BRITISH ASSOCIATION FOR CANADIAN STUDIES

UNIVERSITY OF WARWICK

33rd Annual Conference

CANADA IN THE AMERICAS

'Canada, the Americas and the World: economic linkages in the new era of globalisation'.

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Canada's international economic linkages are distinctive in two respects. In the first place Canada has an exceptionally open economy. As the world entered the second great era of globalisation in the 1970s, the proportion of Canadian GDP represented by international trade rose sharply, and when it peaked in 2000 it stood at 85.6 per cent, the highest exposure of any OECD country[1]. This was reinforced by a second aspect, very high levels of international investment. Measured by the stock of inward Foreign Direct Investment (FDI) to GDP, Canada ranked as the second most open country in the G7 after the UK in 2005.[2]

While high levels of international trade and investment are wholly consistent with globalisation, the second distinctive aspect of the Canada's international economy, its huge dependence on exports to the USA, is more surprising. By 2001, 87% of Canadian merchandise exports were sold to its neighbour. While there are many historical examples of countries selling a very high proportion of exports to a single trading partner, such as New Zealand, South Africa or Denmark to the UK during the middle of the 20th century, this was at a time of restricted international trade when globalisation was in retreat. Rich countries

[1] Dfait, *Third Annual Report on Canada's State of Trade*, (Ottawa, 2002) Table 1. Exports and imports of goods and services as % of GDP.

[2] Dfait, *Seventh Annual Report on Canada's State of Trade* (Ottawa, 2007), p.52. The figure is 31.6% compared with the UK's 37.1%.

typically enjoy a geographical spread of their trade, and in contrast to Canada countries such as Australia and New Zealand have recently widened their trading links (see Figures A-1 and A-2). But, significantly, the powerful trading ties between Canada and its southern neighbour are matched by fellow NAFTA partner, Mexico, which in 2006 is recorded as having sold nearly 85 per cent of its exports to the US.[3]

This paper seeks to explain the Canadian experience. It first examines three phases of Canada's history during the past thirty years, the period of growing geographical diversification to circa 1990, the reversal during the following decade and finally the record since the opening of the 21st century.[4] It continues with a brief exploration of Canada's economic linkages with the rest of the continent before concluding with an overview of recent developments.

Phase One: 1970s to 1980s

During the post-war period plenty of politicians and other commentators had worried about the extent of Canada's economic linkages with the USA. Prime Minister John Diefenbaker had announced a trade diversion initiative in 1957 explicitly to broaden Canada's trading patterns,[5] and during the following decade growing unease was expressed about the penetration of Canadian industry by American investment. In the 1970s steps were taken to wean the Canadian economy from its heavy reliance on the USA. Prime Minister Pierre Trudeau launched a re-examination of Canadian trade policy, and the resulting 'Third Option', announced late in 1972, was a clear attempt to distance Canada from the American economy. Trudeau, arguing that preservation of the status quo was unacceptable, and dismissing the policy of strengthening economic ties with the United States, pressed instead for the third option of actively seeking diversification of external economic links. In many respects this was unsuccessful, not least because the timing was so poor, the troubled 1970s

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[3] IMF *Direction of Trade Statistics Quarterly,* December 2007. The 84.7% reported probably overstates the amount going to the US and understates sales to Canada.
[4] A portion of the paper draws on an earlier article by T. Rooth and P. Walsh, 'Canada in the Twentieth Century: Continental Drift?'**,** *London Journal of Canadian Studies*, 19, pp. 1-18.
[5] T. Rooth, 'Britain, Europe, and Diefenbaker's Trade Diversion Proposals, 1957-58' in P. Buckner (ed.), *Canada and the End of Empire*, (UBC Press, Vancouver and Toronto, 2005), pp. 117-132.

providing an unpropitious economic environment for trade expansion.[6] The Canadian share of both the Japanese and British import markets fell during the decade (Britain had joined the EEC in 1974). Nonetheless Canada's trading patterns were affected during these years by the greater dispersion of global economic power. Although this had only a limited and transitory impact on exports in the late 1970s, it was far more pronounced in the sources of imports. In the 1980s the EU and Japan made conspicuous gains and the American share of imports fell from 67.5 per cent in 1980 to 62.6 per cent in 1990.

The Trudeau government was also worried by American involvement in Canadian industry. By the end of 1970 non-residents, predominantly Americans, controlled 36% of all capital employed in nonfinancial industry in Canada. In response to the growing anxieties about U.S. ownership, in 1974 the Foreign Investment Review Agency was established to screen incoming investment. The National Energy Program of 1980 also involved restrictions on foreign ownership. Canadians moved to reclaim ownership of their economy, and by the 1980s non-residents ownership had retreated to 23% of all capital outside the financial sector.[7] The sources of inward investment were also beginning to diversify. One cause of this was that the preponderance of the USA became less pronounced and power in the international economy became increasingly dispersed. This was reinforced by the increasing globalisation of international capital markets. The integration of domestic financial markets meshed with growing international capital mobility: the emergence of Euro currency markets in the late 1960s, the re-cycling of the OPEC surpluses in the mid-1970s, and the relaxation or scrapping of controls on international investment by several countries contributed to a great surge in international capital mobility. This had a considerable impact on the sources and type of inward investment to Canada. Portfolio investment rose sharply and the U.S. share of total investment declined noticeably. Bonds, mainly government debt, increased as a proportion of total external liabilities. While up to the early 1970s the United States had accounted for 80% of total foreign ownership of bonds this had fallen to 29% by 1989. Japan in particular became important, but other countries participated too. FDI also came increasingly from Japan, the European Union, and 'other' sources. By

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[6] G. Mace and G. Hervouet, 'Canada's Third Option: A Complete Failure?', *Canadian Public Policy*, Vol. 15, No. 4, pp. 387-404, emphasise the poor international economic environment rather than lack of Federal endeavour.

[7] L. Laliberté, Globalisation and Canada's International Investment Position, 1950 to 1992. Statistics Canada, Balance of Payments Division, Research Paper No. 6 (1993), p.6. Nearly four-fifths of these investments were held by the USA.

1991 the U.S. share of total stocks of foreign investment in Canada had fallen from its 1980 level of 79 per cent to 43.8 per cent. Another striking feature was the rapid accumulation of overseas assets by Canadians. Portfolio investment became more important with mutual funds, increasingly liberalised, playing a prominent part.[8] The holdings of immigrants, especially from the Far East, also contributed to the rapid accumulation of funds. There was also a limited diversification of Canadian FDI away from the USA, and by the mid-1980s a sharp increase to Europe, notably the UK, France and the Netherlands.

