I. ECONOMIC ENVIRONMENT

(1) OVERVIEW

1. Canada's per capita GDP, at US$39,390, is among the world's highest. Since 2002, Canada's economic performance has been impressive. Annual average GDP growth between 2002 and 2005 was just below the economy's potential of 3%; GDP growth slowed during the second and third quarters of 2006. This overall positive performance is largely the result of sound macroeconomic management and structural reform. Canada continues to apply the inflation targeting regime introduced in 1991. On the fiscal front, Canada has posted federal surpluses since its last Review. The provinces have also practiced fiscal discipline, resulting in a combined surplus of 1% of GDP in fiscal year 2005/06. Canada has made remarkable progress in reducing its federal debt burden, as the debt-to-GDP ratio fell to 35% in 2005/06. The Government's target is to lower federal debt to 25% of GDP by 2012/13.

2. The composition and direction of merchandise trade have changed considerably during the period under review. The share of fuels in total exports jumped from 14% in 2001 to 20% in 2005, partly as a result of high energy prices, but for commodities such as crude oil, the higher share was also due to increased export volumes. Although most of Canada's trade continues to take place with the United States, merchandise imports have diversified away from this source, reflecting primarily the growing importance of China as a source of imports.

3. Canada's robust performance in recent years reveals the economy's remarkable flexibility, as growth has taken place against the backdrop of significant shocks, including soaring energy prices, expanding oil and gas production, and exchange rate appreciation. Despite this, relatively slow productivity growth is a feature of the economy, possibly as a result of a lack of capital deepening during the 1990s. Productivity growth could be accelerated by, among other things, eliminating barriers to agricultural imports, removing restrictions on foreign investment, minimizing subsidies that distort competition, and dismantling obstacles to internal trade.

(2) RECENT ECONOMIC DEVELOPMENTS

(i) Output, productivity, and employment

4. The Canadian economy has expanded steadily since 2002. Annual GDP growth averaged 2.7% during the period 2002-05, underpinned by strong domestic demand, particularly investment (Table I.1). Although growth slowed down in 2003, it picked up thereafter, led by a sharp increase in residential and non-residential investment and continued strong consumer spending. Gross exports expanded, but the contribution to GDP of net exports was negative due to the faster increase in imports. High import growth of both goods and services has gone hand-in-hand with strong consumption. GDP growth in the second and third quarters of 2006 slowed to 2% and 1.7%, largely because of weaker housing investment and an easing in consumer spending growth.

5. Domestic demand growth was underpinned by gains in real personal disposable income between 2004 and the third quarter of 2006. Despite the increase in real personal disposable income, the personal savings rate has contracted, reaching 1.2% in the second quarter of 2006; this contrasts with the 13-14% observed in the early 1990s.

6. Although investment in residential structures was strong between 2002 and 2004, it has slowed down since 2005. Non-residential private investment, particularly in machinery and equipment, has picked up since 2003, and has been one of the main components underpinning GDP

growth since then. This reflects the high degree of capacity utilization.[1] Since Canada's last Review, consumer and mortgage debt levels have continued to rise, and the household debt-to-income ratio reached 108% in the fourth quarter of 2005, compared with 99.4% in the second quarter of 2002.

Table I.1
Selected macroeconomic indicators, 2002-06[a]
(Can$ billion and per cent)

