

## Micro-Economic Policy Analysis Branch Bulletin

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## Measuring Canada's International Trade and Investment Performance

Economic activity is increasingly becoming global. The volume of world trade and investment has been growing rapidly - significantly faster than that of world output - as producers take advantage of increasing trade and investment liberalization and dramatic improvements in information and communications technology. To prosper, Canada must participate in the globalization of economic activity. Canadian producers must compete successfully in world markets, and global businesses must find Canada an attractive place to invest, if the economy is to grow at the pace needed to create sustainable job opportunities and support continued improvements in Canadians' living standards.

Against that general background, this special edition of *Micro* examines Canada's recent performance in the areas of international trade and investment. Canadian activities in those areas grew considerably during the first part of the present decade. Recent trends in Canada's exports, imports, and foreign direct investment are reviewed; some of the main factors underlying these developments are discussed; and international trade and investment trends affecting Canada are compared with those at work in other industrialized economies. A case study explores the impact of recent developments on forestry - a major sector whose fortunes are closely linked to its performance in global markets.



## INDUSTRY CANADA RESEARCH AND PUBLICATIONS PROGRAM

### RECENT RELEASES

#### WORKING PAPER SERIES

No. 18: *Regional Disparities in Canada: Characterization, Trends and Lessons for Economic Policy*, Serge Coulombe.

This paper examines Canada's regional disparities by focusing on growth factors -- such as productivity, employment rates, and the participation rate. The paper also provides a comparison of the situation in Canada with that in bordering regions of the United States.

#### OCCASIONAL PAPER SERIES

No. 17: *Measuring Sustainable Development: A Review of Current Practice*, Peter Hardi, Stephan Barg, with Tony Hodge and Laszlo Pinter.

This paper attempts to answer one very simple question: How does one measure progress towards sustainable development? The most common definitions and basic concepts of sustainable development are introduced before the study moves towards an examination of practical examples of ongoing measurement work and a brief analysis of the advantages and limitations of each.

### FORTHCOMING

#### OCCASIONAL PAPER SERIES

No. 18: *Reducing Regulatory Barriers to Trade: Lessons for Canada from the European Experience*, Ramesh Chaitoo and Michael Hart.

No. 19: *Analysis of International Trade Dispute Settlement Mechanisms and Implications for Canada's Agreement on Internal Trade*, E. Wayne Clendenning and Robert J. Clendenning.

### ANNOUNCEMENTS

#### UPCOMING DISTINGUISHED SPEAKERS LECTURES

April 3, 1998: Economics and Identity, George Akerlof.

April 30, 1998: International Comparisons of Prices and Quantities, Robert Summers.

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*Over the 1990s, Canada has experienced a sharp improvement in its trade balance, owing to significant gains in the goods sector.*

## Developments in Canada's Trade Sector

Over the 1990s, the Canadian economy has become much more dependent on trade. Exports of goods and services have grown from less than 30 percent of gross domestic product (GDP) in 1990 to almost 45 percent in 1996. All provinces and all sectors of the economy have experienced an increase in trade orientation. In Ontario, which accounts for about half of Canada's total merchandise exports, close to 55 percent of production is now sold outside the country.

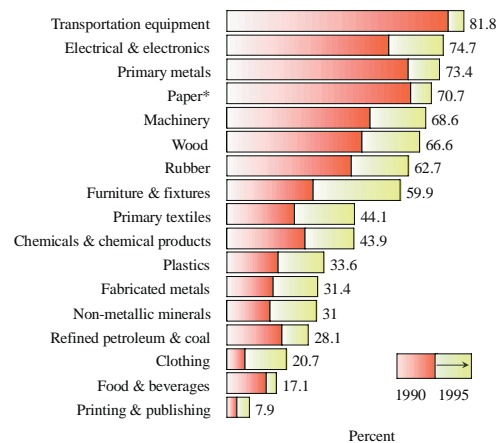
The dramatic rise in Canada's trade orientation has been accompanied by a sharp improvement in the trade balance. Over the period 1990-96, exports of goods and services outpaced the growth of imports – a reversal of the trend observed during the preceding five years. The resulting trade improvement has made an important contribution to Canada's recent economic performance, with advances in net exports accounting for about one quarter of economic growth and one sixth of new job creation during the 1990s.

