I. RECENT ECONOMIC DEVELOPMENTS

1. After a decade of strong expansion, Canadian economic growth slowed in the fourth quarter of 2000. This was followed by a contraction in output in the third quarter of 2001, ending 37 consecutive quarters of economic growth. The Bank of Canada provided substantial monetary stimulus is 2001, in the face of a series of major external shocks. The economy started to show signs of recovery towards the end of 2001. In the first half of the year, the fiscal discipline of previous years, combined with low inflation, made it possible for Canada to use a counter-cyclical fiscal policy stance to stimulate growth. This resulted in a relatively strong economic performance at the time of reduced global economic growth; growth in the first half of 2002 averaged well over 4% at an annualized rate.

2. Trade plays an important role in Canada's economy. Two-way trade flows represented nearly 80% of GDP in the first half of 2002, and exports of goods and services have been a major component of growth in recent years. The United States is the destination for some 87% of Canadian merchandise exports and the source of about two thirds of its imports.[1] Although this makes the Canadian economy potentially vulnerable to events in the United States, Canada has successfully weathered the U.S. slowdown since 2000.

3. Canada renewed its successful inflation target policy in 2001, and aims to stabilize inflation at around 2%. Canada has also made remarkable progress in reducing its public debt burden, as the debt/GDP ratio fell to 49% in 2002 from 71% in 1995.

(1) OUTPUT, EMPLOYMENT AND PRICES

4. The Canadian economy experienced four years of strong growth up to late 2000 underpinned by expanding exports and investment (Table I.1). Economic growth began to slow down in the fourth quarter of 2000, and contracted in the third quarter of 2001, largely reflecting the impact of the economic downturn in the United States. Real growth for the whole of 2001 fell to 1.5%, the lowest rate since the early 1990s, led by a sharp fall in exports of goods and services and strong inventory decumulation. In contrast to developments in the previous years, when the contribution of net exports largely supported GDP growth, in 2001 domestic demand supported growth, particularly consumer and government expenditure, since non-residential investment stalled.

5. Faster growth resumed in the fourth quarter of 2001, and GDP expanded at an annualized rate of 5.7% in the first quarter of 2002, driven mainly by slower inventory reduction , a sharp increase in residential investment, and strong export expansion. Growth moderated slightly in the second and third quarters of 2002 but remained solid at 4.4% and 3.1%, respectively. With strong gains in real personal disposable income since the fourth quarter of 2001, Canadian growth is expected to continue to be supported by residential investment and consumer expenditure. Recent income strength has been aided by both a reduction in personal income taxes and stronger growth in income from employment and transfers from the Government. The increase in real personal disposable income has helped lift the personal savings rate from its historical low of 3.7% in the third quarter of 2001 to 4.7% in the third quarter of 2002. However, that rate remains well below the level of 13-14% observed in the early 1990s.

6. Although investment in residential structures soared in the first three quarters of 2002 (taken as a whole), non-residential private investment started to recover only in the second quarter, after declining in 2001 and the first quarter. Part of this decline is linked to reduced export opportunities to the U.S. market. Consumer and mortgage debt levels have been rising sharply, and the household

[1] Estimates based on UNSD, Comtrade database.

debt-to-income ratio reached 99.4% in the second quarter of 2002. However, historically low interest rates and rising income are helping to sustain housing demand, by keeping housing affordability near its record best levels.

Table I.1
Selected macroeconomic indicators, 1997-02
(Can$ billion and per cent, annualized values, except as indicated)

