53.0 billion, and a downward revaluation of foreign currency denominated assets of just over \$67.0 billion. Thus, although there were substantial additions to the holdings of Canadian investors, the currency effect overwhelmed the acquisitions and left a net reduction in the value of Canadian outward direct investment from 2006 to 2007.

At the same time, foreign corporate inflows to Canada were booming and resulted in foreign direct investment holdings in Canada chalking up a 14.4 percent increase over 2006 levels. For the first time, the stock of FDI in Canada surpassed the half a trillion dollar mark at the end of 2007.

Nevertheless, at the end of 2007, the stock of Canadian direct investment abroad still exceeded foreign direct investment in Canada.

Special feature: the rapid expansion of outward direct investment

Foreign direct investment (FDI) across the globe has accelerated dramatically since the early 1990s, with a dip following the high-tech bust at the beginning of this decade, and the recent dislocation in global financial markets is likely to lead to a further correction. Nevertheless, in the most recent data available on outward flows (2006), these were 22.6 times larger than they were in 1980 and the stock of FDI holdings in the world was 20.8 times larger in size in 2006 than in 1980. In addition, the stock of world FDI at the end of 2006 was larger than world GDP or world imports for that year. Much of this growth has been driven by FDI in services, which now accounts for over two-thirds of the stock of world FDI compared to less than one-half in 1990.

Canada has been an active participant in these developments. The stock of Canadian direct investment abroad (CDIA) has expanded by 11 percent annually on average since 1990, compared to 6.9 percent for our trade in goods and services and 4.8 percent for nominal GDP.

As with trade, Canada has been diversifying its foreign direct investment abroad away from the United States over time, although that country remains the largest destination for Canadian direct investment abroad.

Foreign direct investment is oftentimes characterized as an alternative strategy to trade. Firms may either produce at home and export or they may produce abroad and substitute the sales of their foreign subsidiaries for exports. The literature on whether outward FDI is complementary to or a substitute for exports is, however, inconclusive, with findings for both. The association was tested for Canada and a complementary relation was found — a 10 percent increase in the stock of Canadian outward direct investment would raise exports by 1.2 percent. Thus, there is no evidence that CDIA leads to a reduction in Canadian exports. On the contrary, this empirical finding supports the view that the rapid increase in the stocks of Canadian outward direct investment during the 1990s and 2000s facilitated rather than detracted from the substantial increase in Canadian exports.

Global Economic Performance

Overview and global prospects

The continuing rise in oil prices, underlying the economic developments of 2006, took a backseat to the turmoil in global financial markets that emerged out of the American subprime mortgage problem in mid-2007. With a sharp downturn in the United States and the spreading crisis in financial markets, global economic activity decelerated in the second half of 2007. Nonetheless, over the full year, the growth in world output edged down only marginally from 5.0 percent in 2006 to 4.9 percent¹.

Commodity markets have continued to boom despite the recent slowing global activity. Strong demand from emerging economies, which has accounted for much of the increase in commodity consumption in recent years, has been a driving force in the price run-up, and biofuel-related demand has boosted prices of major food crops. At the same time, supply adjustments to higher prices have lagged, particularly for oil. Somewhat perversely, the strength in commodity prices also seems to have been at least partly due to financial factors, as commodities have increasingly emerged as an alternative asset class. As a result, headline inflation has increased around the world, particularly in the developing economies².

The financial shock originating in the U.S. subprime market spread quickly and unpredictably to inflict extensive damage on markets and institutions at the core of the financial system³. The fallout has

curtailed liquidity in the interbank market, weakened capital adequacy at major banks, and prompted the repricing of risk across a broad range of instruments. Equity prices have also retreated as signs of economic weakness have intensified, and evidence is gathering of a broad credit squeeze. However, the trade spillovers from the slowdown in the advanced economies have been limited so far and are more visible in economies that trade heavily with the United States. The financial market stress also had an impact on foreign exchange markets and the U.S. dollar has depreciated further since mid-2007. This, in turn, has helped boost U.S. net exports.

Prospects are for a marked slowdown in 2008 that will linger on through most of 2009. The problems in the United States have spread to western Europe and are spilling over into the real economy worldwide. Global growth is now projected to slow to 3.7 percent in 2008 (Table 1-1). However, achieving this rate will require that most advanced economies experience only mild slowdowns and that many developing economies keep their rapid pace of growth largely on track.

The United States

For the third straight year, the pace of economic activity in the U.S. economy slowed as real gross domestic product (GDP) grew by 2.2 percent in 2007 compared to 2.9 percent a year earlier and 3.1 percent the year before that. Real growth in the economy weakened sharply in the fourth quarter

1 All projections in this chapter come from the International Monetary Fund's *World Economic Outlook*, April 2008.

2 Headline inflation gauges the rate at which the cost of living is rising. That is, it measures the rate of change in the consumer price index (CPI).

3 *World Economic Outlook*, Executive Summary.

as the economy expanded by only 0.6 percent at an annualized rate.

Performance in the U.S. economy over the past year has been dominated by three major factors: the continuing deep correction in that country's housing market; the unresolved financial sector problems that first emerged in subprime mortgage lending, but which have now spread more broadly; and the broadly-based depreciation of the U.S. dollar against its foreign counterparts.

U.S. consumers increasingly became reluctant spenders over 2007 as a number of factors cut into both their purchasing power and confidence.

Household wealth, and the ability to borrow against home equity, were negatively impacted by falling home valuations. Many households were increasingly contending with tighter bank lending conditions in the wake of the financial fallout triggered by the unfolding sub-prime mortgage crisis. Rising food and gasoline costs also cut into disposable income and discretionary purchases, while more recently, moderating employment gains are threatening to further reduce spending intentions. Growth in consumer expenditures slipped to 2.9 percent in 2007 from 3.1 percent the year before, while in the fourth quarter they only grew at a 2.3 percent annualized rate. For 2007 as a whole, consumer

TABLE I-1
Real GDP growth in Selected Economies over 2004-2007 and forecast for 2008, in percent

	2004	2005	2006	2007	2008
World	4.9	4.4	5.0	4.9	3.7
Advanced Economies	3.2	2.6	3.0	2.7	1.3
Canada	3.1	3.1	2.8	2.7	1.3
United States	3.6	3.1	2.9	2.2	0.5
United Kingdom	3.3	1.8	2.9	3.1	1.6
Japan	2.7	1.9	2.4	2.1	1.4
Euro Area	2.1	1.6	2.8	2.6	1.4
<i>of which France</i>	2.5	1.7	2.0	1.9	1.4
<i>of which Germany</i>	1.1	0.8	2.9	2.5	1.4
<i>of which Italy</i>	1.5	0.6	1.8	1.5	0.3
Developing Economies	7.5	7.1	7.8	7.9	6.7
China	10.1	10.4	11.6	11.9	9.3
India	7.9	9.1	9.7	8.7	7.9
Russia	7.2	6.4	7.4	8.1	6.8
Brazil	5.7	3.2	3.8	5.4	4.8
Mexico	4.2	2.8	4.8	3.3	2.0
ASEAN-5					
Indonesia	5.0	5.7	5.5	6.3	6.1
Malaysia	6.8	5.0	5.9	6.3	5.0
Philippines	6.4	4.9	5.4	7.3	5.8
Thailand	6.3	4.5	5.1	4.8	5.3
Vietnam	7.8	8.4	8.2	8.5	7.3
NIEs					
Hong Kong (China)	8.5	7.1	7.0	6.3	4.3
Korea	4.7	4.2	5.1	5.0	4.2
Singapore	9.0	7.3	8.2	7.7	4.0
Taiwan	6.2	4.2	4.9	5.7	3.4

Source: IMF *World Economic Outlook*, April 2008 — except for 2006 and 2007 data for China, which reflect April revisions by the Chinese National Bureau of Statistics, and 2007 data for India, which reflect the advanced estimates published by the Indian Central Statistical Organisation. Rates of growth calculated on data expressed in U.S. dollar terms.

expenditures contributed about 2 percentage points to the 2007 change in U.S. real GDP.

The deep and ongoing correction in the U.S. housing market also helped push real residential investment down by 17 percent in 2007 thereby trimming U.S. economic growth by a full percentage point. Real investment in this sector has contracted over each of the past eight quarters and those contractions accelerated over the last two quarters of 2007. Private inventory investment also provided a negative contribution to U.S. real GDP, trimming one-third of a percentage point off the rate of U.S. economic growth in 2007. Partly offsetting the losses were gains to non-residential investment. Overall, gross private domestic investment contracted over the year and reduced GDP growth by just over 0.8 percentage points in 2007.

Foreign trade was the good news story of U.S. economic performance. The weaker U.S. dollar rendered U.S. exports more competitive and U.S. imports less competitive in 2007. Although the substantial trade deficit has been very slow to recede, the most significant contribution to U.S. growth over the past year has come from the improvement in real net exports. With export volumes expanding some 8 percent over the year, four times the pace of imports, the US\$68.9 billion improvement in real net exports added 0.6 percentage points to GDP growth in 2007.

Finally, government expenditures added about 0.4 percentage points to the growth in U.S. economic activity in 2007.

Looking forward, the outlook is for further turbulence in the U.S. housing market. After peaking in the second half of 2005, the U.S. housing market has already undergone a major correction, with house prices falling by up to 10 percent, depending on the measure used, and housing starts in 2008 down by over 50 percent from their peak. The market remains far from equilibrium, with inventories of unsold homes close to record levels and home

value indicators well above historical norms⁴. However, rising negative equity on home ownership and resets of variable-rate mortgages are likely to push defaults and foreclosures up even higher, putting downward pressure on house prices, which will raise incentives to default. Reflecting these concerns, prices in the U.S. housing market could fall from 14 to 22 percent during 2007-08.

The spreading financial market crisis has already induced a credit squeeze, but a full-blown credit crunch has not developed so far. Risk spreads have widened, prompting repricing and falling asset values. Overall economic expansion has weakened and labour market conditions have deteriorated. The U.S. economy is projected to slip into a modest recession in 2008, followed by a gradual recovery in 2009. All major components of domestic demand will be sickly during 2008: residential investment will continue to contract; consumption will fall in face of adverse wealth effects, tight credit, and a waning labour market; and business investment will also turn down. In 2009, consumption will remain sluggish as households raise their savings rates after a long period during which personal wealth was boosted by capital gains on assets. Net exports will continue to improve. On an annual basis, U.S. growth is projected to slow to 0.5 percent before edging up to 0.6 percent in 2009. The trajectory is clearer when measured on a fourth-quarter to fourth-quarter basis. On this metric, the U.S. economy is projected to decline 0.7 percent during 2008 before recovering to grow at 1.6 percent in 2009.

Euro area

After posting its best year since 2001, growth in economic activity in the euro area slipped slightly to 2.6 percent growth in 2007 from 2.8 percent a year earlier. Robust domestic demand was fuelled by steady employment growth and buoyant investment. Signs of strain increased toward the end of 2007, however. In the fourth quarter, GDP growth slowed to 1.5 percent on an annualized basis. Both consumer and business sentiment deteriorated in

⁴ *World Economic Outlook*, Chapter 2

response to financial sector dislocation and the impact of rising oil prices on real disposable income. Euro appreciation and a weaker export market also diminished growth expectations. The effects were not felt equally across Europe, however, as the smaller European countries, such as Austria, the Netherlands, and Sweden, continued to grow well above potential in the second half of 2007.

Looking forward, the IMF projects growth in the euro area to decelerate to 1.4 percent in 2008 and 1.2 percent in 2009. Export growth will likely hold up through the first half of 2008, based on full order books, especially in Germany, but is projected to fall off in the second half of the year, as a moderation in global demand and euro appreciation slow export growth. The impact of the U.S. slowdown will feed through with a short lag, as fourth-quarter-2008-over-fourth-quarter-2007 growth is expected to fall to 0.9 percent before recovering to an expected fourth-quarter-2009-over-fourth-quarter-2008 1.6 percent rate of growth, a year later.

United Kingdom

Real GDP growth in the U.K. has accelerated over the past three years, rising from 1.8 percent in 2005 to 2.9 percent the next year to 3.1 percent in 2007. However, like the euro area, signs of a slowdown emerged in the fourth quarter as GDP growth slowed to 2.5 percent on an annualized basis.

For 2007, growth was driven by consumer expenditures, which increased 3.1 percent. Gross fixed capital formation remained a strength as it grew by 5.0 percent, although lower than the 7.9 percent pace registered a year earlier. The change in the level of inventories was up by £6.5 billion. A rise in the trade deficit in real terms, to £44 billion from £36 billion a year earlier, acted as a drag on GDP in 2007, resulting in a subtraction of 0.6 percentage points from GDP growth.

The U.K. is feeling the effects of the global market turbulence: the rate of expansion in the British financial services sector has dampened and lending

to companies and households has tightened. British housing prices have now fallen for six consecutive months and the rate of decline is set to accelerate⁵. For the United Kingdom, growth is forecast to slow to 1.6 percent in 2008, as the lagged effects of the 2007 monetary tightening, a turning in the house price cycle, and the financial turbulence are projected to slow activity. Economic activity is forecast to remain below potential through 2009, with projected growth of 1.6 percent for that year, although growth is expected to pick up towards the second half of the year, with an expected fourth-quarter-2009-over-fourth-quarter-2008 rate of growth of 2.3 percent.

Japan

After picking up momentum in 2006, growth in Japan edged down in 2007 mainly on problems encountered during the first half of the year. For the year as a whole, growth eased to 2.1 percent from 2.4 percent in 2006. However, the Japanese economy remained largely resistant to the global slowdown through the end of the year. Fourth quarter GDP grew at an annualized rate of 3.5 percent, led by robust net exports and business investment. Business investment rebounded after contracting during the first half of the year. Exports continued to be supported by strong demand from Asia and Europe. The emerging Asian economies now account for nearly one-half of Japanese exports, while the United States and the euro area have declined to slightly over a third of the total. Following the tightening of building standards in June, the slump in residential investment continued and household spending remained weak.

The growth momentum entering 2008 appears to have slowed with deteriorating business and consumer confidence, and export growth showing signs of moderating. Higher food and fuel prices and sluggish wages continue to weigh on consumption, and business investment could weaken if the global financial market turmoil were to intensify and credit conditions were to tighten further, although the

⁵ *United Kingdom Country Report*. Economist Intelligence Unit. April 2008

Japanese financial system has limited direct exposure to U.S. subprime securities. On the upside, housing starts appear to have turned a corner and residential investment is expected to provide some support to growth in the first half of 2008. Reflecting these considerations, growth for Japan is projected to slip to 1.4 percent in 2008 before edging up to 1.5 percent in 2009.

The emerging Asian economies

Growth in emerging Asia held up well in the second half of 2007, although with some signs of softness. Growth was led by China and India. Robust domestic demand, led by consumption, supported activity in Indonesia, Malaysia, Hong Kong (China), the Philippines, and Singapore. Export growth remained strong in Korea and Thailand. However, the strength of domestic demand in the region, combined with rising food and energy prices, has contributed to a buildup of inflationary pressures in a number of countries. Growth prospects will depend on the resiliency of the region's economies and their financial systems to the financial market turbulence and the associated slowdown in the advanced economies. Ongoing robust domestic demand, a high degree of openness in the region, and a rising share of intra-Asia exports will help to offset some of the impacts of the weaker external environment.

China

2007 was the fifth straight year that growth has been posted in double-digit figures for the Chinese economy. Moreover, this growth has been accelerating on an annual basis over this period. In 2007, the Chinese economy expanded by 11.9 percent compared to 11.6 percent in 2006. Growth was led by the manufacturing and services sectors (which China formally calls the "secondary" and "tertiary" sectors), which grew by 13.4 percent and 12.6 percent, respectively.

The Chinese government is trying to rein in the economy somewhat, attempting to achieve "sound and fast" growth, with price stability as one of its top

priorities. On the one hand, it wants to keep growth high to reduce poverty. On the other hand, it has been tightening monetary policy in an effort to rein in inflation without denting economic growth too much. Consumer prices rose 8.3 percent in March 2008 over the same month a year earlier, down only slightly from February's 8.7 percent rate, the highest rate in nearly 12 years. Most of the gains came from a 21 percent jump in food costs in the first quarter, including pork and vegetables. Government authorities worry about a backlash if prices keep rising rapidly. Bouts of high inflation in the 1980's and 1990's have previously sparked protests. Moreover, the government is trying to cool an investment boom in real estate and some other industries that it worries could ignite a financial crisis.

China posted large income and current account surpluses in 2007. China maintains a growing stock of foreign exchange reserves and has become an important international investor, for which it earns income from its rising overseas investments. The current account surplus is estimated to have widened to US\$381.3 billion in 2007, driven by the trade surplus which was boosted by surging export growth and relatively weaker import demand. The trade surplus will remain large in 2008. Tourism-related inflows linked to the Olympic Games will likely push the services account briefly into surplus for 2008, but rising services imports will push it back into deficit in 2009. Growth in goods exports will remain strong, although it is expected to be not quite as strong as in 2007 due to rising domestic costs, currency appreciation against the U.S. dollar (by about 5 percent against that currency), and lower world demand.

China's currency — the renminbi — is, however, linked by a crawling peg to the U.S. dollar. In 2007, because of the recent weakness of the U.S. dollar, the renminbi actually depreciated against the euro. Side effects of these dual surpluses in the capital and current accounts include more rapid growth in money supply and investment⁶. It is thus expected that investment will continue to grow vigorously

6 Economist Intelligence Unit *China Monthly Report* for March 2008.

and remain the single most important driver of economic growth. Low costs of borrowing — with lending rates below the real rate of economic expansion — also contribute to this expectation. Overall, growth in China is projected to moderate to 9.3 percent in 2008.

India

The advanced estimate of expenditures on real GDP during 2007-08 pegs growth of the Indian economy at 8.7 percent as compared to growth of 9.7 percent in 2006-07⁷. Expenditures on capital formation were up 15.7 percent in real terms while consumer expenditures advanced 6.8 percent. Both real exports and real imports increased by 6.4 percent in 2007-08. Growth slowed in the second half as consumption cooled in response to tighter monetary policy⁸. India's real GDP slowed to 8.4 percent in October-December 2007. This was the slowest quarterly growth rate in three years. With the release of the full-year advance estimate by the Indian Central Statistical Organisation, it would appear that growth slowed even more in the final quarter of 2007-08⁹.

India's level of trade dependency is among the lowest in Asia, so despite the outlook for a U.S.-led global slowdown, real GDP in India is likely to be only somewhat affected by these events. Nevertheless, the U.S. is India's largest export market and the U.S. recession will hurt some Indian exporters, such as those in the textile sector. However, other major export markets, notably China, will remain buoyant. The onset of the U.S. subprime lending crisis in August 2007 helped to temper the surge in capital inflows into India. Nonetheless, India remains an attractive location for investors and investment will continue to be the fastest-growing component of GDP. The capital inflows will continue to put upward pressure on the rupee. Private consumption will remain strong, propped up by strong growth in real wages. Net exports will exert a drag on

economic growth as imports of goods and services continue to outpace exports. Overall, growth in the Indian economy is projected to expand by a little under 8 percent for the forthcoming year.

Newly Industrialized Asian Economies (NIEs)

This composite region is made up of Korea, Taiwan, Hong Kong (China), and Singapore. Collectively growth in the NIEs was unchanged between 2006 and 2007, at 5.6 percent. Declines in GDP growth from Hong Kong (down 0.7 percentage points to 6.3 percent), Singapore (down 0.5 percentage points to 7.7 percent), and Korea (down 0.1 percentage points to 5.0 percent) were offset by an increase of 0.8 percentage points (to 5.7 percent) for Taiwan. Looking forward to 2008, growth is projected to fall to 4.0 percent for the region as most of the economies grow in the range of 4.0 percent to 4.3 percent. The exception to this is Taiwan, which is expected to post only a 3.4 percent rate of economic expansion in 2008. Consumption should moderate across all four economies in the region while investment remains flat, as gains accruing to Hong Kong are offset by a decline for Singapore.

Inflation in 2007 for the NIEs was fairly low, ranging from 1.8 percent for Taiwan to 2.5 percent for Korea. The pace of inflation is expected to increase for Korea (from 2.5 percent to 3.4 percent) and to increase significantly for Hong Kong (from 2.0 percent to 3.6 percent) and Singapore (from 2.1 percent to 4.7 percent). For Taiwan, the rate of price increase is expected to slow to 1.5 percent.

ASEAN-5

The ASEAN-5 (Indonesia, Thailand, Philippines, Malaysia, and Vietnam) collectively grew by 6.3 percent in 2007, up from 5.7 percent the year before. Growth was led by Vietnam (at 8.5 percent) and the Philippines (at 7.3 percent). Indonesia and Malaysia

7 Real GDP at market prices. The Central Statistical Organisation (CSO) reports data on a financial year basis that runs from the start of April in one year to the end of March in the next year. Data taken from *Press Note: Advance Estimate of National Income 2007-08*. Press Information Bureau. Government of India. 7 February, 2008.

8 IMF World Economic Outlook, April 2008.

9 According to the Economist Intelligence Unit's *India Monthly Report* for April 2008, India's Chief Statistician noted that "the Indian economy was slowing to a trend rate of growth around 8-8.5 percent".

both registered growth of 6.3 percent last year, while Thailand expanded by 4.8 percent. For 2008, overall growth in the region is projected to slow by one half of a percentage point based on mixed performances by the individual countries that comprise this region. Domestic demand is projected to hold up reasonably well across the five economies. However, consumption growth is expected to fall 0.7 percentage points, as growth moderates, most notably in Malaysia and Vietnam. On the other hand, investment growth for the region should climb by 1.6 percentage points from 2007 to 2008, led by Thailand. The region's commodity resource endowment should also support growth, and real export growth in both Malaysia and Vietnam should accelerate by more than five and a half percentage points.

Inflation in the region is projected to jump to 6.1 percent in 2008, up from 4.5 percent in 2007. Nonetheless, at 6.1 percent, the rate of inflation will be a full two percentage points below the 8.1 percent rate recorded for 2006. Malaysia is expected to experience the smallest jump in the inflation rate — 0.3 percentage points to 2.4 percent — while the rate in Vietnam will nearly double from 8.3 percent to 16.0 percent.

For 2008, real growth in Indonesia is projected to slip to 6.1 percent, down 0.2 percentage points from the previous year. For Vietnam, Malaysia, and the Philippines, real economic activity will likely slow in the range of 1.2 - 1.5 percentage points, to 5.0 percent, 5.8 percent, and 7.3 percent, respectively. On the other hand, real output in Thailand is projected to accelerate to 5.3 percent, up from 4.8 percent in 2007.

Latin America and the Caribbean

The pace of economic activity in Latin America and the Caribbean edged up slightly in 2007, to 5.6 percent from 5.5 percent the year before. At 6.5 percent, growth was highest in Central America. Economic activity picked up in South America, led by the commodity-exporting countries such as Peru (9.0 percent), Argentina (8.7 percent), Venezuela

(8.4 percent), and Colombia (7.0 percent). Growth in Brazil picked up amid sustained declines in real interest rates and strong employment. This country registered a 5.4 percent rate of growth, coming on the heels of a 3.8 percent rate recorded a year earlier. The effects of the U.S. slowdown, however, spilled over into Mexico, and growth in that country slowed to 3.3 percent from 4.8 percent in 2006. Likewise, the pace of real economic activity in the Caribbean dropped to 5.7 percent from 7.8 percent, as this region too was affected by the U.S. slowdown.

Domestic demand has been the key driver of growth in Latin America and the Caribbean. Driven by high capacity utilization in some countries and by rising food and energy prices, inflation has accelerated in the region. This has encouraged a tightening of monetary policy stances in Chile, Colombia, and Peru, and to a lesser extent in Mexico, and an end to easing in Brazil.

In the past, the Latin American and Caribbean region was invariably hit hard by slowdowns in the United States. In the current business cycle, it is expected that economic activity will be dampened but not overwhelmed by the slowdown in the U.S. and other advanced economies and by the dislocation in international financial markets. Overall growth in the region is projected to decelerate to 4.4 percent in 2008 and to slow further to 3.6 percent in 2009. Growth in some countries will moderate in response to the tightening monetary conditions and to less favourable external financial conditions, but high commodity prices should help sustain domestic demand. Elsewhere, growth will suffer appreciably as capacity constraints are expected to bite. Inflation rates are forecast to rise in a number of countries in 2008 before easing in 2009.

Assumptions and risks

As mentioned in footnote 1, all projections in this chapter stem from the IMF's April 2008 *World Economic Outlook*. In making their projections, the IMF has adopted a number of assumptions that underpin their forecasts. Key amongst these

assumptions are that (1) for most countries, real effective exchange rates remain constant at their average levels over the January 30-February 27, 2008 period; (2) that established policies (fiscal and monetary) be maintained; and, (3) that the average price of oil, measured as the simple average of prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil, will be US\$95.50 in 2008 and US\$94.50 in 2009, and remain unchanged in real terms over the medium term. In addition, there are a number of working hypotheses concerning various deposit rates in the world's financial sectors. The interested reader should consult the *Outlook* for further detail. Any real deviations from above assumptions have the potential to affect the reliability of the projections.

There are several downside risks and uncertainties that may hamper economic performance:

Chief among such uncertainties is the ultimate impact, or impacts, of the still unfolding financial crisis. As mentioned earlier, the problems of this sector have spread to affect real activity and the final impacts are as yet unknown.

In addition, beyond the deep correction taking place in the U.S. housing market is the possibility that housing prices may adjust downward significantly in other advanced economies. Housing may now play a more marked role in the business cycle, with linkages tied back to consumer wealth and confidence.

Another potential vulnerability is commodity prices. Surging commodity prices have contributed to the strong performance of almost all commodity-based economies in recent years. However, according to the IMF, commodity prices have fallen, on average, some 30 percent during significant global slowdowns over the past 30 years. The effects of a serious fall in commodity prices would likely be significant and negatively impact growth for commodity producing countries.

While falling prices will have their impacts, so too will rising prices. Even though faced with the prospects of a global slowdown, many of the devel-

oping economies find themselves beset by inflation pressures, particularly in food and oil prices. Therefore, at the very time when preparations for counter-cyclical measures would seem warranted, many leading developing economies find themselves trying hard to take the edge off inflation.

Lastly, although the IMF projections account for a minor recession in the United States economy, a more pronounced or prolonged recession would increase vulnerabilities across global economies.

On the upside, should the United States perform more strongly than projected, vulnerabilities would be reduced. There is also some upside potential from the projections for domestic demand in the emerging economies, which would help attenuate negative spillovers from the advanced economy business cycle.

Overview of World Trade Developments

The value of world merchandise trade increased by 14.8 percent in U.S. dollar terms while the value of services trade grew by 17.8 percent in 2007¹. At these rates, the rate of expansion in services exports was much faster than in 2006 and exceeded the growth rate for merchandise trade. Much of the acceleration in services was due to exchange rate movements and, in some cases, to higher costs of transportation fuels. Europe, with its appreciating currencies accounts for a larger share of services than merchandise exports.

Weaker demand in the developed countries provided a less favourable framework for the expansion of international trade in 2007 than in preceding years. In real terms, growth in world merchandise trade slowed to 5.5 percent, down from 8.5 percent in 2006, and is projected to grow even more slowly in 2008 — at about 4.5 percent. The three percentage point drop brought real merchandise export growth back to the average annual rate of trade expansion recorded over the 1997-2007 period. Notwithstanding the reduction, real growth in trade exceeded real global output growth by about 2 percentage points.

The variation in real trade growth between regions remained large, reflecting marked differences in economic activity and relative price movements. Major terms-of-trade gains² continued in countries and regions exporting primary fuels or minerals. More

recently, net-food exporters have also enjoyed gains from favourable terms-of-trade movements.

Merchandise trade

Trade values (nominal trade)

In nominal terms, world merchandise exports rose by 14.8 percent in 2007 to US\$13.9 trillion — slightly lower than the 15.5 percent rate registered a year earlier (Table 2-1). About two-thirds of the increase in the dollar value was due to price appreciation.

The highest rates of growth for both merchandise exports and imports were recorded for the Commonwealth of Independent States (CIS) region³. This region benefited from strong domestic demand, increases in FDI inflows, and favourable relative price movements over the past few years. Imports into the region were up by more than a third over 2006 levels while exports were up by nearly a fifth.