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

	1985	1990	1996
<b>Goods</b>			
Exports	123	152	280
Imports	107	141	239
Balance	16	11	41
<b>Services</b>			
Exports	13	22	39
Imports	19	33	49
Balance	-6	-11	-10
<b>Goods &amp; Services</b>			
Balance	10	–	31

The table shows that the improvement in the trade balance occurred in goods rather than service trade. This development stems in part from structural changes that occurred in the wake of trade liberalization – in particular through the implementation of the Canada-U.S. Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA). Improved market access encouraged firms to rationalize production and increase product specialization. Canadian manufacturing plants now tend to produce a narrower range of products, but they often supply the entire North American market – and in some cases the entire world market. One result of this restructuring is that the number of manufacturing industries depending on foreign markets for at least 50 percent of their sales doubled between 1990 and 1995.

### Manufacturing exports as percent of shipments

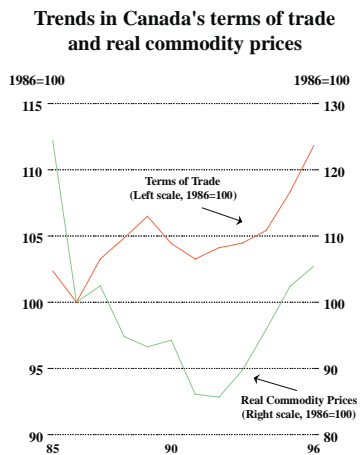


At the same time, Canada's trade performance benefited from a significant improvement in the relationship between the prices received by Canadian exporters and those paid by Canadian importers. The terms of trade increased by about 7 percent between 1990 and 1996, mainly as a result of a strong rise in real commodity prices, which more than offset the downward influence of

*Our trade performance has benefited from an improvement in the prices received by Canadian exporters relative to those paid by Canadian importers.*



the depreciation of the Canadian dollar. The strengthening of commodity prices is reflected in the trade performance of forestry, energy, and other resources. These sectors, which have traditionally enjoyed positive trade balances, recorded particularly large surpluses in the 1990s.

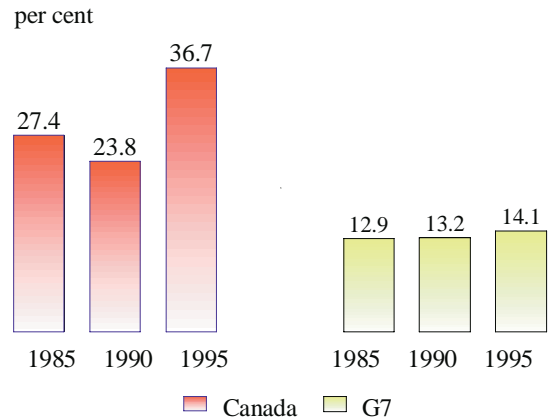


Canada's services trade is comprised mainly of transportation, travel, and commercial services – the last being an increasingly important component that includes computer services, insurance and financial services, management consulting, and royalties. Although Canada's overall trade deficit on services declined only marginally over the period 1990 to 1996, its travel balance improved significantly, with tourism exports expanding nearly three times as fast as imports. Most of Canada's travel deficit is with the United States, and this shrank by over a third in 1996, to \$3 billion.

## Canada's Relative Trade Performance

Trade is much more important to Canada than to most other industrialized economies. In 1995, merchandise exports comprised 37 percent of Canadian output – more than two and half times the average for all G-7 countries<sup>1</sup>.

