
I. ECONOMIC ENVIRONMENT

(1) INTRODUCTION

1. Canada has consolidated many of the macroeconomic gains noted in its 1996 Trade Policy Review, including steady output growth and low inflation while eliminating fiscal deficits. Exports continued to benefit from the United States' cyclical lead, supported by efficiency gains from internal deregulation and greater internal market integration (Chapter II(2)). The secular shift away from commodity exports has continued, although primary products still account for slightly over 30% of total merchandise exports. The financial crisis in Asia has had so far only a limited impact on Canada's overall economic growth, although slower growth in Asia has reduced Canadian exports of goods and services to the region. Nevertheless, a protracted crisis could have significant indirect effects on the Canadian economy. Commodity prices have already fallen for a broad range of export products, which, together with volatility in financial markets, has put downward pressure on the relative value of the Canadian dollar and required interest rate increases at various times in 1997 and the first half of 1998 (followed by a reduction in September 1998). Canadian exports and aggregate output remain vulnerable to slower growth in the United States, which absorbs some 85% of Canada's exports. These factors create particular concerns because the high debt to GDP ratio leaves Canada exposed to interest rate increases or slow-downs in economic activity. Unemployment also remains a significant issue.

(2) RECENT MACROECONOMIC PERFORMANCE¹

(i) Output and employment

2. The pace of economic growth quickened during 1991-94; after peaking at 4% in 1994, the expansion decelerated in 1995 and slowed down sharply in 1996 (Table I.1). The latter resulted from a reduction in business inventory investment and slower export growth, which in turn reflected a temporary slow-down in the U.S. economy. Economic activity regained momentum in late 1996 and 1997, largely thanks to a boost in private consumption and investment supported by accommodative monetary conditions and strong growth in the U.S. economy. During that period, private domestic investment - concentrated in the finance, oil and gas and, to a lesser extent, the telecommunications industries - replaced exports as the most dynamic sector. The rate of economic expansion slowed in early 1998 in the wake of the Asian financial crisis, lower commodity prices, and one-time events such as strikes and a severe ice storm.² The slump in commodity prices in particular has led to reduced exports and output in mining and mineral refining, lumber and pulp and paper industries, as well as oil and gas (section (3) below).

3. Domestic demand growth, which lagged behind GDP during 1992-95, has made a major contribution to economic expansion since 1996. Consumer expenditure recovered from the slump in 1995, reflecting strengthened consumer confidence as well as reduced interest and unemployment rates. In contrast, government expenditure has declined each year since 1994 as fiscal policy has been tightened (section (ii) below). Although the upsurge in domestic spending in 1997 helped to reduce the budgetary deficit by generating higher revenues, it also contributed to a sharp reduction in the merchandise trade surplus.

¹This section is based on statistics available up to the second quarter of 1998. As the Asian financial crisis unravels, the picture drawn here may change.

²Bank of Canada (1998b), p.5. The Bank estimates that the January 1998 ice storm in eastern Canada lowered real GDP growth in the first quarter of 1998 by about 0.2 percentage points.

Table I.1
Performance of the Canadian economy, 1992-98^a

	1992	1993	1994	1995	1996	1997	1998(Q1) ^c	1998(Q2) ^c
(Annual percentage change)								
Real GDP	0.8	2.2	4.1	2.3	1.2	3.7	3.4	1.8
Consumer expenditure	1.3	1.6	2.9	1.4	2.4	4.1	0.6	5.5
Government expenditure	0.9	0.5	-0.8	-0.3	-1.5	-0.7	0.7	3.5
Residential investment	7.9	-4.2	1.8	-15.1	10.9	13.1	-0.6	-6.4
Business fixed investment	-5.5	2.7	9.4	5.2	4.2	14.5	2.7	11.5
Final domestic demand	0.6	1.1	2.9	0.7	2.0	4.5	0.8	5.1
Exports (goods and services)	7.6	10.4	14.2	11.8	5.7	8.0	6.3	5.3
Imports (goods and services)	5.6	8.8	10.5	9.0	5.2	13.3	0.1	6.1
GDP price deflator	1.3	1.2	1.2	2.6	1.4	0.5	-0.7	...
Consumer price index – all items	1.5	1.8	0.2	2.2	1.6	1.6	1.0	...
Unit labour costs	1.6	-0.5	-1.4	0.8	1.3	0.1	0.2	0.3
Monetary expansion (M2+)	5.6	3.7	2.2	4.1	3.9	0.9	-0.8	...
(Per cent)								
Interest rates (short-term) ^b	6.5	4.9	5.4	7.0	4.3	3.1	4.5	4.7
Capacity utilization – manufacturing	76.0	79.8	83.2	83.2	82.5	84.8	86.7	...
Unemployment	11.3	11.2	10.4	9.5	9.7	9.2	8.6	8.4
(Per cent GDP)								
Current account	-3.8	-4.0	-3.0	-1.4	0.6	-1.5	-2.0	-1.9

... Not available.

a Calendar years.

b Three-month treasury bills.

c Annual rates.