	1997	1998	1999	2000	2001	2002 QI	2002 Q2	2002 Q3
GDP (current Can$ billion)	**882.7**	**915.0**	**980.5**	**1,065.0**	**1,092.2**	**1,106.2**	**1,138.0**	**1,151.8**
				Change in per cent				
Real GDP	4.2	4.1	5.4	4.5	1.5	5.7	4.4	3.1
Final domestic demand	5.4	2.8	4.3	4.0	2.5	3.7	4.4	2.0
Consumer expenditure	4.6	2.8	3.9	3.7	2.6	2.9	4.2	0.5
Goods	5.5	3.4	4.4	3.8	2.6	5.3	1.5	-1.0
Services	3.9	2.3	3.4	3.7	2.6	0.9	6.7	1.9
Government expenditure								
Goods and services	-1.0[a]	3.2	1.9	2.3	3.3	1.7	3.3	2.8
Gross fixed capital	-3.2	-0.7	12.7	3.0	11.5	7.1	8.3	0.7
Residential investment	8.2	-3.5	5.4	3.5	4.7	35.2	-1.7	15.9
Business fixed investment	18.1	2.8	7.2	6.9	0.4	8.1	5.8	6.2
Non-residential construction	17.7	0.3	2.0	6.4	0.8	-7.7	-1.9	-2.3
Machinery and equipment	26.0	8.6	11.4	9.3	-2.2	1.8	16.7	4.8
Business inventory investment (Can$ billion)	8.2	6.0	6.5	9.9	-3.5	-7.8	7.2	6.4
Period Change (Can $ billion)	5.6	-2.2	0.6	3.4	-13.5	4.9	14.9	-0.8
Real exports of goods and services	8.3	9.1	10.0	8.0	-3.8	5.3	2.0	9.6
Goods	8.5	8.5	11.1	8.6	-4.1	6.5	1.6	10.3
Services	7.1	13.1	2.7	3.9	-1.7	-2.6	4.7	4.2
Real imports of goods and services	14.2	5.1	7.8	8.2	-5.8	5.2	18.9	6.3
Goods	16.5	6.1	8.5	8.9	-5.9	7.0	18.3	7.9
Services	3.7	-0.1	4.1	4.1	-4.8	-4.0	22.0	-1.6
Real personal disposable income	1.3	2.8	2.7	6.9	4.4	7.2	4.5	4.1
Prices				**Change in per cent**				
CPI (period average)	1.6	0.9	1.7	2.7	2.6	1.5	1.3	2.3
Core CPI (excluding eight most volatile items and indirect taxes)	1.9	1.3	1.4	1.2	2.1	2.1	2.2	2.4
GDP deflator (implicit)	0.8	-0.6	1.6	3.9	1.1	3.5	7.4	1.9
Unit labour costs	2.0	2.9	-2.3	3.8	3.2	0.4	-0.5	..
Wage settlements	1.4	1.7	2.2	2.5	3.2	2.9	2.6	..
Commodity price index (1982-90=100 (US$)								
Energy	83.4	64.6	78.9	122.9	116.1	..	..	..
Non energy	118.4	103.6	105.2	108.8	101.9	..	..	..
Employment/unemployment								
Employment (changes in per cent)	2.3	2.7	2.8	2.6	1.1	2.8	3.7	3.4
Unemployment rate (end-of-period for quarters)	9.2	8.3	7.6	6.8	7.2	7.7	7.5	7.7

.. Not available.

a Includes gross fixed capital expenditure.

Source: Statistics Canada [Online]. Available at: http://www.statcan.ca/english/Pgdb/; Department of Finance, *The Economy in Brief*, various issues [Online]. Available at: http://www.fin.gc.ca/purl/econbr-e.html; Bank of Canada [Online]. Available at: http://www.bankofcanada.ca/en/inflation/index.htm; and IMF, *International Financial Statistics*, August 2002.

7. Strong output and consumption growth was accompanied by high import growth throughout the late 1990s and in 2000, particularly of goods. In 2001, however, imports of goods and services contracted by 5.8%, linked partly to falling exports, which, in Canada, have a high import content. In

the first three quarters of 2002, stronger-than-expected growth was accompanied by substantial increases in imports.

8. Personal expenditure on services represents over half of total personal expenditure, about 30% of real GDP, and made a strong contribution to GDP growth in 2000 and 2001. As one of the most stable components of GDP, and considering the slowdown in personal expenditure on durable goods and other cyclical components of GDP during the downturn in economic activity, the relative contribution of personal expenditures on services to GDP increased in 2000 and 2001. However, the strong housing sector and financing incentives in the auto sector helped push up personal expenditures on durable goods at the end of 2001 and the beginning of 2002, reducing the relative contribution of services in economic activity in 2002 with respect to the previous two years. Government expenditure, particularly gross capital formation has also underpinned growth in most of the 2000-02 period.

9. Despite the generally rapid expansion of the economy, inflation has remained low, and within the inflation target of 1-3% set by the Bank of Canada (see below); the annual increase in the consumer price index (CPI) averaged 1.9% in the period 1997-01 (Table I.1). The rate of increase of the CPI accelerated somewhat in 2000 and 2001, due partly to an increase in oil prices and to the effect on import prices of the real depreciation of the Canadian dollar *vis-à-vis* the U.S. dollar. Core inflation, however, increased by less.[2] The increase in the CPI decelerated in late 2001 linked with the slowdown of the economy and the effects of reductions in crude oil and natural gas prices, but edged up in the first three quarters of 2002, to reach 3.2% in October, reflecting higher food, transportation, shelter, and especially crude prices. Core CPI increased at a year-over-year rate of 2.5% in September and October, largely reflecting increases in insurance premiums and electricity prices.

10. The unemployment rate rose during 2001 to a peak of 8% in December 2001. This rate fell to 7.5% by November 2002. The overall decline has been moderated by strong employment growth accompanied by an increase in labour-force participation. Most gains in employment since the beginning of 2002 have been concentrated in Ontario (in manufacturing), followed by Quebec (in construction and services). In the first eleven months of 2002, the economy created about 502,000 jobs, up from 167,000 for the whole of 2001. The total number of employed persons reached 15.6 million in November 2002; the labour force participation rate, calculated quarterly, stood at 67.3% in the third quarter of 2002, up from 66% in 2001 and 65% in 1997.