Phase Two: forging closer links with the USA

While the Trudeau governments had been wary of the USA and had sought to distance the Canadian economy from its neighbour, the Progressive Conservative administration of Brian Mulroney enthusiastically ushered in a new era of economic consolidation with the Americans. The modest screening devices of the Foreign Investment Review Agency were replaced in 1985 by the Investment Canada Agency the task of which was to encourage funds to Canada. Developments in the USA, moreover, were to exert a powerful influence on Canada's trading patterns and policies. Consciousness of a challenge to the world status of the USA that went well beyond economic discomforts, the new President, Ronald Reagan, determined that America should 'Stand Tall'. The economic implications of this were confusing. While tight monetary policy both squeezed the domestic economy and drove the value of the dollar sharply upwards, tax cuts combined with massive increases in military spending wrought havoc with the national finances. Military Keynesianism bought rapid recovery, initiating a sustained expansion of the economy that sucked in imports that were made all the cheaper by the appreciation of the American dollar. Canada benefited, but became increasingly exposed. The less favourable economic conditions of the 1970s had already led to a proliferation of non-tariff barriers in the USA: voluntary export restraints, orderly marketing agreements and buy-American requirements increasingly hampered trade.[9] Intense import competition, particularly in the recession, hit smokestack

[8] Laliberté, p.12.
[9] P. Nivola, 'The New Protectionism: U.S. trade policy in historical perspective', *Political Science Quarterly*, 101, pp. 577-600, 1986; P. Lindhert, 'U.S. and Foreign Trade and Trade Policy in the Twentieth Century' in S.L. Engerman and R.E. Gallman (Eds) *The Cambridge Economic History of the United States: the 20th Century* (Cambridge, 2000).

industries, savaged jobs and, combined with a burgeoning balance of payments deficit, fed a great protectionist revival. By the mid-1980s there were some 300 protectionist bills circulating in Congress.[10] Mounting protectionism and emerging trade disputes formed the backdrop for debate in Canada about the Macdonald Commission Report. A product of its era, this expressed alarm about the relentless rise of government expenditure. The Commission was also deeply pessimistic about the future for natural resource exports, arguing that Canada had to have a sophisticated manufacturing base. The pre-requisite for this was considered to be a market of 100 million plus; this, the Report recommended, could be found by negotiating substantially freer trade with the U.S. But the negotiations for this soon turned, under U.S. pressure, into a far more wide-ranging pact than the Commissioners had first envisaged. Although economists were almost unanimously in favour of the Free Trade Agreement that emerged, the high degree of reliance of Canada on an increasingly protectionist American market ensured that the national debate that ensued during the election of 1988 was conducted in an atmosphere of fear and vulnerability.[11] The Canada-U.S. Free Trade Agreement, implemented in 1989 following the victory of the Progressive Conservatives, gave institutional force to Continentalism.

Several factors increased the overall exposure of Canada's economy to the USA during the 1990s. In an increasingly open economy, international trade expanded far more rapidly than domestic trade. Figure 4 contrasts the virtual stagnation of inter-provincial trade against the dynamism of international sales: by the mid 1990s every province bar Prince Edward Island exported more to the USA than the rest of Canada[12], and exports continued to rise spectacularly during the rest of the decade. In 1989 international trade represented 51 per cent of overall Canadian economic activity; by 2000 the figure was 87 per cent.[13] The reassertion of American hegemony during the 1990s served to tighten Canadian links even further. The triumph of the Anglo-Saxon model

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[10] Mel Watkins, 'A Canada-US Free Trade Agreement: For and Against', *British Journal of Canadian Studies*, 1, pp. 185-204, 1986.

[11] But see Malcolm Fairbrother, 'Why did Canada Globalise Its Economy?' (this conference session) for an argument that emphasises the growing preference of the business sector for a more open economy and an accord with the USA.

[12] Stephen Clarkson, *Uncle Sam and Us: Globalization, Neoconservatism, and the Canadian State.* (Toronto and Washington: University of Toronto Press and Woodrow Wilson Center Press, 2002)

[13] Dfait, *Second Annual Report on Canada's State of Trade*, (Ottawa, 2002) Table 1. Exports and imports of goods and services as % of GDP.

owed much to the contrasting fortunes of the Americans with those of the USSR, Japan and Germany. The collapse of the Soviet empire and the poor economic performance of Japan and Germany contrasted with the dynamism of the American economy. The German and Japanese models lost their lustre while American global hegemony was reasserted. The weakness of the German and Japanese economies during the 1990s was reflected in slow growing imports.[14] As Figure 2 shows, the relative shrinkage of non-US markets after 1989 was rapid and persistent; Japan led the way, but the European Union and particularly the rather amorphous ‘Rest of the World’ group were not far behind. In contrast the United States economy experienced its longest ever period of uninterrupted expansion between 1992 and 2001; although this was not the fastest growth in American history, jobs and total output increased impressively, and towards the end of the decade productivity growth accelerated too. American imports proved rather too dynamic. Accordingly the US increased its weight in world imports: while in 1990 it accounted for 14.4 per cent of world imports, by 2000 that share had reached 19 per cent.[15] Moreover, aided by the trade agreements and the depreciation of the Canadian dollar,[16] Canada made increasing inroads into the American market, although its share of the market rose only modestly from 18.7 per cent in 1990 to a peak of 19.6 per cent in 1999. Trade in the newly liberalised sectors grew substantially faster than in the non-liberalised groups.[17] These forces combined to increase still further the high proportion of Canadian sales to the USA: by 2002, 87.2 per cent of total merchandise exports went to its neighbour (measured on a Customs basis).

Figure 1

Canada: international and inter-provincial trade ($billion)