Source: Department of Finance, *The Economy in Brief*, September 1998; *Bank of Canada Review*, Summer 1998; and GATT (1994) and WTO (1996), *Trade Policy Reviews - Canada*.

4. After peaking in 1992 in the wake of the 1991 recession, unemployment has generally retreated (Table I.1). A temporary setback in 1996, in part due to public sector cutbacks and weaker overall growth, was followed by a gradual fall in the unemployment rate, which stood at 8.4% in the second quarter of 1998, its lowest level since mid-1990. Since late 1997, private firms have accounted for most of the increase in jobs. Significant variations in unemployment persisted across provinces.³

5. The Bank of Canada has estimated that demand during 1997 grew faster than the economy's capacity to produce, narrowing the output gap – the difference between actual output and estimated potential output – to about 1.25% by the end of that year. The authorities consider that this and the slowing in economic growth in 1998 suggest that the slack in the Canadian economy will disappear

³In July 1998, unemployment was highest in the maritime provinces of Newfoundland (17.5%), Prince Edward Island (12.4%) and New Brunswick (11.2%), reflecting the decline of the fisheries sector; it was lowest in Manitoba (5.3%), Alberta (5.4%) and Saskatchewan (6.0%).

within the next two years. Nevertheless, there seems to exist considerable scope to increase potential output in the longer term by reducing structural unemployment.

(ii) Public finance and debt

6. The authorities have continued their efforts to restore sound public finances after the marked deterioration during the 1980s and early 1990s. The federal deficit fell to Can\$8.9 billion in 1996/97, equivalent to 1.1% of GDP, the lowest since 1970/71 (Table I.2). The improvements are largely due to the reduction and reform of programme spending complemented by increasing budgetary revenues reflecting sustained economic growth. Since fiscal year 1995, budgetary revenues have exceeded programme spending but the resulting operating surpluses have not covered interest charges on the public debt (Box I.1). The provinces and territories have also moved to eliminate their deficits.

Table I.2
Summary statement of the Federal Budget, 1994-2000^a
(Can\$ billion and per cent)

	1994	1995	1996	1997	1998 ^b	1999 ^b	2000 ^b
Revenues	116.0	123.3	130.3	140.9	147.5	151.0	155.0
Spending	-120.0	-118.7	-112.0	-104.8	-106.0	-104.5	-107.0
Operating balance	-4.0	4.6	18.3	36.1	41.5	46.5	48.0
Public debt charges	-38.0	-42.0	-46.9	-45.0	-41.5	-43.5	-45.0
Underlying balance	-42.0	-37.5	-28.6	-8.9	0.0	3.0	3.0
Contingency reserve ^c	0	0	0	0	0.0	3.0	3.0
Budgetary balance	-42.0	-37.5	-28.6	-8.9	0.0	0.0	0.0
(% of GDP)	(-5.8)	(-4.9)	(-3.6)	(-1.1)	(0.0)	(0.0)	(0.0)
Non-budgetary transactions	12.2	11.6	11.4	10.2	12.0	6.0	9.0
Financial requirements ^d	-29.8	-25.8	-17.2	1.3	12.0	6.0	9.0
Net public debt	508.2	545.7	574.3	583.2	583.2	583.2	583.2
(% of GDP)	(70.1)	(71.6)	(71.9)	(71.1)	(68.1)	(65.4)	(62.9)
Memorandum items:							
Total government ^e							
Revenues	343.9	361.5	374.9	396.1	...	...	...
Expenditures	379.7	389.7	385.8	385.3	...	...	...
Capital accounts	-6.5	-6.5	-5.2	-3.3	...	...	...
Balance	-42.2	-34.7	-16.1	7.5	...	...	...

... Not available.

a Fiscal years ending 31 March.

b Projections.

c The contingency reserve is intended to protect the deficit target from unpredictable events or macroeconomic forecast errors.

d Excluding foreign exchange transactions.

e Federal and provincial governments including Canada Pension Plan and Quebec Pension Plan; calendar years.

Note: Numbers may not add due to rounding.

Source: Department of Finance, *The Budget in Brief* 1998, 24 February 1998; and *Fiscal Reference Tables*, October 1997.

Insert Box I.1: Canada's fiscal strategy

The Federal Government's fiscal strategy, based on two-year rolling fiscal targets, has targeted budgetary balance in each year to 2000. This target implies holding programme spending about constant in nominal terms throughout the period, declining relative to GDP, and achieving a small underlying surplus in 1999 and 2000.

The federal deficit fell to Can\$8.9 billion in 1996/97, the lowest deficit since 1976/77 and the third consecutive deficit coming below target. Since fiscal year 1995, budgetary revenues have exceeded programme spending (total spending excluding interest charges), resulting in operating surpluses that reached Can\$36.1 billion, or some 4% of GDP, in fiscal year 1997. These surpluses have not, however, covered interest charges on the net public debt, which reached an all time high of just under Can\$47 billion (almost 6% of GDP) in 1995/96 but fell slightly in 1996/97 as decreasing interest rates more than offset increases in interest-bearing debt.