## Share of merchandise exports in GDP Canada and the G7



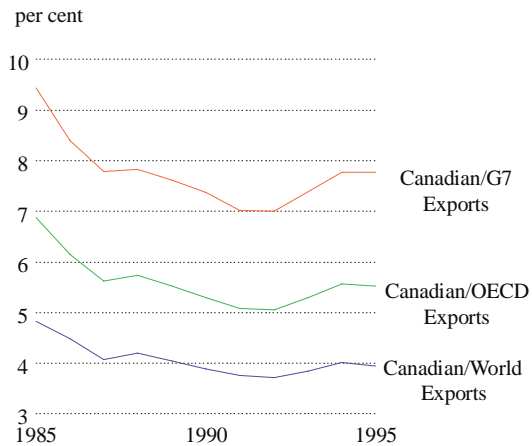
Notwithstanding the large and growing difference in trade orientation between Canada and other countries, it is useful to view Canada's recent trade gains in an international perspective. How does Canada's performance stack up in relative terms? Over the 1990s, Canada's trade sector fares well when its performance is compared to that of other countries. Its share of merchandise exports within the G-7 and the OECD (Organisation for Economic Cooperation and Development) increased significantly. Its share of world exports grew as well, albeit more modestly. The rebound over the 1990s, however, only partly offset the loss in export share that Canada experienced over the preceding five-year period.

Canada's merchandise export gains were mainly achieved in the U.S. market. Canada has lost considerable ground in the high-growth markets of Asia<sup>2</sup>, although it has recently improved its position relative to other G-7 countries in high-growth Latin American markets<sup>3</sup>. It is significant that one area in which Canada has gained market share is that of the high-technology goods that are an increasingly important component of global trade (i.e., electrical machinery, medicinal and pharmaceutical products, office machines and data processing equipment, and telecommunications and sound-recording apparatus).



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

**Canadian share of G7, OECD and world merchandise exports 1985-1995**



Canada's share of G-7 and OECD service exports improved as well over the first half of the 1990s. Here again, however, its position relative to other industrialized countries has deteriorated considerably since the 1980s. Moreover, Canada's share of world service exports has declined steadily since 1985.

## Future Trade Prospects

Canada's recent trade performance was highly dependent on the ability of Canadian firms to expand sales in the U.S. market. Indeed, with the strengthening of Canada-U.S. trade links, over three quarters of all Canadian exports of goods and services now flow to our southern neighbour. We must continue to take advantage of our largest trading partner. At the same time, we must now endeavor to rise to the exciting challenges that await in the emerging markets of China, East Asia, Latin America and other ports of call.

How can the healthy trade performance of the early 1990s be sustained? To answer this question it is necessary to understand the factors contributing to the

improvement in Canada's trade position. The export gains that Canada achieved in the early 1990s were mainly the result of three developments:

- the strong growth in U.S. domestic demand;
- the successful negotiation of two free-trade agreements (FTA and NAFTA); and
- the improvement in Canada's cost competitiveness.

The first factor is outside of the control of Canadian firms and policymakers. Economic growth in the United States has already begun to slow down, whereas domestic demand in Canada has been strengthening. These swings in U.S. and Canadian economic activity largely explain the reduction in Canada's net exports over 1996 and 1997.

The second and third factors, however, do raise challenges for private and public sector actors. The impact of the free-trade agreements on Canadian exports depends on how quickly and effectively domestic firms restructure and transform themselves into specialized suppliers for North American product markets. While much restructuring has actually taken place, Canadian firms still have some distance to go in responding to the increased integration of U.S. and Canadian markets. The long-term trade impact of FTA and NAFTA will also be influenced by government policies; in particular, Canada's export prospects will be helped if government policies are viewed favourably by foreign investors seeking a location from which to base their North American operations.

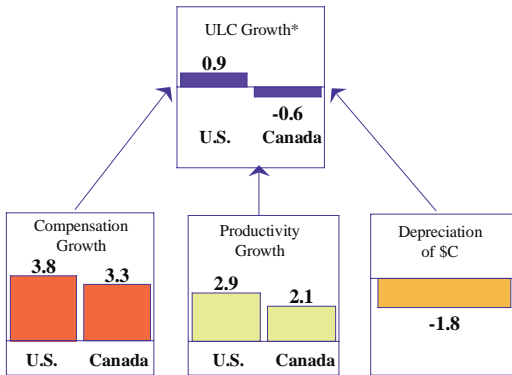
The third of the factors cited above – Canada's cost competitiveness – also focuses attention on the structure and efficiency of Canadian industrial activities. The accompanying chart analyses the sources of improvement in Canada's cost competitiveness relative to the United States over the period 1990-96. It is significant that productivity growth in Canada was well below that in the United States over this period. Were it not for the significant depreciation that occurred in the value of the



*Devoting attention to investment, training, innovation, and other potential sources of productivity growth can establish the foundation needed to sustain a strong trade performance.*



**Average annual growth of the components of unit labour costs (ULC): Canada & the U.S., 1990-1996**



\* In Canadian dollars.