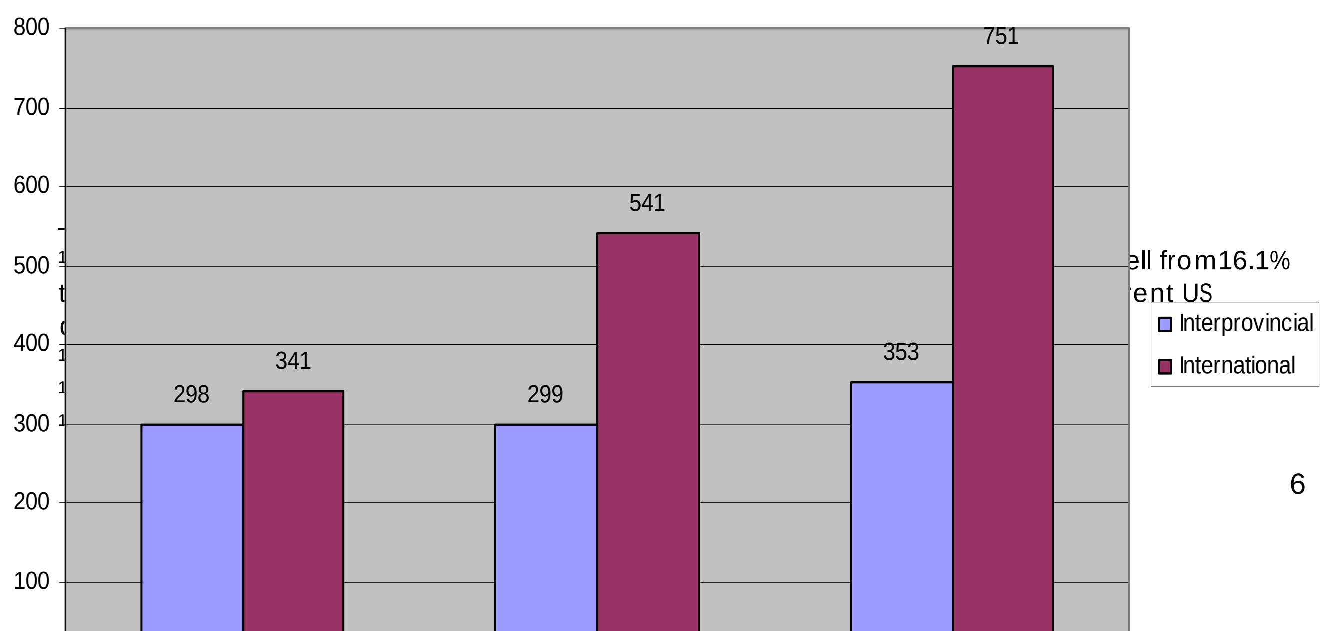
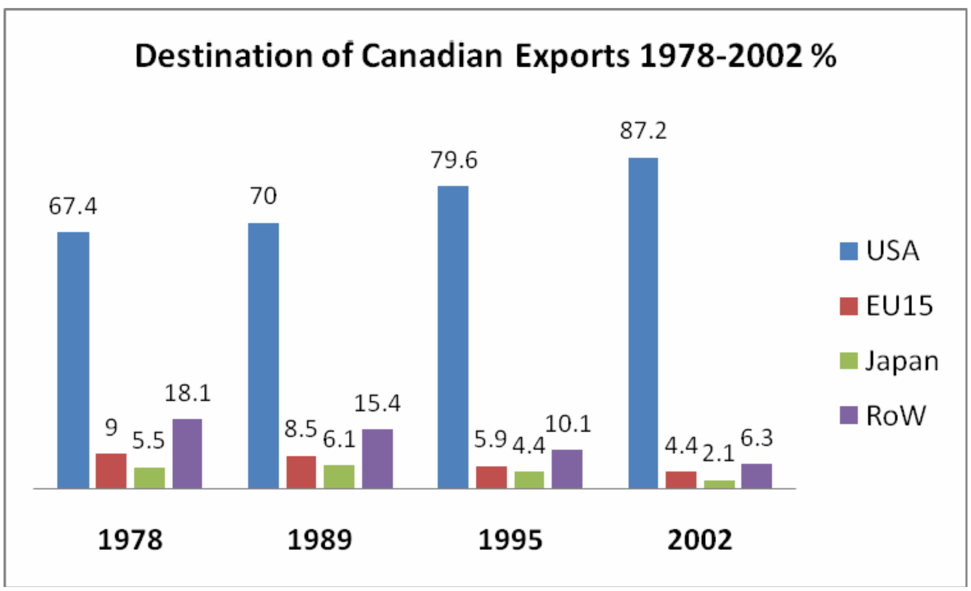


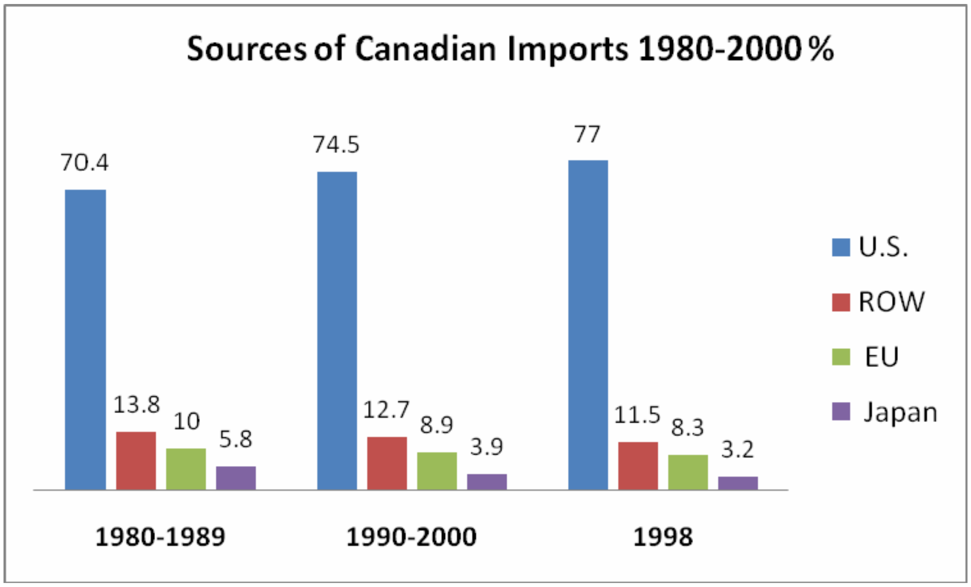
Figure 2



Source: IMF, *Direction of Trade Statistics* (Washington, various years)

The increase in Canadian exports was mirrored in the behaviour of imports from the USA. The *proportion* of total imports coming from the USA had remained stable since the 1950s but during the 1990s the position changed dramatically. Not only did the value of sales rise rapidly but the United States increased its share of Canadian imports until, hampered by the appreciation of the US dollar, it dropped back after 1998.

