CANADIAN GLOBAL AFFAIRS INSTITUTE
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Hedging Our Bet: A Diversification Strategy for Canadian Trade

by Brian Kingston

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POLICY UPDATE

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Canada's trade strategy is at a critical juncture. The NAFTA negotiations are making little progress, casting continuing uncertainty on Canada's largest trade and investment relationship, while an increasingly protectionist U.S. administration is damaging Canada-U.S. trade and investment with arbitrary tariffs on key exports. At the same time, Prime Minister Justin Trudeau's recent missteps in Asia demand a rethink of Canada's overall trade objectives in the region.

Since coming to power in 2015, the Liberal government's trade strategy has been based on the Global Markets Action Plan introduced by former trade minister Ed Fast. Now is the time to develop a modernized global trade strategy that positions Canada for success in increasingly uncertain times.

Why Trade Matters

Since the end of the Second World War, trade has been the principal means by which countries around the world have grown and prospered. As trade has flourished, incomes have increased and workers have benefited from new opportunities.

From Canada's early days of the fur trade through today, where trade of goods and services represents 64 per cent of gross domestic product (GDP), Canadians have relied on international trade to prosper. According to Global Affairs Canada, one in every five Canadian jobs is directly linked to exports.

Trade not only creates jobs, it improves productivity through greater competition. Trade and trade-enhancing policies have improved Canada's productivity performance, particularly in the manufacturing sector. From 1974 to 2010, the 35 per cent of manufacturers that were exporters were responsible for more than 72 per cent of total manufacturing employment and 79 per cent of total manufacturing shipments. Canada's trade agreement with the U.S. is estimated to have singlehandedly raised Canadian manufacturing productivity by 13.8 per cent over the period from 1988 to 1996.

Recognizing the importance of trade to the Canadian economy, successive governments have negotiated free trade agreements (FTAs) to enable companies to access new markets around the world. Put simply, trade agreements create a level playing field for companies to compete in foreign markets. They open markets to Canadian businesses of all sizes by reducing trade barriers, such as tariffs, quotas or non-tariff barriers. They create more predictable, fair and transparent conditions for businesses operating abroad.

Many of Canada's newer FTAs go beyond traditional trade issues to cover areas such as services, intellectual property, investment, e-commerce, labour and the environment. The recently provisionally implemented Canada-EU Comprehensive Economic and Trade Agreement (CETA) includes a chapter on trade and sustainable development that promotes sustainable development through the co-ordination and integration of labour, environmental and trade policies.

Canada now has 14 free trade agreements in force and is an original member of the World Trade Organization (WTO), the international organization that deals with the global rules of trade between nations. Once Canada ratifies the Comprehensive and Progressive Trans-Pacific Partnership Agreement (CPTPP), we will have free trade with more than 60 per cent of the global economy. This would give Canadian companies preferential access to nearly 90 per cent of existing export markets, making Canada the only G7 nation with free trade access to the U.S., the Americas, Europe and the Asia-Pacific region, including three of the world's four largest economies.

The Case for Diversification

Protectionism is on the rise around the world. Since the outset of the global financial crisis in 2007, G20 countries have implemented more than 1,200 new trade restrictions. The Trump administration has escalated trade tensions globally by slapping tariffs on steel and aluminum imports and imposing and/or threatening tariffs on US$450 billion in imports from China and US$335 billion in imported cars and parts from around the world.

In this increasingly hostile environment, Canada's support of the liberal trade system is more important than ever. This can be achieved through active engagement at the WTO and an aggressive trade liberalization strategy.

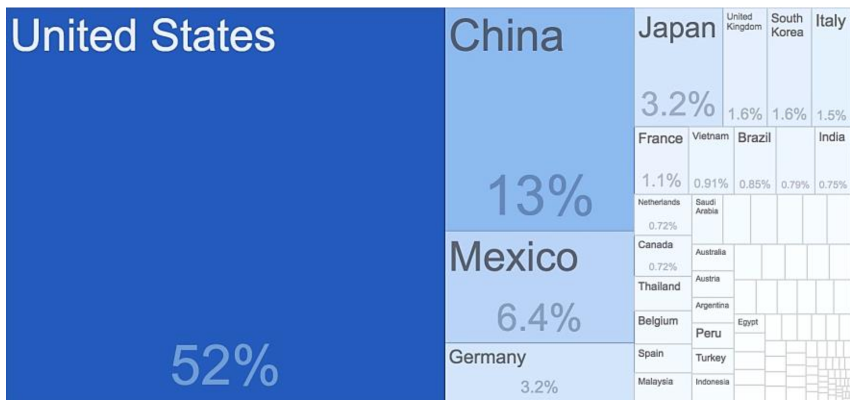

Figure 1: Canadian imports per country for the year 2017. (Source: Trading Economics)