11. Canada's labour productivity growth averaged 2% from 1997 to 2001, up from 1.2% in the 1990-96 period, but slowed to 0.8% in 2001. The authorities have noted that the improvement in labour productivity growth in the business sector in the second half of the 1990s was due mainly to higher productivity growth in the services sector. The rebound in Canadian labour productivity growth since 1997 has reduced the average productivity growth gap between Canada and its main trading partner, the United States, over the period. Although growth in unit labour costs remained moderate in 2000 and 2001, it was above productivity growth. Nevertheless, Canadian firms improved their competitive position *vis-à-vis* the United States: adjusted for exchange rate movements, unit labour costs with respect to the United States were down 2.9% in 2001.

[2] The "core" measure of CPI inflation that the Bank of Canada has been using since May 2001 excludes the eight most volatile components of the CPI (fruit, vegetables, gasoline, fuel oil, natural gas, mortgage interest, inter-city transportation, and tobacco products) and adjusts the remaining components to remove the effect of changes in indirect taxes.

(2) MONETARY POLICY AND EXCHANGE RATES

12. Canadian monetary policy is aimed at keeping a low, stable inflation rate. To this end, the Bank of Canada and the Government have set an inflation target range of 1% to 3%, as measured by increase in the CPI. The Bank considers that by focusing on inflation the output gap between the potential and actual performance of the economy is kept as narrow as possible thus avoiding inflationary "boom-and-bust" cycles. Inflation targeting has been in place since 1991, and has been renewed three times, in 1995, 1998, and 2001. In the 2001 renewal, which is for a period of five years, the Bank of Canada maintained the target range at between 1% and 3%, with policy aimed at keeping the trend of inflation at the 2% target midpoint; this would allow deviations of 1% up or down as a result of demand or supply shocks.[3]

13. The Bank of Canada conducts monetary policy mainly through changes in its target for the overnight interest rate, which is the middle of the operating band for overnight financing. Changes in the target for the overnight rate influence, to varying degrees, other interest rates along the term structure, and also has an impact on the exchange rate. Starting in December 2000, the Bank of Canada introduced a system of eight pre-specified dates each year for announcing any changes to the policy rate.[4] This replaced the previous system whereby rate changes could be introduced at any time.

14. The Bank of Canada, in its conduct of monetary policy, recognizes the importance of international trade for the Canadian economy. In this respect, the Bank considers that, in an open economy with a flexible exchange rate like Canada's, it must take into account the exchange rate when changing the target for the overnight rate, since it is the combined effect of interest rates and the exchange rate that determines monetary conditions. While the former capture the effect of domestic economic conditions, movements in the latter take into account economic conditions abroad and their effect on the Canadian economy. The Bank considers that these changes in the monetary conditions of the economy will be transmitted to the real economy with a lag of 18 to 24 months.

15. Due to the slowdown of the economy, and given that inflation was low, the Bank of Canada eased monetary policy substantially during 2001 to support aggregate demand. From January 2001 through January 2002, the Bank lowered its target for the overnight rate ten times, by a total of 375 basis points, to 2% (Table I.2). As signs of economic recovery appeared in early 2002, the Bank reduced the amount of monetary stimulus in the economy, increasing its target for the overnight rate three times between April and July 2002, to 2.75%.

16. Monetary aggregates have expanded rapidly since 2000, at rates higher than the rate of nominal GDP growth. The expansion has been particularly brisk in the case of narrow monetary aggregates (such as Gross M1 and M1++), for which demand has expanded due to the easing of monetary conditions, and the low rates of return on other assets, which have reduced the opportunity cost of holding money. The demand for narrow money also increased for precautionary purposes, given the heightened uncertainty about the performance of the stock and money markets.

17. In 2000 and 2001, the Canadian dollar depreciated *vis-à-vis* the U.S. dollar, falling to a historical low of US$0.62 in January 2002 before appreciating in the first half of 2002. Over the 2000-01 period, there was also a real effective depreciation of the Canadian dollar, which turned to a real appreciation in 2002.

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[3] See Bank of Canada (2001), *Renewal of the Inflation-Control Target*, Background Information, May 2001.

[4] See Bank of Canada (2001), A New System of Fixed Dates for Announcing Changes to the Bank Rate, on Internet address http://www.bankofcanada.ca/fixed-dates/.