High commodity prices, especially those for oil and metals, were at the root of the strong expansion of South and Central America's trade performance in 2007. While exports advanced by 14.9 percent, imports were up by even more, at 25.6 percent. Brazil, which accounts for about one quarter of the region's imports and one-third of the region's exports, helped lead the advances. Chile, Argentina, Colombia, and Peru also registered strong growth in both exports and imports, while imports into Venezuela jumped some 44.5 percent.

1 Data used in this chapter are taken from the World Trade Organization Press Release PRESS/520/Rev.1 entitled *World Trade 2007, Prospects for 2008*. 17 April 2008. All data are expressed in U.S. dollar terms and rates of growth are calculated from these data. Services data include transportation services, travel services, and commercial service, but exclude government services.

2 The expression "terms of trade" refers to the ratio between export prices and import prices.

3 This region comprises Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, the Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

TABLE 2-1
World Merchandise Trade by Region and Selected Countries (US\$ billion and %)

	Exports				Imports			
	2007	2007	2006	2007	2007	2007	2006	2007
	Value	Share	Annual growth		Value	Share	Annual growth	
World	13,898.0	100.0	15.5	14.8	14,211.0	100.0	14.5	14.4
North America	1,853.8	13.3	13.3	10.7	2,704.4	19.0	11.2	6.3
United States	1,163.2	8.4	14.6	12.2	2,017.0	14.2	10.7	5.2
Canada	418.5	3.0	7.6	7.8	389.7	2.7	10.9	9.0
Mexico	272.0	2.0	17.1	8.6	296.6	2.1	15.7	10.6
Central and South America¹	495.6	3.6	21.2	14.9	454.6	3.2	21.5	25.6
Brazil	160.6	1.2	16.3	16.6	126.6	0.9	23.5	32.1
Europe	5,768.8	41.5	13.1	15.9	6,054.6	42.6	14.5	15.6
EU(27)	5,312.6	38.2	12.9	15.7	5,452.2	38.4	14.6	15.3
Germany	1,326.5	9.5	14.1	19.7	1,059.4	7.5	16.7	16.8
France	552.2	4.0	7.0	11.4	613.2	4.3	7.5	13.2
Italy	491.5	3.5	11.7	17.9	504.6	3.6	15.0	14.0
U.K.	435.6	3.1	16.7	-2.9	617.2	4.3	17.0	2.7
CIS	507.8	3.7	25.0	19.3	377.2	2.7	30.6	33.6
Russia	355.2	2.6	24.7	16.9	223.1	1.6	31.3	35.4
Africa	421.9	3.0	18.8	15.2	355.1	2.5	13.9	22.4
Middle East	720.9	5.2	21.4	9.6	461.8	3.2	12.5	22.5
Asia	4,129.0	29.7	16.9	15.5	3,802.9	26.8	15.4	14.1
China	1,217.9	8.8	27.2	25.7	955.8	6.7	19.9	20.8
Japan	712.8	5.1	8.8	10.2	621.0	4.4	12.6	7.1
India	145.2	1.0	21.3	20.2	216.7	1.5	22.7	23.6
NIEs	1,266.9	9.1	13.9	10.8	1,210.2	9.5	15.1	11.4

1 Includes the Caribbean.

Source: WTO Statistics, April 2007

Europe was the only major region reporting an acceleration in exports from 2006 to 2007. Within the EU, gains were widespread and were most notable, in terms of percentage increases, for some of the newer members such as Slovakia (up 38.8 percent), Latvia (up 34.0 percent), Slovenia (up 29.2 percent), and the Czech Republic (up 29.0 percent). However, Germany alone accounted for 30 percent of the absolute value of the increase, with the Netherlands, Italy, and Belgium accounting for another 30 percent of the gains. Both the U.K. and Luxembourg saw their merchandise exports to the world fall between 2006 and 2007.

European import growth was only slightly below the rate for exports, at 15.6 percent. Imports were

up across all countries with growth rates ranging from 2.7 percent for the U.K. to 48.5 percent for Montenegro. This growth in nominal trade values (i.e., exports and imports) is largely attributed to the strong appreciation of European currencies vis-à-vis the U.S. dollar.

In a number of ways, 2007 was the year of China. First, for the first time, Chinese trade (exports + imports) exceeded the combined trade of Japan and Korea, the second and third largest merchandise traders in Asia. Second, China replaced Canada for the first time as the largest supplier of merchandise imports into the United States. And finally, China replaced the United States as the second largest merchandise exporting nation in the world, behind

Germany. For the year as a whole, Chinese exports advanced by nearly a quarter of a trillion dollars, or up by over a quarter from 2006 levels.

India, with export gains of 20.2 percent, also experienced strong export growth. Elsewhere across the major Asian economies, export growth was more subdued with exports from Japan expanding by 10.2 percent while those of the four Asian newly industrialized economies (NIEs — Hong Kong (China), Korea, Singapore, and Taiwan) experiencing a 10.8 percent increase in their exports. The situation was much the same for Asian regional imports as it was on the exports side.

For the first time since 2002, Africa's merchandise exports rose less quickly than its imports. In contrast, South Africa, the region's largest trader, reported slower import growth and faster export growth.

A sharp deceleration in U.S. import growth in combination with slowing import growth in Canada and Mexico held North American imports to a 6.3 percent increase in 2007. North American exports increased faster than imports, at 10.7 percent, but decelerated from their 2006 pace. Canada recorded a slight acceleration in export growth from 2006 to 2007, although some of that performance can be attributed to the appreciation of the Canadian dollar when Canadian trade data are converted into U.S. dollar figures, whereas both the U.S. and Mexico experienced slower growth in their nominal merchandise exports last year.

Trade volumes (real trade)

The regions that exhibited the most robust trade performance in real terms in 2007 were the Commonwealth of Independent States and South and Central America (including the Caribbean). These regions increased their real imports by 18-20 percent, more than 3 times the global average in 2007. South and Central American export volumes were up by 5 percent while those of the CIS increased by 6 percent.

Africa and the Middle East have benefited from the relative price changes of the past few years in that more than half of their merchandise exports are resource products, but export volumes were nearly stagnant. At the same time, these regions increased their import volume by some 12.5 percent.

Real exports from Asia outpaced real imports — 11.5 percent versus 8.5 percent. Within the region, large variations were registered on the import side, with China and India recording double-digit import growth while Japan eked out a 1 percent increase. The trade performance of the Asian NIEs⁴ was somewhat less vigorous than that of the region as a whole, but still recorded an excess of export growth over import growth.

Europe's real merchandise export growth of 3.5 percent was balanced off by import growth of 3.5 percent, as this region's trade performance lagged behind the global rate of expansion in volume terms. This has been the case for Europe since 2002. Individual trade performance varied widely by country in 2007 with most of the new EU members and Turkey experiencing growth in real exports and real imports in excess of 10 percent. A second group, comprised of Germany, the Netherlands, Austria, Belgium, and Switzerland registered trade growth of about 5 percent. A third group's trade, represented by countries such as France, Spain, Ireland, and Malta, was almost stagnant.

Finally, real merchandise exports from North America kept pace with world exports in 2007, at 5.5 percent, and more than double the 2.5 percent rate of growth for imports into the region. The excess of regional export growth over import growth is attributed to U.S. trade performance, as import volumes into the U.S. expanded by only 1 percent while exports rose by 7 percent. Canada and Mexico, two net exporters of resource products with currencies strongly appreciating against the U.S. dollar, increased their merchandise imports much faster than exports.

4 The four newly industrialized economies (NIEs) of Hong Kong (China), Korea, Singapore, and Taiwan.

Prices and exchange rates

Developments in relative prices and exchange rates affected the pattern of trade in 2007. Prices of metals, fuels, food and beverages, and other commodities were on the rise and all made headline news at one time or another during the year. Prices for metals, which had risen by more than half in 2006, continued to rise to new record levels in the first half of 2007 before falling back during the second half. For the year as a whole, prices increased by 18 percent for metals, by 15 percent for food and beverages, by 10 percent for fuels, and by 5 percent for agricultural raw materials⁵.

Export prices of manufactured goods were estimated to have increased by 9 percent in 2007, but rates varied widely by individual countries. For example, the WTO puts German manufacturing export prices rising by 10.2 percent, those for the U.S. rising by 3.2 percent, those for Japan edging up marginally, and those for Korea declining slightly. China's export unit value index for manufactured goods rose by nearly 5 percent in 2007. Moreover, different types of manufactured goods experience different price movements. Export prices for iron and steel products rose at double-digit rates, while prices for office and telecom equipment exports were estimated to have fallen. Export prices for chemicals were estimated to have risen faster than the average for all manufactured goods, while prices for automotive products increased at a slower rate.

Overall, prices of manufactured goods were less strong than those of primary products for the fourth consecutive year. Consequently, the shifts in relative prices had significant impacts on regional unit export values (prices), which ranged from increases of about 10 to 13 percent for Africa and the Middle East and the CIS regions to between 4 percent and 5 percent in Asia and North America.

Additionally, exchange rate developments in 2007 had significant impacts on the dollar price levels of internationally traded goods. The U.S. dollar depre-

ciated strongly (in terms of annual averages) against the major European currencies and the currencies of major exporters of resource products, such as Canada, Australia, and Russia. In Asia, the currencies of Hong Kong (China) and Taiwan remained relatively little changed against the U.S. dollar, while those of India, Thailand, and the Philippines appreciated by about 10 percent. The Chinese renminbi, or yuan, which is on a limited float against the U.S. dollar, appreciated by about 5 percent against that currency. According to the WTO, the combination of an export structure largely concentrated on electronics and other manufactures and a moderate average appreciation of the Asian currencies against the U.S. dollar kept Asian export price increases at about half the world average in 2007. In contrast, European export prices were estimated to have increased at double-digit rates, largely due to exchange rate changes.

Leading merchandise traders

After taking into account the annual variation in trade, there were a number of changes to the listings of the top individual exporting and importing countries (Table 2-2). As mentioned above, the United States was displaced by China as the second largest merchandise exporting nation. Italy recorded a strong export performance in 2007, as exports climbed by 17.9 percent above 2006 levels. In contrast, the U.K. experienced a decline in their exports from 2006 to 2007. As a result, Italian exports surpassed those of Great Britain, and Italy moved into the 7th spot in the list of leading exporters, while the U.K. fell to 8th place. Similarly, Belgian exports grew by 17.8 percent in 2007 in comparison to the 7.8 percent registered by Canada. With this performance, Belgium moved from the 10th position to the 9th, switching places with Canada.

There were two instances of switching places between the listings of top importers between 2006 and 2007. Again, faster import growth rates allowed Japanese imports to surpass those of the

⁵ According to the WTO press release quoting IMF statistics.

TABLE 2-2
Leading Exporters and Importers in world merchandise trade, 2007 (US\$ billions and percent)

2007 Rank	2006 Rank	Exporters	2007 Value	2007 Share	2007 Rank	2006 Rank	Importers	2007 Value	2007 Share
1	1	Germany	1,326.5	9.5	1	1	United States	2,017.0	14.2
2	3	China	1,217.9	8.8	2	2	Germany	1,059.4	7.5
3	2	United States	1,163.2	8.4	3	3	China	955.8	6.7
4	4	Japan	712.8	5.1	4	5	Japan	621.0	4.4
5	5	France	552.2	4.0	5	4	United Kingdom	617.2	4.3
6	6	Netherlands	550.6	4.0	6	6	France	613.2	4.3
7	8	Italy	491.5	3.5	7	7	Italy	504.6	3.6
8	7	United Kingdom	435.6	3.1	8	8	Netherlands	490.6	3.5
9	10	Belgium	432.3	3.1	9	10	Belgium	415.8	2.9
10	9	Canada	418.5	3.0	10	9	Canada	389.7	2.7

Source: WTO Statistics, April 2007

U.K. and for Belgium imports to surpass Canadian imports. As a result, Japan became the 4th largest importer in 2007 just edging out the U.K., which fell to 5th place, and Belgium moved to 9th spot from the 10th position, again switching places with Canada.

Services trade

World services⁶ exports climbed by almost a half-a-trillion dollars to reach US\$3.3 trillion in 2007, a 17.8 percent increase over 2006 (Table 2-3). This was an acceleration from the 12.0 percent growth registered the year before and was significantly above the 11.9 percent annual average over the 2000-2007 period. At this value, services were equivalent to a little less than a quarter of world merchandise exports (23.4 percent).

Among the three broad sub-categories that comprise services, transportation services and travel services accounted for a little under 22.8 percent and 26.5 percent, respectively, of all services exports in 2007 (Table 2-4). Commercial services made up the remaining 50.7 percent of the services category. Of the three sub-categories, commercial services expanded the fastest in 2007, at 19.4 percent,

followed by transportation (18.3 percent), and travel (14.4 percent).

Most regions recorded an acceleration in their growth of services exports and imports. The exception to this was the Middle East, where both exports and imports grew at a slower pace than in 2006, and North America, where services trade recorded the weakest export and import expansion of all the major regions. Growth rates were below the world averages for Mexico, Canada, and the United States. A deceleration in the growth of U.S. services imports was responsible for a slight decline in the region's overall rate of expansion of services imports, while the slowdown in the U.S. economy was a key factor limiting the expansion of Canada's services exports.

Growth was most robust for the CIS and African regions, followed by Asia and Europe. All these regions registered growth rates above the world averages for both services exports and imports. Central and South America (including the Caribbean) experienced an acceleration in services activity, however export growth, at 16.3 percent, came in below the world average.

⁶ In order to avoid possible confusion between discussions of services trade in this section and in Chapter 4 later on, we have adopted the Statistics Canada nomenclature for services. That is, what the WTO calls "commercial services", we call "services" or "all services" and what the WTO calls "other commercial services", we simply call "commercial services". The two remaining categories, transportation and travel, remain the same.

TABLE 2-3
World Services Trade by Regions and Selected Countries (US\$ billions and percent)

	Exports				Imports			
	2007 Value	2007 Share	2006 Annual growth	2007 Annual growth	Value 2007	2007 share	2006 Annual growth	2007 Annual growth
World	3,257.3	100.0	12.0	17.8	3,059.1	100.0	11.3	16.4
N. America	533.0	16.4	9.4	12.9	439.9	14.4	9.5	9.3
U.S.	454.4	13.9	10.0	14.2	335.6	11.0	9.3	8.8
Canada	61.2	1.9	7.1	5.9	80.0	2.6	11.2	11.5
Mexico	17.4	0.5	1.7	6.4	24.3	0.8	6.8	8.9
Central & S. America¹	90.6	2.8	12.6	16.3	96.5	3.2	14.6	18.4
Brazil	22.5	0.7	20.8	25.4	33.6	1.1	21.2	23.9
Europe	1,662.0	51.0	10.0	18.6	1,443.8	46.9	9.1	17.4
EU(27)	1,512.1	46.4	10.3	18.6	1,337.3	43.7	9.3	17.3
Germany	197.3	6.1	11.6	18.2	245.4	8.0	6.2	15.0
France	130.4	4.0	-0.3	10.9	120.1	3.9	2.2	12.3
Italy	108.9	3.3	10.3	12.1	116.7	3.8	11.0	19.0
U.K.	263.4	8.1	9.7	16.6	193.3	6.3	6.8	13.1
CIS	64.2	2.0	23.3	25.1	89.6	2.9	16.4	28.9
Russia	38.3	1.2	24.1	24.8	56.9	1.9	15.3	30.2
Africa	83.9	2.6	19.1	21.4	97.2	3.2	14.0	19.3
Middle East	78.6	2.4	16.4	15.4	124.5	4.1	19.1	16.8
Asia	745.0	22.9	16.7	19.1	777.6	25.4	14.0	17.1
China	126.7	3.9	23.7	38.6	128.9	4.2	20.6	28.5
Japan	135.6	4.2	13.6	10.6	157.4	5.1	8.6	9.3
India	86.4	2.7	35.2	15.1	78.1	2.6	32.6	23.8
NIEs	242.9	7.5	13.4	15.4	230.1	7.5	12.6	14.7

1: Includes the Caribbean.

Source: WTO and author's calculations.

Among the major nations, China and Brazil posted the fastest growth in services exports, at 38.6 percent and 25.4 percent, respectively. They were also the fastest growing import destinations too, at 28.9 percent and 23.9 percent, respectively. Germany and the U.K. reported notable increases in services exports in 2007, with exports expanding by 18.2 percent for the former and by 16.6 percent for the latter. Similarly, India and Italy experienced strong growth in their services imports last year, at 23.8 percent and 19.0 percent, respectively.

TABLE 2-4
World exports of services in 2007 (US\$ billions and percent)

	Value	2007 share	2007 growth
All services	3,257.3	100.0	17.8
Transportation	742.1	22.8	18.3
Travel	862.3	26.5	14.4
Commercial services	1,652.8	50.7	19.4

Source: WTO and author's calculations.

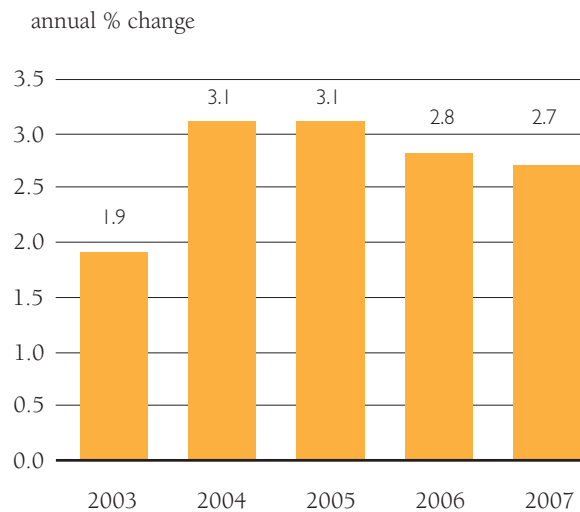
Canadian Economic Performance

Gross domestic product

Canada's real gross domestic product (GDP) growth continued at a solid pace in 2007, with consumer spending driving the 2.7 percent increase. This was a slight deceleration from the 2.8 percent rate of growth in 2006 and matched the average growth for the past five years. However, the economy experienced a sharp deceleration in the fourth quarter stemming from the slow-down in the U.S. economy, and the outlook is for slower growth in 2008.

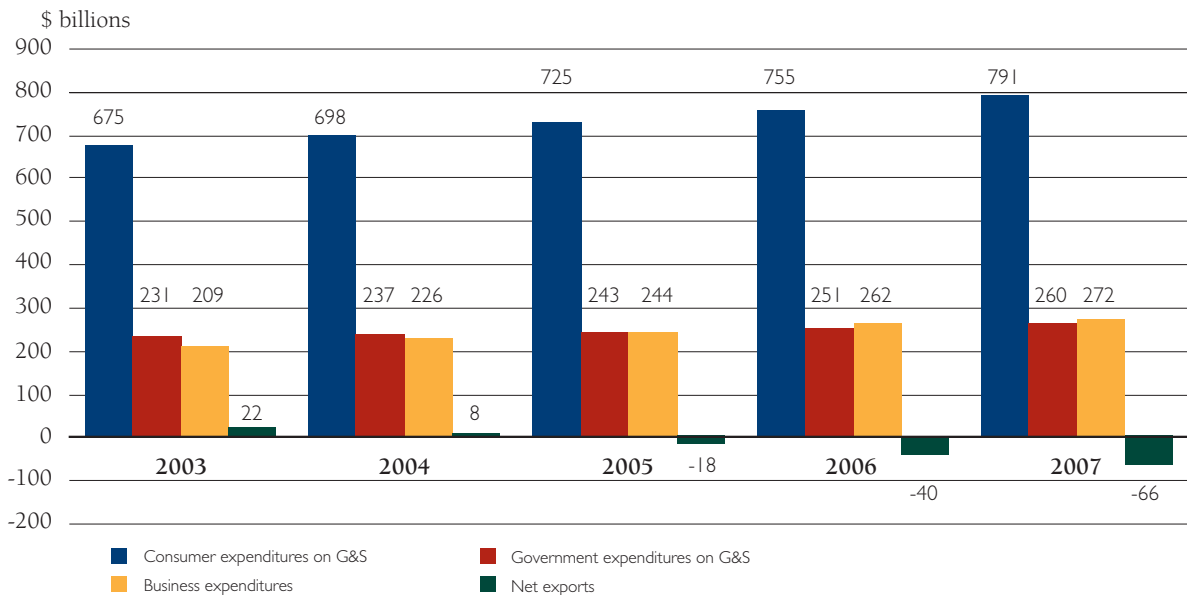
All real expenditure-based categories of GDP advanced in 2007, with the exception of real net exports (Figure 3-2). **Real personal expenditure on consumer goods and services** was the strongest contributor, advancing 4.7 percent in 2007, its

FIGURE 3-1
Canadian Real GDP Growth, 2003-2007



Source: Statistics Canada

FIGURE 3-2
Real Gross Domestic Product, Expenditure-Based, 2003-2007 (Billions of Chained 2002 Dollars)



Source: Statistics Canada

best performance since 1985. Labour income (up 6.1 percent) and corporate profits (up 5.8 percent) contributed to that strength. Low inflation and interest rates also helped boost personal consumer spending. **Durable goods** was the fastest growing category of real consumer spending, registering a 7.7 percent increase, the largest since 2002. Purchases of cars, up 7.2 percent in 2007 from 2.1 percent in 2006, helped drive up spending on durable goods. As in 2006, Canadians increased spending on furniture and household appliances, by 5.4 percent in 2007. Spending on **semi-durable goods** also remained strong, up 6.1 percent in real terms. Consumer purchases of clothing and footwear advanced 6.0 percent in 2007, after climbing 8.1 percent in 2006. Real purchases of services grew by 4.5 percent in 2007. The strong dollar made foreign destinations more affordable, so spending on air transportation saw another year of robust growth, advancing 7.1 percent. Overall, consumer spending contributed 2.6 percent to real GDP growth, leading all other categories.

In 2007, **real business investment** contributed only 0.8 percent to economic growth, with investment in non-residential structures exceeding investment in residential structures as a contributor to growth. This happened despite a deceleration in real spending on non-residential structures to 3.9 percent in 2007, down from 12.9 percent in 2006, and an acceleration of real spending on residential structures, up 3.2 percent in 2007 compared to 2.1 percent in 2006. Among the non-residential structures, spending on engineering structures saw the fastest growth (4.7 percent). While decelerating slightly relative to 2006, real business investment in machinery and equipment advanced by a robust 5.1 percent rate in 2007, driven by strong growth in transportation and telecommunication equipment, furniture equipment, and software.

Compared to the previous year, the contribution of **net exports** to real GDP growth was even more negative (-1.6 percent) as growth of real imports (5.7 percent) outpaced growth of real exports (0.9 percent). In nominal dollar terms, the value

of Canadian exports and imports of goods and services reached record levels of \$532.7 billion and \$502.5 billion respectively in 2007, as the nominal trade balance fell to its second lowest point in the last ten years.

Turning to **GDP by individual sectors and industries**, for the seventh consecutive year, real growth in **services-producing industries** (up 3.4 percent) once again outpaced that in goods-producing industries (up 0.8 percent) in 2007. Among the services-producing sectors, finance and insurance, retail and wholesale trade, and construction were the main sectors contributing to growth in 2007. Finance and insurance activities moved ahead 5.4 percent and once again provided significant growth to the economy. Banking activities accelerated 7.5 percent while securities trading jumped 10.2 percent on sustained increases in the volume of transactions on the Canadian stock exchanges. The value added by the retail trade sector advanced by a strong 5.6 percent in 2007. Consumers continued to purchase furniture and computers at a substantial rate. Also, used cars and parts, new car dealers, home electronics, and clothing stores contributed to that strength. Wholesaling activities were up by 4.3 percent, led by home and personal goods as well as building supplies. Construction activities continued to expand (up 4.2 percent) fuelled once again by increases in repair and engineering construction work (up 6.3 percent). Both residential and non-residential construction advanced through the year.

In **manufacturing**, some sectors came under pressure from the rising Canadian dollar, particularly export-sensitive sectors and sectors vulnerable to import competition. For example, real output for textile mills and clothing, and wood products declined by 8.5 percent and 10.7 percent, respectively. In the case of wood products, a significant decline in the U.S. housing market was also a key factor. On the positive side, food manufacturing continued to expand, up 2.2 percent, as did the real output of non-metallic minerals (5.5 percent), fabricated metal products (2.6 percent), machinery

(2.5 percent), and computer and electronic products (3.5 percent).

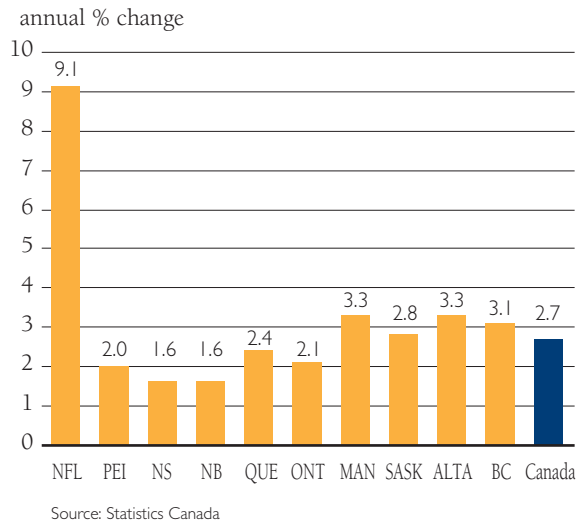
GDP growth by province

GDP growth in five provinces, powered by natural resources, surpassed the national average, with Newfoundland and Labrador more than tripling the national average. Once again, provinces west of Ontario recorded growth rates above the Canadian average of 2.7 percent. However, the variation in the growth rates of the western provinces was less marked than last year. In particular, Alberta's growth has come down from 6.6 percent in 2006 to 3.3 percent last year while Saskatchewan's rate has risen from -0.4 percent to 2.8 percent over the same period. For the fifth year running, both Ontario and Quebec registered growth rates below the national average.

In 2007, Newfoundland and Labrador led all provinces in growth, recording a robust growth rate of 9.1 percent. This was sparked by a sharp jump in mining and oil and gas extraction. Continued expansion of the White Rose project pushed crude oil output upward. The Voisey's Bay mine also increased production, despite a strike, and a new copper and zinc mine opened in the province at Duck Pond. Manufacturing also contributed to this expansion, rebounding in 2007, following three years of decline. All these positive developments were reflected in the province's exports, which advanced by 14 percent in 2007 to register their largest gain since 2002. Corporate profits also went up, propelled by commodity prices, while personal expenditures advanced more strongly last year than previous years, particularly on cars and trucks.

Alberta's GDP growth rate remained strong in 2007, at 3.3 percent, but was at least two full percentage points lower than the rates registered in the past two previous years. A downturn in oil and gas exploration and extraction explained this moderation of growth. However, strong population growth and tight labour markets continued to push up personal income and, in turn, personal spending. Employment growth was the strongest in Canada.

FIGURE 3-3
Real GDP Growth by Province, 2007



Labour income recorded its third year of growth above 11 percent and personal saving remained the highest among the provinces. Also, government investment in structures (which grew at more than 20 percent), robust growth in health, education and public administration services, and government spending on goods and services, supported strong growth of Alberta's economy.

Economic activity in British Columbia decelerated slightly to 3.1 percent in 2007, down from 3.3 percent in 2006, but was still higher than the national average. Strong personal spending, boosted by strong labour incomes and the second-lowest unemployment rate in the country (at 4.2 percent), was the main driver of growth. Advances in services also helped carry the economy in 2007 as growth was widespread. The construction industry increased at a slower rate than in the previous four years, reflecting the completion of several projects related to the Olympic Games and the effects of a slump in housing construction south of the border.

The Saskatchewan economy experienced the fastest turnaround in 2007, growing by 2.8 percent, after contracting (down 0.4 percent) in 2006. Mining, financial services, and retail and wholesale trade were the factors underpinning this growth. Soaring commodity prices were a boon to Saskatchewan's

economy. Potash mining rebounded following a significant decline the year before. Also grain prices boosted crop receipts. The strong housing market stimulated demand for financial services, and accommodation and food and drink services were caught up in the economic momentum. As total employment increased by 2.1 percent — the best result since 1997 — the unemployment rate fell to 4.2 percent, and rising labour incomes stimulated consumer spending on a variety of goods and services. As a result, both retail and wholesale trade climbed up strongly.