Figure 2: Canadian exports per country for the year 2017. (Source: Trading Economics)

Despite recent efforts to diversify trade, Canada has much work to do. Nearly 76 per cent of Canada's exports went to the U.S. in 2017. While our export dependence on the U.S. has declined from 87 per cent in the early 2000s, it remains stubbornly high. Just like any business, relying heavily on one customer responsible for 76 per cent of total sales is a risky proposition.

Over the past decade, the share of Canada's total exports destined for emerging markets has risen slowly from around four per cent to 10 per cent. This, despite the fact that emerging markets are expected to account for 65 per cent of global GDP in the next five years. Canada must do more to take advantage of opportunities in rapidly growing markets if we are to lessen our trade dependence on the U.S.

Canada's trade performance continues to be heavily dependent on the U.S. Given our geographic proximity this will not change dramatically. But at a time when NAFTA is under threat and our largest trade partner is imposing unilateral tariffs, we must aggressively pursue a plan B.

Global Trade Strategy

1. Pivot to Asia

With growing protectionism in the U.S., the need to diversify has never been clearer. Asia is the growth engine of the global economy and Canada must be positioned to take advantage of it. Despite the region's importance to the global economy, Asia-Pacific nations collectively account for only 17 per cent of Canada's goods trade and 11 per cent of Canada's services trade.

Last year, Asia was responsible for much of the recovery of world merchandise trade on both the export and import sides. According to the WTO, Asia contributed 2.3 percentage points to global export growth of 4.5 per cent, or 51 per cent of the total increase. Asia also added 2.9 percentage points to world import growth of 4.8, or 60 per cent of the overall increase.

Expanding Canada's trade and investment in Asia could be achieved with the following actions:

- *Launch trade negotiations with China* – The government has established a goal of doubling trade with China before 2025. To achieve this ambitious goal Canada needs to launch and conclude FTA negotiations. Achieving a comprehensive trade agreement with China that addresses the numerous trade and investment barriers facing Canadian companies won't be easy and could take nearly a decade, requiring that negotiators get to work as soon as possible.

- *Ratify the CPTPP* – Canada should move to implement the CPTPP agreement as quickly as possible. It is critical that Canada be among the first six countries to ratify the agreement. This will give Canadian companies a first-mover advantage in lucrative markets such as Japan. When the CPTPP is fully in force, Canada will have preferential market access to 51 countries with nearly 1.5 billion consumers and a combined GDP of US$49.3 trillion.

- *Boost trade and investment with ASEAN* – An Asia-Pacific trade deal should include efforts to bolster Canada's trade and investment with the fast-growing countries that comprise ASEAN. According to the International Monetary Fund (IMF), six of the 10 fastest growing economies in 2016 were in Asia including three members of ASEAN:

Cambodia, Myanmar and Laos. Research by the Asia Pacific Foundation suggests that a Canada-ASEAN free trade agreement could generate between C$4.8 billion and C$10.9 billion in additional bilateral trade, benefiting a wide range of companies and workers.

Figure 3: *Prime Minister Justin Trudeau, center, talking to China's Premier Li Keqiang at the Great Hall of the People in Beijing on December 4th, 2017. As the author notes, Canada should see the conclusion of free trade negotiations with China as a key priority within its diversification strategy, and pivot to the Asian market. (Source: Fred Dufour/AP)*

Asia can be an important alternative market for Canadian products and services that traditionally were exported to the U.S. For example, if it weren't for the fact that Canadian lumber producers doubled their combined market share in China and Japan in the past decade, Canada's lumber industry would be even more exposed than it already is to protectionist measures south of the border.

2. Enable SMEs exports

Few small and medium-sized businesses have the capacity and resources to be the first movers into new international markets; most often, big businesses lead the way. If Canada is to improve its trade performance, we need to find ways to support SMEs and encourage them to trade, particularly in emerging markets.

The evidence shows that Canadian SME exporters generally have better chances of surviving in emerging markets if they are older when they enter, export to an advanced economy first, introduce new products more often, have access to financing and export to more destinations. Technology-enabled SMEs selling through online platforms are much more likely to export and to reach more foreign markets than even traditional, large multinationals, although their sales, of course, are generally much smaller.