Table I.2
Selected monetary and exchange rate indicators, 1997-02

	1997	1998	1999	2000	2001	2002 Q1	2002 Q2	2002 Q3
Money stock (end of period, per cent change)[a]								
Gross M1	14.7	7.0	9.8	15.6	14.3	12.2	12.9	11.2
M1++	5.3	1.0	6.8	10.1	13.9	15.6	15.0	12.1
M2++	6.1	5.5	5.5	7.9	7.1	6.7	6.6	6.5 (Aug)
Interest rates (%)								
Overnight rate (policy instrument)	425	5.0	4.75	5.75	2.25	2.0	2.5	2.74
Prime lending rate	4.96	6.60	6.44	7.27	5.81	3.75	4.08	4.50
90-day commercial paper	4.8	5.02	5.27	5.71	2.08	2.36	2.78	2.90
Exchange rate (yearly average)								
Nominal effective exchange rate (1995=100)	101.9	95.8	95.2	96.3	93.5	91.4	93.1	..
C- 6 Trade-weighted exchange rate[b]	85.84	78.32	83.9	81.66	78.33	78.45	80.99	77.97
Real effective exchange rate (1995=100)	103.5	97.0	95.9	96.0	91.1	91.0	93.7	..
Can$ per US$	1.38	1.48	1.48	1.48	1.54	1.58	1.53	1.57
Can$ per £	2.26	2.45	2.40	2.24	2.22	2.25	2.27	2.45
Can per Euro	..	..	1.58	1.37	1.38	1.39	1.46	1.54

.. Not available/applicable.

a Gross M1**:** Currency outside banks plus personal checking accounts plus current accounts plus some adjustments to M1; M1++: M1+ plus non-chequable notice deposits held at chartered banks, trust and mortgage loan companies, and credit unions and caisses populaires less interbank non- chequable notice deposits plus continuity adjustments. M2++: includes Canada Savings Bonds plus cumulative net contributions to mutual funds other than Canadian dollar money market mutual funds.

b The C-6 exchange rate is an index of the weighted- average foreign exchange value of the Canadian dollar against major foreign currencies. Weights for each country are derived from Canadian merchandise trade flows with other countries over the three years from 1994 through 1996. The index has been based to 1992.

Source: Bank of Canada, *Monetary Policy Report*, April 2002, and other online information, available at: http://www.bankofcanada (http://www.bankofcanada.ca/en/graphs/a1-table.htm and http://www.bank-banque-canada.ca/pdf/wfs.pdf); and International Monetary Fund, *International Financial Statistics* (August 2002).

(3) FISCAL POLICY

18. As a result of a deficit-reducing policy, Canada has achieved a budget surplus at a federal level in every fiscal year between 1997/98 and 2001/02. Moreover, the ratio of federal debt-to-GDP ratio fell from a post-World War II peak of 71% in 1995-96 to about 49% in 2001-02. Key in this fiscal turnaround has been the decline in programme spending as a percentage of GDP, from 16.4% in 1993-94 to 11.3% in 2000-01.[5]

19. Canada adopted a more expansionary fiscal stance starting in 2000. The Government cut taxes in February 2000 and restored full indexation of the personal income tax system to inflation in order to spur economic growth. The tax cuts will be implemented over a period of five years, during which it is estimated that taxes will be reduced by a cumulative amount of at least Can$58 billion.[6] The middle income tax rate was reduced from 26% to 23%, starting with a 2 percentage point reduction to 24% in July 2000. It was also decided that the 5% income surtax established to reduce the deficit would be eliminated for incomes of up to about Can$85,000 and reduced for incomes above that level by 2004.

[5] The Government estimates that nearly three quarters of the improvement in the budgetary balance since 1993-94 is attributable to the decline in programme spending. See, *The Economic and Fiscal Policy Update*, 30 October 2002 [Online]. Available at: http://www.fin.gc.ca/.

[6] Government of Canada (2000). Budget 2000 [Online]. Available at: http://www.fin.gc.ca/budget00/features/bud_tax_e.html.

20. In October 2000, new expansionary measures were adopted under the Government's Four-Part Plan, which include stepping up federal transfers to Canada Health by some Can$21.1 billion to strengthen Canada's system of universal health care, as well as increasing spending in education and environmental protection. It was also decided to cut taxes faster and further than set out in Budget 2000, leading to an average personal income tax cut of 21%, instead of 15% and combined with the measures in Budget 2000, providing total cumulative tax relief of Can$100 billion by 2004.[7] Other measures of fiscal stimulus to the economy adopted in 2000 included corporate income tax rate reductions for the highest-taxed sectors, such as services.[8] Also, the capital gains inclusion rate for individuals and corporations was cut to one-half of the gain.

21. The overall Federal Government's fiscal balance rose to 1.9% in 2000-01, before declining to 0.9% of GDP in 2001-02 (Table I.3). The reduction of the surplus in 2001-02 resulted from a 4.8% increase in expenditures, the tax cuts introduced in 2000, and lower economic growth. The latter had an impact on most major revenue components, particularly corporate income tax revenues, and resulted in an overall 3.5% decline in revenue compared to the previous fiscal year.