Canadian dollar, unit labour costs would have grown faster in Canada than in the United States, reducing this country's cost competitiveness.

While the Canadian dollar depreciated over 1990 to 1996, Canada's terms of trade improved because of the more-than-compensating rise in the real prices for Canada's commodity exports. Such a fortuitous development, however, cannot be counted on in the future. Indeed, over the last few years, real commodity prices have already declined substantially.

For Canada to be cost-competitive, the most important requirement is that it must achieve productivity growth at least comparable to that of its major trading partner. It is by devoting attention to investment, training, innovation, and other potential sources of productivity growth that Canadians can establish the solid economic foundation that is needed to sustain a strong trade performance.

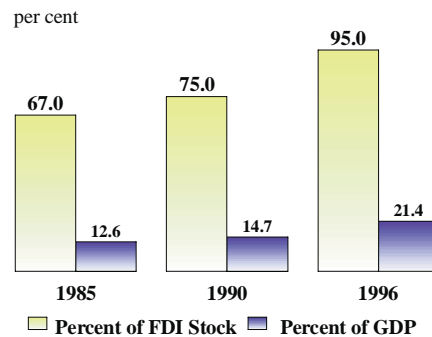
## Foreign Investment Trends

Like foreign trade, foreign investment became a much more important element within the Canadian economy over the 1990s. Between 1990 and 1996, both inward flows of foreign direct investment (FDI) to Canada and outward FDI flows from Canada were about 50 percent higher, on average, than they were between 1983 and 1989. These changes reflect the greater entry of global enterprises into Canada through new investment or through mergers or acquisitions, and the increased expansion of Canadian-based firms into other countries. As both a home and a host economy, Canada has been a participant in the efforts of transnational firms to further rationalize their activities on a global scale.

The total stock of inward FDI, resulting from inflows and from the reinvestment of earnings by foreign enterprises in Canada, had reached \$180 billion by 1996. This investment has brought not only capital, but also technology and skills that have helped to improve this country's industrial competitiveness. Canada's investment orientation, as indicated by the ratio of inward FDI stock to GDP, increased from 18.9% in 1985 to 22.6% in 1996.

Over this same period, however, Canada's outward FDI stock has grown even more swiftly, with major Canadian firms becoming more internationally oriented. As a consequence of this development, the gap between Canada's inward and outward investment stocks has largely disappeared.

**Canada's outward FDI stock as a percent of inward FDI stock & GDP**

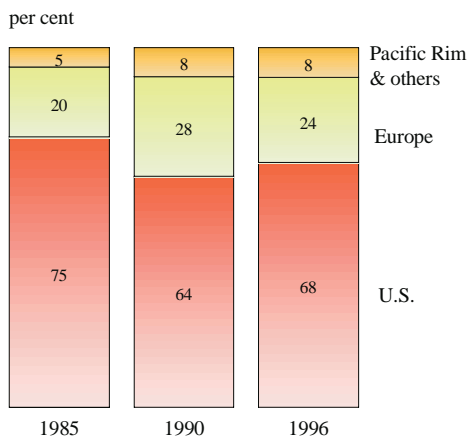




*Over 1985-1996, the gap between Canada's inward and outward investment stocks largely disappeared as Canadian firms became much more internationally oriented.*

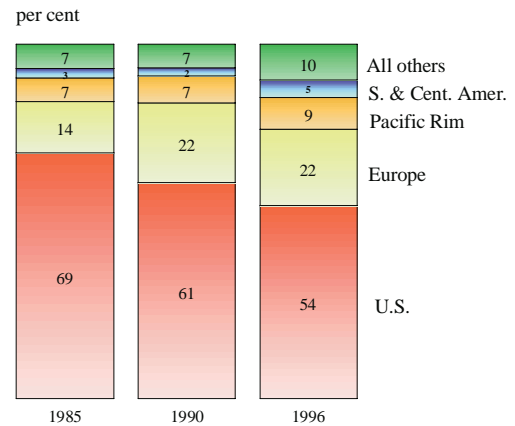
In the recent period, significant changes have taken place in Canada's investment position with the United States. Since the implementation of the FTA in 1989, our North American neighbour has become a much more important source of inward investment. Almost three quarters of the cumulative net FDI inflows to Canada over 1991 to 1996 originated from across the border, compared to only one third in the previous five-year period. Conversely, other OECD countries, including the United Kingdom and Japan, have become less important sources of FDI. Meanwhile, Canadian firms have diversified their outward investment, focussing less on the U.S. market and more on opportunities in the European Union (EU) and the developing economies of the Asia-Pacific region and Latin America. Only 40 percent of Canada's outward FDI flows over the period 1991-96 went to the United States, down from 65 percent during the period 1985-90.