Figure 3

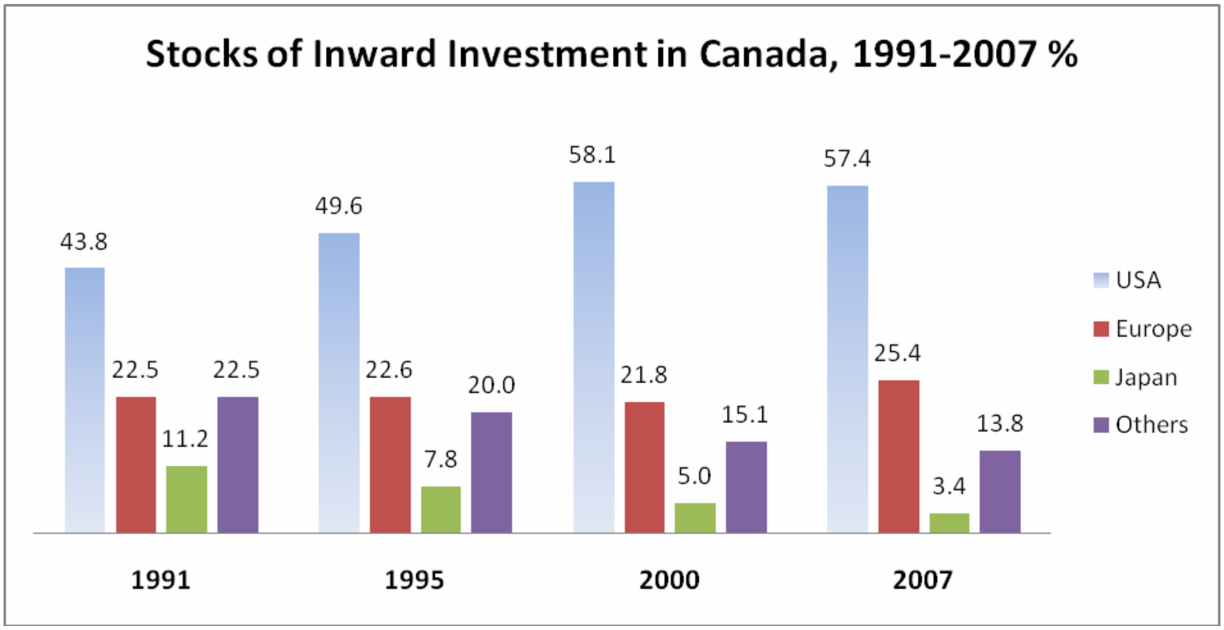


Source: Dfait, *Second Annual Report on Canada's State of Trade* (Ottawa, 2001).

The American share of Canadian capital imports also revived, and this was apparent both in bonds and stocks. The Japanese retreated; the European Union retained the share it staked out in the 1980s, so the U.S. gain was at the expense of Japan but also of the 'other' investors that had appeared in the 1980s. As indicated in Figure 4, between 1991 and 2003 the U.S. share of the total stock of foreign investment in Canada rose from 43.8 per cent to 60.4 per cent while that of Japan dropped sharply[18]. Canadian outward foreign investment (see Figure A-5) continued to grow apace, and remained cosmopolitan in range.

[18] Dfait, *Sixth Annual Report on Canada's State of Trade*, Table 8 (Ottawa, April 2005)

Figure 4



Source: Statistics Canada, *Canada's International Investment Position* (Ottawa, various years)

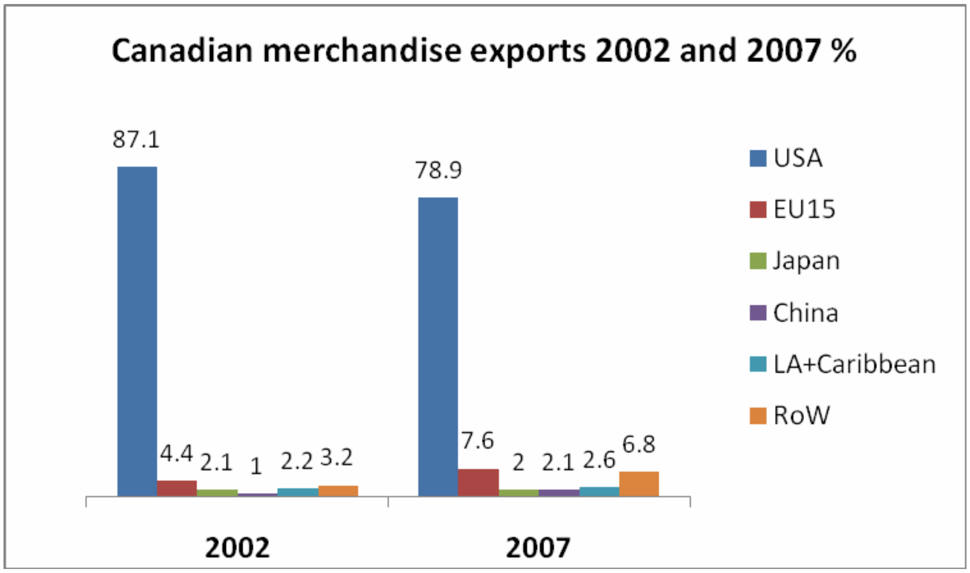
Phase Three: c. 2002-2008

The third phase in Canadian international economic history followed close on the heels of the opening of the new millennium. While trade linkages with the USA have remained of supreme importance they have become slightly less overwhelming. The pronounced trends of the 1990s have been reversed. Exports to the USA fell sharply in 2003, and although they recovered in the next two years values have subsequently tailed off again. As indicated in Figure 8, the proportion of Canadian merchandise exports destined for the American market declined from 87.1% of the total in 2002 to 78.9% in 2007.[19] One factor in this is the diminished international weight of the USA as a trading power. In contrast to the 1990s, the relatively sluggish performance of the American economy has been reflected in a reduced share of world imports.[20] Compounding this for Canada has been the intense competition it has faced in that market, above all from China, and a sharply reduced share of imports. The appreciation of the

[19] PFACT, *Canadian Trade*, February 2008. Exports plus re-exports on a Customs basis.
[20] UNCTAD, *Handbook of Statistics On-Line*. The American share of world imports declined from 19% in 2000 to 15.7% in 2006.

Canadian dollar has been a handicap to exporters, and in recent months the Canadians have been overtaken by the Chinese as principal supplier to the US market.[21]

Figure 5



Source: Statistics Canada, *PFACT Canadian Trade*, March 2008

Import sources have also become more diversified. Figures 6 and 7 outline the main changes between 2002 and 2007. Although the USA accounts for 54% of Canadian imports, this is well down on earlier years, and the trends of the 1990s have been reversed. Japan has also slipped. The major gains have been widely distributed although dominated by China.