Table I.3
Selected fiscal indicators, 1997-02

	1997-98	1998-99	1999-00	2000-01	2001-02[a]
Federal fiscal balance (per cent of GDP)					
Revenues	17.3	17.0	17.0	16.6	15.9
Spending	-12.3	-12.2	-11.5	-10.8	-11.5
Operating balance	5.0	4.8	5.5	5.8	4.4
Public debt charges	-4.6	-4.5	-4.3	-3.9	-3.5
Budgetary balance	0.4	0.3	1.3	1.9	0.9
Non-budgetary transactions	1.0	0.9	0.2	-0.1	-0.4
Financial requirements	1.4	1.3	1.5	1.8	0.5
Provincial fiscal balance	-0.4	-0.3	0.3	1.1	..
Public debt (Can$ billion, fiscal year)	583.2	579.7	576.8	564.5	547.4
Public debt (% of GDP)	65.6	63.0	57.9	51.8	49.1

.. Not available.

a Preliminary data, to be subject to end-on-year accounting adjustments.

Source: Department of Finance (2002), *The Fiscal Monitor*, May; and Budget 2002.

22. At a provincial level, fiscal reform and economic growth have resulted in surpluses in the majority of provinces, including those with the larger economies (Ontario, Quebec, and Alberta).[9] The overall provincial fiscal balance was in surplus in both fiscal years 1999-00 and 2000-01, the latest for which complete information is available. In 2001-02, the provincial sector as a whole is expected to have achieved close to a balanced budget. British Columbia, Yukon and the Atlantic provinces, except New Brunswick, were expected to have recorded budgetary deficits.

[7] For details see Canadian Government online information. Available at: http://www.fin.gc.ca/toce/2000/ec00e.htm.

[8] From 28% in 2000, to 27% in 2001, 25% in 2002, 23% in 2003 and 21% in 2004 and subsequent years. The corporate tax rate on small business income between Can$200,000 and Can$300,000 earned by a Canadian-controlled private corporation from an active business carried on in Canada was reduced from 28% to 21% effective 1 January 2001.

[9] More information on the fiscal accounts of the Canadian provinces is available online at: http://www.fin.gc.ca/frt/2002/frt02_4e.html#Provincial%20and%20Territorial%20Governments%20Public%20Accounts.

23. The overall fiscal surplus of the past few years has allowed a reduction in public debt as a share of GDP, to 49.1% in fiscal year 2001-02, down from 65.6% in fiscal year 1997-98 (Table I.3). Assuming balanced budgets, the Government aims to reduce this ratio to 40% by 2005, using any overall fiscal surplus to further pay down the debt.

(4) BALANCE OF PAYMENTS

24. Foreign trade has played a major role in Canada's economic growth during the 1990s and early 2000s. Both exports and imports have in general expanded faster than GDP. Exports of goods represented some 38% of GDP in 2001, up from 24% 20 years earlier.

25. The current account has been in surplus since 1999 (Table I.4). As a result of a strong surplus in the trade balance, triggered by a sharp increase in exports of goods, the current account surplus increased substantially in 2000 with respect to the previous year. In 2001, the surplus topped Can$30 billion, or some 2.8% of GDP, as imports contracted more than exports and the trade surplus increased.

26. While the trade in goods balance showed a surplus in both 2000 and 2001, the services balance was in deficit. This deficit worsened slightly in 2001, while the trade in goods surplus increased. Although the capital account continued to post a surplus, the deficit in the financial account has increased substantially since 1999, mainly due to a surge of Canadian direct and portfolio investment abroad, which exceeded the large investment inflows.

(5) TRADE AND INVESTMENT PATTERNS

27. Canada accounts for 5.5% of total world exports and for 4.5% of world imports (excluding intra-EU trade). In 2001, Canada was the fifth largest trader, having been replaced at fourth place by China.[10]

(i) Trade in goods

28. Using Comtrade data, exports expanded rapidly in 1999 and 2000, but contracted in 2001 mainly reflecting weaker import demand in the United States (Table AI.1). Some of the more affected sectors were office machines and telecommunication equipment, automotive products, agricultural products, iron and steel. Imports grew by more than 40% (in U.S. dollars) between 1996 and 2000, but fell in 2001 as growth decelerated (Table AI.2).[11]

29. Some two thirds of exports are manufactured goods. In terms of product categories, in 2001 Canada's main merchandise exports were automotive products, especially passenger vehicles (21.2% and 12.1%, respectively), mining products, especially fuels (18.4% and 14.1%, respectively), and agricultural products (excluding agro-industry, 12.9%). Since the mid 1990s, agriculture has been losing market share in total exports, while mining products (especially natural gas) have gained (Table AI.1).