The authorities recognize that the large share of revenue going to pay interest on the public debt, about 32%, significantly reduces their ability to address other priorities (Department of Finance, The Economic and Fiscal Update, 15 October 1997). They seek to overcome the public debt problem through sustained economic growth and a debt repayment plan. This relies on achieving balance or surplus budgets during 1998-2000 and prudent planning assumptions, including a Contingency Reserve of Can\$3 billion. The Government expects the net federal public debt to GDP ratio to fall to just under 63% in 1999/2000.

The budget position of the provinces and territories deteriorated in the early 1990s, leading to a peak deficit of Can\$25.0 billion, some 3.5% of GDP, in 1992/93. Tighter fiscal programmes in recent years cut back the provincial-territorial budgetary deficit, which declined to Can\$7.1 billion (just under 1% of GDP) in 1996/97. Five provinces reported budgetary surpluses that year; provinces still in deficit, including Ontario and Quebec, are committed to eliminating their deficits by the year 2000/1 at the latest. Programme spending at the aggregate provincial-territorial level, which is larger than spending at the federal level, fell from Can\$140.4 billion in 1992/93 to Can\$137.4 billion in 1996/97. All provinces realized an operating surplus in 1996/97.

Given the expected budget surpluses, the focus of the fiscal policy debate has shifted to the issue of how to use the surpluses (the so-called fiscal dividend), including the appropriate balance among debt reduction, tax cuts, and spending increases. For example, arguments have been put forward that maintaining balanced budgets is a better strategy than running surpluses, which by requiring an excess of taxation over spending can potentially limit demand and GDP growth. The Government has indicated that it would seek to devote half of the budget surpluses to increase spending, and half to reduce the federal public debt as well as taxes.

The fiscal dividend may allow reduction of the tax burden of business and individuals. In March 1996, the Minister of Finance appointed an independent advisory committee, the Technical Committee on Business Taxation, to review business taxes. The Committee's report was released on 6 April 1998 (the full report is available in Internet, <http://www.fin.gc.ca/taxstudy/grie-e.html>). In releasing the report, the authorities indicated that the priority was tax relief for individuals, building on the personal income tax reductions introduced in the 1998 Budget.

Source: WTO Secretariat.

7. Reflecting the accumulation of annual deficits, the federal net public debt reached an all time high of Can\$583.2 billion in 1996/97, equivalent to just over 71% of GDP (Table I.2). As a share of GDP, the federal debt has increased almost continuously since 1974/75, more than doubling since the early 1980s. The net debt to GDP ratio of the provinces and territories has also increased, to reach about 28% in 1995/96 but declining slightly the year after. Thus, the combined federal-provincial-territorial debt to GDP ratio rose to just under 100% in 1995/96. The authorities see reducing the debt burden as their main fiscal challenge. They recognize that the high debt to GDP ratio leaves Canada's fiscal situation vulnerable to interest rate increases or slow-downs in economic activity. It also undermines economic efficiency and growth by making necessary high levels of taxation and pushing up interest rates to offset the risk premium associated with high debt.

(iii) Monetary, exchange rate and balance-of-payments developments

8. The stated objective of Canada's monetary policy is to contribute to sustainable economic expansion, high levels of employment, and rising standards of living by creating an environment of stable low inflation. In conducting monetary policy, the Bank of Canada aims to influence the rate of inflation over four to eight quarters into the future, and to direct monetary conditions along a path that will, over time, hold inflation inside the target range. In 1991, the Federal Government and the Bank of Canada established the target range at 1 to 3%; they extended it in 1993 and again in February 1998, to the end of 2001

9. Since mid-1995, the Bank of Canada has adopted a generally accommodative monetary policy, with a modest tightening since late 1997. In implementing monetary policy, the Bank focuses on the overnight (one-day) interest rate. The Bank announces a band of 0.5 of a percentage point for movements of this rate and sets the Bank Rate – the Bank's official lending rate – at the upper limit of the band. In 1997, this band was raised three times by 0.25 of a percentage point and once by 0.5 of a percentage point; during the first semester of 1998, the band was raised once by 0.5 of a percentage point. On 29 September 1998, the Bank of Canada lowered the Bank Rate by 0.25 of one percentage point to 5.75%.⁴ The Bank also operates in the money market to keep the overnight rate within the announced band. During 1997, there were eight transactions to keep the rate from falling below the band and 31 to keep it from rising above.⁵

10. Inflation pressures have remained subdued, with inflation, as measured by the Consumer Price Index, remaining at the lower half of the Bank of Canada's target range in 1996 and 1997 (Table I.1). The even lower level for the GDP price deflator reflected the nil inflation rate experienced outside the consumer sector in 1997. That year, prices dropped outright in the export and government sector. Growth in broad money suggests that inflationary pressures will continue to be subdued.⁶ According to various surveys of inflation expectations and the differential between the yields on nominal and "real return" bonds, a low inflation mentality seems to be increasingly embedded in the Canadian economy.⁷

⁴The decrease followed a move by the U.S. Federal Reserve to lower the federal funds rate by 0.25 of one percentage point

⁵Bank of Canada (1998a), p.23. Additional information may be found in the Bank's Internet site (<http://www.bank-banque-canada.ca/>).