Manitoba's economy grew 3.3 percent in 2007, about the same rate as the previous year and above the national average. Construction activity was the main driver, increasing 13.7 percent for the second consecutive year. Large projects included continued expansion of the Winnipeg airport and the Red River floodway. Residential investment did not lag far behind, increasing 5.5 percent — its eighth consecutive rise. Higher economic activity led to a 4.3 percent gain in exports, a 6.4 percent jump in disposable income, and continued low unemployment. As a consequence, personal spending advanced at the fastest pace (5.0 percent) since 1984.

The economic expansion in Ontario, at 2.1 percent in 2007, continued to lag the Canadian average (2.7 percent). Just as the year before, the manufacturing sector experienced a further contraction, with 16 of 21 sub-groups declining. Transportation equipment was the hardest hit with a drop of 2.8 percent. The continued rise of the Canadian dollar against the U.S. dollar combined with a slowdown in the U.S. continued to be a source of weakness for the Ontario economy. As was the case the year before, services industries outperformed goods industries and employment gains in the various service industries (housing resale, stock market activity, banking, and security brokerage) more or less compensated for job losses in manufacturing. As a result, the unemployment rate was fairly steady.

Quebec's economic activity accelerated by 2.4 percent in 2007, from 1.7 percent in 2006. Construction and personal spending boosted the economy. Construction activity was widespread with several large engineering projects, including hydroelectric projects, leading the way. Investment in residential construction grew in 2007, more than offsetting two years of declines. Employment growth was strong as the unemployment rate dropped for the fourth consecutive year. A strong labour income increase (5.8 percent) and a hefty pay equity settlement for government employees helped personal spending grow 4.6 percent, mostly on durables. Strong production of aerospace products and machinery and equipment contributed to a moderate growth of the manufacturing sector.

New Brunswick's economy decelerated to 1.6 percent growth in 2007, down from 3.0 percent in 2006. While manufacturing declined, construction continued to be a force for the New Brunswick economy. Large construction projects, including the Point Lepreau nuclear plant and the Canaport liquefied natural gas terminal in Saint John, boosted non-residential construction investment. Residential construction investment also registered a strong increase with housing starts up. New Brunswick's employment growth was the best among the provinces east of Quebec, which helped push the unemployment rate to a thirty-two year low of 7.5 percent.

The Nova Scotia economy advanced 1.6 percent in 2007, up from 0.9 percent in 2006. The services-producing industries carried the economy forward as both retail and wholesale trade expanded, with positive impacts on consumer spending and labour income.

GDP in Prince Edward Island grew by 2.0 percent in 2007, down from 2.6 percent the previous year. Manufacturing activity expanded by 5.2 percent, and as a consequence, boosted exports and corporate profits. Among the sectors which were a drag on the economy were crop production, non-residential construction and accommodation.

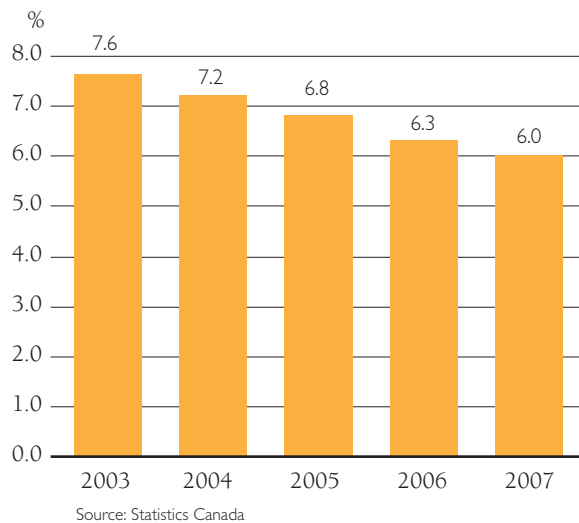
Employment

In 2007, employment creation in Canada was the largest in the last three decades. Employment grew 2.3 percent with 382,100 net new jobs created.

Over three times as many full time jobs were created as part time jobs (293,400 versus 88,600), but growth in part time jobs was faster at 3.0 percent than that of full time jobs at 2.2 percent, in contrast to the two previous years where full time job growth exceeded part time job growth.

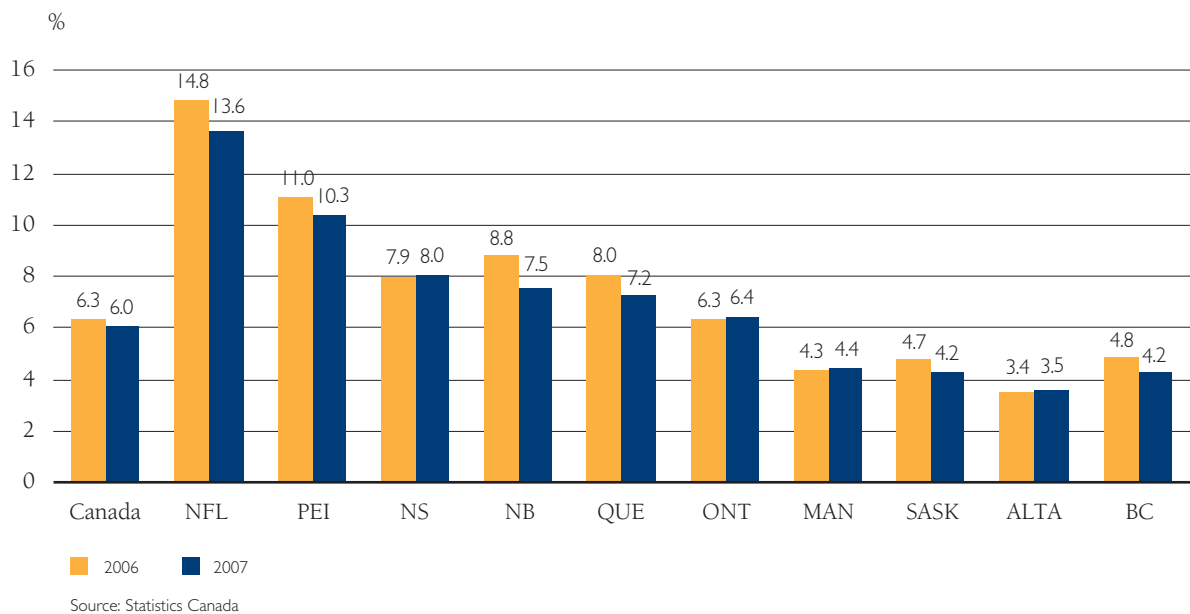
By **province**, for the second straight year, Alberta and British Columbia experienced the fastest job creation at 4.7 percent and 3.2 percent, respectively. Alberta's gains were in full-time employment, primarily in natural resources, construction and a number of service-producing industries whereas those in British Columbia were in construction, utilities, natural resources, and agriculture, as well as service industries such as information, culture and recreation, transportation and warehousing, public administration, and trade. Employment gains were also solid in Quebec (up 2.3 percent) and New Brunswick (up 2.1 percent). Quebec's employment gains were in construction, utilities, accommodation

FIGURE 3-4
Unemployment Rate in Canada, 2003-2007



and food services, and other services. At 1.6 percent, Ontario's employment growth was moderate in 2007, mainly due to weakness in manufacturing, primarily in motor vehicles, body and parts, fabricated metals, and wood products, but also in agriculture, natural resources, and construction.

FIGURE 3-5
Unemployment Rates in Canada and Provinces, 2006-2007



As in previous years, the services-producing sector accounted for most of the employment gains in 2007, with an increase of 3.0 percent (375,100) compared to a modest 0.2 percent increase (7,100) for the goods sector. Within the goods-producing sector, manufacturing experienced another drop in 2007, with employment falling by 3.4 percent (72,800). This was due to a combination of factors, including a surge in the Canadian dollar, higher costs for energy and other materials and stiff competition from other countries. Production of non-durables and of durables reversed roles, with employment in the latter being harder hit (down 4.9 percent or 63,300). Fishing, hunting, and trapping activities experienced the steepest decline in employment of all industries while utilities industries saw a robust year with employment rising by 13.1 percent (16,000). The construction industry continued to thrive in 2007, with employment increasing 6.0 percent (63,800). Within the services-producing sector, accommodation and food services (up 5.4 percent) and information, culture, and recreation (up 5.0 percent) had the strongest employment growth in 2007. Professional, scientific and technical services and health care and social assistance also recorded a strong year growing by 4.3 percent (47,000) and 3.4 percent (60,600), respectively.

In contrast to the two preceding years, the participation rate increased to 67.6 percent. As a result, the employment rate advanced by 0.5 percentage points, as the unemployment rate in Canada reached the lowest level in 32 years, at 6.0 percent in 2007, down from 6.3 percent in 2006.

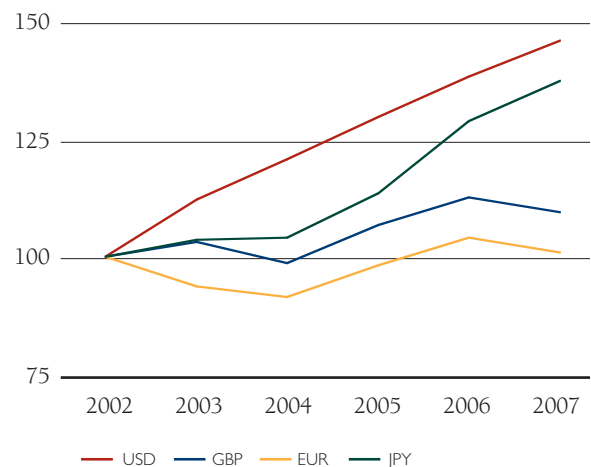
Across the provinces, unemployment rates were more mixed in 2007 than in the two preceding years. Although the national average reached a 32-year low, unemployment increased slightly in Nova Scotia, Ontario, Manitoba, and Alberta. However, there was a great deal of variation in performance. Once again, all provinces east of Ontario experienced higher unemployment rates relative to the national average while those west were lower.

Alberta, Saskatchewan, and British Columbia registered the lowest unemployment rates in 2007, at 3.5 percent, 4.2 percent, and 4.2 percent, respectively. It is also worth noting that four provinces east of Ontario — Newfoundland and Labrador, New Brunswick, Prince Edward Island, and Quebec — experienced the fastest declines in unemployment in 2007.

The dollar

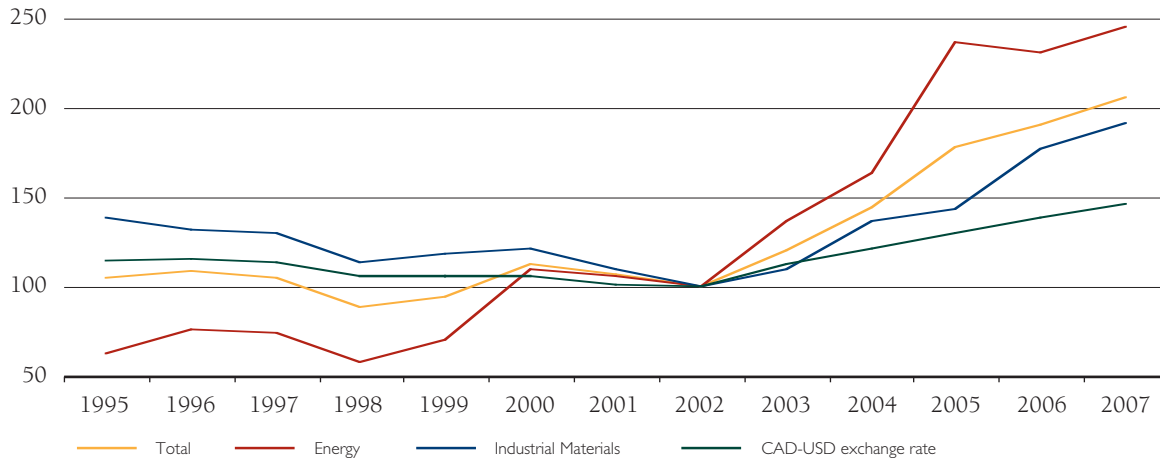
Relative to key currencies, the annual average value of the Canadian dollar appreciated against the U.S. dollar and the Japanese yen in 2007, by 5.5 percent and 6.9 percent respectively in 2007, continuing the trend that began in 2003 (see Figure 3-6). The trend changed however against the euro and the pound with the Canadian dollar depreciating by 3.1 percent and 2.8 percent, respectively, on an annual average basis. The appreciation against the U.S. dollar reflected not only a rise in the commodity prices but also concerns about the outlook for the U.S. economy and, especially, the magnitude of the U.S. twin deficits — current account and budget. Commodity prices have been soaring since 2002, propelled by energy prices and industrial materials (Figure 3-7).

FIGURE 3-6
Exchange Rate Indexes (2002=100)



Source: Bank of Canada

FIGURE 3-7
Commodity Price and Exchange Rate Indexes (2002=100)



Source: The Bank of Canada

Interest rates

Short-term interest rates rose in July 2007 and fell towards the end of the year. As shown in Figure 3-8, the Bank of Canada raised its key policy interest rate by 25 basis points in July 2007, bringing it to 4.50 percent. The fall out of the sub-prime crisis in the U.S. and risk of economic slowdown have led the Bank of Canada to cut the key policy interest rate aggressively since then, although less so than the U.S. Federal Reserve. As of April 22, 2008, the Bank's key policy rate stood at 3.00 percent.

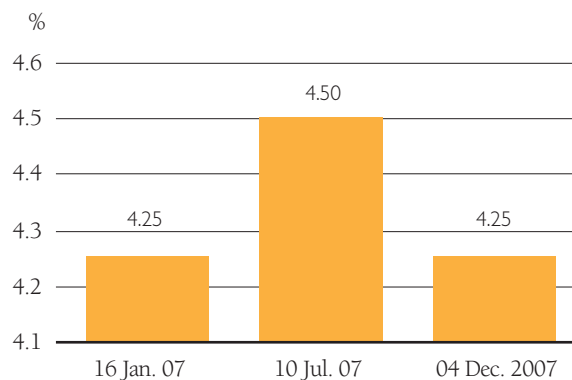
Prices

In 2007, Canadian consumers paid an average of 2.2 percent more than they did in 2006 for the goods and services included in the Consumer Price Index (CPI) basket. The main contributors to this overall increase were increases to homeowners' home and mortgage insurance (up 6.7 percent), mortgage interest costs (up 6.0 percent), homeowners' replacement costs (up 5.9 percent)¹, and other owned accommodation expenses (up 5.8 percent). Other upward contributors were owned accommodation (up 4.9 percent), gasoline

(up 4.5 percent), tobacco products and smokers' supplies (up 4.4 percent), and passenger vehicle maintenance and repair services (up 4.3 percent). On the other hand, declines in passenger vehicles, both purchased (down 1.5 percent) and leased (down 1.3 percent), helped to limit the overall advance in the CPI.

The Core CPI, which excludes volatile items such as energy and food, rose slightly less than the total

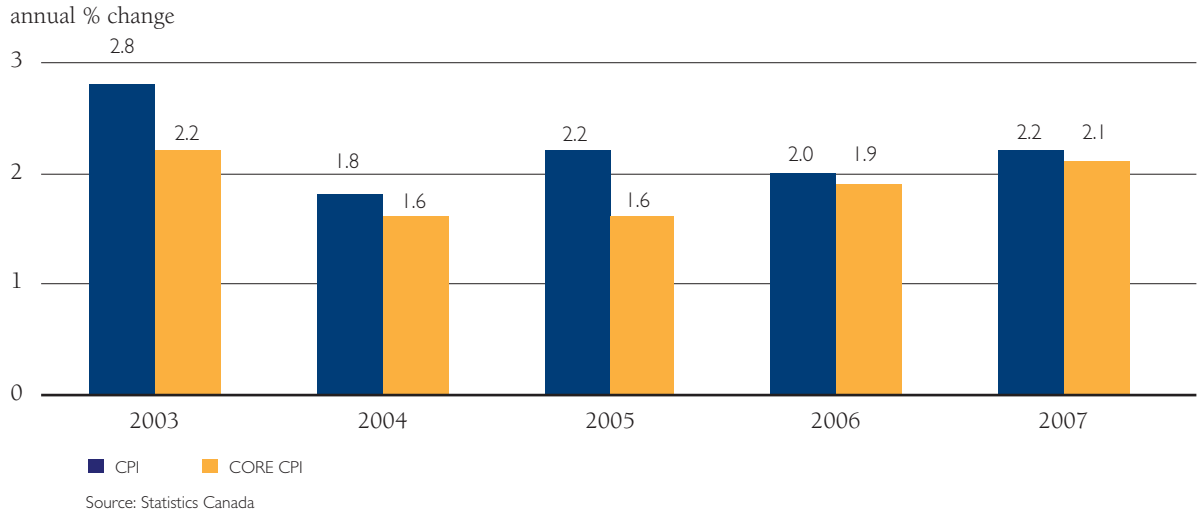
FIGURE 3-8
The Bank of Canada Key Policy Rate



Source: Bank of Canada

¹ The replacement cost is the cost of replacing worn-out structural components of housing, but it is estimated from the price of new homes (excluding land). The increase can be accounted for by the ongoing demand for new houses, fuelled by rising employment and a buoyant economy in the western provinces.

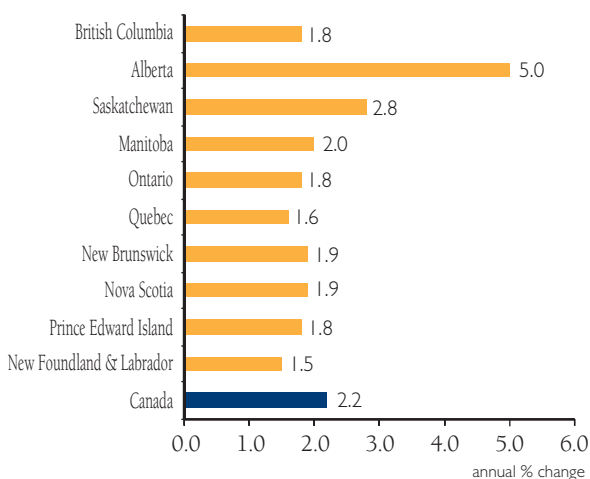
FIGURE 3-9
CPI and Core CPI



CPI, at 2.1 percent in 2007, a 0.2 percentage point increase over the 1.9 percent increase witnessed in 2006 (Figure 3-9).

The rate of inflation eased or remained steady in most provinces, with the exception of New Brunswick and the three provinces west of Manitoba (Figure 3-10). Alberta and Saskatchewan experienced the fastest increase in CPI, reflecting the buoyancy of their economies.

FIGURE 3-10
Provincial CPI



Productivity gap

Productivity growth is key to raising living standards as it is the main source for *per capita* income growth, and closely linked to wage growth. Canada's productivity performance continues to lag our main competitors. Figure 3-11 displays Canada's labour productivity levels relative to those of the United States². In 2007, Canadian labour productivity in the Canadian business sector was only 73.8 percent of U.S. levels, down considerably from its 83.5 percent level in 1994. Similarly, Canadian labour productivity in the manufacturing sector was about 62 percent of U.S. levels, significantly lower than the 90.1 percent achieved in 1994.

There are an increasing number of OECD countries which are also outperforming Canada in terms of productivity growth. Not only are 16 countries of the 20 selected OECD countries outperforming Canada, but thirteen of them outperformed both Canada and the U.S.³ (Figure 3-12).

² Labour productivity is defined as GDP per hour worked, PPP-based. The series are extrapolated based on 1999 benchmarking estimates of the Canada-U.S. labour productivity gap, using labour productivity indexes from Statistics Canada and U.S. Bureau of Labor Statistics.

³ Labour Productivity is measured as real GDP per hour worked.

FIGURE 3-11
Relative Labour Productivity in Canada, 1991-2007

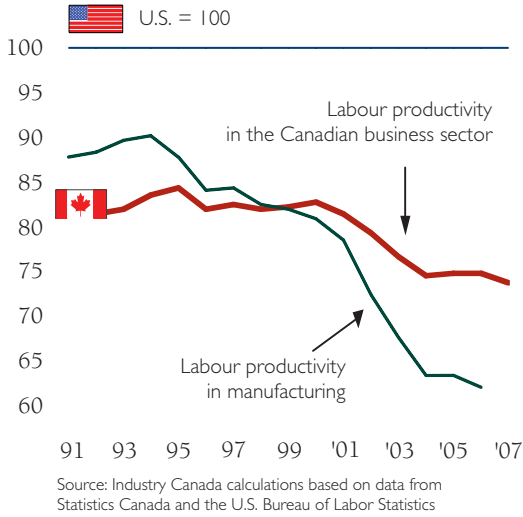
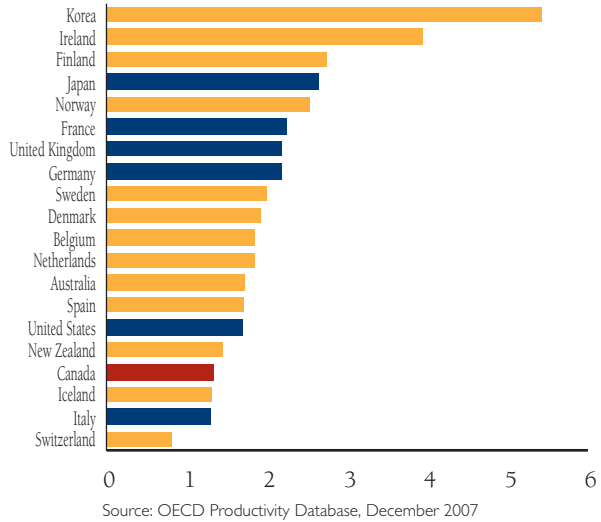


FIGURE 3-12
Labour Productivity: Growth in Selected OECD Countries (1981-2006 average annual growth rate in percent)



Productivity measures the efficiency with which an economy transforms inputs into outputs. Partial measures of productivity consider a single input: labour productivity or capital productivity. Labour productivity is measured as gross domestic product (GDP) per hour worked while capital productivity is measured as GDP per unit of capital. Multifactor productivity (MFP) is a complex measure and consists of GDP per unit of a combined bundle of labour and capital. Growth in labour productivity is closely linked to changes in real labour compensation over time. Growth in labour productivity may come from applying more capital (machinery and equipment, structures) to the production process or from technological change. Productivity can be measured either in level or growth terms. As with GDP, most of the attention is focused on productivity growth and on comparisons of productivity growth across countries.

Overview of Canada's Trade Performance

IV

New highs in commodities prices and in the value of the Canadian dollar, as well as slowing growth in the U.S. were key developments influencing Canadian trade in goods and services in 2007. High commodities prices were the driver behind those exports that led growth performance: industrial goods and materials, agri-food products, and energy products. At the same time, the appreciation of the Canadian dollar *vis-à-vis* the U.S. dollar¹ and slower growth in the U.S., particularly towards the end of the year, were offsetting factors bringing down overall export growth.

Cheaper imports in Canadian dollar terms, as well as the continuing strength in the Canadian economy, led to healthy growth in imports of goods and services. Services imports showed the most marked expansion, as Canadians took advantage of the strong dollar to travel to the United States.

The slowing U.S. economy and the continued strength in emerging market demand led to further diversification of Canada's trade. China replaced Japan as the third most important market for Canadian merchandise exports, and the share of the U.S. in Canada's total goods and services trade now stands at 68.8 percent, compared to 74.0 percent in 2003.

This chapter examines the performance of Canada's goods and services trade, beginning with an overview of the developments in goods and services trade with major partners, followed by an examination of goods trade, a review of services trade, and a brief discussion on the overall current account balance. Finally, merchandise trade with key trading partners is examined in further detail.²

Goods and services

Canada's exports of goods and services grew by 1.9 percent in 2007 to reach \$532.7 billion, as both goods exports (\$465.2 billion) and services exports (\$67.5 billion) hit record highs in value terms. Imports of goods and services outpaced exports of goods and services by a fair margin, expanding 3.2 percent to reach \$502.5 billion, and as with exports, both goods imports (\$415.6 billion) and services imports (\$86.9 billion) established new record values.

Exports and imports of goods and services to or from all principal markets (the U.S., the 27-member European Union (EU), Japan, and the rest of the world) increased, with the exception of exports of goods and services to the U.S. and Japan, which declined (Figures 4-1 and 4-2).

1 The dollar started the year at US 85.8¢; by the end of September it had attained parity with its U.S. counterpart; it peaked in early November at US\$1.09 before settling back at just above parity at year's end. However, based on annual averages, the Canadian dollar appreciated by 5.5 percent, from roughly US 88.2¢ in 2006 to US 93.0¢ last year.

2 The term "goods trade" refers to trade on a Balance of Payments basis in contrast with "merchandise trade" which is used to refer to commodity trade on a Customs basis. Balance of Payments (BOP) data are derived from customs data by making adjustments for items such as valuation, coverage, timing, and residency. Trade data for all individual countries are available on a customs basis only, whereas they are available on a BOP basis for the United States, Japan, and the United Kingdom only.

FIGURE 4-1
Exports of Goods and Services by Major Area, 2003-2007

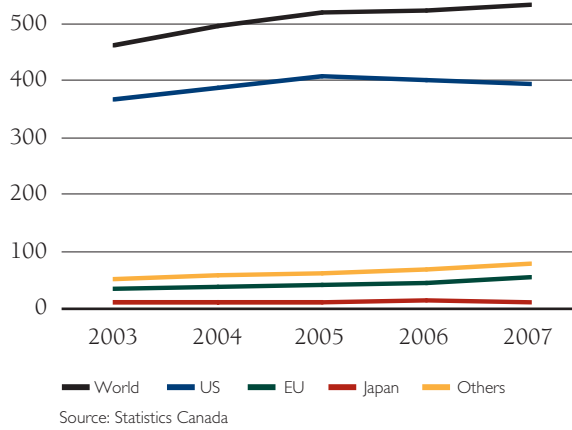
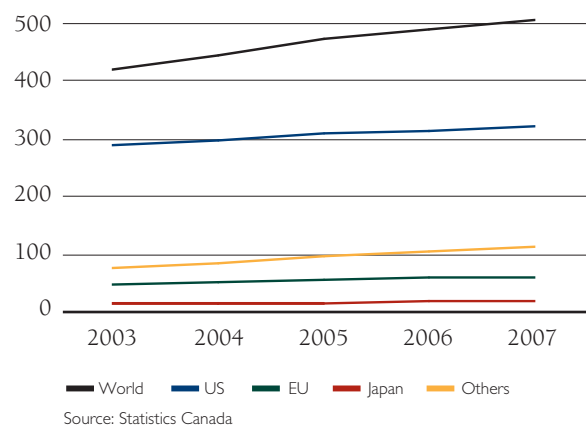


FIGURE 4-2
Imports of Goods and Services by Major Area, 2003-2007



Exports of goods and services to the U.S. fell 1.7 percent to \$391.7 billion, whereas imports of goods and services from the U.S. rose by 2.6 percent to \$320.2 billion (Figure 4-3). The resulting trade surplus with the U.S. narrowed 17.2 percent to its lowest level since 1999, at \$71.5 billion. However, this was still a large enough surplus to more than

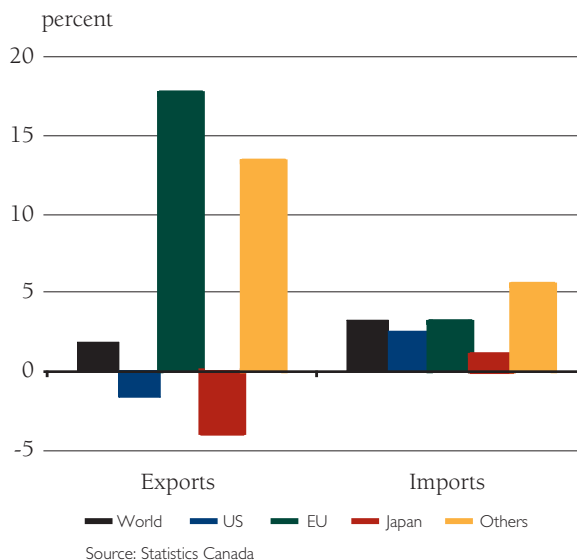
offset Canada's deficit with non-U.S. destinations, leaving Canada's overall trade balance in surplus.