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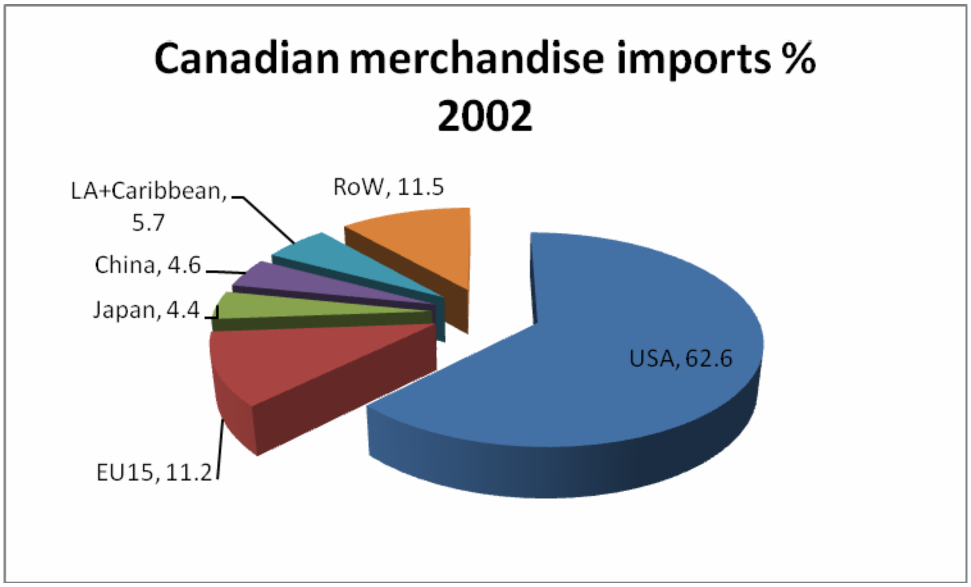
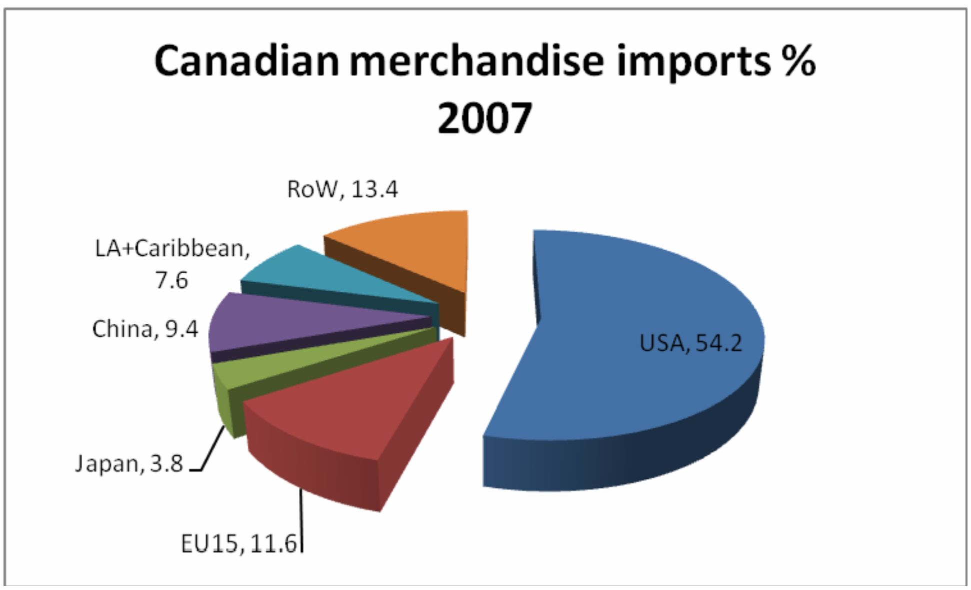
[21] In 2007 China supplied 16.5% of US imports of goods, Canada 16% and the third supplier, Mexico, 10.8%. US Census Bureau, *Foreign Trade Statistics* (Washington, 2008).

Figure 6



Source: Statistics Canada, *PFACT Canadian Trade*, March 2008

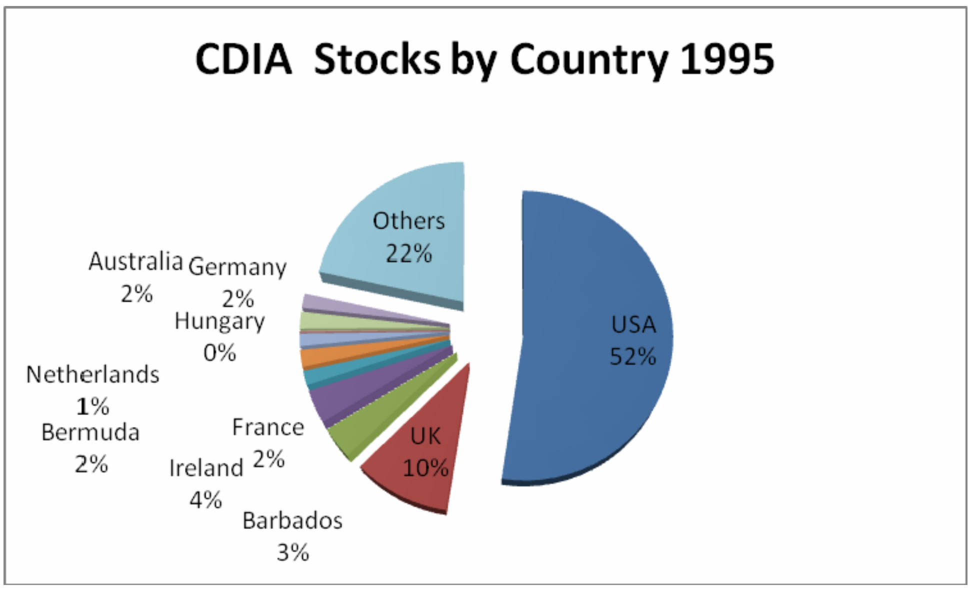
Figure 7



Source: Statistics Canada, *PFACT Canadian Trade*, March 2008

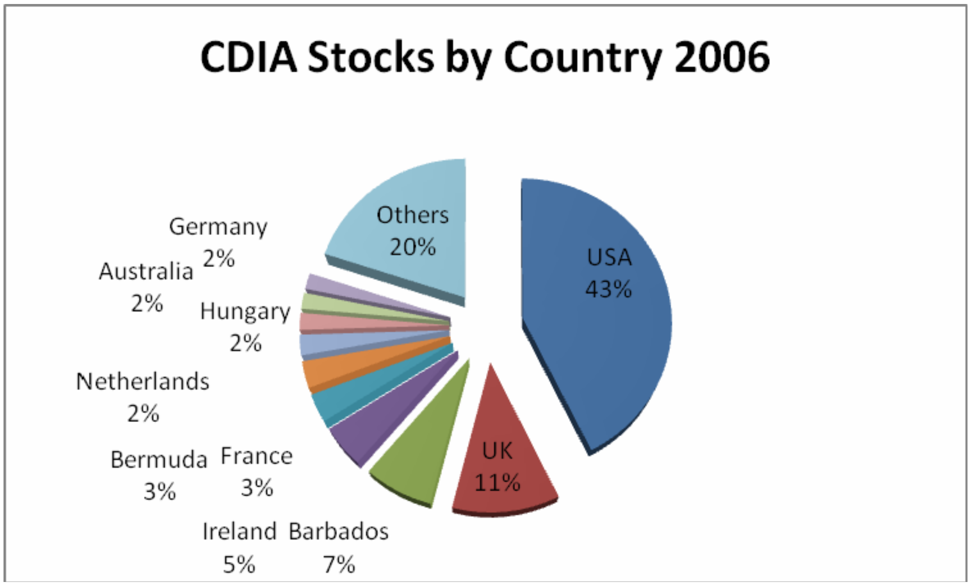
The theme of growing diversification has also characterised Canadian FDI where the pattern of Canadian holdings has become less concentrated on the US. Figure 9 reveals the slightly diminished role of the USA since 1995 and a more cosmopolitan distribution of Canadian funds (the pattern is repeated for total investment holdings – see Figure A-5). However, when inward investment to Canada is examined the diversification thesis fails to hold. The USA has maintained its prominent place as an investor in Canada, accounting in 2007 for 57% of the total stock of investment, barely less than in 2000. Europe, especially the UK, has become an absolutely and relatively larger supplier of funds while Japan and the 'Rest of the World' have become progressively less important.