⁶The term "broad money" replaced "M2+". Bank of Canada (1998b), p.29 notes that "the enormous shift from deposits to mutual funds has rendered the previously accepted definitions obsolete".

⁷Bank of Canada (1998b), pp. 26-27.

11. After having traded in a narrow range about US\$0.73 since mid-1995, the Canadian dollar weakened in 1997, reaching record lows during the first half of 1998.⁸ This was mainly due to the uncertainty associated with the Asian crisis, and its effect on world currencies and financial markets, as well as sporadic recurrence of nervousness about political developments in Quebec.⁹ To adjust monetary conditions to where the Bank of Canada considered they should be and to avoid a potential loss of confidence in Canadian dollar assets, the Bank responded with increases in the Bank Rate (see above).

12. After improving consistently up to early 1997, the terms of trade turned against Canada as export prices fell slightly due to weaker commodity demand (Table I.3). Imports surged in 1997 because the domestic spending increase was particularly large in import-intensive areas such as machinery and equipment, and consumer durables (Table I.4 and section (3) below). The combination of lower export prices and increased imports caused Canada's traditional merchandise trade surplus (which had reached a 1990s high in 1996) to shrink sharply and, as a result, combined with an increased net outflow on the income account, the current account balance slipped into a deficit in 1997. On the other hand, the capital and financial account shifted back into a sizable surplus in 1997, owing to sharp increases in net portfolio as well as other capital and investment inflows which easily offset larger net direct investment outflows.

Table I.3
Commodity prices and Canada's terms of trade, 1990-98
(1990 = 100)

Period	Agricultural raw materials ^a	World primary commodity prices ^b			All commodities	Canadian trade: implicit price index ^c		
		Metals	Non-fuel commodities	Petroleum		Exports	Imports	Terms of trade
1990	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1991	96.4	85.7	94.3	84.3	90.1	94.6	96.8	97.7
1992	99.0	83.7	94.4	82.8	89.5	97.1	98.8	98.3
1993	115.0	71.9	96.1	73.0	86.4	101.9	102.4	99.4
1994	125.9	83.8	109.0	69.4	92.2	107.1	106.2	100.9
1995	131.3	100.2	118.1	74.8	99.8	111.3	107.3	103.6
1996	127.7	88.2	116.7	88.6	104.9	112.9	105.4	107.1
1997(Q1)	126.8	92.0	116.6	91.7	106.1	112.6	103.3	108.9
1997(Q2)	123.0	92.8	117.2	80.5	101.7	111.2	103.7	107.2
1997(Q3)	117.8	93.4	111.2	81.2	98.5	110.0	100.8	109.1
1997(Q4)	108.7	85.4	106.5	82.0	96.1	...	...	...
1998(Q1)	102.8	79.6	102.2	61.6	85.1	...	...	...
1998(Q2)	103.0	77.6	98.2	57.8	81.1	...	...	...

... Not available.

a Includes forestry products.

b In terms of US\$.

c Paasche index; original series 1986 = 100.

Source: Bank of Canada Review, Spring 1998; and International Monetary Fund, Primary Commodity Prices.

⁸ As noted in the Secretariat reports for previous Trade Policy Reviews, exchange rates in Canada are market-determined.

⁹ Bank of Canada (1998b), p.18.

Table I.4
Balance of payments, 1991-97
(US\$ million)

	1991	1992	1993	1994	1995	1996	1997
Current account balance	-22,173	-21,014	-21,758	-14,725	-5,305	2,808	-12,247
Merchandise trade balance	6,126	7,381	9,905	14,106	24,642	30,062	16,908
Merchandise exports, f.o.b.	128,914	135,153	147,549	166,788	193,085	205,799	217,780
Merchandise imports, f.o.b.	122,788	127,772	137,644	152,682	168,443	175,737	200,872
Services balance	-9,958	-10,083	-10,383	-8,681	-7,555	-7,260	-6,389
Income balance	-17,398	-17,512	-20,821	-19,907	-22,380	-20,312	-23,009
Current transfers balance	-943	-800	-459	-244	-13	318	243
Direct investment, net	-2,963	1,230	-1,111	-651	-349	-2,117	-4,727
Portfolio investment, net	17,348	10,706	27,768	10,619	11,957	1,158	6,980
Other capital and investment, n.i.e.	6,279	1,413	1,356	3,308	-6,456	1,384	10,122
Net errors and omissions	-340	2,879	-5,352	1,057	2,862	2,265	-2,521
Overall balance	-1,848	-4,786	904	-392	2,710	5,498	-2,392
Change in reserve assets	-1,848	-4,786	904	-392	2,710	5,498	-2,392
Memorandum items:							
Total reserves except gold	16,252	11,431	12,481	12,286	15,049	20,422	17,823
Market exchange rate (US\$/Can\$) ^a	0.8621	0.7874	0.7576	0.7143	0.7353	0.7299	0.6993
Real effective exchange rate (1990=100)	103.3	96.1	88.4	82.4	79.8	82.7	82.2

a End of period.