Exports of goods and services to the EU grew by 17.6 percent to \$52.8 billion in 2007, powered by a robust growth in goods exports to the U.K. Growth in exports to the EU outpaced the growth in imports by a wide margin with the latter increasing by only 3.1 percent. Nevertheless, as has been the case since 1983, imports from the EU have exceeded exports, resulting in a trade deficit for Canada. For 2007, that deficit was \$5.0 billion, down by \$6.2 billion from the \$11.2 billion recorded for 2006.

Canadian goods and services exports to Japan retracted 3.9 percent to \$11.5 billion in 2007, while imports of goods and services from Japan increased by 1.0 percent to \$15.3 billion. As a consequence, the trade deficit with Japan was nearly \$3.9 billion for the year.

For the rest of the world, the rate of growth of Canadian exports of goods and services was more than double the growth rate for imports. Exports advanced 13.3 percent to \$76.7 billion while imports grew 5.5 percent to \$109.1 billion in 2007. For the first time since 1995, the trade deficit with

FIGURE 4-3
Growth in Exports and Imports of Goods and Services by Major Area, 2007



REGIONAL SHARES OF CANADA'S TRADE IN GOODS AND SERVICES, 2003 AND 2007 (PERCENT)

	Exports		Imports		Total Trade	
	2003	2007	2003	2007	2003	2007
World	100.0	100.0	100.0	100.0	100.0	100.0
U.S.	79.1	73.5	68.2	63.7	74.0	68.8
EU	7.5	9.9	11.3	11.5	9.3	10.7
Japan	2.4	2.2	3.2	3.1	2.8	2.6
Other OECD	3.6	4.4	5.7	5.7	4.6	5.1
Non-OECD	7.5	10.0	11.6	16.0	9.4	12.9

Diversification of Canada's trade

Over the past five years, the share of the United States in Canada's trade has declined quite markedly, although the U.S. is still by far our largest trading partner. U.S. shares in both exports and imports of Canadian goods and services have declined by about 5 percentage points, bringing the U.S. share in our total trade to

68.8 percent. Japan's share in Canada's trade has also declined, although only slightly. The EU has gained share, principally on the exports side. But the biggest gainer in share has been the rest of the world, particularly the non-OECD countries, now accounting for 12.9 percent of total Canadian trade, a 3.5 percentage point increase in the past five years.

the rest of the world narrowed, falling to \$32.5 billion last year, compared with \$35.8 billion in 2006.

With imports of goods and services outpacing exports of goods and services (3.2 percent versus 1.9 percent), the overall balance on Canadian goods and services trade narrowed by \$6.0 billion in 2007 to \$30.2 billion. Both the goods balance (down \$1.7 billion) and the services balance (down \$4.3 billion) retracted, as imports grew faster than exports for both the goods and services components. The deterioration in the deficit on services trade was more than double the decline in the goods surplus.

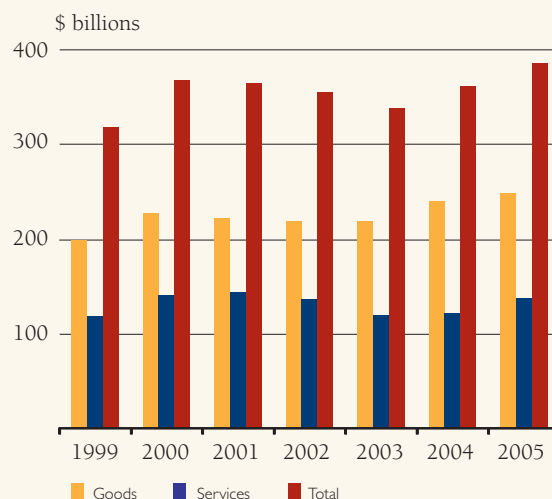
Operations abroad by Canadian foreign affiliates

Canadian goods and services are not only sold abroad as exports, but also through foreign affiliates of Canadian companies. Sales by foreign affiliates (FA) of Canadian businesses¹ are equivalent to approximately three-quarters of the value of Canadian exports of goods and services. These sales abroad are another measure of Canadian interests abroad, and bring important benefits to Canada. These benefits may come not only in the form of repatriated earnings, but also as a means of enabling entry into foreign markets, gaining access to new technologies and/or increasing competitiveness through entry into or development of value chains. These sales do not however have the same impact on the Canadian economy as exports in terms of jobs creation or contribution to Canadian economic growth.

Sales of goods and services by foreign affiliates of Canadian businesses rose to \$385 billion in 2005, the most recent year for which data is available. This was an increase of \$25 billion (or 6.9 percent) over the previous year, the second consecutive annual increase following three years of decline. It brought total sales to their highest level since foreign affiliate trade statistics were first compiled in 1999 (Figure 1).

Sales for both goods-producers and services-producers advanced. For goods producers, sales edged up \$9 billion (or 3.7 per cent) to a record \$248 billion while sales for service-producers climbed \$16 billion (or 13.2 per cent) to 137 billion. The retail trade (up \$12 billion), finance (up \$9 billion), manufacturing (up \$5 billion), and mining and oil and gas extraction (up \$4 billion) sectors were the principal contributors to the higher sales. In the manufacturing sector,

FIGURE 1
FA Sales of Goods and Services



higher sales were the result of strength in transportation equipment manufacturing and in primary metal manufacturing.

The geographic distribution of FA sales and employment is summarized in Table 1. The share of total sales of affiliates located in the US has declined from 64.3 percent in 1999 to 56.3 percent in 2005. Two factors help to explain this observation. First, Canadian direct investment abroad has been diversifying away from the United States, consistent with falling share of foreign affiliate sales in the United States in the total. Second, the increase of the Canadian dollar relative to the U.S. dollar translates into lower sales values in Canadian dollars.

On the other hand, the share of sales by affiliates situated in the EU territory expanded from 19.6 percent to 23.3 percent over the same period, also accompanied by a growing share of total affiliate sales in Other OECD and Non-OECD countries.

¹ The data cover only majority-owned foreign affiliates and exclude depository institutions and foreign branches of firms, consistent with the international practice for measuring foreign affiliate trade statistics.

TABLE 1
Geographic distribution of Canadian foreign affiliate sales and employment, 2005

	Sales			Employment		
	\$millions	2004/05 growth (%)	share (%)	'000's	2004/05 growth (%)	share (%)
World	384,955	6.9	100.0	1,029	9.6	100.0
United States	216,717	4.5	56.3	597	10.4	58.0
European Union	89,742	10.3	23.3	211	7.1	20.5
Other OECD	25,659	9.0	6.7	62	6.9	6.0
Non-OECD	52,837	10.8	13.7	159	11.2	15.5

Canadian-owned foreign affiliates employed an additional 90,000 persons in 2005, bringing employment to 1,029,000, an increase of 9.6 percent over the previous year. Retail trade (+35,000), manufacturing (+28,000), mining and oil and gas extraction (+12,000), and finance (+11,000) were the key sectors contributing to the rise in employment over the year.

Over 1999-2005, the share of the U.S. in employment by Canadian foreign affiliates has fallen from over 62 percent to 58 percent. At the same time, the share for countries other than the US and the EU has held fairly steady between 21 and 22 percent. Thus, the EU has captured most of the employment share lost by U.S. affiliates of Canadian operations abroad.

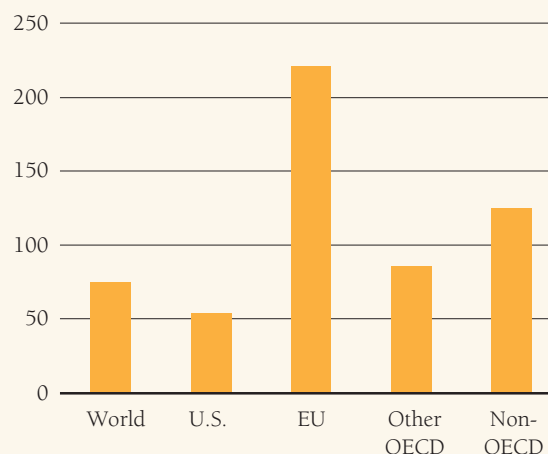
Value of foreign affiliate sales compared to exports

Total sales by foreign affiliates were equivalent to 74.2 percent of Canadian exports of goods and services in 2005 (Figure 2). As Canadian firms are much more likely to serve the U.S. market through exports than through affiliate sales, this share was only 53.4 percent in the U.S. However, foreign affiliate sales play a more important role among Canadian firms serving more distant

markets, with foreign affiliate sales in 2005 at a level more than twice the value of exports to the EU and exceeding the value of exports to non-OECD countries by 25 percent.

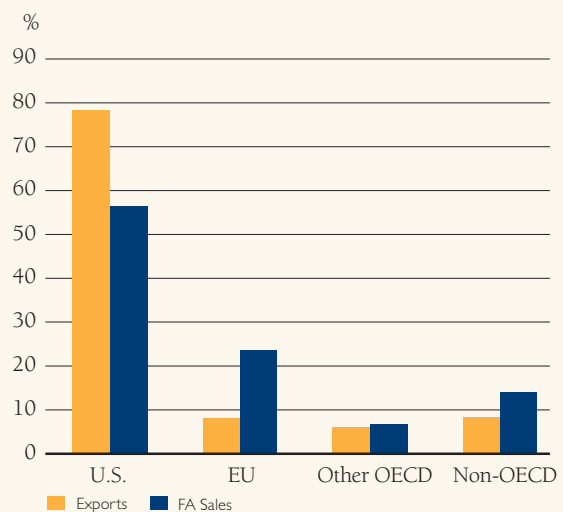
In 2005, the U.S. accounted for 78.2 percent of Canadian world exports, but only for 56.3 percent of foreign affiliate sales (Figure 3). On the other hand, the EU accounted for only 7.8 percent of exports, but a much greater 23.3 percent of foreign affiliate sales. For the non-U.S., non-EU OECD countries, the shares of both exports

FIGURE 2
Foreign Affiliate Sales as Share of Total Exports
(percent of Goods and Services Exports, 2005)



and sales by subsidiaries were fairly similar at around 6 percent. Finally, for the non-OECD countries, sales by affiliates captured about 13.7 percent of total foreign affiliate sales while Canadian exports to the regions were a more modest 8.2 percent of the total.

FIGURE 3
Shares in Canadian Exports and Foreign Affiliate Sales
(percent of total, 2005)



Goods trade

Exports of goods advanced 2.1 percent in 2007 to \$465.2 billion, an increase of \$9.5 billion over 2006 levels. Gains were led by exports to the European Union and the rest of the world. Partly offsetting the gains were declines in exports to the United States and Japan. Imports rose more strongly, by 2.8 percent, or \$11.2 billion.

Exports of goods to the U.S. fell 1.6 percent to \$355.3 billion whereas imports of goods from the U.S. rose by 2.1 percent to \$270.3 billion. The goods surplus with the U.S. thus retracted by about 11.5 percent to its lowest level since 1999, at \$85.0 billion, but was still \$35 billion greater than the Canadian global trade surplus and therefore the key contributor to our overall goods trade balance.

Exports of goods to the EU grew by 20.6 percent to \$39.6 billion in 2007, powered by a robust growth in goods exports to the U.K. The latter was Canada's second largest destination for goods in 2007. By a wide margin, growth in exports to the

EU outpaced the growth in imports (0.5 percent), resulting in a \$6.6 billion reduction in our bilateral goods trade deficit with this region as the deficit fell to \$2.6 billion.

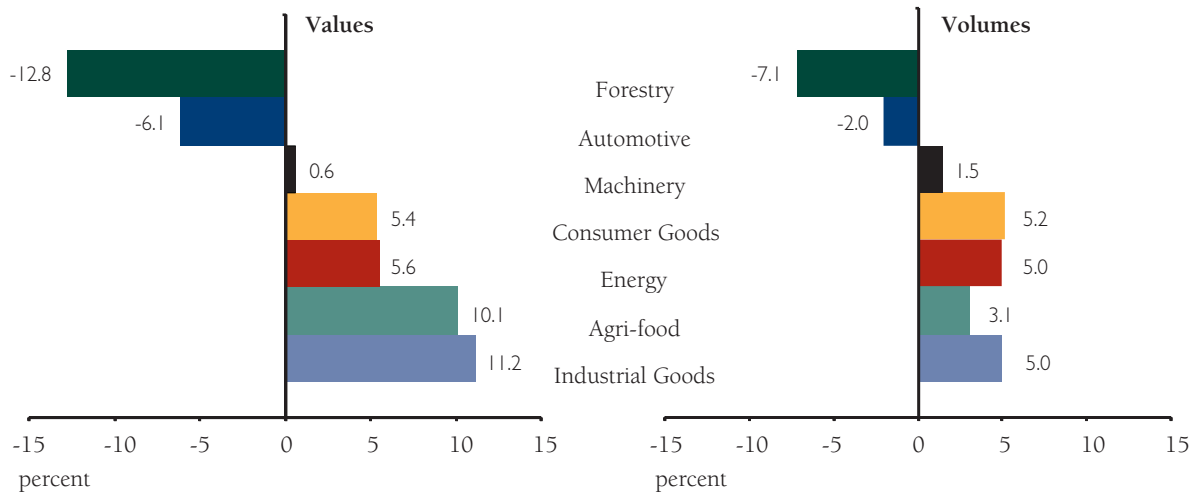
Canadian goods exports to Japan fell by 3.4 percent to \$10.1 billion while imports of goods from Japan increased by 0.8 percent to \$12.0 billion. This resulted in a goods deficit with Japan that was nearly \$1.9 billion.

To the rest of the world, the rate of growth of exports more than doubled the rate for imports as Canadian goods exports advanced by 17.1 percent to \$60.2 billion while imports grew 6.4 percent to \$91.1 billion in 2007. The goods trade deficit with the rest of the world fell, shrinking to \$30.8 billion, compared with \$34.1 billion in 2006.

Sectoral performance of goods trade

As shown in Figure 4-4, with the exception of forestry and automotive products, which fell by 12.8 percent and 6.1 percent respectively, all major categories of exports increased in value terms, led

FIGURE 4-4
Growth in Goods Exports by Major Groups, 2007 (annual percent change)



Source: Statistics Canada

by industrial goods and materials³ and agri-food products. Growth in industrial goods exports was fuelled by the continued strength in both demand and prices for metal ores and alloys, driving up the value and volume of sales. The export value of industrial goods and materials reached \$104.5 billion in 2007, marking a fourth consecutive year of expansion for this category. Rapid industrialisation of Asian emerging economies has played a key role in the increase of prices for primary metals (nickel, copper, zinc, and iron ore).

Exports of agricultural and fish products benefited from resumption of cattle exports to the United States and new markets for wheat and canola. Rising food prices ensured that growth in the value of agri-food exports outpaced the increase in volume by a considerable margin. Energy exports also expanded, largely through increased volume, as the appreciating Canadian dollar offset most of the increase in U.S. dollar-denominated energy prices. The United States remained the biggest consumer of Canada's energy products, while new demand for crude oil from China and Singapore boosted Canada's energy exports to Asia. Consumer goods exports also experienced strong growth.

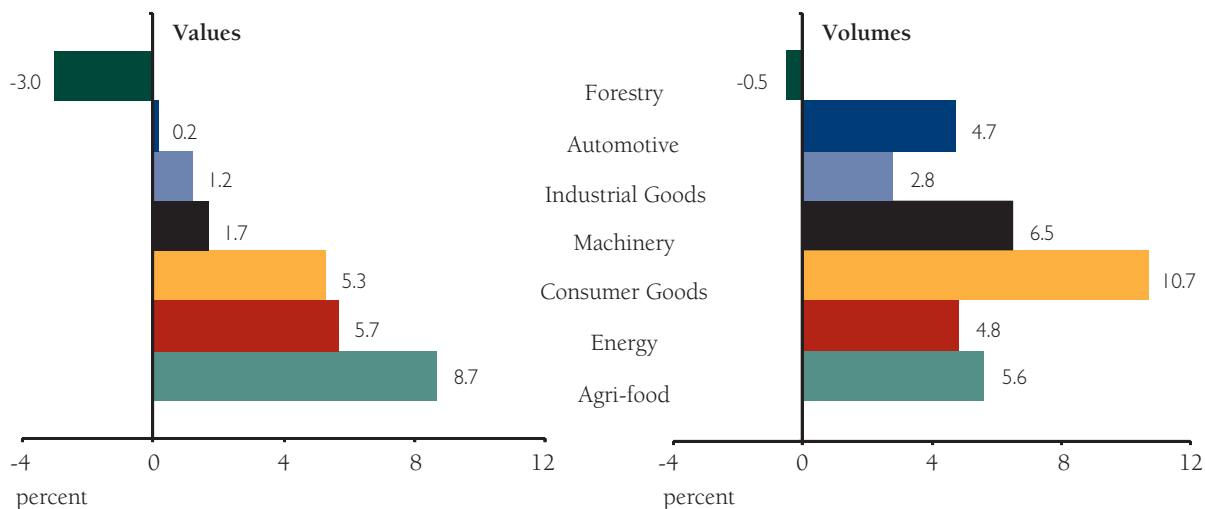
The U.S. accounted for 71.5 percent of Canadian exports of forestry products and 95.3 percent of exports of automotive products, so conditions in that country have affected our exports of these products. Specifically, the deep and ongoing correction in the U.S. housing market has been at the root of a contraction in demand for Canadian lumber from that country and the value and volume of Canadian exports of forestry products have fallen sharply as a result.

Likewise, falling wealth, tighter credit conditions, and moderating labour market conditions along with rising gasoline costs and a weaker U.S. dollar have combined to reduce U.S. demand for Canadian automobiles and trucks, resulting in a 6.1 percent decline in the value of Canadian automotive exports. The volume of automotive exports declined by less, as export prices fell. Machinery exports were virtually flat in value terms, rising slightly more in volume terms, as export prices for this category also fell. Two-thirds of Canadian exporters overall are also importers, and almost half imported more than they exported⁴, so these firms could offset reduced export prices with lower import costs in Canadian dollars.

³ Industrial goods and materials are comprised of metal ores, chemicals, plastics, and fertilizers, and metals and alloys.

⁴ Statistics Canada Catalogue no. 65-208-XIE (2008). International Merchandise Trade: Annual Review 2007.

FIGURE 4-5
Growth in Goods Imports by Major Groups, 2007 (annual percent change)



Source: Statistics Canada

In terms of shares in total goods exports, machinery and equipment (20.5 percent), industrial goods and materials (22.5 percent), energy products (19.7 percent), and automotive products (16.7 percent) together accounted for about 79.3 percent of exports in 2007.

Imports recorded gains across the board with the exception of forestry products, which were down by 3.0 percent in value terms, and virtually flat in volume terms (Figure 4-5). For all categories except energy, falling import prices in Canadian dollar terms meant that volume growth outpaced growth in value. In the cases of automotive, industrial goods, machinery and consumer goods imports, volume growth was at least double the growth in value.

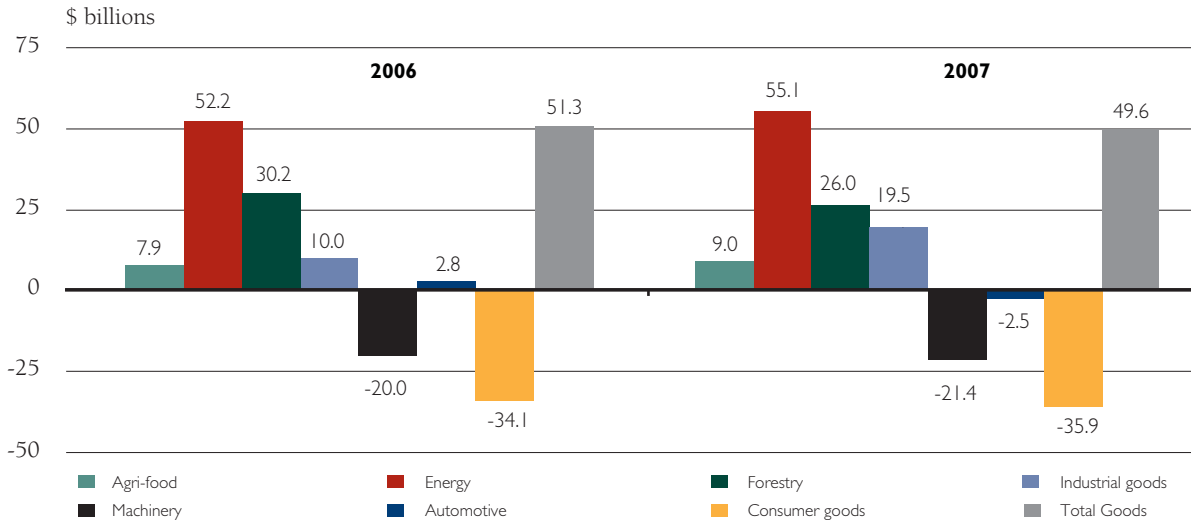
As imports of industrial goods and materials advanced in value only 1.2 percent to \$85.0 billion, the industrial goods trade surplus almost doubled from \$10.0 billion in 2006 to \$19.5 billion in 2007. Imports of consumer goods grew 5.3 percent to \$54.8 billion on the back of strong demand for pharmaceutical products, toys, clothing and house furnishings. This category recorded the largest trade deficit of all sectors in 2007, at \$35.9 billion.

In terms of shares in total imports, four categories — machinery and equipment (28.1 percent), industrial goods and materials (20.5 percent), automotive products (19.2 percent) and consumer goods (13.2 percent) — accounted for more than 80.9 percent of imports in 2007.

Goods trade surplus

After peaking at \$70.7 billion in 2001, Canada's goods surplus has decreased, reaching \$49.6 billion in 2007, its lowest value in eight years. Meanwhile, structural changes have taken place in Canada's trading relationship with the world. As of 2007, the goods surplus was being sustained by gains in energy, industrial goods and materials and agri-food products (Figure 4-6), counterbalancing declines for consumer goods, machinery and equipment, automotive products, and forestry products.

FIGURE 4-6
Goods Trade Balance by Major Groups, 2006- 2007



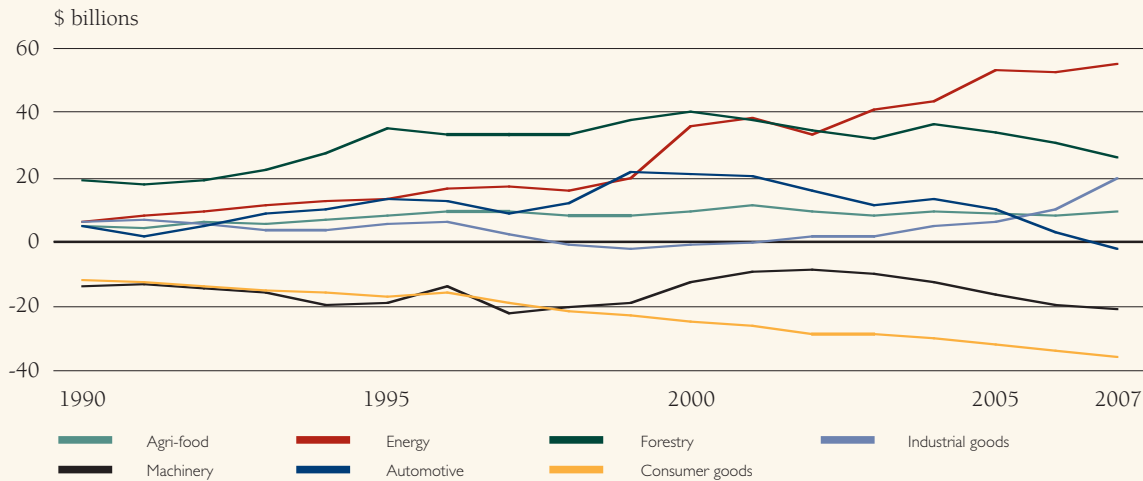
Source: Statistics Canada

The evolution of Canada's trade surplus

Of the seven major categories of goods, three have consistently posted a trade surplus over the past 28 years. These are Canada's traditional resource strengths:

agricultural and fish products, forestry, and energy products. In nominal dollars, the surplus in agricultural and fish products was at its highest point in 2001, at \$10.7 billion. The surplus in

Trade Balance by Major Groups: 1990-2007



Source: Statistics Canada

energy products reached a new high at \$55.1 billion in 2007, whereas the surplus for forestry products peaked in 2000 at \$39.7 billion and has trended down since. The categories in which Canada has always run trade deficits are machinery and equipment and consumer goods, and these deficits have been growing in recent years.

Automotive products and industrial goods and materials are the only sectors that have posted both surpluses and deficits over the course of

the past 28 years. Even these reversals of trend were the exception rather than the rule, and were limited to short periods. In 2007, the auto sector registered its first deficit since 1987, essentially due to a decrease in exports, while imports remained fairly steady. Industrial goods and materials consistently posted surpluses, except for 1998-2001, a period characterized by low metal prices and high steel and chemical imports.

Services Trade

Canadian services exports edged up 0.3 percent to \$67.5 billion in 2007. However, services imports rose 5.5 percent to a record \$86.9 billion. As a result, the deficit in services trade rose to a record \$19.5 billion, up from \$15.2 billion in 2006, a \$4.3 billion deterioration in the trade balance.

The bulk of the increase in the deficit was largely due to the widening deficit in travel services, which reached \$10.3 billion. This deficit has been trending up sharply since 2002, as Canadians take advantage of the strong Canadian dollar to travel to the United States. Broken down into subcategories, both business travel and personal travel deficits dramatically increased. The deficit on transportation also expanded from \$7.1 billion in 2006 to \$7.7 billion in 2007, whereas that of commercial services remained steady. Both the travel and transportation deficits for the year were the highest ever recorded.

By major categories, transportation services exports posted a solid growth (up 2.9 percent), while exports of travel services edged up slightly (0.3 percent). Commercial services was the only category to decline in 2007 (down 0.6 percent) as declines in construction services (down 36.9 percent), research and development (down 8.3 percent), audio-visual services (down 7.0 percent), and other financial services (down 2.0 percent) were only partly offset by gains in communication services and royalties and licence fees, at 4.2 percent and 6.1 percent, respectively.

On the import side, travel and transportation services imports grew by 15.5 percent and 5.3 percent, respectively, while commercial services imports fell by 0.3 percent in 2007. Architectural, engineering and other technical services (down 8.2 percent), communication services (down 7.8 percent), and research and development (down 6.3 percent) were the main contributors to the decline in commercial services while other financial services

TABLE 4-1
Services Trade Balances by Category (\$ billions)

	2005	2006	2007
World			
Services (total)	-12.2	-15.2	-19.5
Travel	-5.4	-6.7	-10.3
Transportation	-5.8	-7.1	-7.7
Commercial services	-1.6	-2.2	-2.3
U.S.			
Services (total)	-9.5	-9.8	-13.5
Travel	-3.2	-4.3	-7.1
Transportation	-1.4	-1.8	-2.3
Commercial services	-5.0	-3.9	-4.3
EU			
Services (total)	-0.9	-1.9	-2.3
Travel	-1.2	-1.3	-1.8
Transportation	-1.1	-1.4	-1.3
Commercial services	1.5	0.8	0.7
Japan			
Services (total)	-0.9	-1.8	-2.0
Travel	0.4	0.4	0.2
Transportation	0.0	-0.1	-0.1
Commercial services	-1.2	-2.1	-2.1

experienced robust growth (at 12.7 percent) limiting the overall decline.

By geographical destination, the service trade deficit with the U.S. widened from \$9.8 billion to \$13.5 billion, while those with the EU and Japan reached \$2.3 billion and \$2.0 billion, respectively (Table 4-1). The increase in the deficit with the U.S. was mainly due to the increase of imports in both travel and transportation services, while the increase in travel imports from the EU was responsible for the widening deficit with that region.

The current account

In addition to goods and services trade discussed above, the current account also includes payments and receipts of investment income and current

transfers. Last year, the current account balance fell to \$14.2 billion from \$23.6 billion in 2006, a reduction of about 40 percent. About two-thirds of the fall in the current account balance was accounted for by the nearly \$6.0 billion decline in the balance on goods and services trade. The remainder of the decline came in net investment income flows as the difference between the profits earned by foreign direct investors versus those earned by Canadian foreign direct investors widened by \$5.9 billion and was only partially offset by a net \$3.8 billion improvement in portfolio investment income flows. The goods trade balance only weakened over the second half of 2007 and Canada's current account posted its first deficit in nine years in the fourth quarter.