Figure 8



Source: Dfait, *7th Annual Report on Canada's State of Trade, 2007*.

Figure 9



Source: Dfait, 7th *Annual Report on Canada's State of Trade, 2007.*

Canada's Truncated Continentalism

Canadian Continentalism does not extend very far south in the Americas. Economic links with Mexico, starting from a low base, have grown rapidly since the formation of NAFTA, but beyond Mexico connections for the most part remain weak.

Exports to Mexico expanded at over 10% per annum in the 1990s and have continued to grow at a rapid pace. Yet according to Canadian statistics they still represent only 1.1 per cent of worldwide sales. In reality the official figures overstate exports to the USA and understate the eventual destination, Mexico. Mexican figures credited Canada with an additional $4 billion in 2006, so the true total may be little short of $10 billon and therefore roughly 2 per cent of Canadian exports. Imports from Mexico have proved still more dynamic, growing faster than exports, and from a larger base, and in 2007 Mexico displaced Japan to rank third as a source of Canadian imports.

Yet it is difficult to represent this as part of a broader Latin American movement for Canada. Far from it, for in a sense Mexico in the 1990s displaced other non-US western hemisphere suppliers, the total imports from which failed to keep pace with the overall expansion of Canadian imports. Only in the past decade has there been some relative recovery. When it comes to exports Latin America has also proved a disappointing market. Despite expansion to Mexico, total sales to Latin America and the Caribbean were lower in 2002 than they had been six years earlier, having been badly affected by the financial crises of 2001-2 that hit the major South American economies of Brazil and Argentina. Despite some revival, sales to the region excluding Mexico account for less than their 2002 proportion and are well below the levels of a decade ago.

Nor has Continentalism had much bearing on investment linkages beyond the USA. Latin America has never been a major source of funds into Canada, although it has been more important as an outlet. Looking at Canadian investment outflows to the western hemisphere (minus the USA), the Caribbean countries are particularly prominent. The exotic locations of Barbados, Bermuda and the Cayman Islands have proved the main attraction for Canadian investors, accounting together for 12 per cent of Canada's global FDI holdings in 2006.[22] Figures 8 and 9 give an idea of the outlets for Canadian FDI holdings.

Recent changes in a long perspective

Taking a long view – from Confederation to the end of the 20th century – by the end of the 1990s Canada had diverged in two important respects from the some of the defining characteristics of its earlier engagement with the international economy. An increasingly sophisticated trading structure had reduced the reliance on natural resource exports. Canada had become less a 'hewer of wood and drawer of water'. By the end of the century, as indicated in Figure 10, Canadian manufactures accounted for more than half of total exports. But two qualifications need to be made: first, of the individual provinces this was true only of Ontario and Quebec, the rest predominantly exporting natural resource products, and, secondly, the Canadian balance of payments depended on export surpluses of primary products. None the less, compared with other Settler economies, Canada had been a great 20th century success: not only had it experienced a much faster growth of exports and income but it had developed a more diverse export structure.[23]

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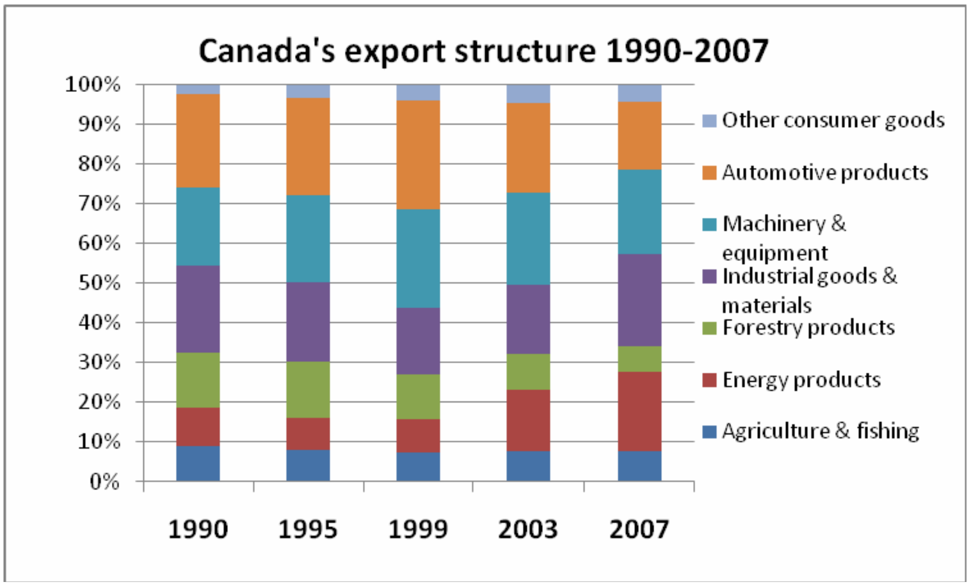
[22] With the recent take-over of Trinidad's RBTT by the Royal Bank of Canada, Canadians now control the English-speaking Caribbean's three largest banks with $42 billion in assets. *Economist*, 29 March 2008, p.67.
[23] T. Rooth, 'International trade and investment of the settler economies during the twentieth century: Argentina, Australia, Canada, New Zealand and South Africa', paper presented at the International Economic History Congress, Helsinki, 2006.

The other major development had been the emergence of persistent balance of payments surpluses. From its beginnings Canada had run deficits on its trading and services accounts with the rest of the world and financed these by borrowing.[24] By the 1990s Canada began to generate substantial current account surpluses with the USA, using these to cover deficits with other countries and, increasingly, to finance net foreign investment.[25] In 1999 Canada earned a small overall current account surplus which in the next few years it rapidly enlarged (see Appendix Figure A-4).

Figure 10



Sources: Statistics Canada, *Canada Yearbooks*, 2001 and 2007.

Recent developments, notably the relative decline of the US market and the great surge in commodity prices, have modified the position. This is most obvious in the structure of exports revealed in Figure 10 above. Manufactures have lost their recently won ascendancy: accounting for 56.2 per cent of exports in 1999, their share had fallen to 42.6 per cent by 2007. As the *Economist* reported, 'the engines of growth in the 1990s – cars and high-tech industries – have slowed or shrunk ... [and]... dowdy perennials, such as mining, have become the new stars'.[26] This has been accompanied by some shifts in provincial power.

[24] There had been exceptions, certainly during WWII and perhaps during some years of the 1930s depression, but these had been few.

[25] As a result Canada's net external liabilities to GDP fell from 44% in 1992 to 18.8% in 2001. Stat Can.

[26] 'A return to an older pattern of growth', *Economist*, 22 Sept. 2005.