**Geographic distribution of FDI stock in Canada**



As a result of recent developments, the U.S. share of Canada's inward FDI stock, which had declined significantly during the late 1980s, has again begun to increase. Meanwhile, the importance of the United States as a destination of Canada's outward FDI stock has continued to diminish. In 1996, most of Canada's investment assets abroad were still located in the United States, but almost a quarter of Canada's outward FDI stock was now in Europe, and almost 10 percent in Pacific Rim countries.

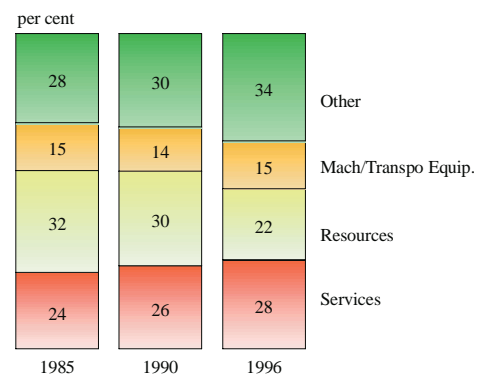
**Geographic distribution of Canada's outward FDI stock\***



\* Canadian direct investment abroad (CDIA) stock.

Changes in the sectoral composition of foreign investment in Canada and of Canadian investment abroad reflect the growing importance of services and the reduced role of resource industries in industrial economies. Since 1985, there has been a significant increase in the proportion of Canada's inward FDI stock in service activities and in manufacturing industries such as chemical products, foods and beverages, and electronic and communications products. In investing abroad, Canadians have concentrated much more heavily on service activities and have substantially reduced their share of investments in resource-based industries.

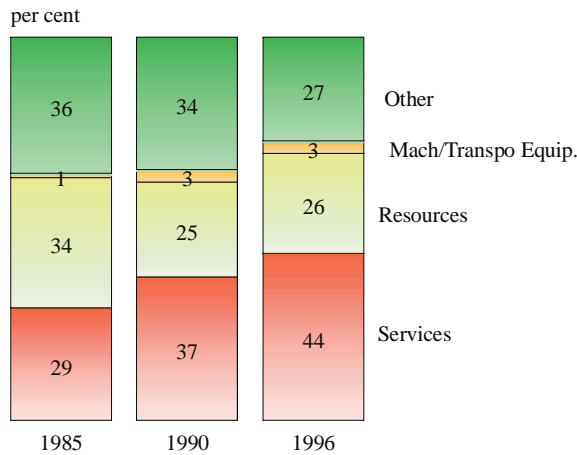
**Industry distribution of FDI stock in Canada**



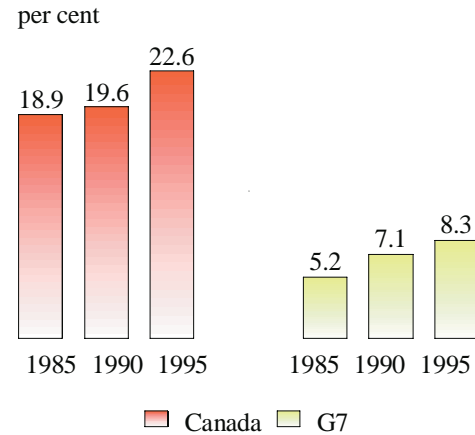
*In the 1990s, inward FDI flows accelerated and Canada's investment orientation increased.*