Source: IMF, *International Financial Statistics*, June 1998; and *Bank of Canada Review*, Spring 1998.

(3) TRADE AND INVESTMENT PATTERNS

(i) Trade in goods

13. Foreign trade has been one of Canada's main engines of economic growth during most of the decade. The authorities have noted that exports as a percentage of GDP grew from 18% in 1977 to about 41% in 1997, and that this growth has been a significant factor in the creation of jobs: 39% of net jobs created between 1990 and 1995 resulted from exports.¹⁰ One in three Canadian jobs depends on trade with the rest of the world, and every Can\$1 billion in new exports creates an estimated 6,000 to 8,000 new jobs in Canada. Large firms account for a high proportion of export activity: the top five exporters account for 21% of Canada's exports, and the next 45 largest for almost 30%.

14. After double-digit expansion in 1994 and 1995, growth in merchandise exports and imports weakened considerably in 1996, to about 5% and 4% respectively in U.S. dollar value (Tables AI.1 to AI.4). In 1997, import growth outpaced exports for the first time in six years: the value of exports grew by 6.5%, while imports increased by 14.5%. The rate of growth in both imports and exports appeared to have abated again in early 1998, mainly reflecting a slow-down in the auto sector throughout North America; export growth was also affected by reduced Asian demand (see below).

¹⁰Department of Foreign Affairs and International Trade (1998), section 1.

15. Canadian trade is dominated by the bilateral flows with the United States; Canada and the United States are each other's largest trading partner (Chart I.1). This reflects the natural advantages offered by geographic proximity, reinforced through preferential trade agreements, including the previous Free Trade Agreement (CUSFTA) and the NAFTA. Since the implementation of the CUSFTA in 1989, two-way merchandise trade has almost doubled: the U.S. share in total Canadian exports increased to almost 83% in 1997, while the U.S. share in total Canadian imports rose to over 67%. In 1997, automotive product shipments to the United States alone represented more than Canada's total exports to the rest of the world. The pattern of Canada-U.S. trade is also special in that intra-industry and intra-firm trade in industrial goods is more significant with the United States than with the rest of the world. Intra-firm trade of U.S.-controlled firms alone accounts for close to 45% of bilateral trade.

16. Two-way merchandise trade between Canada and Mexico has grown rapidly since the NAFTA was implemented in 1994, but its share in the total remains small. However, there is evidence to suggest that the recorded value of Canada's exports may be underestimated, perhaps by as much as 50%, due, for example, to goods from Canada being re-exported through the United States and not measured as exports to Mexico.¹¹ The statistical agencies of the three NAFTA countries are currently working at reconciling their trade data.

17. Canada's MFN trade is dominated by the European Union and Japan. The relative importance of MFN trade has tended to shrink: in 1997, the shares in total Canadian exports of the European Union and Japan reached their lowest point in recent years, about 5% and 4%; their shares of Canadian imports also fell, to under 10% and 5% respectively. In the wake of the financial crisis in Asia, exports to that region have fallen considerably: exports to Canada's main Asian trading partners – Japan; the Republic of Korea; China; Hong Kong, China; Chinese Taipei; Indonesia; Malaysia; Thailand; India; and Singapore – fell by 34% in the first five months of 1998 compared with the same period in 1997. On the other hand, as Asian currencies depreciated, Canadian imports from these countries rose more strongly than total imports.