Ontario's dominance as a source of exports has slipped: Ontario's exports in 2006 were still below the level of 2002, and its share of Canadian exports had dropped from 52 to 45 per cent. This has been reflected in weak economic performance with Ontario's growth persistently lagging the national average. Alberta has made the greatest gains. [27]

The second major development discussed above was the emergence of a balance of payments surplus after 1997, as shown in Appendix Figure A-4. Net payments have remained in surplus on an annual basis but at a sharply reduced level, and in the fourth quarter of 2007 moved into deficit. With an appreciating dollar increasingly taking on the behaviour of a petro-currency,[28] the balance of payments has inevitably suffered (and this has made life much more difficult for manufacturers).

Conclusions

Canada's intense economic relations with the USA have been one of the hallmarks of its 20th century economic history. Its superior export record compared with other Settler economies over the course of the century has owed much to the relative openness and rapid growth of the American market as well as the advances Canada staked out for itself in that market.[29]

Yet the high degree of dependence has fluctuated, partly reflecting Canadian policy but also changes in the global economic environment. Regional links with the rest of the continent have remained comparatively slender notwithstanding the NAFTA and other initiatives (although official figures understate the importance of Mexico, and bilateral trade has grown very rapidly but from a small base). Three distinct phases have been traced in this paper. In the second of these in the 1990s a conjunction of Canadian policy, notably in the form of the free trade pacts, and of American ascendency operated together to intensify economic relations with the USA. Since then the weakening of the US economy and the impact of China on world commodity markets has led to

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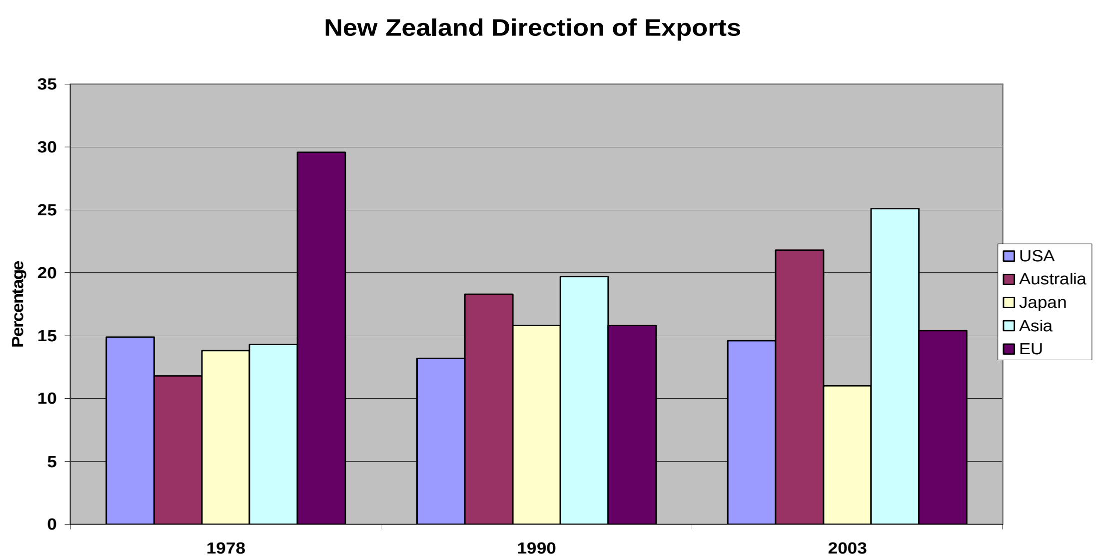
[27] Dfait, *Seventh Annual Report on Canada's State of Trade* (Ottawa, 2007). Alberta's share rose from 12 to 19% between 2002 and 2006.
[28] In reality driven by high commodity prices as a whole and helped also by the strength of Canada's fiscal position. In late 2007 the Canadian dollar became worth more than the US dollar prompting parity parties across Canada!
[29] This applies more to the period since 1945; Canada suffered grievously from US protection in the 1930s.

some diversification. Canada's export boom of the nineties accelerated the growing weight of manufactures in the export structure and eventually led to the emergence of a balance of payments surplus. Both have subsequently shrunk.