**Industry distribution of CDIA stock**



**Share of inward FDI stock /GDP Canada and the G-7**



## Canada's Relative Investment Performance

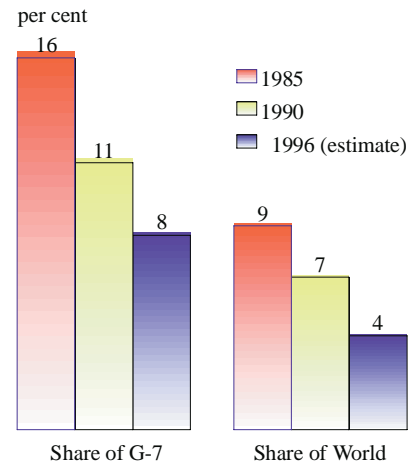
It is generally recognized that Canada is a highly open economy, much more dependent on foreign trade and investment than most other industrial nations. Canada's strong investment orientation is underlined by the accompanying chart, which shows that in 1995 the ratio of inward FDI stock to GDP in Canada was approaching three times the average for all G-7 countries.

But while inward FDI flows accelerated and Canada's investment orientation increased significantly over the period 1990-95, this country's share of global inward FDI stock has continued to decline. Canada's importance as a host economy has also declined in the context of the G-7 countries; in 1996, its share of G-7 inward FDI stock was about half of what it was in 1985. Even within North America, Canada has lost ground: between 1985 and 1996, its share of North American inward FDI stock fell from 24 percent to 16 percent.

There has also been some slippage over the past decade in Canada's share of world and G-7 outward FDI stocks. Its share of the total world stock of outward FDI stock fell

from 6 percent in 1985 to 4 percent in 1996. Note that this does not reflect a failure of Canadian-based firms to look outward. As can be seen from the strong growth in outward FDI, Canadian firms have been actively participating in the globalization of business operations. Rather, the fall in Canada's share of outward FDI is mainly the result of the recent emergence of certain other countries – including Japan and a number of Southeast Asian economies – as important sources of outward direct investment.

**Canadian share of G7 and global inward FDI stock: 1985-1996**





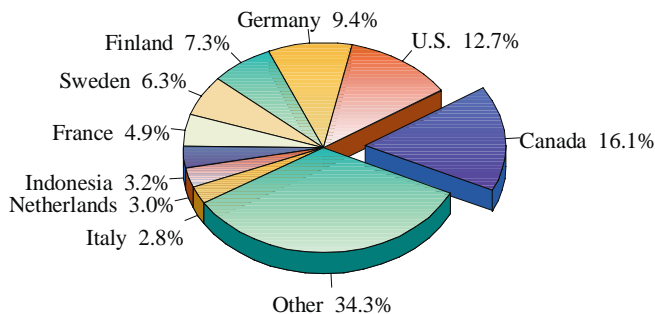


*Canada is the largest exporter of forest products globally, with sixteen per cent of total world exports.*

## The International Performance of Canada's Forest Products Sector: A Case Study

The forest products industry is Canada's leading manufacturing sector, employing a quarter of a million workers and producing shipments valued at C\$57 billion in 1995. This industry alone accounts for about 45 percent of manufacturing output in British Columbia and almost 35 percent in New Brunswick. In the context of this special edition of *Micro*, the forest products industry is of interest because it is Canada's largest net exporter. Moreover, with over 16 percent of total world exports, Canada is the largest exporter of forestry products globally.

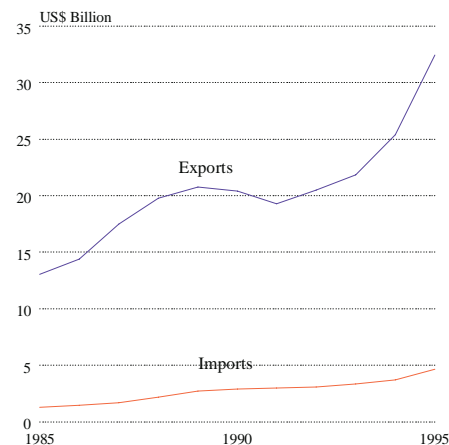
**Distribution of world forestry exports by country. 1995**



Given Canada's importance as a forest products exporter, it is somewhat surprising to find that its producers are small by international standards. MacMillan Bloedel – Canada's largest firm, with net sales almost twice that of second-placed Domtar – ranked only 26th in worldwide sales in 1994. Nonetheless, dynamic structural changes within the industry are underway. The Canadian industry has over 3500 establishments and a majority of Canadian forest products shipments are exported. In 1995, exports accounted for over 70 percent of the industry's output.