Helping SMEs effectively sell their products on Tmall and JD.com – Chinese e-commerce platforms with hundreds of millions of active users – would be a powerful way to diversify Canada's trade. But using e-commerce platforms alone will not guarantee success. SMEs need to develop an in-depth understanding of new markets and the challenges they will face with the support of the Trade Commissioner Service (TCS).

3. Expand trade promotion efforts

Canada's TCS does an admirable job of promoting Canadian exports abroad. Diversifying Canada's trade will require a new approach and more resources:

- *Co-ordination* – Efforts should be made to better co-ordinate Export Development Canada (EDC), responsible for export financing, and the Business Development Bank of Canada (BDC), responsible for supporting small and medium-sized businesses, with the TCS. EDC and BDC service offerings in support of going global should be complementary and include a direct link to the services offered by the TCS. While progress has been made on co-ordination in recent years, there exists no explicit protocol between EDC, BDC and the TCS to ensure that Canadian exporters are made aware of the full range of services available to them.

- *Flexibility* – The TCS should be given more flexibility to respond to global trends and manage resources. For example, making the TCS a Crown corporation would allow the organization to quickly deploy human resources where required and utilize private sector expertise as needed. Permitting the TCS to charge for premium services could enhance service delivery and provide another mechanism to raise revenue.

- *Resources* – The TCS would be able to help more firms take advantage of Canada's FTAs and access global markets if it had additional resources. Australia, with a smaller population than Canada, spends nearly double on its trade promotion efforts through Austrade. Significant new funding, with a portion dedicated to enhancing the TCS's digital service offerings, should form a critical component of Canada's trade diversification efforts.

Canada's impressive suite of free trade agreements, including the recently implemented CETA, will be more beneficial to Canadians if there is broad awareness of the deals and there are tailor-made services available to exporters to take advantage of the preferential access negotiated. The TCS has an important role to play in this endeavour.

4. Attract investment

A global trade strategy should include efforts to grow investment in Canada. Foreign affiliates play an important role in the Canadian economy and Canada's international trade. In fact, foreign affiliates are responsible for nearly half of Canada's exports despite controlling only 17 per cent of all corporate assets in Canada.

Last year, total inflows of foreign direct investment (FDI) into Canada declined by 36.4 per cent to C$31.5 billion. Reversing this trend and enhancing Canada's attractiveness as an investment destination will create jobs in Canada while helping to grow exports. This could be achieved by restoring Canada's corporate tax advantage vis-à-vis the U.S., reducing regulatory barriers facing new investments by implementing a clear policy of "one project, one approval" and empowering and resourcing the new Invest in Canada agency to incentivize foreign companies to consider Canada as an investment location.

Conclusion

Canadian prosperity depends on global trade. With access to our most important trade partner under threat, now is the time for a renewed global trade strategy that aims to reduce our exposure to a single market. This can be achieved but only with considerable effort and resources. The strategy outlined above can help put Canada on the right track.

About the Author

Brian Kingston is the Vice-President of Policy, International and Fiscal Issues at the Business Council of Canada. He leads the Council's work on international trade, investment, fiscal and monetary policy issues. In this role he advises on bilateral and trilateral issues with the United States and Mexico, manages CEO engagement with India, Japan, Brazil and China and leads the Council's tax policy advisory network. Prior to joining the Council, Brian was an economist in the federal government with positions at the Department of Finance, Global Affairs Canada, the Treasury Board Secretariat and the Privy Council Office. In addition to his experience in business and government, Brian is active in the non-profit sector as President of the Ottawa Economics Association and a board member of the Banff Forum. Brian holds a bachelor's degree in economics from Carleton University, a master's degree in international affairs from the Norman Paterson School of International Affairs and an MBA from Ivey Business School.

Canadian Global Affairs Institute

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The Institute was created to bridge the gap between what Canadians need to know about Canadian international activities and what they do know. Historically Canadians have tended to look abroad out of a search for markets because Canada depends heavily on foreign trade. In the modern post-Cold War world, however, global security and stability have become the bedrocks of global commerce and the free movement of people, goods and ideas across international boundaries. Canada has striven to open the world since the 1930s and was a driving factor behind the adoption of the main structures which underpin globalization such as the International Monetary Fund, the World Bank, the World Trade Organization and emerging free trade networks connecting dozens of international economies. The Canadian Global Affairs Institute recognizes Canada's contribution to a globalized world and aims to inform Canadians about Canada's role in that process and the connection between globalization and security.

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