[10] WTO (2002).
[11] The increase was 53% using Statistics Canada's balance-of-payments-based statistics.

Table I.4
Canada's balance of international payments, 1997-02
(Can$ million)

	1997	1998	1999	2000	2001	2002 QI	2002 Q2	2002 Q3
Current account								
Total receipts	**385,415**	**414,777**	**458,767**	**528,643**	**513,264**	**122,122**	**125,391**	**128,249**
Exports of goods and services	347,134	377,385	420,210	482,731	471,250	113,656	116,233	119,249
Goods	303,378	327,162	367,171	425,587	414,638	99,661	102,017	104,946
Services	43,755	50,223	53,039	57,144	56,612	13,994	14,216	14,303
Travel	12,221	14,019	15,141	16,098	16,682	4,054	3,903	3,967
Transportation	8,407	9,143	9,688	11,170	10,523	2,610	2,710	2,770
Other services	23,128	27,062	28,210	29,876	29,407	7,331	7,602	7,567
Investment income	33,252	32,338	32,913	39,815	34,990	6,723	7,552	7,382
Direct investments	15,164	12,955	14,148	18,403	15,791	2,712	3,547	3,402
Portfolio investments	4,972	5,741	6,074	6,949	7,683	1,954	1,997	1,932
Other investments	13,115	13,643	12,692	14,463	11,515	2,057	2,007	2,047
Transfers	5,029	5,054	5,644	6,097	7,024	1,743	1,607	1,618
Total payments	**396,812**	**426,140**	**456,771**	**500,862**	**483,216**	**116,785**	**120,680**	**123,146**
Imports of goods and services	330,346	359,947	387,152	427,997	415,617	101,547	104,985	107,389
Goods	277,727	303,399	326,961	363,432	350,623	85,779	88,526	90,943
Services	52,619	56,549	60,191	64,565	64,994	15,768	16,459	16,446
Travel	15,873	16,029	17,049	18,313	17,998	4,365	4,515	4,547
Transportation	11,417	11,759	12,288	14,004	14,209	3,261	3,507	3,676
Other services	25,329	28,761	30,853	32,249	32,787	8,142	8,437	8,222
Investment income	62,133	61,965	64,983	68,241	62,524	13,938	14,458	14,497
Direct investments	18,885	16,271	20,578	23,470	20,920	4,617	5,134	5,130
Portfolio investments	29,519	31,302	30,453	29,240	29,652	7,198	7,238	7,382
Other investments	13,730	14,391	13,952	15,531	11,951	2,123	2,087	1,985
Transfers	4,333	4,228	4,636	4,624	5,074	1,300	1,238	1,259
Current account balance	**-11,397**	**-11,363**	**1,996**	**27,781**	**30,049**	**5,336**	**4,711**	**5,104**
Goods and services	16,788	17,438	33,058	54,735	55,633	12,109	11,248	11,860
Goods	25,652	23,763	40,210	62,155	64,016	13,883	13,491	14,003
Services	-8,864	-6,325	-7,152	-7,421	-8,382	-1,774	-2,243	-2,143
Investment income	-28,882	-29,627	-32,070	-28,427	-27,534	-7,215	-6,906	-7,116
Transfers	697	826	1,008	1,473	1,949	443	369	359
Capital account								
Total capital and financial accounts, net flow	15,764	4,530	-13,192	-21,518	-20,918	2,321	564	-7,574
Capital account, net flow	7,508	4,934	5,049	5,270	5,678	1,500	1,678	934
Capital account, inflows	8,107	5,617	5,736	6,003	6,482	1,654	1,835	1,265
Capital account, outflows	-599	-682	-687	-733	-804	-154	-157	-331
Financial account, net flows	8,256	-405	-18,241	-26,788	-26,596	821	-1,114	-8,507
Canadian assets, net flows	-62,546	-67,161	-40,710	-142,429	-110,385	-25,747	-11,837	-13,118
Canadian direct investments abroad	-31,937	-50,957	-23,182	-70,545	-54,924	-7,052	-8,620	-12,814
Canadian portfolio investments	-11,849	-22,497	-23,067	-62,274	-37,718	-11,382	-6,316	-2,068
Other Canadian investments	-18,760	6,292	5,540	-9,610	-17,743	-7,313	3,100	1,764
of which official international reserves	3,389	-7,452	-8,818	-5,480	-3,353	-696	-1,450	1,885
Canadian liabilities, net flow	70,803	66,757	22,468	115,641	83,789	26,568	10,724	4,611
Foreign direct investments in Canada	15,958	33,828	36,306	98,940	42,527	17,466	7,027	1,569
Foreign portfolio investments	16,181	24,779	3,255	14,025	30,868	2,281	6,633	-3,557
Other foreign investments	38,664	8,149	-17,092	2,677	10,394	6,821	-2,936	6,599
Statistical discrepancy	-4,367	6,833	11,196	-6,264	-9,130	-6,236	-4,385	798
Memorandum: Current account balance/GDP	**-1.3**	**-1.2**	**0.1**	**2.6**	**2.8**	**0.5**	**0.4**	**0.4**

.. Not available.