Goods and Services Trade in the Economy

Ratios of trade to GDP are used as a measure of openness of economies to trade, or alternatively as a measure of the importance of trade to an economy (these measures should not be misinterpreted as indicating that these percentages of GDP are accounted for by trade: the contribution of trade to GDP in an accounting sense is exports minus imports). Canadian exports of goods and services were equivalent to 34.8 percent of GDP in 2007, and total trade (exports plus imports) was equivalent to 67.6 percent, the second highest ratio in the G8. These ratios have been declining for Canada in recent years, illustrating the limitations of these ratios as a measure of openness to or importance of trade. Their decline in Canada does not indicate that Canada is less open or even less reliant on trade: it is simply the result of the appreciating Canadian dollar and Canada's improving terms of trade. Prices of tradeable goods have declined relative to non-tradeable goods, with the effect that the value of trade is smaller relative to Canada's GDP.

EXPORTS OF GOODS AND SERVICES AS A PROPORTION OF GDP (PERCENT)

	2005	2006	2007
Canada	37.7	36.2	34.8
France	26.0	26.9	26.7
Germany	40.9	45.1	46.8
Italy	26.0	27.8	n.a.
Japan	14.3	16.1	n.a.
U.K.	26.5	28.5	25.9
U.S.	10.5	11.1	11.9
Russia	35.2	33.8	30.3
Mexico	30.0	31.9	n.a.

TOTAL TRADE OF GOODS AND SERVICES AS A PROPORTION OF GDP (PERCENT)

	2005	2006	2007
Canada	71.7	69.8	67.6
France	53.0	55.1	55.2
Germany	76.7	84.7	86.5
Italy	52.0	56.5	n.a.
Japan	27.3	30.9	n.a.
U.K.	56.5	60.6	55.4
U.S.	26.8	28.0	28.8
Russia	56.7	54.9	52.2
Mexico	61.5	65.1	n.a.

TABLE 4-2
Canada's merchandise exports and imports by area

Canada's merchandise exports by area (\$ billions and percent)				
Country	2006	2007	2007 share	2007 annual growth
World	440.3	450.3	100.0	2.3
U.S.	359.3	356.0	79.1	-0.9
U.K.	10.1	12.8	2.8	26.3
China	7.7	9.3	2.1	21.3
Japan	9.4	9.2	2.0	-2.5
Mexico	4.4	5.0	1.1	13.2
Netherlands	3.1	4.0	0.9	32.0
Germany	4	3.9	0.9	-1.8
Norway	1.9	3.7	0.8	95.0
France	2.9	3.1	0.7	8.5
Korea	3.3	3.0	0.7	-7.9
EU	29.2	34.8	7.7	19.4
Canada's merchandise imports by area (\$ billions and percent)				
Country	2006	2007	2007 share	2007 annual growth
World	396.6	406.6	100.0	2.5
U.S.	217.6	220.4	54.2	1.3
China	34.5	38.3	9.4	11.0
Mexico	16.0	17.2	4.2	7.2
Japan	15.3	15.4	3.8	0.8
Germany	11.1	11.5	2.8	3.7
U.K.	10.9	11.5	2.8	5.6
Korea	5.8	5.4	1.3	-6.9
Norway	5.4	5.3	1.3	-2.1
France	5.2	5.1	1.3	-1.9
Italy	4.9	5.1	1.3	3.3
EU	49.3	49.4	12.1	0.2

Source: Statistics Canada

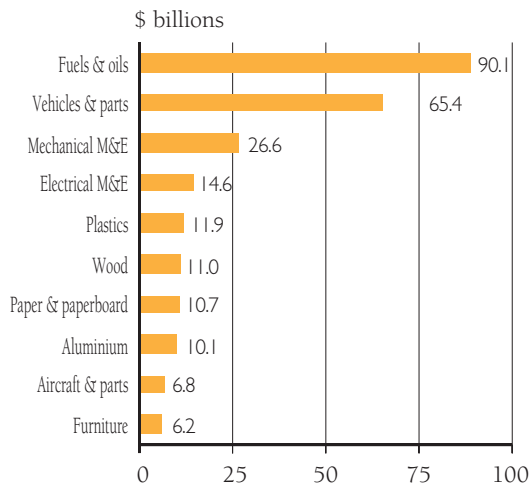
Merchandise trade with principal trading partners

As noted above, in recent years, Canada has been diversifying its trade away from the United States. Last year, Canada's total merchandise exports to the United States declined 0.9 percent to \$356.0 billion⁵. As a result, the U.S. share in total merchandise exports fell 2.6 percentage points to 79.1 percent, the first time it has been below 80 percent since 1995. However, merchandise exports to non-U.S. destinations grew 16.5 percent.

Table 4-2 shows the 10 largest individual country trading partners for Canada. Growth in Canadian merchandise exports was the strongest with respect to Norway (95.0 percent), the Netherlands (32.0 percent), and the U.K. (26.3 percent). Rising prices and exports of metals, particularly nickel, were responsible for the strong growth in exports to these three European destinations, as this metal accounted for nearly 90 percent of the total increase in exports to Norway, about one-third of the increase in exports to the Netherlands, and about 30 percent of the increase to the U.K. Canada's

5 As noted previously, the term "merchandise trade" is used to refer to commodity trade on a Customs basis in contrast with "goods trade" which refers to trade on a Balance of Payments basis. The Customs data is produced on an internationally harmonized commodity classification system (HS) 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 following analysis.

FIGURE 4-7A
Top-10 Merchandise Exports to the U.S., 2007



exports to China rose by 21.3 percent in 2007 and consequently China overtook Japan as Canada's third largest export market.

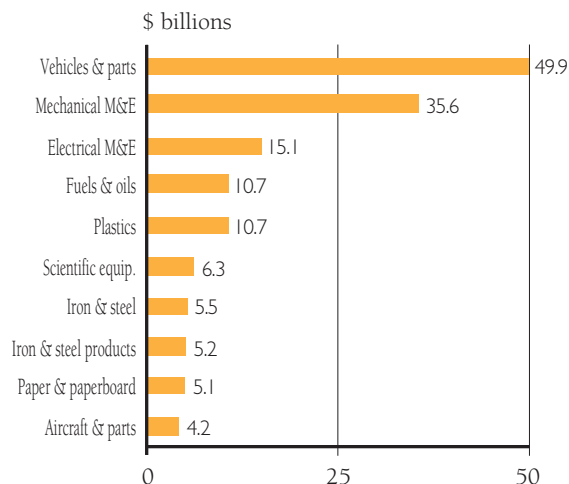
The U.S. still accounts for the lion's share of Canadian merchandise imports, at 54.2 percent in 2007. China and Mexico followed at 9.4 percent and 4.2 percent, respectively. Italy overtook Algeria as Canada's tenth largest import market. In terms of growth, imports from China (11.0 percent), Mexico (7.2 percent) and the U.K. (5.6 percent) witnessed the fastest growth among the top 10 sources in 2007.

Merchandise trade by sector with selected major trading partners

The United States

As mentioned above, exports to the U.S. fell in 2007. Declines were most notable for automotive products, softwood lumber, paper and paperboard, and plastics, which, when combined, accounted for losses of nearly \$11.8 billion. As can be seen in Figure 4-7a, Canadian merchandise exports to the U.S. remain concentrated in three trade categories: mineral fuels and oil (at 25.3 percent of all merchandise exports to the U.S.), motor vehicles and parts (at 18.4 percent), and mechanical machinery and equipment (at 7.5 percent). Combined, these three categories accounted for some 51.1 percent

FIGURE 4-7B
Merchandise Imports from the U.S., 2007



of all merchandise exports to the U.S. The share of Canada's top 10 exports amounted to 71.1 percent of all exports to the U.S. or \$253.3 billion. Exports in seven of the top 10 categories declined last year. The exceptions were mineral fuels and oils, mechanical machinery, and aircraft exports, which went up by 7.0 percent, 3.3 percent and 22.2 percent, respectively.

Canadian merchandise imports from the U.S. advanced 1.3 percent to \$220.4 billion in 2007, equivalent to 54.2 percent of all merchandise imports into Canada. At this level, the U.S. share was down 0.7 percentage points from a year earlier. Motor vehicles and parts, and machinery and equipment — both mechanical and electrical — accounted for 45.6 percent of all merchandise imports from the U.S. in 2007 (Figure 4-7b). The 10 largest merchandise imports at the HS 2-digit level accounted for about 67.2 percent of total merchandise imports from the U.S. or \$148.2 billion.

As was the case for exports, imports of aircraft and spacecraft products saw the fastest increase amongst the 10 largest import categories in 2007, rising by 38.9 percent, whereas machinery and equipment (-3.0 percent) and plastic products (-4.5 percent) experienced the largest declines.

Intra-firm Trade between Canada and the U.S.

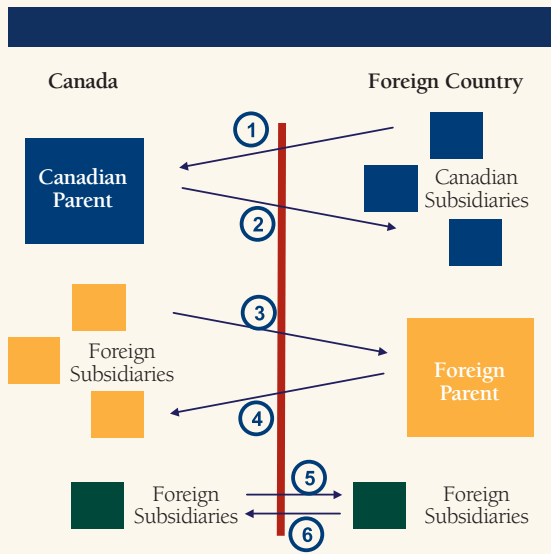
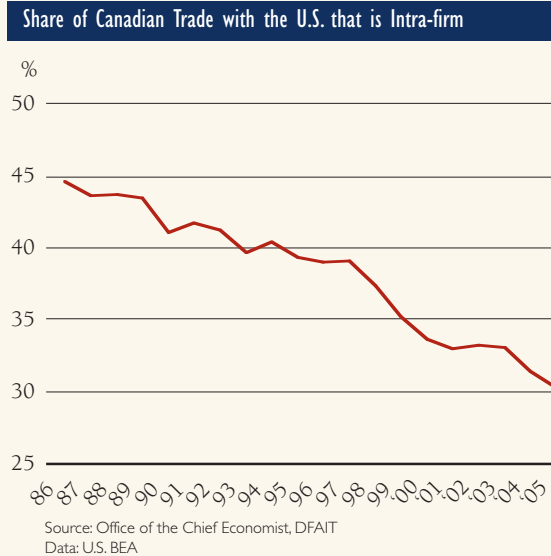
In 2005, the latest year for which data is available, 30.3 percent of Canada-U.S. trade in goods was intra-firm, down from almost 45 percent in the late 1980s. Canada also has among the lowest shares of intra-firm trade among the U.S.'s major developed-country trading partners. This reflects the fact that much of Canadian direct investment in the U.S. is in financial services and other sectors that would not be expected to result in much intra-firm trade in goods. It also suggests a high level of comfort of Canadian exporters in the U.S. market and *vice-versa*.

Intra-firm trade is trade that takes place between related firms operating on both sides of the border. In the case of Canada and the U.S., there are six types of intra-firm trade:

- (1) Imports by the Canadian parent from its U.S. affiliate;
- (2) Exports from the Canadian parent to a subsidiary in the U.S.;
- (3) Exports from a U.S. subsidiary operating in Canada back to its parent company in the U.S.;
- (4) Imports by that affiliate from its U.S. parent;
- (5) Exports from a subsidiary in Canada of a foreign parent (not Canadian or U.S.) to an affiliate of the same company in the U.S.; and,
- (6) Imports by a foreign (not Canadian or American) affiliate from its counterpart in the U.S.

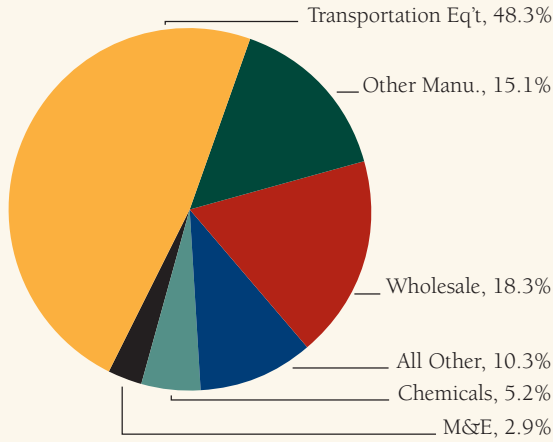
Data limitations prevent us from measuring the trade between foreign affiliates from third countries (types 5 and 6 listed above).¹

¹ Data comes from the U.S. Bureau of Economic Analysis and covers the Operations of Foreign Multinationals in the U.S. and U.S. Multinationals Abroad.



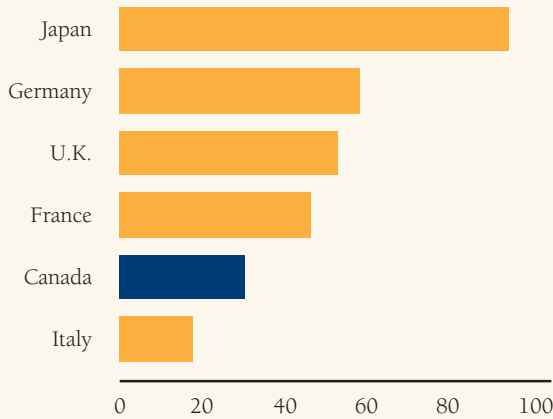
As of 2005, 30.3 percent of Canada-U.S. trade, or roughly US \$153.4 billion, was intra-firm. Some 34.0 percent of Canadian exports were intra-firm, but a much lower 25.2 percent of

Canada-U.S. Intra-Firm Trade by Industry (2005)



Source: Office of the Chief Economist, DFAIT
Data: U.S. BEA

Share of Trade with the U.S. that is Intra-firm (2005)



Source: Office of the Chief Economist, DFAIT
Data: U.S. BEA

imports could be classified as intra-firm. To a large degree, this difference between imports and exports reflects the difference between Canadian and U.S. firms. Of Canadian exports that are intra-firm, more than three-quarters involves the affiliate of a U.S. company exporting back to its parent in the U.S., while only 22.8 percent was from a Canadian parent company shipping to its subsidiary in the U.S. For intra-firm

imports the difference is even more marked. Some 94.4 percent of intra-firm imports were accounted for by Canadian affiliates importing from their U.S. parents in contrast to only 5.6 percent being affiliates in the U.S. shipping back to their Canadian parents.

Nearly half of all intra-firm trade between Canada and the U.S. is in transportation equipment with motor vehicles making-up much of that — an industry that is dominated by large American companies operating on both sides of the border. “Other manufacturing” accounted for another 15.1 percent of intra-firm trade, but the second largest sector, after transportation equipment, is wholesale. In 1990, 85.1 percent of intra-firm trade in goods between Canada and the U.S. was in manufacturing, but by 2005, this had fallen to 71.4 percent with wholesale making up the largest share of the difference.

Among G7 countries, Canada has the second lowest share of intra-firm trade with the U.S. after Italy. The three other big European countries — Germany, the U.K. and France — have fairly similar shares ranging from 58.2 percent for Germany to 46.2 percent for France. Japan has, by far, the highest share of trade with the U.S. that is intra-firm at 94.1 percent.

The relatively low share of related-firm trade between Canada and the U.S. is a reflection of the pattern of direct investment; in particular, a large portion of Canadian direct investment in the U.S. is in sectors not having a large amount of intra-firm goods trade. For example, among the G7, Canada has the second lowest value of FDI in the U.S. in manufacturing (again second to Italy) even though overall Canadian FDI in the U.S. is comparable to that of Japan or the three big European countries.

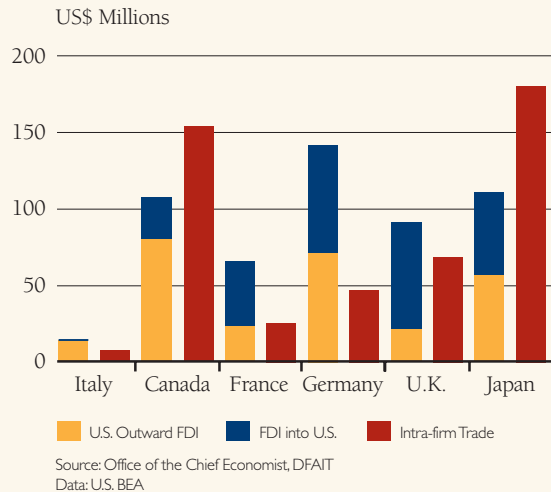
Notwithstanding the relatively smaller share, it is important to note that Canada-U.S. intra-firm goods trade is not small. In fact, it is the second highest of any of the U.S.'s trade partners after only Japan. This is because of the sheer size of Canada-U.S. trade.

It is well known that Canada and the U.S. trade more than any two countries in the world. While large firms account for much of this, there is also a relatively high share of smaller Canadian exporters to the United States. 18.8 percent of

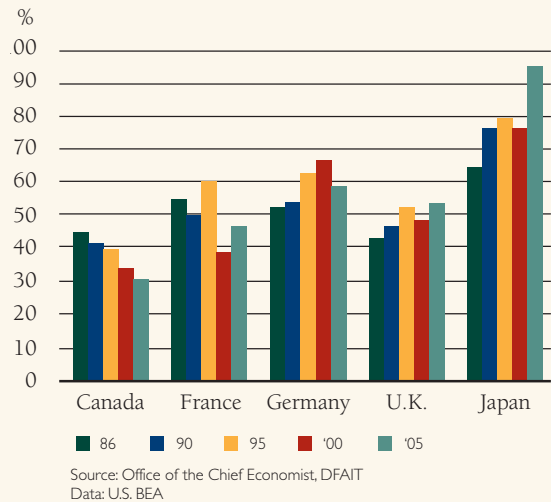
Canadian manufacturing exports to the U.S. are by exporters that export less than \$25 million a year compared to only 15.0 percent for non-U.S. markets. This may indicate an increased level of comfort that Canadians exporters have in the U.S. market.

Furthermore, Canada did not always have such a low intra-firm trade share with the U.S. In 1996, it was at roughly similar levels to the three big European countries and was actually higher than that of the U.K. This could suggest that the two trade agreements that occurred over this period (the Canada-U.S. FTA and the NAFTA) have made it easier to trade between the two countries without the need for a foreign presence.

FDI in Manufacturing and Intra-Firm Trade (2005)



Share of Trade with the U.S. that is Intra-firm



The European Union

Canadian merchandise exports to the EU shot up dramatically in 2007, propelled by merchandise exports to the U.K. and to the Netherlands. Exports were up 19.4 percent to \$34.8 billion. The U.K. in particular, was responsible for nearly one-third of Canada's total exports growth. The 10 largest export categories accounted for 70.7 percent of all exports to the EU last year (Figure 4-8a). Exports of inorganic chemicals, aluminium, and nickel products more than doubled in 2007, with growth rates of 143.5 percent, 105.8 percent and 103.4 percent, respectively. The increasing demand for uranium led to the sharp increase in exports of inorganic chemicals. Ores (+59.1 percent) and mechanical machinery and equipment (+11.5 percent) also recorded strong export growth, while exports of aircraft and spacecraft products (-14.7 percent), mineral fuels and oils (-13.0 percent), and electrical machinery and equipment (-12.2 percent) declined in 2007.

Like the year before, Canadian merchandise imports from the EU grew at a slower pace than did exports, edging up by only 0.2 percent to \$49.4 billion in 2007. Four products — mechanical machinery and equipment, mineral fuels and oils, pharmaceutical products, and motor vehicles — accounted for

53.1 percent of imports from the EU (Figure 4-8b). Imports of organic chemicals (-14.1 percent), iron and steel products (-13.3 percent), aircraft and spacecraft products (-5.5 percent), and mineral fuel and oils (-4.3 percent) all declined in 2007, while imports of beverages grew by 10.1 percent.

Japan

Canadian merchandise exports to Japan retracted by 2.5 percent to \$9.2 billion in 2007. This was the first decrease since 2003. Declines were led by reductions in exports of ores, wood, wood pulp, and mineral fuels and oils. A sharp increase in nickel exports helped to limit the losses. The 10 most important products exported to Japan accounted for more than 75 percent of total merchandise exports to that country (Figure 4-9a). Five products alone — wood, ores, mineral fuels and oils, grain seeds, and meat — accounted for more than half of all exports.

Merchandise imports from Japan advanced 0.8 percent to \$15.4 billion in 2007, up from \$15.3 billion in 2006. As in previous years, imports were concentrated in only a few sectors (Figure 4-9b). The three largest sectors — motor vehicles (43.0 percent), mechanical machinery and equipment (22.2 per-

FIGURE 4-8A
Top-10 Merchandise Exports to the EU, 2007

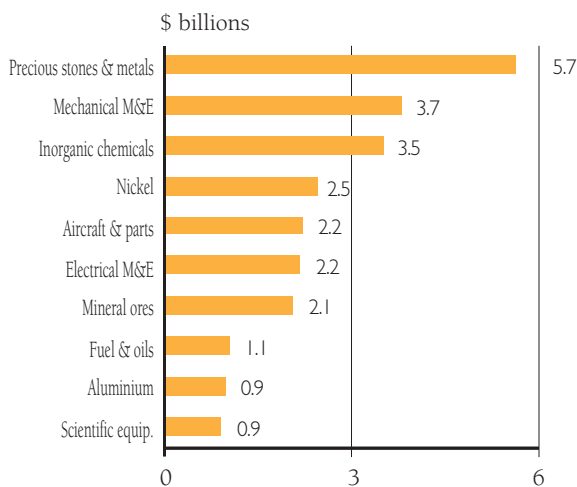


FIGURE 4-8B
Top-10 Merchandise Imports from the EU, 2007

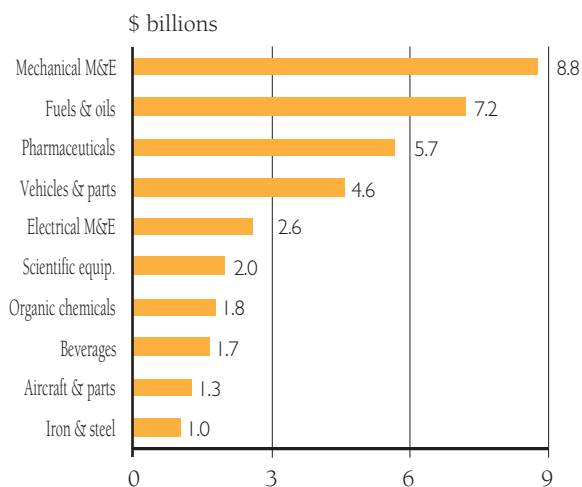


FIGURE 4-9A
Top-10 Merchandise Exports to Japan, 2007

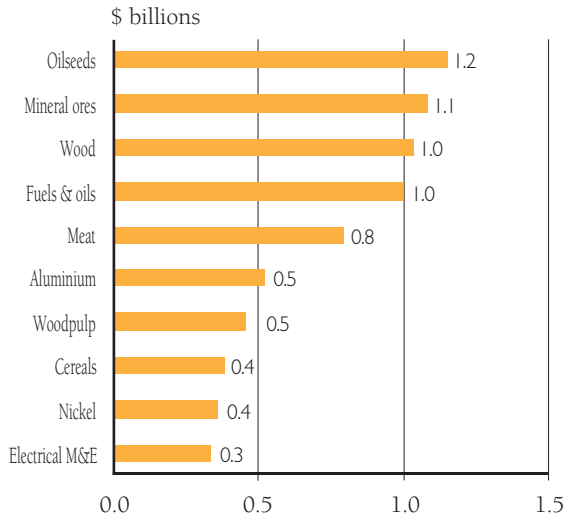
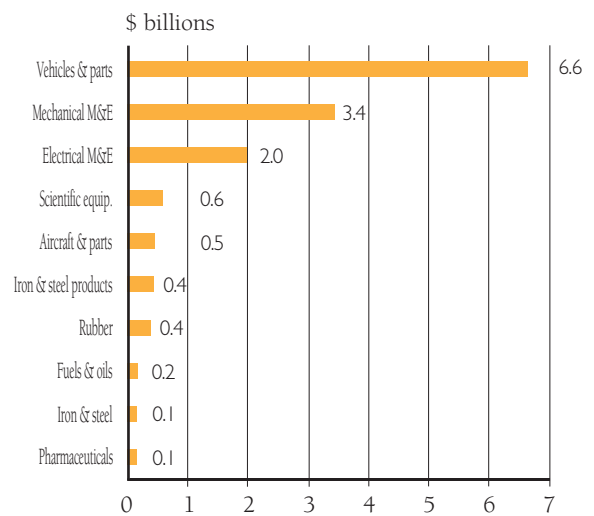


FIGURE 4-9B
Top-10 Merchandise Imports from Japan, 2007



cent), and electrical machinery and equipment (12.7 percent) — accounted for over three quarters of total merchandise imports from Japan, with the seven next largest categories raising the share total to 92.8 percent.

China

The increase in Canadian merchandise exports to China contributed about a fifth of the total increase

in Canadian exports to all destinations last year, as exports to China surged 21.3 percent to \$9.3 billion in 2007, up from \$7.7 billion the year before. The top 10 products accounted for nearly 70 percent of exports in 2007 (Figure 4-10a). Exports of wood pulp grew by 32.0 percent to reach \$1.5 billion last year, and organic chemicals broke the one billion dollar mark for the first time, rising to \$1.1 billion

FIGURE 4-10A
Top-10 Merchandise Exports to China, 2007

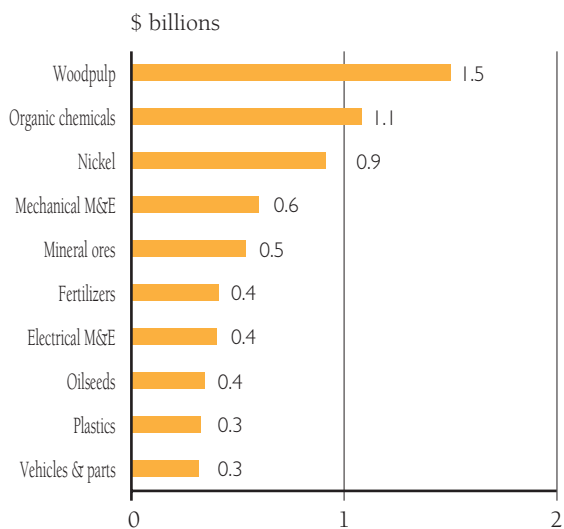


FIGURE 4-10B
Top-10 Merchandise Imports from China, 2007

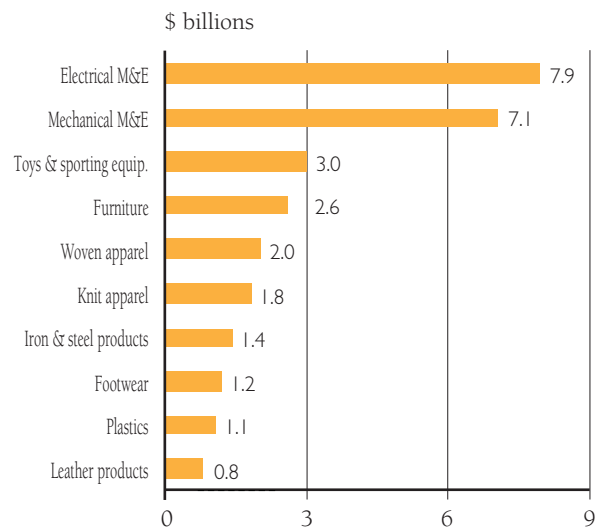
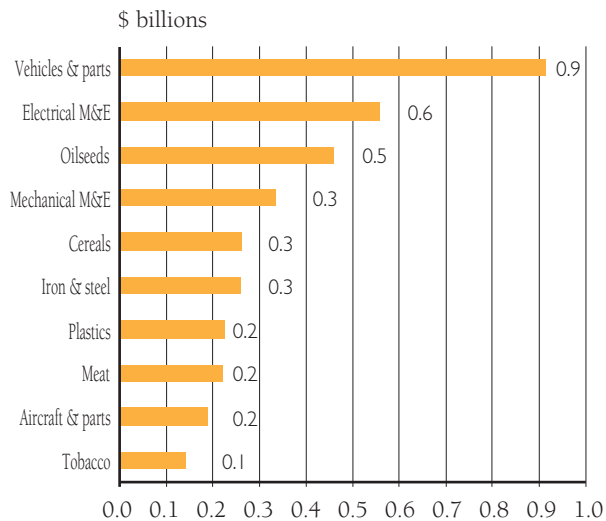


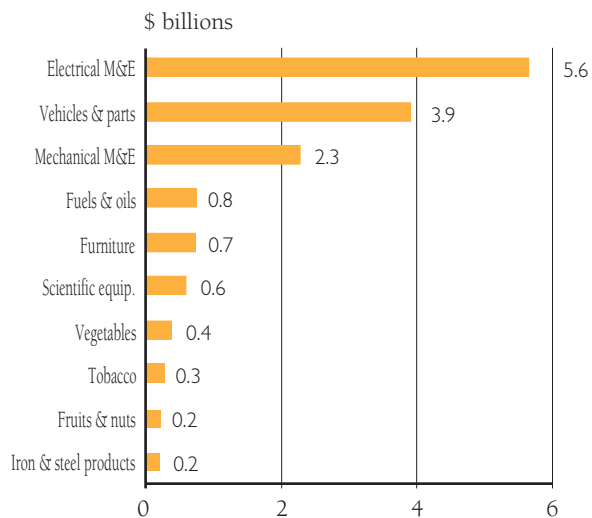
FIGURE 4-11A
Top-10 Merchandise Exports to Mexico, 2007



in 2007 compared with \$881.0 million a year earlier. Exports of oilseeds (up 92.3 percent), fertilizers (up 69.9 percent), and nickel products (up 42.8 percent) all contributed to the gains. While these resource-based exports provided the largest boost, there was also a rise of 15.4 percent in mechanical machinery exports. These gains were offset by declines for motor vehicles (down 22.4 percent) and electrical machinery and equipment (down 5.9 percent).