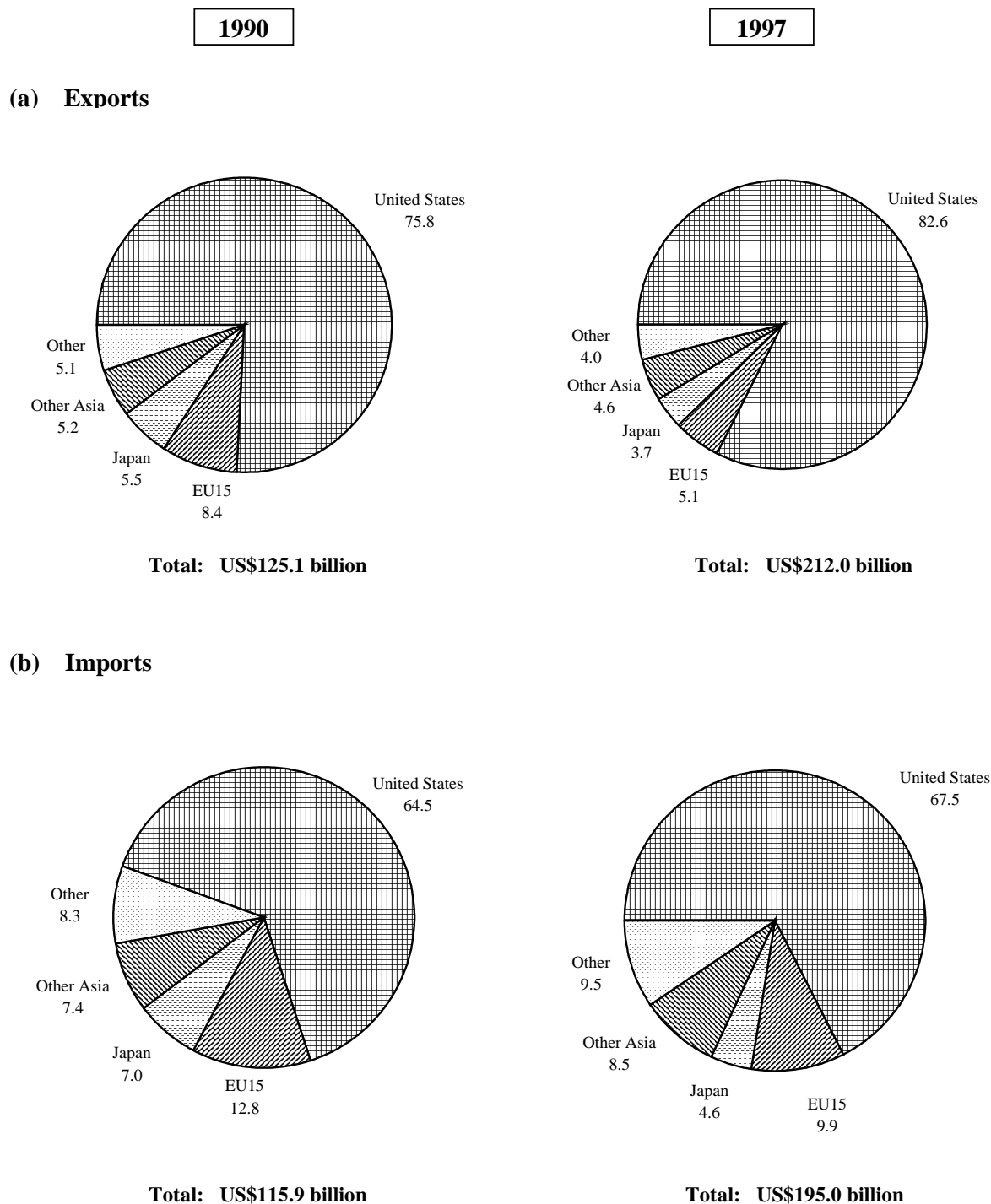
18. In terms of product categories, Canada's merchandise exports are dominated by automotive, mining and agricultural products; together these three categories accounted for about 55% of total exports in 1997 (Chart I.2). A different categorization shows that forestry products are also an important export group, lumber shaped conifers, and newsprint and other paper products contributing 4.3% and 2.3% of total exports (Table AI.1). The share of primary products in total exports has continued its gradual downward trend, having fallen from 36.4% in 1990 to 31.9% in 1997.

19. Reflecting the high import content of motor vehicle exports, automotive products also dominate imports with about 22% of the total (Chart I.2). The two next largest import categories are non-electrical machinery, and office machines and telecommunications equipment, reflecting the extensive use of foreign technology and capital equipment throughout Canada's economy and accounting for the growth in the relative importance of manufactured imports (Table AI.2). On the other hand, the shares of passenger motor vehicles (but not other automotive products) and clothing have tended to fall.

¹¹Department of Foreign Affairs and International Trade (1998), section 4, URL: <http://www.infoexport.gc.ca/>.