Note: A minus sign denotes an outflow of capital resulting from an increase in claims on non-residents or a decrease in liabilities to non-residents.

Source: Statistics Canada.

30. Among imports, over 80% are manufactured goods. Machinery and equipment and automotive products account for about half of goods imports. In 2001, automotive products were the main single item, with some 19% of the total, followed by office machines and telecommunications equipment and non-electrical machinery (Table AI.2). Following a trend already observed in Canada's previous Reviews, the shares of automotive products and iron and steel, have tended to fall, while the shares of chemicals and fuels have increased. The authorities have noted that increases in the share of fuels respond mainly to changes in energy prices.

31. Some 90% of Canada's exports and over two-thirds of its imports take place with preferential partners. Canada's main trading partner remains the United States, the destination for 87% of Canada's exports in 2001 and the source of some two thirds of its imports (Tables AI.3 and AI.4). Canada and the United States remain each other's largest trading partner due to geographic proximity, and the effect of preferential trade agreements, including the previous Free Trade Agreement (CUSFTA) and the NAFTA. Since its last Review, Canada's share of exports going to the United States has continued to increase (from 79% in 1995 to 87% in 2001). Canada-U.S. trade is mostly intra-industry and intra-firm trade in industrial goods; a large part comprises automotive products.

32. Of Canada's remaining trading partners, only the United Kingdom, Japan and China account for export shares above 1%. Although two-way merchandise trade between Canada and Mexico has grown rapidly since the NAFTA, its share in Canada's total trade remains small. Imports sources are more diversified, with the European Union and East Asia each accounting for some 11-14% of Canada's total imports.

(ii) Trade in services

33. Canada has traditionally been a net importer of services. Using balance-of-payments statistics, Canadian global trade in services has lagged behind trade in goods. In 2001, about half of Canada's transactions were in commercial services, with transportation and travel accounting for the remainder (Table I.5).

Table I.5
International transactions in services, by category, 1998-01
(Can$ billion)

Category	1998			1999			2000			2001		
	a	b	c	a	b	c	a	b	c	a	b	c
Total	**50.2**	**56.5**	**-6.3**	**53.0**	**60.2**	**-7.2**	**57.1**	**64.6**	**-7.4**	**56.6**	**65.0**	**-8.4**
Travel	14.0	16.0	-2.0	15.1	17.0	-1.9	16.1	18.3	-2.2	16.7	18.0	-1.3
Transportation	9.1	11.8	-2.6	9.7	12.3	-2.6	11.2	14.0	-2.8	10.5	14.2	-3.7
Commercial services	25.9	28.0	-2.2	26.9	30.1	-3.2	28.5	31.5	-3.0	28.0	32.0	-4.0
Communications	2.2	2.3	-0.0	2.0	2.0	0.0	2.0	2.0	-0.1	1.9	2.0	-0.1
Insurance	3.5	4.3	-0.8	3.3	4.4	-1.1	2.9	4.2	-1.3	3.1	4.5	-1.4
Other financial services	1.2	2.1	-0.9	1.4	2.0	-0.5	2.0	2.4	-0.5	2.3	2.6	-0.2
Computer and information services	2.1	1.1	0.9	2.4	1.3	1.1	2.4	1.3	1.1	2.2	1.4	0.9
Royalties and licence fees	2.1	4.0	-1.9	2.3	5.0	-2.6	2.3	5.4	-3.0	2.3	5.4	-3.1
Management services	2.2	3.7	-1.5	2.7	4.2	-1.5	3.0	4.6	-1.6	3.2	4.8	-1.6
Research and development	2.7	1.3	1.5	3.1	1.6	1.6	4.1	1.7	2.4	3.2	1.4	1.8
Architectural, engineering & other technical services	3.2	1.5	1.7	2.4	1.3	1.1	2.5	1.5	1.0	2.6	1.8	0.8
Government services	1.2	0.7	0.5	1.3	0.8	0.6	1.4	0.8	0.6	1.4	0.8	0.7

a Receipts.
b Payments.
c Balance.

Source: Statistics Canada Catalogue No. 67-203-XIB [Online]. Available at: http://www.dfait-maeci.gc.ca/eet/ CIMT/ transactions_services-e.pdf.

34. The United States is Canada's major trading partner in services trade, accounting for about 60% of payments and receipts. The EU is the second largest, with the United Kingdom accounting for about 40% of total trade with the European Union.