Canadian merchandise imports from China rose at a slower pace than exports in 2007, up 11.0 percent to \$38.3 billion. All of the 10 largest import categories registered positive growth rates last year, with the sole exception of mechanical machinery and equipment. Mechanical machinery, electrical machinery and equipment, and toys and sports equipment comprise the three largest import categories (Figure 4-10b), while toys and sports equipment (up 25.0 percent), electrical machinery (up

FIGURE 4-11B
Top-10 Merchandise Imports from Mexico, 2007



16.9 percent) and knitted apparel (up 16.5 percent) were the growth leaders. China has been the second-largest single country source for Canadian imports since 2002.

Mexico

On an individual country basis, Mexico is the Canada's fifth largest merchandise export market and third largest import market. Merchandise exports to Mexico last year advanced at a robust 13.2 percent to \$5.0 billion, from \$4.4 billion in 2006⁶. Ten commodities accounted for almost three-quarters of all exports to Mexico, led by motor vehicles (18.6 percent), electrical machinery (11.3 percent), and oilseeds (9.3 percent) (Figure 4-11a). Of the top 10 exports to Mexico, aircraft and spacecrafts products posted a growth rate of over 100 percent in 2007, at 137.0 percent. Exports of tobacco products also rose sharply in 2007 (at 72.2 percent).

⁶ As in previous years, discrepancies between Canadian and Mexican statistics were significant in 2007. Mexico's imports from Canada exceeded Canada's exports to Mexico by \$3.6 billion. Similarly, Canadian imports from Mexico were greater than Mexican exports to Canada by \$10.2 billion. Reconciliation studies between Canada and Mexico identified misallocation and export undercoverage as the major causes for discrepancies. Country misallocation is the attribution of trade to a country that is not the final destination of goods, resulting in the situation where the two countries credit trade to different countries. For example, Canada may ship goods through the United States to the final destination of Mexico. Undercoverage is a situation in which trade is not reported to the compiling country and is therefore missing entirely from its officially published statistics.

Imports from Mexico grew 7.2 percent to \$17.2 billion in 2007, a record high. In general, merchandise imports from Mexico are highly concentrated and the year 2007 was no exception as the top three imports claimed 69.0 percent of all imports from this country. All in all, the top 10 imports were responsible for about 87.8 percent of all imports

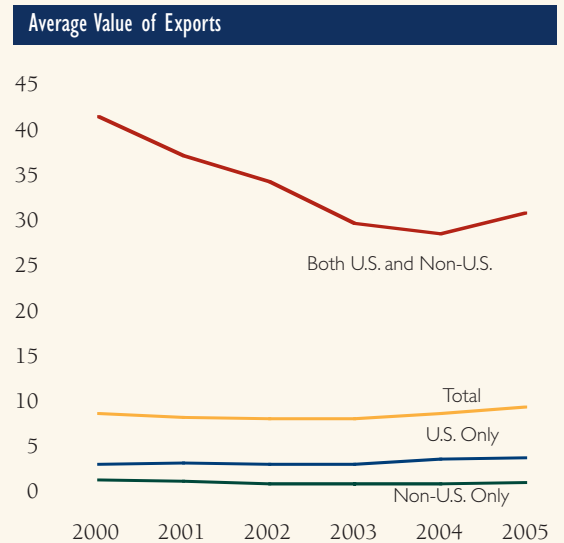
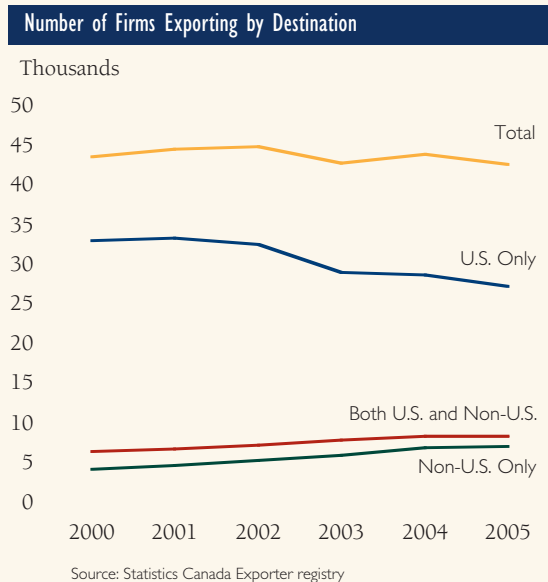
(Figure 4-11b). Growth was most notable for imports of tobacco, which almost doubled (up 95.5 percent), vegetables (up 28.8 percent), and electrical machinery (up 16.2 percent). Imports of mineral fuels and oils fell by 24.3 percent last year.

Canadian Exporters: Going Global

Analysis of the number of Canadian firms exporting, as opposed to the value of exports, gives additional insights into trends in Canadian trade. Exporter Registry data¹ show that Canadian firms are increasingly global exporters, with the number of firms exporting only to the U.S. falling over time.

In 2005, there were 42,600 exporting enterprises in Canada, down from 43,600 in 2000 and a high of 44,800 in 2002. The declines represent a 2 percent decrease from 2000 and a 5 percent drop from the 2002 high.

The dip in Canadian exporters was largely due to a decline in the number of firms exporting only to the United States. Firms exporting only to the U.S. dropped 18 percent, from 33,000 in 2000 to 27,200 in 2005. This was partly offset by an increase in the number of firms that export to both the U.S. and a non-U.S. destination, which rose by 1,900, a 29 percent increase. Firms which export only to non-U.S. destinations increased even more, up 70 percent, or by 2,900 firms.



¹ The Exporter Registry is a Statistics Canada database. As of the writing of this article the latest data available was for 2005.

TABLE I
Export Establishments by Employee Size

Number of Employees	Number of Exporters	% of Exporter Population	Value of Exports (millions)	% of Export Value
Less than 50	33,062	72.3	121,910	30.4
50-99	6,029	13.2	60,786	15.1
100-199	3,741	8.2	42,837	10.7
200 and over	2,905	6.4	175,972	43.8
Grand total	45,737	100.0	401,504	100.0

Source: Statistics Canada Exporter registry, for 2005

While the number of exporting firms has fallen, the total value of Canadian exports has increased. Thus, the average value of exports per firm has climbed to \$9.4 million in 2005 from \$8.7 million in 2000. However, there were wide variations in the average value of exports to various regions. As one would expect, the average value of exports is much higher for firms that export to both U.S. and non-U.S. destinations, but this average value has been falling. The increasing number of small firms exporting globally has contributed to this decline.

The drop in the number of firms exporting solely to the U.S. was largely due to a decline in smaller sized exporters². Many small firms stopped exporting altogether, but some small firms have apparently diversified into the “both U.S. and non-U.S.” group, as it was the smaller exporters that increased in number the most in this group³.

While these trends have been concentrated in the smaller firms, it is important to note that because these firms are small, changes in their export activity have a relatively small impact on overall exports. Larger firms (those with over 200 employees) accounted for only 6.4 percent of all Canadian exporters in 2005 but made up almost half of total export value (Table 1)⁴.

2 Firms which export less than \$1 million annually accounted for 85% of the decline in firms exporting to the U.S. only from 2000 to 2005.

3 Firms which export less than \$1 million annually accounted for 81% of the increase in firms exporting to both the U.S. and a non-U.S. destination from 2000 to 2005.

4 Note that data on exporters by employee size are at the establishment level. This is a different statistical measure than used in previously cited data, which are at the enterprise level. The enterprise is the top hierarchical level associated with a complete (consolidated) set of financial statements. An establishment is a unit of production, such as a factory or a plant, for which the accounting data required to measure production are available. An enterprise may consist of many establishments.

TABLE 4-3
Merchandise Exports by Province and Territory (\$ millions and percent)

Province	2003	2004	2005	2006	2007	2007 share	2007 annual growth
All Provinces	381,071.4	412,290.0	436,257.2	440,266.2	450,315.5	100	2.3
Ontario	189,095.5	199,007.3	200,791.8	198,663.9	202,406.3	44.9	1.9
Alberta	57,639.7	64,539.2	77,419.5	78,999.9	82,874.4	18.4	4.9
Quebec	64,190.9	68,478.2	71,005.2	73,195.8	69,919.9	15.5	-4.5
British Columbia	29,334.6	32,261.0	35,575.0	34,878.2	32,375.8	7.2	-7.2
Saskatchewan	10,389.1	13,460.5	14,932.6	16,409.6	19,970.4	4.4	21.7
Manitoba	9,328.7	9,438.0	9,388.4	10,428.0	11,830.7	2.6	13.5
Newfoundland	4,798.7	7,165.6	8,106.9	9,599.3	11,593.8	2.6	20.8
New Brunswick	8,573.7	9,479.7	10,722.9	10,408.9	11,179.9	2.5	7.4
Nova Scotia	5,477.4	5,810.4	5,802.9	5,193.7	5,451.3	1.2	5.0
N. W. Territories	1,587.8	1,975.2	1,687.1	1,605.2	1,882.0	0.4	17.2
P. E. Island	647.7	666.8	810.0	838.0	802.8	0.2	-4.2
Yukon	4.8	4.8	11.4	39.7	22.6	0.0	-42.3
Nunavut	2.9	3.2	3.6	5.9	5.6	0.0	-6.1

Source: Statistics Canada

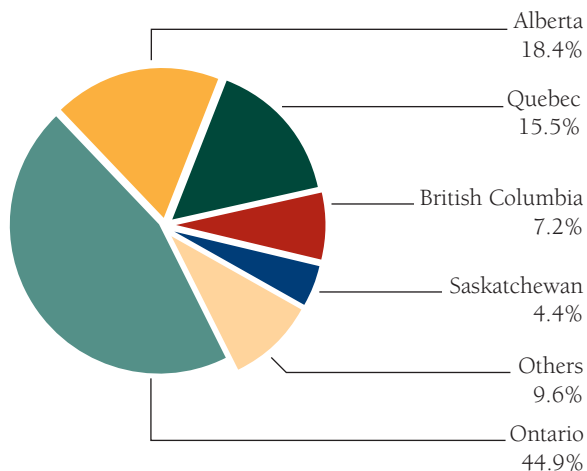
Provincial trade performance

Three provinces and two territories — Quebec, British Columbia, Prince Edward Island, Yukon and Nunavut — saw their merchandise exports to the world fall (Table 4-3). Yukon was hardest hit, experiencing a 43.1 percent drop-off in total exports. At the same time, Saskatchewan and Newfoundland registered the highest increases in their merchandise

exports, led by mineral fuels and oils, cereals, and fertilizers for Saskatchewan and mineral fuels and oils, ores, and fish and seafood for Newfoundland.

Of the Canadian provinces and territories, Ontario accounted for 44.9 percent of all Canadian exports to the world in 2007, followed by Alberta at 18.4 percent, Quebec at 15.5 percent, and British Columbia at 7.2 percent (Figure 4-12).

FIGURE 4-12
Share of Merchandise Exports by Province



Imports from the world were slightly down in four provinces 2007 — New Brunswick, British Columbia, Nova Scotia, and Alberta (Table 4-4). On the other hand, one province and two territories experienced double-digit growth — Prince Edward Island, Yukon, and Nunavut. For the latter, the increase was due to growth in its imports of aircraft and spacecraft products, which accounted for almost all of Nunavut's imports from the world.

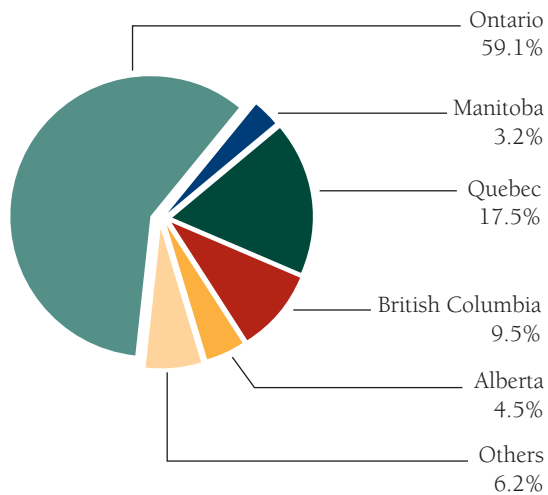
By province, Ontario accounted for a bigger share of Canadian merchandise imports (59.1 percent) than it did for exports, followed by Quebec (17.5 percent), and British Columbia (9.5 percent) (Figure 4-13).

TABLE 4-4
Merchandise Imports by Province and Territory (\$ millions and percent)

Province	2003	2004	2005	2006	2007	2007 share	2007 annual growth
All Provinces	336,141.3	355,886.2	380,859.2	396,645.3	406,620.0	100	2.5
Ontario	210,191.8	220,619.6	228,646.7	233,597.8	240,216.6	59.1	2.8
Quebec	52,412.7	57,493.8	65,284.9	68,680.9	70,978.5	17.5	3.3
British Columbia	31,269.6	32,885.0	35,295.9	38,891.4	38,687.9	9.5	-0.5
Alberta	13,257.6	13,638.8	16,455.8	18,494.5	18,437.8	4.5	-0.3
Manitoba	10,398.6	10,565.4	11,795.6	12,426.2	13,153.0	3.2	5.8
New Brunswick	5,974.1	6,899.0	8,002.6	7,521.6	7,470.4	1.8	-0.7
Nova Scotia	5,816.3	6,377.3	6,992.6	7,488.5	7,452.5	1.8	-0.5
Saskatchewan	4,151.7	4,669.0	5,596.4	6,496.2	6,958.9	1.7	7.1
Newfoundland	2,567.6	2,552.9	2,653.8	2,892.9	3,092.3	0.8	6.9
Yukon	75.2	85.4	76.9	86.3	96.0	0.0	11.2
P.E. Island	19.7	36.5	53.9	49.4	54.4	0.0	10.1
Nunavut	2.9	0.0	2.9	16.0	17.6	0.0	10.3
N. W. Territories	3.5	63.6	1.1	3.7	4.0	0.0	8.0

Source: Statistics Canada

FIGURE 4-13
Share of Merchandise Imports by Province



Overview of Canada's investment performance

Global foreign direct investment inflows

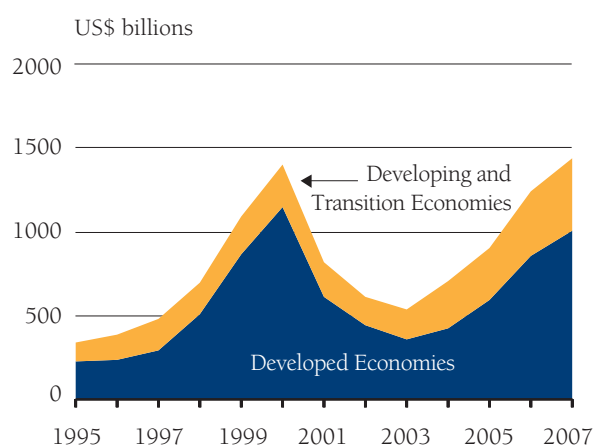
Foreign Direct Investment (FDI) provides benefits to host economies through the transfer of knowledge, technology and skills, and increased trade related to the investment, all of which contribute to productivity and competitiveness, and is one of the ways in which countries can integrate their economies into global value chains.

FDI has played a critical role in globalization, with flows increasing 600 percent between 1990 and 2000. Since 1980, the world FDI stock has dramatically outpaced growth in both world exports and world GDP. While flows declined in the early part of this decade, world FDI inflows have grown on average by 28.5 percent per year since 2003, rising to US\$1.5 trillion in 2007 (Figure 5-1), and surpassing the previous record observed in the year 2000.

The continued rise of FDI reflects strong global economic growth, increases in corporate profits, higher stock prices, the growth in private equity and hedge funds, and the increasing role of state investment agencies in emerging economies. However, despite the doubling of global FDI flows between 2004 and 2007, there are mixed prospects for 2008. World economic growth has slowed and recent turmoil in credit markets has resulted in a slowing down of cross border merger and acquisition activity in the last half of 2007, a trend that may continue into 2008.

FDI flows grew fastest for developed countries in 2007 at 16.8 percent, with total inflows valued at over US\$1.0 trillion (Table 5-1). The United States

FIGURE 5-1
Global FDI Inflows



received the most FDI inflows at US\$192.9 billion, although the European Union member states¹ accounted for 39.7 percent of all FDI inflows at US\$610.0 billion. Of the EU countries, three were responsible for two-thirds of the EU's share: the United Kingdom at 28.0 percent (US\$171.1 billion), followed by France at 20.2 percent (US\$123.3 billion) and the Netherlands at 17.0 percent (US\$104.2 billion).

Developing countries also experienced a brisk growth rate of 15.6 percent, bringing total flows for 2007 to US\$438.4 billion, a 145 percent increase over 2003 inflows. FDI flows to Latin America and the Caribbean rose to their highest recorded level at US\$125.8 billion, with inflows nearly doubling in Mexico, Chile and Brazil. Growth in this region was driven by greenfield² investments rather than mergers and acquisitions.

¹ Excluding Romania and Bulgaria which are not yet included in EU data.

² Greenfield investment is outlays for the establishment of a new enterprise or the expansion of an existing enterprise.

TABLE 5-1
 Global FDI inflows for selected regions and economies, 2003-2007 (US\$ billions and percent)

Host Region/Economy	2003	2004	2005	2006	2007	2007 Annual Growth	2007 Share	2003-2007 Annual Growth ^a
World	564.1	742.1	945.8	1,305.9	1537.9	17.8	100.0	28.5
Developed economies	361.2	418.9	590.3	857.5	1,001.9	16.8	65.1	29.1
Canada ^b	8.1	-0.4	30.1	61.1	118.1	93.3	7.7	95.5
United States	53.1	135.8	101.0	175.4	192.9	10.0	12.5	38.0
Europe	277.1	209.2	495.0	566.4	651.0	14.9	42.3	23.8
EU 25	256.7	204.2	486.4	531.0	610.0	14.9	39.7	24.2
France	42.5	32.6	81.1	81.1	123.3	52.1	8.0	30.5
Germany	32.4	-9.2	35.9	42.9	44.8	4.5	2.9	8.5
Italy	16.4	16.8	20.0	39.2	28.1	-28.2	1.8	14.4
Netherlands	21.0	2.1	41.5	4.4	104.2	2,284.1	6.8	49.2
United Kingdom	16.8	56.0	193.7	139.5	171.1	22.6	11.1	78.7
Czech Republic	2.1	5.0	11.7	6.0	7.6	27.6	0.5	37.9
Japan	6.3	7.8	2.8	-6.5	28.8	-542.7	1.9	46.1
Developing economies	178.7	283.0	314.3	379.1	438.4	15.7	28.5	25.2
Asia and Oceania	115.3	170.7	209.1	259.8	277.0	6.6	18.0	24.5
China	53.5	60.6	72.4	69.5	67.3	-3.1	4.4	5.9
Hong Kong (China)	13.6	34.0	33.6	42.9	54.4	26.8	3.5	41.4
India	4.3	5.8	6.7	16.9	15.3	-9.4	1.0	37.2
Singapore	11.7	19.8	15.0	24.2	36.9	52.4	2.4	33.4
Latin America and the Caribbean	44.7	94.3	75.5	83.8	125.8	50.2	8.2	29.5
Brazil	10.1	18.1	15.1	18.8	37.4	99.1	2.4	38.6
Chile	4.3	7.2	7.0	8.0	15.3	92.4	1.0	37.3
Mexico	15.3	22.4	19.7	19.0	36.7	92.8	2.4	24.4
Africa	18.7	18.0	29.6	35.5	35.6	0.2	2.3	17.5
Russia	8.0	15.4	12.8	28.7	48.9	70.4	3.2	57.4

a Growth refers to the compound average annual growth rate.

b Since data for Canada is not available from UNCTAD for 2007, these data are from Statistics Canada, converted to US\$ using the end of year exchange rate.

Note: Shares and growth were calculated using raw data, and might not be reproduced with the data in the table, due to rounding.

Source: UNCTAD Investment Brief 2008 No.1 and UNCTAD World Investment Report 2007.

Inflows into South, East and South-East Asia rose by US\$24.5 billion to US\$224.0 billion in 2007, led by increases of 52.5 percent in Singapore (US\$12.7 billion) to US\$36.9 billion and 26.9 percent (US\$11.5 billion) in Hong Kong (China) to US\$54.4 billion. Inflows into China declined by 3.1 percent to US\$67.3 billion and have been

relatively stable for the last 5 years, averaging single-digit yearly growth rates, below the average world growth rate³. Inflows into India declined by 9.4 percent to US\$15.3 billion, and remained small by global standards at around one percent of global flows.

3 Despite the recent slowing of FDI into China's, the stock of inward FDI has increased from US\$20.7 billion in 1990 to US\$292.6 billion in 2006.

FDI inflows to African countries were almost unchanged in 2007 at US\$35.6 billion, although this is almost double the inflows in 2003. Growth in flows to Africa surged between 2003 and 2006 partially as a result of high oil and gas prices that have fuelled cross-border mergers and acquisitions in the extraction industries. In the African continent, Egypt was the largest FDI recipient in 2007 at US\$10.2 billion, followed by Morocco at US\$5.2 billion.

FDI inflows into Russia, the largest of the Transition economies, rose by 70.3 percent to US\$48.9 billion in 2007, this following a 125.1 percent increase in 2006. FDI flows into Russia have increased by over 500 percent since 2003 despite increasing restrictions on FDI in extractive industries. It remains to be seen if future flows will be impacted by new laws passed in 2008 which place further restrictions on foreign investment in certain sectors, including oil and gas, but which may also provide greater clarity for investors.

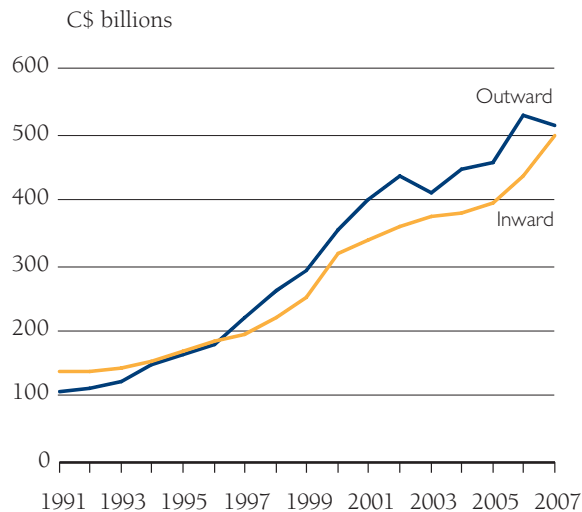
Canadian inward and outward FDI

Canada has been an active participant in rising global FDI flows, and has experienced significant growth in both inward and outward stocks of FDI over the past 25 years. Despite this, Canada's share of world investment declined during the 1980s, 1990s, and into the 2000s. Faster growth in developing countries is increasing the competition for FDI; at the same time these countries are becoming more and more important investors abroad, which is reflected in Canada's diversifying investment position.

In 2007 surging global FDI flows helped contribute to a 14.4 percent increase in the stock of FDI in Canada (bringing it to \$500.9 billion), the largest rise in 7 years (Figure 5-2). This increase was primarily the result of a jump in cross border mergers and acquisitions (M&As).

Canadian direct investment flows abroad were substantial in 2007 at just over \$53.1 billion. However, as a result of the appreciation of the Canadian dollar against several major currencies, the value of Canadian assets abroad declined by \$67.0 billion

FIGURE 5-2
Canada's inward and outward FDI stocks



when converted back into Canadian dollars. The net effect was a decline in Canada's stock of direct investment abroad to \$514.5 billion from \$530.0 billion in 2006.

Canada's net direct investment position, which is the difference between Canadian direct investment abroad and FDI in Canada, narrowed to just \$13.7 billion in 2007, down from \$92.2 billion in 2006. Despite this drop, 2007 was the eleventh consecutive year that Canadian direct investment abroad has exceeded foreign direct investment in Canada.

The stock of foreign direct investment in Canada in 2007

Investors from the United States continued to hold the majority of Canada's FDI stock, with a 57.6 percent share at \$288.6 billion (Table 5-2, Figure 5-3). However, the growth in U.S. investments has been below the average of other countries and the U.S. share has declined by 5 percentage points from 62.9 percent two years ago, continuing a trend towards greater diversity of FDI holders in Canada. Some of the U.S. share shifted to EU countries in the 1990s, but since 2000 the declining U.S. share has shifted to non-European countries. In 2007 the share belonging to investors from outside the U.S. and EU was 15.1 percent of Canada's total inward

TABLE 5-2
Stock of Foreign Direct Investment in Canada by Region (C\$ billions and percent)

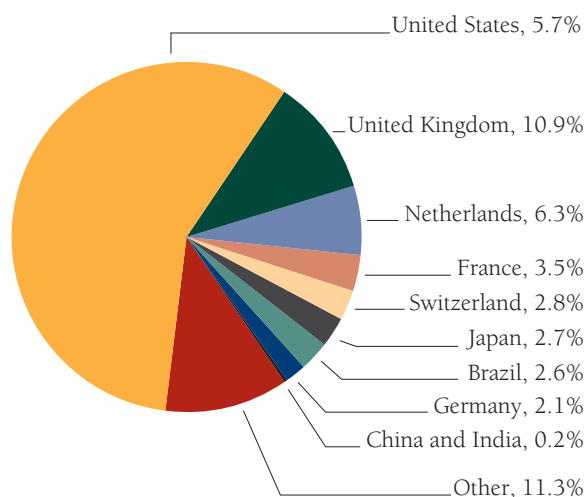
Region	2000	2006	2007	2000 Share	2007 Share	2007 Annual Growth	2000-2007 Annual Growth ^a
World	319.1	437.8	500.9	100.0	100.0	14.4	6.7
North America and Caribbean	196.8	271.9	293.8	61.7	58.7	8.1	5.9
South and Central America	0.7	12.0	13.1	0.2	2.6	9.1	51.2
Europe	107.0	124.8	157.5	33.5	31.4	26.2	5.7
Africa	0.1	1.4	2.9	0.0	0.6	110.2	59.1
Asia/Oceania	14.4	27.7	32.7	4.5	6.5	17.9	12.4
Top-10 Destinations							
United States	193.7	267.2	288.6	60.7	57.6	8.0	5.9
United Kingdom	24.0	39.8	54.8	7.5	10.9	37.5	12.5
Netherlands	15.3	24.7	31.5	4.8	6.3	27.5	10.9
France	37.0	16.9	17.4	11.6	3.5	3.0	-10.2
Switzerland	5.8	13.9	13.8	1.8	2.8	-0.3	13.1
Japan	8.0	12.9	13.4	2.5	2.7	3.6	7.6
Brazil	0.6	11.9	12.8	0.2	2.6	8.1	54.1
Germany	7.4	10.3	10.5	2.3	2.1	1.5	5.2
Sweden	2.6	2.3	8.5	0.8	1.7	269.5	18.3
Luxembourg	3.0	7.2	7.0	0.9	1.4	-2.5	12.9
Emerging Economies							
China	0.2	n.a.	0.6	0.1	0.1	n.a.	18.1
India	n.a.	0.2	0.4	n.a.	0.1	100.9	n.a.