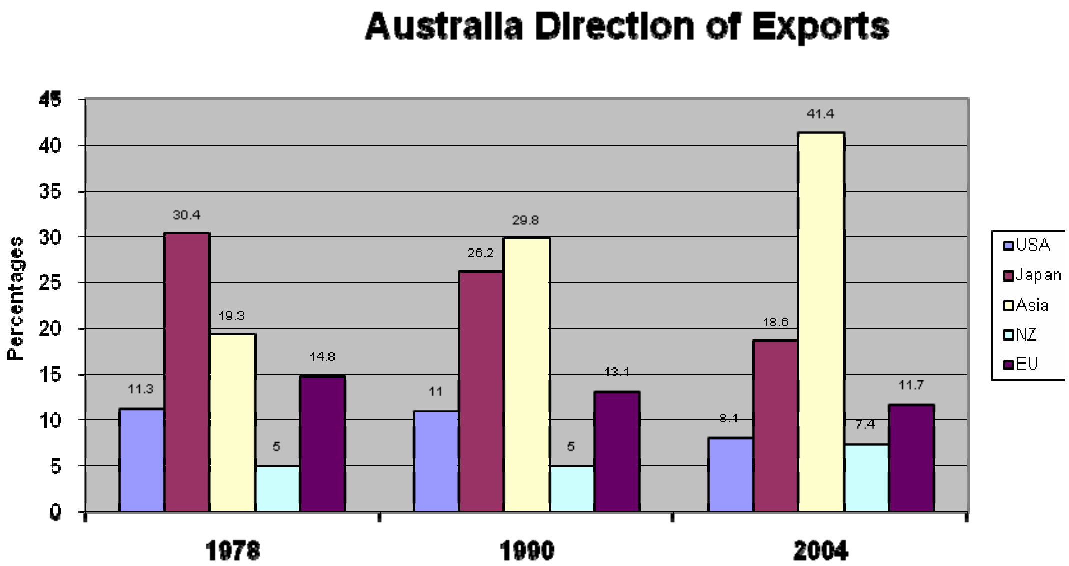
Appendices

Figure A-1



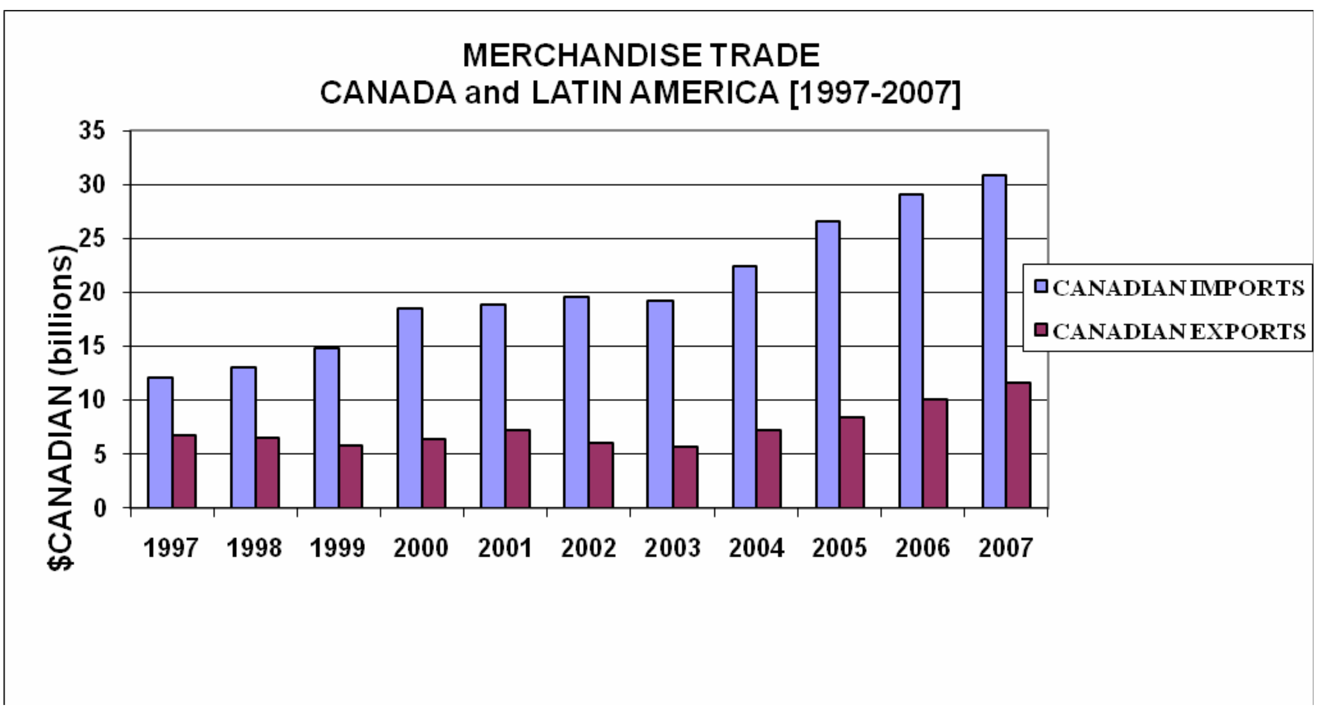
Source: IMF, *Direction of Trade Statistics Yearbooks*

Figure A-2



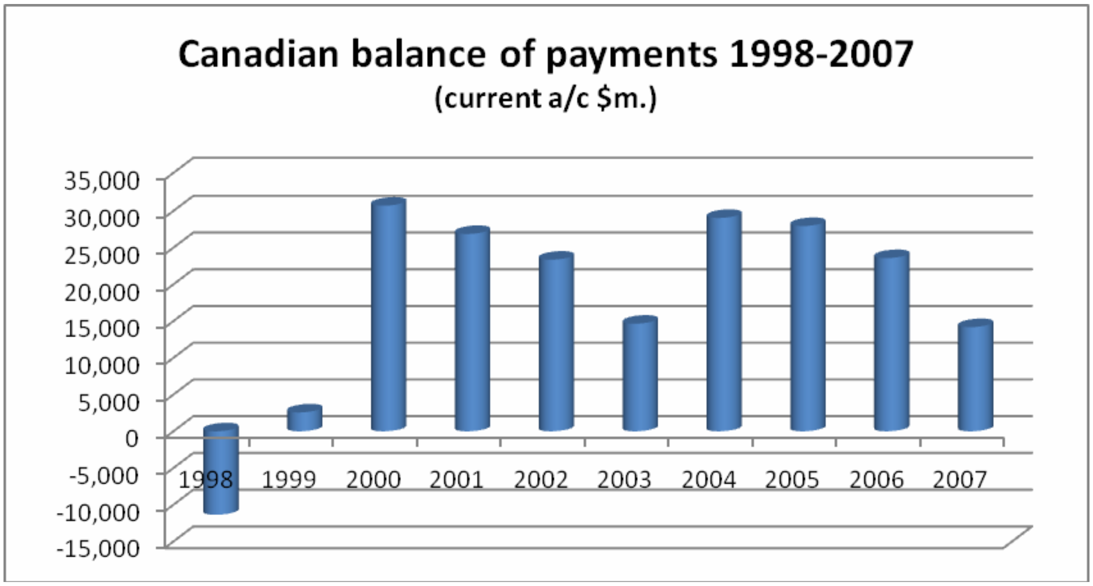
Source: IMF, *Direction of Trade Statistics Yearbooks.* (Washington, various years)

Figure A-3



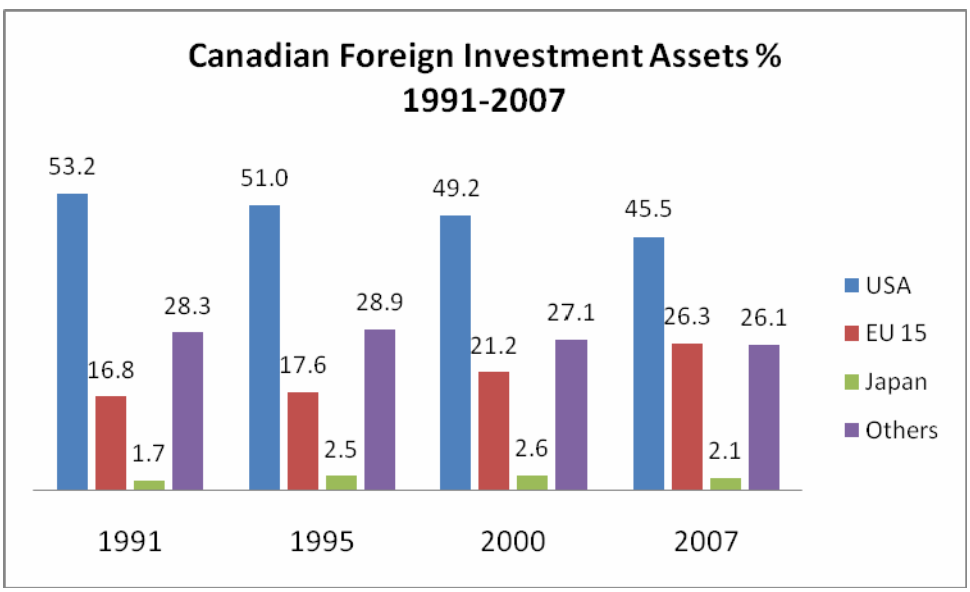
Source: Statistics Canada, *PFACT Canadian Trade*, March 2008

Figure A-4



Source**:** Statistics Canada, CANSIM, tables 376-0001 and 376-0002.

Figure A-5



Source: Statistics Canada, *Canada's International Investment Position* (Ottawa, various years)