The strong performance of Canada's forest products sector has contributed to the sharp improvement in Canada's overall trade performance over the first half of this decade. As can be seen in the accompanying chart, exports of forest products started from a much higher base and grew more rapidly than imports over the period 1990-95. As a result, Canada's trade surplus in forest products rose from just under US\$17 billion in 1990 to US\$28 billion in 1995.

**Canadian forestry trade, 1985-1995**



About one third of Canada's trade surplus is accounted for by paper products. The two other major categories are pulp and waste paper, and wood, each of which accounted for just under 30 percent of the 1995 surplus in forest products. While paper products constitute the biggest export category, they have declined somewhat in importance over the past decade. The strongest growth has occurred in exports of pulp and waste paper and of wood manufactures – a small but increasingly significant category that accounted for about 8 percent of the sector's 1995 trade surplus.

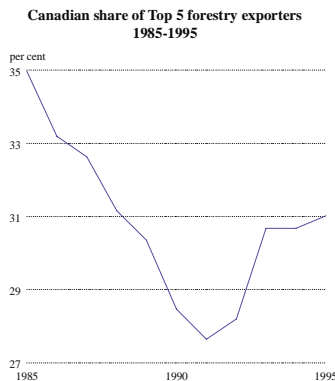
*Canadian firms concentrate on sales of commodities that are subject to more significant cyclical fluctuations than high-value-added forestry products.*



The forest products industry benefited from strongly rising output prices over the early 1990s. Softwood lumber, newsprint, and wood pulp prices all rose sharply in the years prior to 1995. Since then, however, newsprint and softwood lumber prices have declined somewhat, and wood pulp prices have fallen dramatically.

## *Indicators of Relative Performance*

In good times, Canadian forest products firms do well, compared to major foreign producers; conversely, in hard times, Canadian firms fare poorly by international standards. That, at least, has largely been the experience of the past 10 years. As can be seen in the accompanying chart, over the period 1988-91, when exports of the top-five exporting nations were under pressure, Canada's international sales were especially hard hit. But over the period 1992-95, Canada benefited more than other major exporting countries from the rebound in export sales.



The relationship between Canadian and world forest products sales has followed a similar pattern. Canada's share of world exports fell sharply from 1985 to 1992 and then began to recover. By 1995, however, its share of both world and top-five exports were well below the levels attained a decade earlier.

Although significant changes are under way, Canadian firms still concentrate on sales of commodities that are subject to more significant cyclical fluctuations than higher-value-added forestry products. It also appears that Canadian firms serve partly as residual suppliers in some markets; in this role, they would bear the major burden from declining sales while gaining more than domestic producers from improving market conditions.

In addition, the export position of Canadian firms has been influenced by movements in the value of the Canadian dollar. The period from 1986 to 1992, when Canada's share of world exports was falling sharply, was – not coincidentally – a time when the Canadian dollar was appreciating rapidly against the currencies of other G-10 countries<sup>4</sup>. From 1992 to 1995, when Canada's share of world forestry exports increased, Canadian firms were helped by a precipitous drop in the value of the dollar relative to other major currencies.