Data: Statistics Canada, stocks.

^a Compound average annual growth rate

Note: Shares and growth were calculated using raw data, and might not be reproduced with the data in the table, due to rounding.

FIGURE 5-3
FDI stock in Canada by country (2007)



FDI, at nearly \$75.8 billion, up from only \$29.6 billion and a 9.3 percent share in 2000.

In 2007, investment from Europe grew by a substantial 26.2 percent to \$157.5 billion, with growth being driven by investors from the U.K. whose stock jumped by 37.5 percent to \$54.8 billion, and a 27.5 percent increase from the Netherlands to \$31.5 billion. Investment from Europe continues to be dominated by these two countries and France, which combined account for close to two-thirds of European investment in Canada and 20.7 percent of the overall stock of FDI in Canada.

The growth in FDI from South and Central America slowed somewhat from 2006, rising 9.1 percent to

TABLE 5-3
Stock of Foreign Direct Investment in Canada by Selected Industry (C\$ billions and percent)

	2006	2007	2007 Share	2007 Annual Growth	2000-2007 Annual Growth ^a
Manufacturing	155.1	193.5	38.6	24.7	3.3
Primary Metal	10.3	33.2	6.6	223.2	29.5
Chemical	27.8	28.8	5.8	3.8	5.5
Transport Equipment	22.6	26.3	5.2	16.3	1.2
Petroleum and coal	19.3	24.2	4.8	25.4	14.9
Paper and Wood products	13.7	16.3	3.3	19.3	3.2
Mining and Oil and Gas extraction	78.2	81.8	16.3	4.6	16.1
Oil and Gas extraction and support	55.2	57.2	11.4	3.6	13.5
Mining	23.0	24.6	4.9	7.1	25.0
Finance and Insurance	59.9	67.6	13.5	13.0	8.9
Management of Companies	44.8	46.0	9.2	2.7	8.2
Other	99.8	111.9	22.3	12.2	6.5
All Industries	437.8	500.9	100.0	14.4	6.7

a Compound average annual growth rate.

Note: Shares and growth were calculated using raw data, and might not be reproduced with the data in the table, due to rounding.

\$13.1 billion. While growth in 2007 was lower than average, FDI from this region was only \$724 million seven years ago. Growth from this region is almost entirely attributable to Brazil, which has a 98.1 percent share of Canada's stock from the region and has averaged a 54.1 percent compound yearly growth rate since 2000.

Growth in investments from Asia and Oceania remained strong in 2007 at 17.9 percent, raising the total stock from the region to \$32.7 billion. Investors from Asia and Oceania were the third largest set of investors in Canada with a 6.5 percent share of Canada's total stock, led by Japan at \$13.4 billion. Despite their growing importance in international markets, both China and India's share of Canada's FDI stock remains small at just \$616 million and \$446 million, respectively.

The stock of FDI from African countries more than doubled in 2007 to \$2.9 billion. Although Africa's share represents only 0.6 percent of Canada's total FDI, FDI from African countries stood at just \$114 million in 2000. South Africa accounts for just over one-third of investment from the continent, at \$1.1 billion.

Direct inflows in 2007 were led by a surge of investment in the manufacturing industry and steady increases in the finance and insurance sectors. The FDI stock in manufacturing jumped by \$38.3 billion in 2007 to \$193.5 billion (Table 5-3), following years of stagnant growth. The biggest increase (+\$22.9 billion) was in the primary metals manufacturing sector, followed by petroleum and coal products manufacturing (+\$4.9 billion). Despite the growth of FDI in 2007, manufacturing's share of total inward investment has declined to 38.6 percent, down from almost half of the total share in 2000.

The mining and oil and gas sectors continued to attract investment in 2007 with a 4.6 percent increase to \$81.8 billion, or 16.3 percent of Canada's total FDI. Investment in both sectors has increased dramatically in recent years: FDI in oil and gas extraction has increased from \$21.5 billion in 2000 to \$51.5 billion in 2007, a \$30 billion increase; FDI in mining climbed from around \$5.2 billion in 2000 to \$24.6 billion in 2007, a \$19.4 billion jump. Support activities for

TABLE 5-4
 Stock of Canadian Direct Investment Abroad by Region (C\$ billions and percent)

Region	2000	2006	2007	2000 Share	2007 Share	2007 Annual Growth	2000-2007 Annual Growth ^a
World	356.5	530.0	514.5	100.0	100.0	-2.9	5.4
North America and Caribbean	224.0	334.3	320.4	62.9	62.3	-4.1	5.2
South and Central America	21.3	21.4	23.0	6.0	4.5	7.3	1.1
Europe	84.6	140.0	134.6	23.7	26.2	-3.9	6.8
Africa	2.4	3.8	4.0	0.7	0.8	5.0	7.5
Asia/Oceania	24.0	30.5	32.5	6.7	6.3	6.6	4.4
Top-10 Destinations							
United States	177.9	230.4	226.1	49.9	44.0	-1.8	3.5
United Kingdom	35.2	58.0	54.6	9.9	10.6	-5.9	6.5
Barbados	19.7	38.6	36.2	5.5	7.0	-6.2	9.1
Ireland	7.3	19.6	19.3	2.0	3.8	-1.3	15.0
Cayman Islands	3.8	18.5	17.5	1.1	3.4	-5.0	24.2
Bermuda	9.5	22.6	17.4	2.7	3.4	-22.7	9.1
France	4.6	15.4	14.6	1.3	2.8	-5.0	17.8
Bahamas	7.0	n.a.	13.7	2.0	2.7	n.a.	10.1
Australia	3.1	6.9	8.9	0.9	1.7	28.1	16.2
Brazil	6.7	8.4	8.8	1.9	1.7	5.6	4.1
Emerging Economies							
China	0.6	1.6	1.8	0.2	0.3	14.2	18.0
India	0.1	0.5	0.2	0.0	0.0	-58.9	7.0

Data: Statistics Canada, stocks.

a Compound average annual growth rate

Note: Shares and growth were calculated using raw data, and might not be reproduced with the data in the table, due to rounding.

both sectors are also up by \$3.6 billion over 2000 levels to \$5.7 billion.

Investment into the service sectors continued to increase in 2007. The largest of these, finance and insurance, saw investment grow by 13.0 percent (\$7.8 billion) to \$67.6 billion.

The stock of Canadian direct investment abroad

The U.S. continues to be the most important destination for Canadian direct investment abroad at \$226.1 billion in 2007 (Table 5-4, Figure 5-4), or 44.0 percent of the total, although this share is down significantly; as recently as 2000 the U.S. accounted for almost half of Canadian investment abroad. Canadian investments in other markets

have become increasingly important, particularly in Europe and offshore financial centres such as Barbados, The Bahamas and Bermuda. Despite the trend towards greater geographic diversity in Canadian investment abroad, the stock of Canadian investment in the U.S. experienced a smaller decline in 2007 than did our investments in most other countries.

Direct investment in Europe experienced a higher relative decline in 2007 than did other regions, with the stock of Canadian investment falling by 3.9 percent to \$134.6 billion. The top three destinations, the United Kingdom (\$54.6 billion), Ireland (\$19.3 billion) and France (\$14.6 billion), accounted for nearly two-thirds of Europe's total

TABLE 5-5
Stock of Canadian Direct Investment Abroad by Selected Industry (C\$ billions and percent)

	2006	2007	2007 Share	2007 Annual Growth	2000-2007 Annual Growth ^a
Manufacturing	107.7	100.5	19.5	-6.7	-1.7
Mining and Oil and Gas extraction	79.6	79.3	15.4	-0.4	9.0
Oil and Gas extraction and support	56.3	56.4	11.0	0.2	16.2
Mining	23.3	22.9	4.4	-1.8	-0.5
Finance and Insurance	164.5	192.6	37.4	17.1	9.6
Management of Companies	92.1	61.3	11.9	-33.4	15.5
Transport and warehousing	19.7	18.1	3.5	-8.3	-0.1
Information and cultural industries	16.4	16.9	3.3	3.4	-8.5
Other	50.0	45.8	8.9	-8.4	8.3
All industries	530.0	514.5	100.0	-2.9	5.4

^a Compound average annual growth rate.

Note: Shares and growth were calculated using raw data, and might not be reproduced with the data in the table, due to rounding.

share of Canadian direct investment, and the U.K. alone accounted for 10.6 percent of Canada's total stock abroad.

Canada's direct investment in South and Central America posted growth of 7.3 percent in 2007 reaching a total stock of \$23.0 billion, with most investment concentrated in Brazil (\$8.8 billion) and Chile (\$7.0 billion).

Canada's direct investment in Asia/Oceania increased by 6.6 percent to \$32.5 billion in 2007; growth was led by Australia, Canada's largest recipient in the region, with investment growing from \$6.9 billion to \$8.9 billion. This growth helped to offset declines in other markets such as Hong Kong (China), which fell by \$469 million to \$4.5 billion, and in Japan where the stock also dropped by \$412 million to \$3.6 billion. Both China's and India's shares of Canada's outward direct investment remain small, although Canada's stock in China has recorded strong growth since 2000. Canada's direct investment holdings in India fell by nearly \$300 million to just \$207 million in 2007, while the Canadian stock in China rose to \$1.8 billion from \$1.6 billion a year earlier, the seventh

consecutive year of growth, at an average yearly compound growth rate of 18.0 percent.

The stock of Canada's direct investment in African countries increased by 5.0 percent in 2007 to \$4.0 billion. While a small share of Canada's total investment abroad, the stock in African countries has risen from \$2.4 billion in 2000 with an average yearly compound growth rate of 7.5 percent, which

FIGURE 5-4
CDIA stock by country (2007)

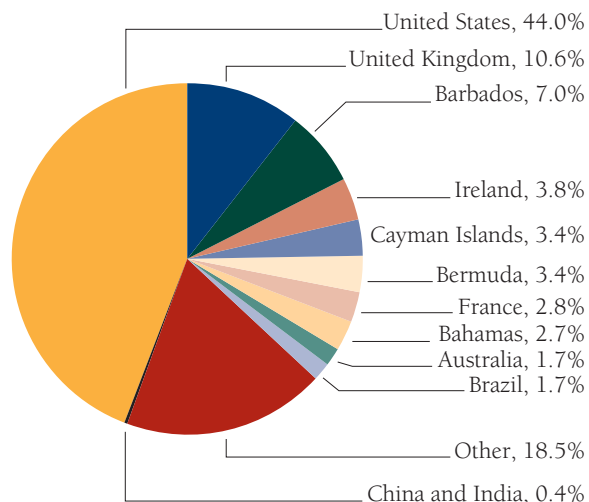
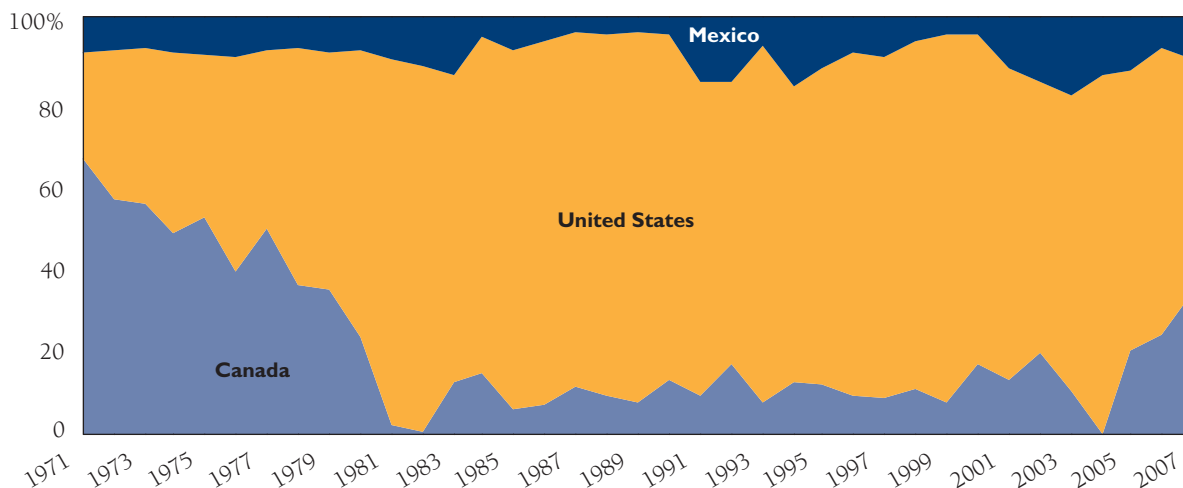


FIGURE 5-5
Distribution of Inward FDI Flows to North America



Sources: UNCTAD for Mexico and U.S.; Statistics Canada for Canada.

is faster than the average growth rate for Canadian investment in other regions.

Canadian direct investment abroad has been shifting away from the goods sector towards the services sector, which now represents over one-half of Canadian investment abroad. The largest sector for Canadian direct investment is the finance and insurance industries, accounting for 37.4 percent in 2007 at \$192.6 billion (Table 5-5). This is a 17.1 percent jump over 2006, despite the appreciation of the Canadian dollar which impacts the valuation of investments abroad. Within services, the next largest destination for Canadian investment is management of companies and enterprises at \$61.3 billion (11.9 percent of Canada's total outward stock), which is a steep \$30.8 billion decline over 2006 levels.

The stock of Canadian direct investment in the manufacturing sector continued to decline in 2007, falling 6.7 percent to \$100.5 billion. This continues a trend of both absolute and relative declines since 2000: the total stock abroad in manufacturing declined by \$13 billion over the last seven years, and manufacturing's share of outward investment dropped from around one-third to just 19.5 percent

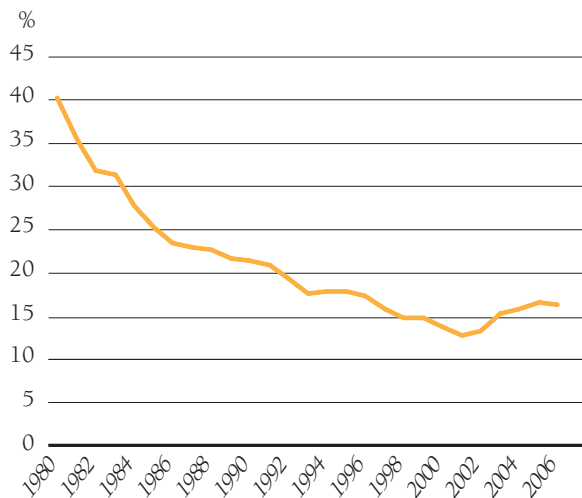
of Canada's total direct investment stock in 2007. Within the manufacturing sector, the computer and electronic manufacturing sector declined the most, from an 11.5 percent share in 2000 to just 2.6 percent in 2007.

Growth in the stock of Canadian investment in the oil and gas (extraction and support) sector was flat in 2007 at \$56.4 billion. Investment in the oil and gas sector accounts for 11.0 percent of Canada's total stock abroad, and is up by \$36.7 billion from 2000 levels.

Canada's performance in the North American context

Canada's share of total FDI inflows into North America (including flows within North America) has improved in recent years (Figure 5-5). Canada's share dropped off in 1982 from the high levels of the 1960s and 1970s, where in some years Canada's share was greater than 60 percent of total North American FDI. Following this drop, Canada's share stabilized at around 10 percent for the remainder of the 1980s, 1990s and early 2000s. Over the last three years Canada's performance as a destination for investment has improved significantly, with Canada's inflow share averaging 26 percent. In

FIGURE 5-6
Canada's share of North American FDI stock



Source: UNCTAD

2007, Canada's share was 34.0 percent, the highest level since 1979.

Canada's share of North American FDI stock remained stable at around 16.0 percent in 2006 – the last year for which data is available – after steadily declining over the last twenty five years, and is expected to increase in 2007 as a result of larger FDI inflows (Figure 5-6).

VI Special Feature

Canadian Foreign Direct Investment Abroad: a Catalyst for Integration into the Global Economy

Introduction

Driven by technological change, the deregulation of industries, and liberalization of trade and investment rules, global foreign direct investment (FDI) outflows have grown exponentially over the last 25 years, reaching US\$1.2 trillion in 2006. Consequently, average annual growth in the stock of global FDI (at 12.8 percent) has outpaced that for world nominal gross domestic product (4.8 percent) and that for world merchandise trade (8.1 percent) over the past two decades. This development has been one of the key drivers of globalization.

International production — the sales of foreign affiliates of multinational companies — increased world-wide from US\$6.1 trillion in 1990 to US\$21.4 trillion in 2006, and was nearly twice

as high as global exports that year. Thus, outward direct investment and international production are now more important than exporting, in terms of the delivery of goods and services to foreign markets.

The purpose of this article is three-fold. First, it surveys trends in global outward foreign direct investment, both flows and stocks, during the years 1980-2006, with an emphasis on the performance in 2006, the latest year for which data is currently available¹. The performance of the top 15 sources of FDI is examined. Second, the article surveys trends in Canadian direct investment abroad (CDIA). Finally, this study empirically examines the extent to which CDIA is linked to exports.

1 While UNCTAD has published data on global *inflows* for 2007, data on *outflows* in 2007 is not published until later this year.

Trends in global outward flows and stocks

In recent years, the main driving force behind the large increase in global FDI has been the exceptional wave of cross-border mergers and acquisitions (M&As). This, in turn, was underpinned by a number of factors, including: the liberalization of trade, investment and capital markets (including the relaxing of controls on M&As across the world); the deregulation and privatization of service industries; and increased competitive pressures stemming from globalization and technological change, thereby increasing the need to achieve economies of scale through overseas expansion. The macroeconomic factors behind this performance include solid

economic growth in the major advanced economies and large emerging economies, strong corporate profits, and low interest rates. Throughout, there was ample liquidity available to those companies wanting to invest abroad.

Moreover, the depreciation of the U.S. dollar against the other major currencies has altered the balance between cross-border corporate investors, favouring investment into the United States and other dollar-based economies in recent years. Yet another important development underlying global direct investment has been the emergence of companies based in developing and emerging economies as active outward investors.

Definition of foreign direct investment

Foreign direct investment is defined as a long-term and lasting investment by a foreign direct investor in an enterprise resident in an economy other than that in which the foreign direct investor is based. The FDI relationship consists of a parent enterprise and a foreign affiliate which together form a multinational enterprise (MNE). FDI may be undertaken by individuals as well as business entities. In order to qualify as FDI, the investment must afford the parent enterprise control over its foreign affiliate, i.e. ownership of 10 percent or more of the ordinary shares or voting power of an incorporated firm or its equivalent for an unincorporated firm.

Greenfield investment is outlays for the establishment of a new enterprise or the expansion of an existing enterprise (sometimes called brown field). Mergers and acquisitions arise when a

transfer of existing assets from local firms to foreign firms takes place. Intra-company loans or intra-company debt transactions refer to short- or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises, and are not considered as FDI.

FDI stock is the value of the share of capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprise. For a large number of economies, FDI stocks are estimated by either cumulating FDI flows over a period of time or adding flows to an FDI stock that has been obtained for a particular year from national official sources or the IMF data series on assets and liabilities of direct investment.

Source: UNCTAD

TABLE 1
FDI in the Global Economy² (US\$ billions and percent)

	1980	1990	2005	2006	Annual Growth 2006	Annual Average Growth over 1990-2006	Proportion 2006/1980
Outward flows							
World	54	230	837	1,216	45.2	11.0	22.6
Developed economies	51	218	707	1,023	44.7	10.2	20.2
Developing economies	3	12	116	174	50.5	18.3	55.3
Outward stocks							
World	599	1,815	6,209	12,474	17.9	12.8	20.8
Developed economies	527	1,669	5,329	10,710	17.1	12.3	20.3
Developing economies	72	146	859	1,600	24.6	16.2	22.1
World GDP	11,797	22,884	44,881	48,436	7.9	4.8	4.1
World merchandise imports	2,075	3,550	10,853	12,427	14.5	11.8	6.0

Source: UNCTAD World Investment Report WIR 2007, IMF World Economic Outlook and WTO Trade Statistics

Outward flows

Global FDI outflows in 2006 were more than 22 times larger than in 1980. Since 1990, they have expanded by 11.0 percent annually, on average (Table 1). FDI outflows grew remarkably fast in the second half of the nineties to reach a peak in 2000, then slowed for three years coinciding with the general slowdown of the global economy, and started growing again in 2004 (Figure 1). Growth rates were higher for developing countries than for developed countries. As a result, the developing countries' share went from 5.9 percent in 1980 to more than 14 percent in 2006.

Turning to main single-country investors, the United States continued to occupy the dominant position as foreign investor in 2006 (Table 2). After a drop of US\$27.7 billion in outflows in 2005 due to changes in the corporate tax code, the United States resumed its position as the largest single-nation investor in 2006, with direct investment outflows of US\$216.6 billion – almost twice

the amount registered by the next largest investing country (France). Reinvested earnings were the major FDI component in that increase, in stark contrast to 2005 when there was a massive withdrawal of funds. Despite the global upsurge in merger and acquisition (M&A) activity in 2006, multinational enterprises based in the United States were not particularly active in acquiring new corporate assets abroad.

The large outward direct investments from France in 2006, following even higher outflows the year before (US\$121.0 billion) reflected a high level of activity in foreign acquisitions. Of the estimated US\$115.0 billion outflows, about one third was accounted for by five large foreign M&As by French companies, notably Alcatel's acquisition of U.S.-based Lucent and AXA's takeover of the Swiss insurer Wintherthur.

² The sum of the developed economies and the developing economies does not equal the world total. A third category, comprised of certain transition economies, is not reported here. The missing nations are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia, Montenegro, Macedonia and the Commonwealth of Independent States (CIS) nations of Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

FIGURE 1
Global outflows, 1980-2006

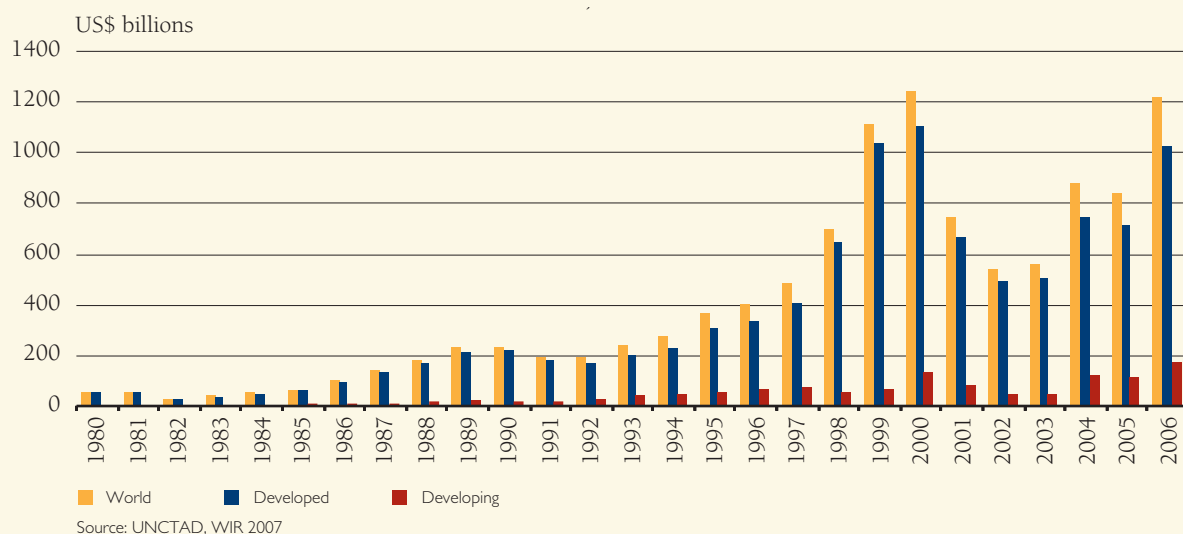


TABLE 2
Outflows and outward stocks: Top-15 economies (US\$ billions, 2006)

Rank	Country	Outflows	Rank	Country	Outward Stocks
1	United States	216.6	1	United States	2384.0
2	France	115.0	2	United Kingdom	1486.9
3	Spain	89.7	3	France	1080.2
4	Switzerland	81.5	4	Germany	1005.1
5	United Kingdom	79.5	5	Hong Kong	689.0
6	Germany	79.4	6	Netherlands	652.6
7	Belgium	63.0	7	Switzerland	545.4
8	Japan	50.3	8	Spain	508.0
9	Canada	45.2	9	Belgium	462.0
10	Hong Kong	43.5	10	Japan	449.6
11	Italy	42.0	11	Canada	449.0
12	Brazil	28.2	12	Italy	375.8
13	Sweden	24.6	13	Sweden	263.0
14	Netherlands	22.7	14	Australia	226.8
15	Australia	22.3	15	Russia	156.8

Source: UNCTAD, WIR, 2007

Companies in Spain took advantage of special incentives and high growth in various sectors (property, construction and banking) to invest a record of US\$89.7 billion in 2006. Of the three largest cross-border M&As in that year, two originated from Spain.

The outward FDI of Switzerland increased from an already high US\$54.3 billion in 2005 to US\$81.5 billion in 2006 – the highest level on record. A significant share of this amount reflected capital increases in foreign subsidiaries, especially by financial institutions domiciled in Switzerland. However, new acquisitions abroad were also part of the story, notably for finance and holding companies, banks, chemical industries and some other manufacturing industries.

The outflows of U.K. companies dropped by about 5.1 percent to US\$79.5 billion, placing the United Kingdom behind not only the United States but also, France, Spain, and Switzerland. This reflected partly a certain disinvestment by U.K. companies from corporate assets previously acquired, and that U.K. cross-border M&A activities were limited.

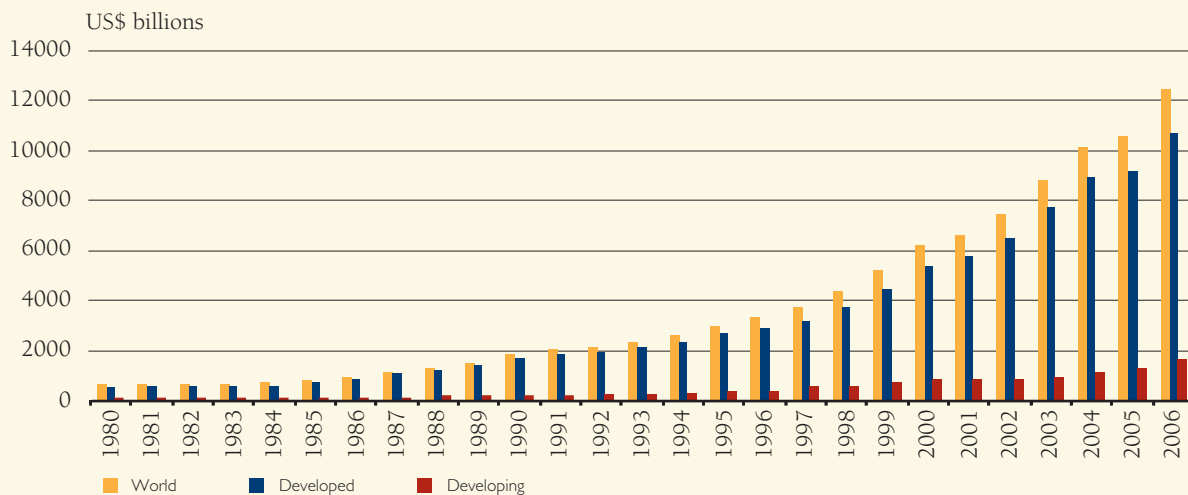
Outflows from Germany, at US\$79.4 billion in 2006, rose to their highest level since the 1990s. This partly reflected a handful of large corporate acquisitions in the United States and the United Kingdom, but also historically large reinvested earnings.