Chart I.1
Merchandise trade by region, 1990 and 1997

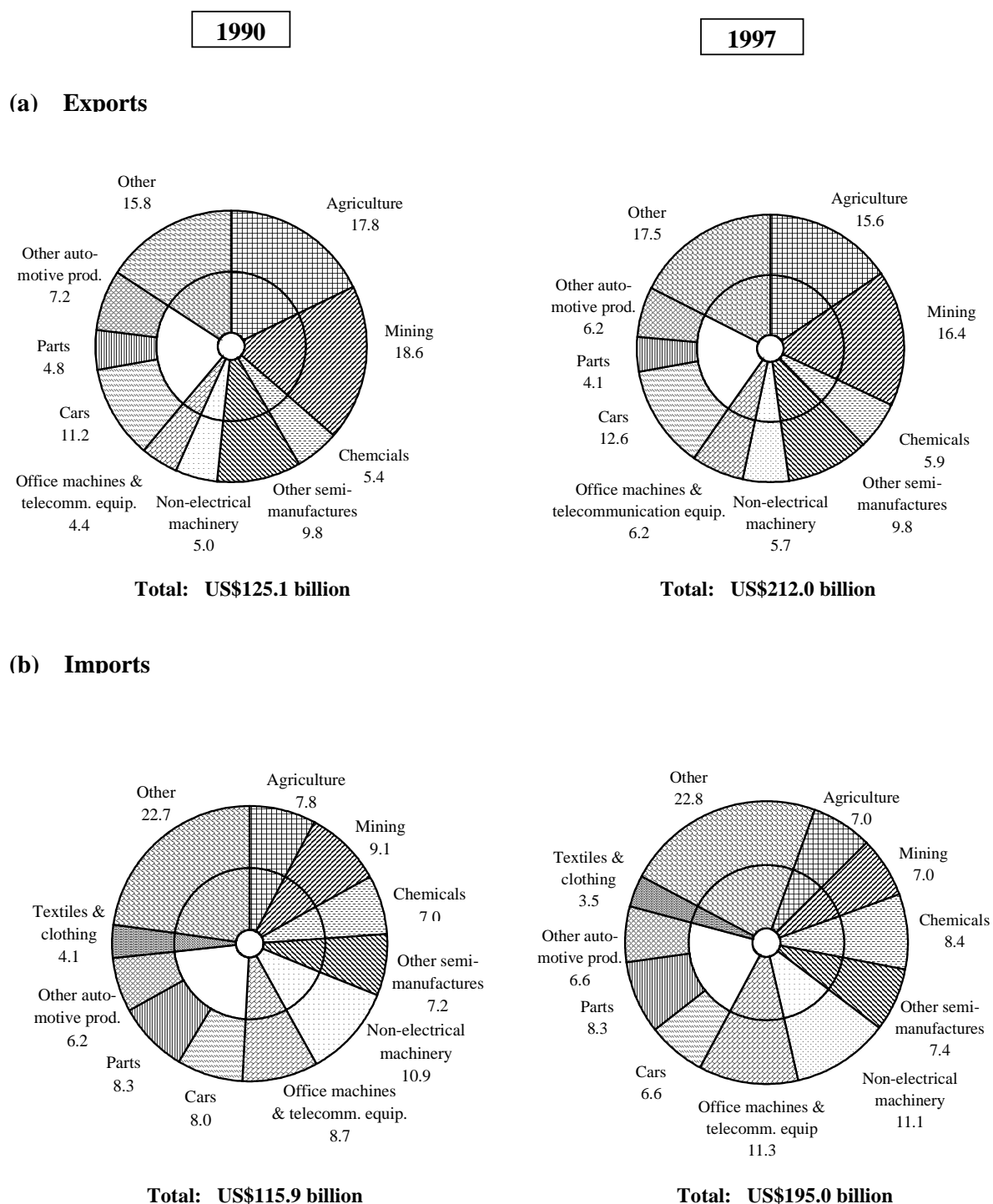
Per cent



Source: UNSD, Comtrade database (SITC Rev.1).

Chart I.2
Merchandise trade by sector, 1990 and 1997

Per cent



Source: UNSD, Comtrade database (SITC Rev.1).

20. Growth in merchandise exports in 1996 and 1997 was mainly driven by fuel and manufactured products. In 1997, this mainly reflected the strong demand in the United States for energy products, consumer goods, and machinery and transport equipment. The increase of just over 15% in the lorries and trucks category was due to the popularity in the U.S. market of vans and sports utility vehicles, many assembled in Canada. Growth in energy exports was based on a booming natural gas industry also servicing U.S. markets. Although exports of non-energy commodities grew in 1997, in spite of price declines, weak industrial demand in Asia helped to check exports of metal and forestry products.

21. The boom in merchandise imports in 1997 was underpinned by rapid growth in each major product category, reflecting the strengthening of demand for both investment and consumer goods during the year. The surge in imports of machinery and transport equipment had a particularly large impact given the weight of those products in the total. The upturn was particularly fast for motor vehicles, while parts used in factories lagged behind. This reflected stronger growth in auto sales in Canada than in the United States, where most of Canada's auto factory output is shipped.

(ii) Trade in services

22. Services account for some two thirds of production and close to three quarters of employment in Canada. In recent years, global trade in services has grown faster than trade in goods: over 1977-97, Canada's services exports grew from Can\$5.3 billion to Can\$41.6 billion (Table 1.5). Canada has historically imported more services than it has exported, in contrast to the surplus usually recorded in trade in goods. Purchases by Canadian importers amounted to around Can\$50.3 billion. The trade in services deficit dropped in 1997 for the fourth consecutive year. This stems largely from a narrowing deficit in commercial services since 1996.

Table 1.5
International transactions in services, by category, 1997
(Can\$ million)

Category	Receipts	Payments	Balance
Total	41,572	50,316	-8,744
Travel	12,141	15,649	-3,508
Business	2,276	3,428	-1,153
Personal	9,865	12,220	-2,355
Transportation	8,323	11,514	-3,191
Water transport	1,883	3,778	-1,895
Air transport	3,475	5,354	-1,879
Land and other transport	2,965	2,382	583
Commercial services	20,100	22,576	-2,477
Communications	1,917	1,815	103
Insurance	3,762	4,883	-1,121
Primary life and non-life	887	1,319	-432
Reinsurance, life	1,729	1,849	-120
Reinsurance, non-life	870	1,447	-577
Other financial services	1,160	1,626	-466
Computer and information services	1,721	9452	779
Royalties and licence fees	686	2,766	-2,080
Patents and industrial design	230	1,006	-776
Management services	1,966	2,765	-799
Research and development	1,774	802	972
Architectural, engineering and other technical services	2,578	894	1,684
Tooling and other	1,267	2,437	-1,170
Government services	1,008	577	431

Source: Statistics Canada, *Canada's international transactions in services, 1997*.