## *Major Export Markets*

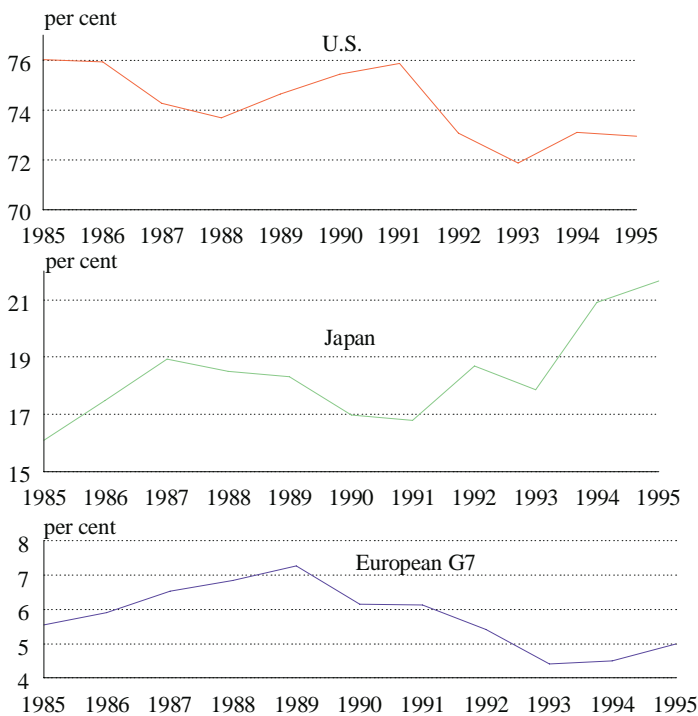
Just under two thirds of Canada's C\$41 billion in exports of forest products in 1995 went to the United States. Asian markets accounted for 18 percent of export sales, with Japanese purchases representing about two thirds of that proportion. Only about 11 percent of Canada's 1995 forestry exports went to the European Union (EU).

Canada is the dominant foreign supplier in the United States, accounting for over 80 percent of that country's imports of wood, and pulp and waste paper, and for over 70 percent of paper product imports. Over the last decade, however, Canadian producers have lost some ground to foreign competitors. Brazil has become a more important competitor in pulp and waste paper products, while Finland and Mexico have gained market share in paper products, at Canada's expense. Wood manufactures (which include improved and reconstituted wood, builder's carpentry and joinery, plywood, sawn wood, and manufac-



*Canadian forest products suppliers have made significant inroads in Japan and have kept their dominant foreign supplier position in the U.S.*

**Canadian share of forestry imports in major markets, 1985-1995**



tured articles) is the one category in which Canada has been successful in gradually increasing its share of U.S. imports.

In the European G-7 countries, Canadian firms have only achieved significant inroads into the market for pulp and waste paper products, where their import share exceeded 20 percent in 1995. They have not experienced much success in European G-7 markets for wood, paper products, and wood manufactures, where European suppliers, especially from Sweden and Finland, have been formidable competitors.

On the other hand, Canadian firms have become much more important players in Japanese forest product markets. Between 1990 and 1995, Canada significantly increased its share of Japanese imports of wood, pulp and waste paper, paper products, and wood manufactures. In the first three product categories, Canada gained market

share at the expense of the United States, which is Japan's major foreign supplier. Canada's market share is greatest in pulp and waste paper, where Canadian firms supply over a third of Japan's import requirements. Although Canada is a less important supplier of wood manufactures (accounting for only 7 percent of Japan's 1995 imports), this has been an area of strong growth; Canadian firms have been particularly successful in developing Japanese markets for niche products, such as manufactured housing, in which they have achieved a significant competitive advantage. However, a recent cyclical downturn in Japan has impeded Canadian gains in Japan.

In balance, Canada's forest products industry has two features working strongly in its favour: an abundance of natural resources and close proximity to the United States. On the down side, it appears that forestry export performance is correlated with exchange rate movements. Foreign sales also seem concentrated on residual-supply and lower-value-added commodities that are subject to significant cyclical fluctuations. Equally unsettling, is that our relatively small producers are not achieving much success in European G-7 markets and are facing growing competition in the U.S. However, Canadian firms became important suppliers in Japan, where they have been successful in exploiting niches, such as manufactured housing.

1. *The Group of Seven Industrialized Countries (G-7) includes France, Germany, Italy, Japan, the United Kingdom, and the United States, in addition to Canada.*

2. *These are: China, Hong Kong, South Korea, Singapore, Taiwan, Malaysia, Thailand, Indonesia, the Philippines, Vietnam, Bangladesh, Brunei, and Cambodia.*

3. *These are: Mexico, Brazil, Argentina, Chile, Panama, Columbia, Venezuela, Peru, Paraguay, Ecuador, Guatemala, Uruguay, El Salvador, Honduras, and Bolivia.*

4. *The G-10 includes the central banks of the G-7 members plus those of Belgium, the Netherlands, Sweden, as well as host Switzerland.*