Canadian investment abroad also increased in 2006 – by more than 30 percent to reach US\$45.2 billion. While Canadian companies were relatively active in takeovers abroad, a significant part of this amount seemed to reflect capital transactions with existing subsidiaries in the United States.

Outward stock

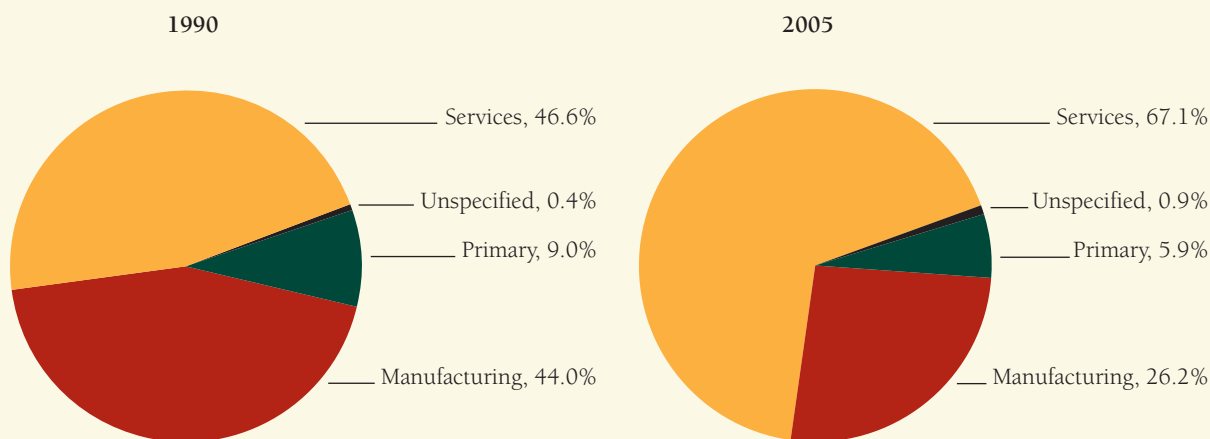
Outward FDI stocks also increased at a robust rate of about 18 percent to reach US\$12.5 trillion in 2006 (Table 1 and Figure 2). Since 1980, outward FDI stocks have increased some 20.8 times over. Over 1990-2006, global outward FDI stocks grew at an annual average rate of 12.8 percent, outpacing both world nominal gross domestic product (4.8 percent annually) and world merchandise imports (11.8 percent annually). The United States, the United Kingdom, France, and Germany were the world's largest sources of FDI on a stock basis.

FIGURE 2
Global outward stocks, 1980-2006



Source: UNCTAD

FIGURE 3
Sectoral distribution of outward FDI stock in 1990 and 2005



Source: UNCTAD

Although the United States continued to be the largest source of FDI stocks in 2006, eight of the top fifteen economies in terms of stocks were from the European Union. Developed countries accounted for 85.9 percent of all outbound FDI stocks in 2006 compared to 84.1 percent for outflows.

Industry distribution

Rapid growth in FDI, faster than the growth of world production and trade, has been one of the key drivers of globalization. This growth has, in fact, been driven by FDI in services. The importance of FDI as an instrument of globalization is much greater in service industries than in manufacturing, because many services are not tradable and establishing foreign affiliates is often the only mode of accessing foreign markets. In addition, other reasons for serving foreign markets through foreign affiliates, such as the need for proximity to clients for effective delivery or because of regulations requiring local presence, while common to both service and

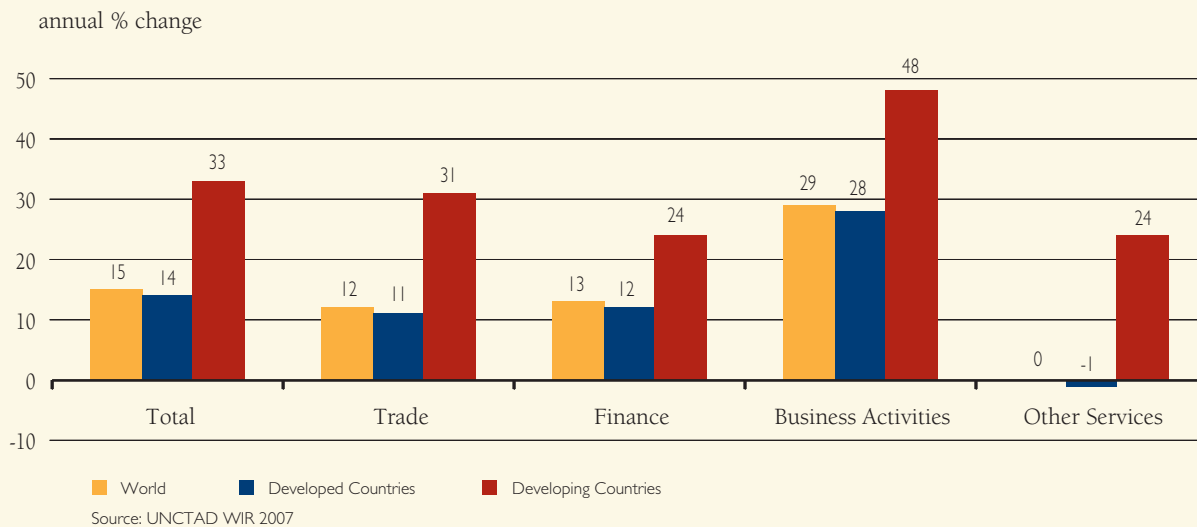
goods industries, are stronger in the former than in the latter.

As a result of these factors, the share of services in global FDI has increased at the expense of the manufacturing and primary sectors (Figure 3). The services sector accounted for 46.6 percent of global FDI stock in 1990, and by 2005 its share climbed to 67.1 percent. On the other hand, the share for manufacturing fell from 44.0 percent in 1990 to 26.2 percent in 2005, while that for the primary sector slipped from 9.0 percent to 5.9 percent over the same period. The pattern observed at the global level holds for the developed countries, which are the main sources of foreign direct investment: services represented 65.5 percent of FDI stock from developed countries in 2005. The share of services in FDI stock from developing countries was even higher, at 82.7 percent, in 2005.

Within the service industries, business activities³, finance, and trade-related activities experienced

3 Business activities are concerned with providing knowledge-intensive support for the business processes of other organizations. They comprise: R&D services; engineering services; computer-related services; legal, accountancy and management consultancy and marketing services.

FIGURE 4
Growth rates of outward FDI stock in services by sub-sector



the fastest annual average growth in FDI stock over 1990-2005 (Figure 4). These three categories dominated FDI stocks in services, accounting for 72 percent of the total in 1990 and 80 percent in 2005. However, FDI stock in business activities has risen at the expenses of all other categories. For instance, it went from a share of 7 percent in 1990 to 34 percent in 2005 for developed countries, and from 11 percent to 55 percent for developing countries over the same period.

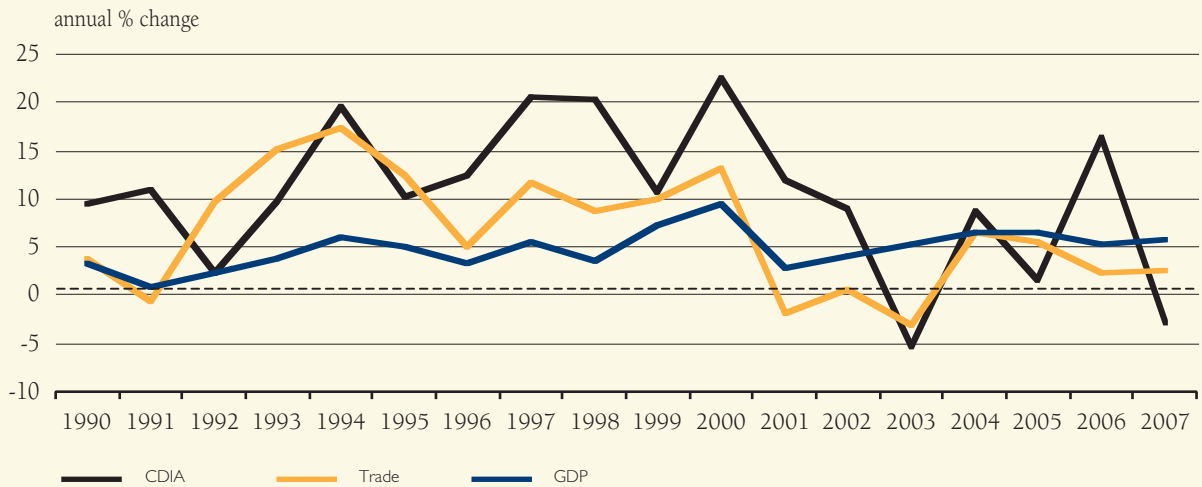
Greenfield investment versus mergers and acquisitions (M&As)

M&As have surpassed greenfield investment as the most common form of FDI. According to UNCTAD data, the value of cross-border M&As reached US\$880.5 billion in 2006, which was equivalent to more than 72 percent of total outflows in that year. Speed and access to proprietary assets are the two most important factors in explaining why firms increasingly prefer to invest abroad via M&As rather than through the establishment of new operations. Establishing or buying a presence in a foreign market is often a quicker route to market entry than traditional exporting. This is particularly true of

mergers and acquisitions, through which firms can quickly access new market opportunities and develop critical mass without adding additional capacity to an industry. Taking over an existing foreign company often provides immediate access to an existing network of suppliers, clients, and distribution channels. Shorter product life cycles make it necessary for firms to respond quickly to opportunities in their competitive environment. The second factor — the quest for strategic assets — refers to the need for companies to acquire proprietary R&D or technical know-how, patents, brand names, local permits and licences, and supplier or distribution networks. Ready-made access to proprietary assets through M&As can be important because, by definition, they are not available elsewhere in the market and they take time to develop.

Greenfield investment is usually the optimal choice for foreign market entry if there are no adequate take-over targets in the host country. Hence, greenfield investment has been the dominant form of market entry in developing or emerging economies. Also, firms may prefer greenfield investment even when there are takeover targets if the cost of

FIGURE 5
Growth in CDIA, GDP and Trade



Source: Statistics Canada

adapting the existing firm to the production, management, and marketing techniques of the acquiring company are considered to be too high.

Trends in Canadian direct investment abroad (CDIA)

The openness of the Canadian economy and the importance of international trade are reflected in the significant growth in total stocks of both inward and outward FDI that Canada has experienced over the past 25 years. Like global outward FDI stocks, Canadian direct investment abroad (CDIA) grew faster on average than trade and GDP over 1990-2007 (Figure 5). While CDIA advanced annually by 10.2 percent on average⁴, total trade in goods and services, and nominal GDP increased by rates of 6.6 percent and 4.9 percent, respectively, over that period.

On a stock basis, Canada became a net exporter of capital in 1997 (Figure 6). CDIA has more than quintupled over 1990-2007, and it was 3 percent

larger than FDI in Canada in 2007. Despite these gains, some analysts have called attention to Canada losing ground in terms of outward FDI stock. This was based on a declining share of world outward FDI stock, especially after 1998. Canada held 4.7 percent of the global outward FDI stock in 1990, but accounted for only 3.6 percent in 2006. However, as a percentage of GDP (Figure 7), CDIA was surpassed only by the United Kingdom and France among selected countries in 2001 and 2006.

⁴ Average annual compound growth rate.

FIGURE 6
Canadian outward and inward FDI stock

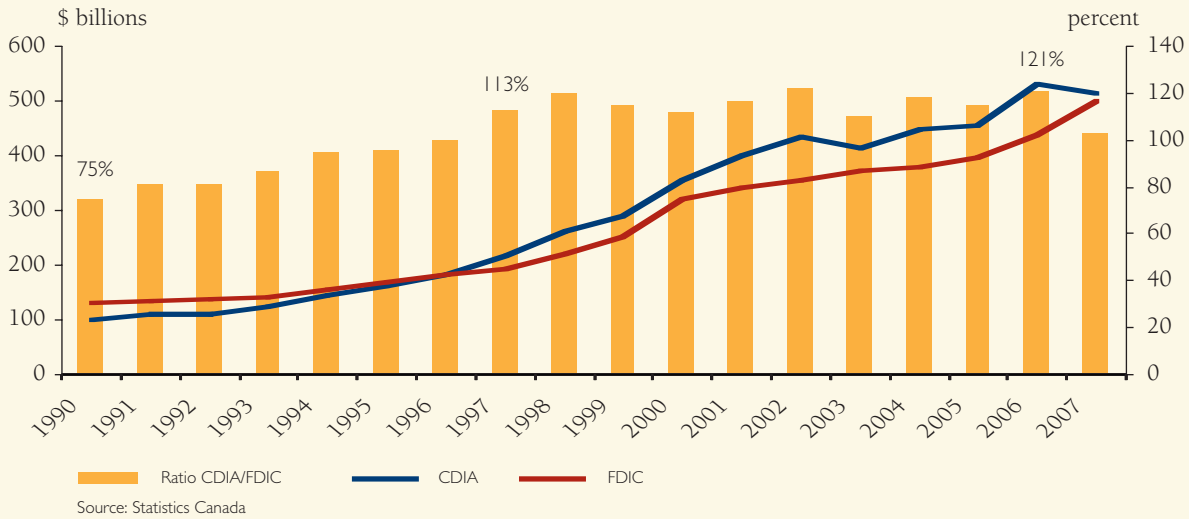
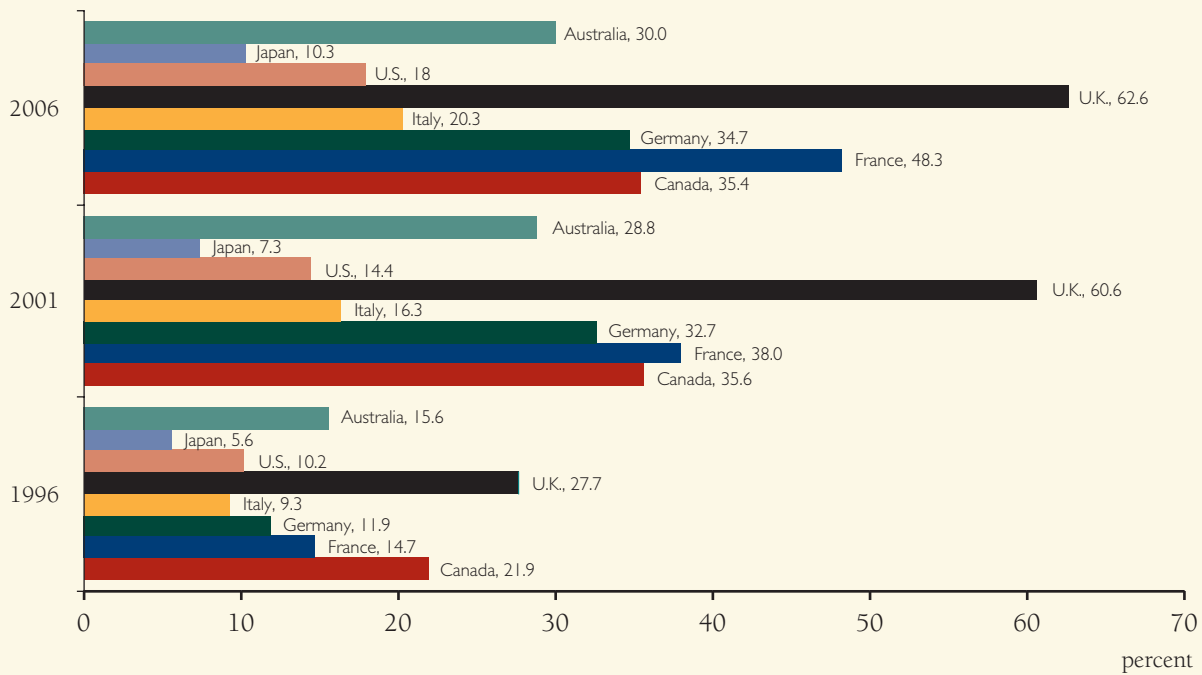


FIGURE 7
Outward FDI stock as a percentage of GDP for selected countries



Why do firms invest abroad?

Outward direct investment, international production, and corporate size are closely related. The most successful companies in the world are also those who are very active in cross-border direct investment flows and international production. Therefore multi-country presence is an international best practice for fast growing companies. The rapid expansion in FDI flows during the 1990s and the 2000s has revived considerable interest among academics and policy makers globally in the reasons why companies make foreign direct investments abroad.

Ownership, location and internalization advantages

FDI occurs to exploit a profit potential that cannot be captured in one's own country. Of the many theories put forward to explain why a firm chooses to engage in FDI activity, Dunning's [Dunning (1980), Dunning (1988)] eclectic paradigm of international production has often been used to explain FDI. According to this theory, pattern and growth of value added activities by MNEs depend on their competitive advantages relative to local firms. They are of three types: ownership advantages, location advantages and internalization advantages.

The ownership advantages manifest themselves as mobile, intangible assets which are exclusive or proprietary to their owners. Examples of these are human capital including marketing expertise, organizational and technical know-how, product differentiation, brand image, product quality, and property rights including patents, formulae and trademarks. These advantages can be exploited abroad and give the firm a market power in the foreign market.

The location advantages are the exogenous and non-exclusive assets which are captured from the environment — foreign country or region — in which the firm's capital and goods are transacted. They

might be in the form of better access to consumers, savings in transport or tariffs, lower cost of production, market structure (i.e., number of firms and product differentiation), and proximity to natural resources.

The internalization advantages are the advantages of administering international transactions within the same firm through a subsidiary rather than licensing or selling its product or process to an unrelated foreign firm. By internalizing activities within the firm and across countries, multinationals are able to reduce transaction costs related to market imperfections. For example, by using affiliates instead of exports to serve foreign markets, MNEs are able to avoid costs associated with tariffs and exchange rates. Transaction-cost economizing is the term often used to describe this benefit. The economies gained are both in terms of scale and synergy, and the more the boundaries of a firm are pushed out, the more important these economies become. These economies are essentially firm rather than country specific and can be associated with factors such as market rationalization, company organization, risk diversification, and the sharing of company-wide resources in terms of R&D, services, marketing, information, distribution, purchasing, and financing. Internalization also allows MNEs to better exploit and protect monopolistic ownership advantages, such as trademarks and know-how.

According to Dunning's theory, all three advantages — ownership, location, and internalization (OLI) — must be present in order for a firm to engage in FDI. Thus, a firm will invest in operations outside of its home market when it holds proprietary assets that can be efficiently exploited internally within the firm.

The link between Canadian direct investment abroad and trade

As noted above, outward investment enables firms to remain competitive. It offers Canadian firms the opportunity to be exposed to new practices and

technology, which can be readily brought home, thus helping the parent firm be up-to-date with technological advances and production processes. It may also help stimulate exports of machinery and other capital goods (particularly if the parent firm has developed unique machinery involved in the production process), and increase demand for intermediary products, know-how, and specialised services. In addition, seeking returns on capital abroad rather than at home allows Canadian firms to repatriate profits, intellectual property royalties, and other similar payments.

Linkages between exports and CDIA: causality tests and gravity models

Exports and outward foreign direct investment have often been characterized as alternative strategies. Firms may either produce at home and export, or produce abroad and substitute local sales of foreign affiliates for exports. It is thus not surprising that concerns have been raised that outward direct investment may lead to loss of investment, exports, and employment from the Canada. Recent economic research, however, suggests that outward direct investment is beneficial to the home economy under certain conditions. For example, by enabling multinationals and their domestic suppliers to expand into new markets and to gain access to new technologies, outward foreign direct investment can secure well-paid jobs in the Canada. Alternatively, outward foreign direct investment can help facilitate a restructuring of industry in Canada by moving companies up the value chain. This is achieved by shifting some labour intensive production processes overseas to more cost competitive locations, allowing the domestic operations to concentrate on strategic high value-added activities that pay higher wages.

Results from empirical studies on the link between FDI and home country exports are mixed but recent studies point to a complementary relationship between outward FDI and exports. Studies by

Mundell (1957) and Svensson (1996), found FDI had a negative effect on home country exports. However, others have found outward FDI had a positive effect on exports [Lipsey and Weiss (1981), Helpman (1984), Grossman and Helpman (1989), and Hejazi and Safarian (2001)]. More recently, Head and Ries (2004) found that FDI increases as foreign markets expand. FDI and exports can be complementary even if FDI consists of vertical specialization or branching. Most recently, Hejazi (2007) showed that CDIA that moves through offshore financial centres results in increased Canadian exports.

To shed light on the issue, the relationship between outward FDI stock and exports for Canada is investigated. We begin by testing for evidence of causality between direct investment and exports. This is followed by a more direct test of the nature of the link using panel data for 44 countries in a Gravity model.

Granger Causality

Correlation does not necessarily imply causation. There is abundance of correlations, which are simply spurious or meaningless. The Granger (1969) approach to the question of whether, say, CDIA causes exports (X) or imports (M) is to see how much of the current X can be explained by past values of CDIA and then to see whether adding lagged values of CDIA can improve the explanation. X is said to be Granger-caused by CDIA if helps in the prediction of X, or equivalently if the coefficients on the lagged CDIAs are statistically significant. Note that two-way causation is frequently the case; CDIA Granger causes X and X Granger causes CDIA.

It is important to note that the statement “CDIA Granger causes X” does not imply that X is the effect or the result of CDIA. Granger causality measures precedence and information content but does not by itself indicate causality in the more common use of the term.

TABLE 3
Pair-wise Granger causality between exports and CDIA, 1946-2006

Null hypothesis	OBS.	F Statistic	Probability
CDIA does not Granger Cause X	49	2.32	0.04
X does not Granger Cause CDIA	49	3.55	0.00

In the computation one should pick a lag length that corresponds to reasonable beliefs about the longest time over which one of the variables could help predict the other. For this study, a 12 year lag was chosen. The test was run using time series data for total exports and the total CDIA stock over the 1946-2006 period. The analysis tests for the joint hypothesis that all coefficients on the lagged variables are null, implying no causality.

The results show that we cannot reject both hypotheses that “CDIA does not Granger cause X” and “X does not Granger cause CDIA” (Table 3). Therefore it appears that Granger causality runs from CDIA to exports and from exports to CDIA. Quite simply, this means that if one considers the relation between Canadian exports and CDIA, past values of exports help explain CDIA and past values of CDIA help predict exports.

Gravity model

Having established that there is a two-way link between trade and direct investment abroad, the question remains as to whether these two elements are complements or substitutes. In order to answer this question for Canada, a gravity model is used to characterize the relationship between Canadian trade flows and Canadian direct investments abroad (CDIA). Gravity models are commonly used to explain bilateral merchandise trade flows between different regions or countries using economic size and distance as explanatory variables. Other variables are usually added to the model to account for

the impact of various factors on the formation and the intensity of international trade patterns.

To this end, the value of Canadian exports and imports with 44 different countries⁵, from 1996 to 2006, are incorporated into the model.

In the basic gravity model, bilateral trade flows are explained by the economic size of countries as approximated by their GDP. A country with a bigger GDP produces more and spends more, and consequently will have a higher supply of exports and a higher demand for imports. Therefore, a strong positive relationship between trade flows and countries’ economic size is expected. Similarly, the farther the distance between two countries, the smaller is their likely bilateral trade. Distance serves as a proxy for time and transportation costs, which cause trade to be more expensive and more complicated. In this case, distances weighted with data on the principal cities are used in each country, thus allowing for the population’s distribution in each country’s territory.

As the main focus under study is the relationship between trade and Canadian outward FDI stock, CDIA is included as an explanatory variable. A negative relationship would imply that CDIA and trade are substitutes, and a positive one signals a complementary relation. Complementarity would indicate that when Canadian companies invest more in a specific country, Canadian trade flows with that country tend to be larger.

Other determinants of trade flows are incorporated into the model to capture their potential effects on

5 Argentina, Australia, Barbados, Belgium, Bolivia, Brazil, Chile, China, Colombia, Costa Rica, Cyprus, Czech Republic, Denmark, France, Germany, Hong Kong SAR, Hungary, India, Indonesia, Ireland, Italy, Japan, South Korea, Luxembourg, Malaysia (1997-2006), Mexico, Netherlands, New Zealand, Norway, Panama, Peru, Philippines, Poland, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan Province of China, Turkey, United Kingdom, United States, Venezuela and Zimbabwe.

TABLE 4
Estimated impact of CDIA on exports and imports

Exports is the dependent variable						
Constant	GDP	DISTANCE	CDIA	FTA	LANGUAGE	R ²
11.65 (14.32)	0.86 (39.56)	-0.35 (-3.99)	0.12 (5.58)	0.74 (5.42)	0.40 (5.44)	86.15
Imports is the dependent variable						
Constant	GDP	DISTANCE	CDIA	FTA	LANGUAGE	R ²
7.63 (7.55)	1.04 (38.55)	-0.02 (-0.19)	0.03 (1.30)	1.22 (7.15)	0.17 (1.80)	83.57

Number of observations: 483

Canadian trade flows. Dummies for the existence of a free trade agreement (FTA) and a common official language with Canada are included into in the model. In algebraic form, the model is as follows:

$$Exports_{c,f} = \beta_0 + \beta_1 GDP_{c,f} + \beta_2 DISTANCE_{c,f} + \beta_3 CDIA_{c,f} + \beta_4 FTA_{c,f} + \beta_5 LANGUAGE_{c,f} + \varepsilon$$

where GDP stands for gross domestic product, DISTANCE for distance, CDIA for Canadian direct investment abroad, FTA for free trade agreement, LANGUAGE for common official language and ε is the error term. The subscripts c and f refer to Canada and foreign country. A similar equation was used for imports.

Before estimating the equation above, the quantitative variables were transformed into natural logs so that the computed coefficients are elasticities, that is they measure the degree to which exports (or imports) reacts to a change in one of the quantitative variables. Table 4 presents the results. The numbers in parentheses are the t-statistics. R² is the R-squared representing the proportion of the variation in exports or imports explained by independent variables. For exports, both GDP and distance have the expected signs and are statistically significant at the 5 percent significance level. This means that a 10 percent increase in GDP and in the distance between Canada and trading partners

will induce an 8.6 percent increase in exports and a 3.5 percent drop in exports respectively. It is found that exports and CDIA are complementary as a 10 percent increase in CDIA will raise exports by 1.2 percent.

This is smaller than the impact found in a 1998 OECD study of member countries. That study⁶ found that each \$1.00 of outward direct investment was associated with \$2.00 of additional exports and a trade surplus of \$1.70. This would reflect the high level of intra-company trade between parent companies and their foreign affiliates, particularly the export from the home country of royalties and licences, consultancy and other “headquarter” services.

Looking at the import equation, both GDP and distance have the correct signs, but the distance variable is not statistically significant. A slightly positive relation was also found between CDIA and imports, although, again, the estimate was not statistically different from zero. That is, the model does not establish a meaningful link between the stock of outward Canadian direct investment and merchandise imports. This is consistent with the view that CDIA is used to serve foreign local markets and not significantly for domestic consumption or production.

6 See OECD (1998). Open Markets Matter: The Benefits of Trade and Investment Liberalisation

Overall, there is no evidence that CDIA by Canadian multinationals has led to a reduction in Canadian exports. To the contrary, the fast rise in Canada's outward FDI stock during the 1990s and the current decade coincided with an increase in Canadian exports. The model finds a significant and positive relationship between exports and CDIA.

Conclusions

At both the global and Canadian levels, outward FDI has outpaced gross domestic product and trade in recent decades. Rapid growth in FDI, faster than growth of world production and trade, has been one of the key drivers of globalization. FDI in services has played an important role as its share has increased at the expense of manufacturing and the primary sector. CDIA is shown to be positively linked to exports by using a Granger causality test and a gravity model. The resulting empirical evidence supports the existence of a complementary relation between exports and CDIA. The model suggests that an increase in CDIA to host countries results in an increase in exports: a 10 percent increase in CDIA will raise exports by 1.2 percent.

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