(iii) Foreign investment

35. Canada is active both as an investor abroad and as a recipient of foreign direct investment (FDI), to which is linked a significant proportion of its merchandise exports, particularly of manufactured goods. Canada also receives a substantial amount of portfolio and other kinds of investment. Continuing to attract foreign investment has thus become a main objective of Canada's economic policy.

36. Canada is a net investor with respect to FDI, but a net recipient with respect to other kinds of investment and overall foreign investment. Outward FDI stock reached Can$389.4 billion in 2001, 78% up from 1997; inward FDI totalled Can$320.9 billion, up 65% from 1997 (Table I.6). Total investment assets reached Can$904.5 billion in 2001, up 51% from 1997, while Canada's liabilities reached Can$1.1 trillion in the same year, up 24.5% from 1997. Canada's negative balance shrank over the period 1997-01 as Canadian investment abroad increased faster than investment inflows. The authorities consider this decline in Canada's foreign investment deficit a result of the booming U.S. economy, which acted as a magnet for Canadian and other investment during the late 1990s. In 2001, the decline began to reverse as the Canadian economy started to accelerate. The authorities expected this trend to be reinforced in 2002 as interest rates rose in Canada while they fell in most other major industrial countries.

Table I.6
Canada's international investment position, 1997-01
(Can$ million, end of year)

	1997	1998	1999	2000	2001
Total assets	**599,483**	**686,347**	**717,297**	**819,114**	**904,505**
Canadian direct investments abroad	218,607	262,909	283,228	340,366	389,426
Canadian portfolio investments	130,366	157,405	179,812	215,328	231,182
Portfolio foreign bonds	26,586	33,254	30,733	34,976	35,125
Portfolio foreign stocks	103,780	124,151	149,079	180,352	196,057
Other Canadian investments	250,510	266,033	254,256	263,421	283,898
Loans	70,638	60,459	56,011	60,508	69,018
Allowances	-10,327	-10,802	-10,777	-11,568	-11,785
Deposits	102,104	118,449	108,826	108,591	108,714
Official international reserves	25,705	35,921	41,463	47,801	53,327
Other assets	62,391	62,006	58,733	58,089	64,623
Total liabilities	**889,707**	**986,008**	**964,277**	**1,021,593**	**1,107,931**
Foreign direct investments in Canada	194,277	219,389	248,618	302,299	320,931
Foreign portfolio investments	459,801	511,384	486,269	485,215	527,083
Portfolio Canadian bonds	367,899	405,772	389,693	371,081	417,132
Portfolio Canadian stocks	51,402	64,344	69,107	85,501	87,780
Portfolio Canadian money market instruments	40,501	41,269	27,469	28,632	22,171
Other foreign investments	235,629	255,235	229,390	234,079	259,918
Loans	51,676	55,402	56,807	57,251	49,486
Deposits	165,357	180,685	152,012	155,174	188,726
Other liabilities	18,596	19,148	20,572	21,653	21,707
Canada's net international investment position	**-290,224**	**-299,661**	**-246,980**	**-202,478**	**-203,426**

Source: Statistics Canada, CANSIM II, Table 376-0037 and Catalogue No. 67-202-XIB.

37. Most FDI in Canada is concentrated in resource-based activities (mainly energy), services (mostly financial services), transportation equipment, chemical products, textiles, food and beverages, and electrical and electronic products. The United States, the United Kingdom and France are Canada's largest sources of FDI, with 67%, 7.7% and 7.2% of the total, respectively, in 2001, followed by the Netherlands, Japan, Germany, Italy, and Sweden. France has made the largest gains in market share over the past decade, while the United Kingdom, Japan, and Germany have lost market share. The United States is also Canada's main investment destination, for both FDI and other kinds of investment, particularly portfolio investment, accounting for over half of total outward direct investment, followed by the United Kingdom and other EU Members

(6) OUTLOOK

38. Growth is expected to slow in the first half of 2003 from the high rates observed in 2002. The authorities anticipate that, with the U.S. economy projected to gain momentum through 2003 and global financial conditions assumed to improve, Canada’s GDP growth may rise above the growth rate of potential output in the second half of 2003. CPI inflation was expected to return to about 2% in the second half of 2003, as the effects on inflation of a number of one-off movements in relative prices diminish.[12]

39. Canadian private-sector forecasters expect real GDP to grow by 3.3% in 2002 and 3.2% in 2003. The IMF and the OECD expect Canadian growth to be the highest among G-7 countries in both 2002 and 2003.

40. The external current account is expected to remain in surplus, despite a slight expected appreciation of the Canadian dollar *vis-à-vis* the U.S. dollar, resulting from the differential in interest rates. Fiscal accounts are also likely to continue showing a surplus, with any increase, as the economy recovers, mitigating the effects of the tax cuts decided in 2000.

[12] Bank of Canada (2002b).