23. Based on data by geographic region available only for commercial services, the United States was by far Canada's major trading partner in 1997, accounting for 70% of payments and 63% of receipts. That year, Canada's trade in commercial services with the United States showed an overall deficit of Can\$3 billion. The European Union members, excluding the United Kingdom, represented Canada's second trading partner, accounting for 7% of payments and 8.5% of receipts; the United Kingdom accounted for 7% of payments and 6% of Canadian receipts. Trade with foreign affiliated companies has historically made up an important share of Canada's trade in commercial services: in 1996, 50% of payments were made to parents, subsidiaries or affiliates located abroad, while receipts from foreign affiliates amounted to 35% of receipts.

(iii) Foreign direct investment

24. The authorities have pointed out that Canada depends on foreign direct investment (FDI) to finance a significant proportion of its economic development. They estimate that one job in ten, about 50% of Canada's total exports, and 75% of manufacturing exports derive from inward FDI. Moreover, they estimate that a Can\$1 billion increase in new inward FDI generates, over a five-year period, about 45,000 jobs and Can\$4.5 billion in GDP.¹² On the other hand, the authorities have also noted that Canada's share of global inward FDI stock has declined sharply, from 9% of the world total in 1985, to an estimated 4% in 1996. Canada's share of North American bound FDI has also fallen, from 24% in 1985 to 15% in 1996. Attracting foreign investment has thus become a main objective of Canada's economic policy.

25. Inward and outward FDI have increased markedly during the decade. Canada's inward FDI stock reached Can\$188 billion in 1997 (Table I.6). The Free Trade Agreement of 1989 and the NAFTA have spurred cross-border investment between Canada and the United States: FDI flows from the United States grew at an average annual rate of 6.4% between 1990 and 1997, compared to 4.4% during 1985-90. In contrast, annual growth in total FDI in Canada fell to 5.3% during 1990-97, from 7.7% during 1985-90. Cumulative U.S. FDI in Canada reached Can\$130 billion in 1997; far behind, with Can\$16 billion in 1997, the United Kingdom was the second largest source of FDI in Canada.

26. The sectoral composition of inward investment shows a shift from resource-based to services sectors (mostly finance and insurance activities), chemical products, food and beverages as well as electronic and communications products. The share of services in inward FDI increased from 24% in 1985 to 27% in 1997, while the share of resource and resource-based industries fell from 32% to 22% during the same period. The share of foreign-controlled operating revenues exceeds 50% in the chemicals, electric and electronic products, and transportation equipment industries.¹³

27. Canada is also a major global investor, Canadian FDI abroad having grown by an annual average of 10% between 1990 and 1997. In 1996, the stock of Canadian FDI abroad surpassed the inward FDI stock for the first time in Canada's history. In 1997, that stock reached close to Can\$194 billion, equivalent to 103% of Canada's inward FDI stock.

28. The United States is Canada's most important investment target, accounting for over 50% of total outward direct investment, followed by the United Kingdom. Canada's investment relationship is diversifying toward other European Union members and developing countries. In investing abroad, Canadians have concentrated more heavily on services; the share of services in Canadian FDI abroad increased from 29% in 1990 to 45% in 1997.

¹²Department of Foreign Affairs and International Trade (1998), section 3.

¹³Industry Canada (1998a).

Table I.6
Canada's inward and outward FDI stock, 1990 and 1997
 (Can\$ billion and per cent)

	1990	1997
Inward stock		
Total (Can\$ billion)	130.9	187.6
Distribution by country or region (%)		
United States	64.2	69.3
United Kingdom	13.1	8.3
Other European Union	10.9	11.9
Japan	4.0	3.8
Other OECD	4.5	3.4
All other	3.2	3.4
Distribution by activity (%)		
Wood and paper	5.8	5.7
Energy and metallic minerals	24.1	16.7
Machinery and transport equipment	14.1	15.7
Finance and insurance	18.9	17.9
Services and retailing	7.5	9.6
Other	29.6	34.5
Outward stock		
Total (Can\$ billion)	98.4	193.7
Distribution by country and region (%)		
United States	61.0	51.6
United Kingdom	13.7	11.2
Other European Union	7.2	10.0
Japan	0.9	1.4
Other OECD	4.1	3.9
All other	13.1	21.9
Distribution by activity (%)		
Wood and paper	3.6	3.1
Energy and metallic minerals	21.2	22.8
Machinery and transport equipment	3.3	2.9
Finance and insurance	29.1	32.1
Services and retailing	8.4	13.2
Other	34.5	26.0

Source: Statistics Canada, *Canada's International Investment Position, 1997*.