	2002	2003	2004	2005	2006 QI	2006 Q2	2006 Q3
GDP (current Can$ billion)	**1,152.9**	**1,213.4**	**1,290.8**	**1,371.4**	**1,427.0**	**1,432.8**	**1,440.8**
GDP per capita (Can$)	**36,807.0**	**38,359.0**	**40,403.9**	**42,514.1**	**43,978.7**	**44,053.6**	**44,164.7**
				Per cent change			
Real GDP	2.9	1.8	3.3	2.9	3.8	2.0	1.7
Final domestic demand	3.0	3.8	4.2	4.3	5.6	3.6	2.8
Consumer expenditure	3.6	3.0	3.3	3.9	4.8	3.8	4.2
Goods	3.5	3.0	3.3	3.9	5.6	5.1	4.8
Services	2.8	3.5	3.9	4.1	4.0	2.7	3.8
Government expenditure	2.4	3.8	3.1	3.2	3.9	4.4	0.6
Goods and services	2.5	3.5	3.0	2.7	3.3	4.9	0.7
Gross fixed capital	3.7	5.8	3.3	6.8	6.7	3.4	0.5
Residential investment	14.1	6.0	7.8	3.2	14.2	-4.8	-8.2
Business fixed investment (non-residential)	-4.1	7.0	9.1	9.4	8.1	5.4	7.0
Non-residential construction	-5.9	5.5	7.4	7.9	8.4	3.0	4.7
Machinery and equipment	-2.8	7.9	10.3	10.5	7.9	7.4	8.9
Business inventory investment (Can$ billion)	0.6	8.7	9.7	15.5	11.5	18.6	15.3
Real exports of goods and services	1.2	-2.4	5.2	2.1	-3.8	-1.7	3.6
Goods	0.8	-2.2	5.5	2.5	-3.9	-2.7	5.0
Services	3.9	-3.4	3.4	-0.1	-2.7	5.0	-5.6
Real imports of goods and services	1.7	4.5	8.2	7.1	-2.0	8.6	4.1
Goods	1.7	3.6	8.4	7.9	-3.6	9.2	6.1
Services	1.7	8.4	7.2	3.5	6.6	5.4	-5.4
Real personal disposable income	1.7	2.3	3.2	2.5	12.8	-3.8	5.6
Gross national saving	21.1	21.3	22.8	23.6	23.3	23.3	23.3
Employment/unemployment and productivity							
Employment (per cent change)	2.4	2.4	1.8	1.4	1.6	3.1	0.4
Unemployment rate	7.7	7.6	7.2	6.8	6.4	6.2	6.4
Business sector labour productivity growth	1.4	0.0	0.3	2.1	1.7	-1.0	-0.3

.. Not available.

a Annualized values, except as indicated.

Source: Statistics Canada. Viewed at: http://www.statcan.ca/english/Pgdb/.

7. Consumer expenditure in services was an important contributor to GDP growth during the period under review. This type of expenditure is one of the most stable components of GDP and has been growing at 3% to 4.5% since 2002. Government expenditure has been growing at an average of about 3-4%, with gross capital formation expanding more rapidly than spending in goods and services and supporting growth in 2002-06.

[1] The Bank of Canada estimates the potential growth rate for the 2006-08 period at 2.8% (Bank of Canada, 2006b).

8. Unemployment has continued to fall gradually since 2002; the unemployment rate fell to 6.1% in May and June of 2006 and has remained at about that level. The overall decline in the unemployment rate has been triggered by strong employment growth, which has more than offset a modest increase in labour-force participation. The labour force participation rate stood at 67.2% in the third quarter of 2006, slightly up from 66.9% in 2002.

9. The growth of labour productivity in Canada has been sluggish in recent years. Business sector labour productivity averaged 1% from 2001 to 2005, compared with 3% between 1998 and 2000; this means that growth has been linked mainly to increased labour participation rather than productivity. One possible explanation is a lack of capital deepening during the 1990s, a consequence of labour costs being low relative to the costs of mostly imported capital goods.[2] According to the OECD, productivity gains could be obtained by introducing reforms in labour and product markets (Box I.1).

Box I.1: Policy reforms in product markets and financial services recommended by the OECD

Most of Canada's product markets function well, but there are some exceptions where policy reforms are needed. The OECD has thus recommended various reforms in product markets, including:

- Liberalization of provincial electricity markets to obtain more efficient generation and use of such energy as well as to provide clear price signals for investment (Chapter IV(3)).
- Removing restrictions on foreign direct investment in airlines, telecommunications and broadcasting to boost competition by making the threat of entry more credible and to allow for infusion of new technology and management into those sectors (Chapter II(4) and Chapter IV(8) and (5)).
- Winding up agricultural supply management schemes and instead allowing prices in open markets to balance supply and demand. This would not only give all farmers more opportunities, but would also lead to significantly lower prices for Canadian consumers, especially for dairy products where large scarcity rents have been artificially created (Chapter IV(2)).
- Minimizing subsidies that distort competition, which include some large one-off packages to specific companies and a plethora of programmes providing grants, soft loans, and advice (Chapter III(3)(iv)) and (4)(ii)). This would reverse the rising trend in government transfers to business.
- Dismantling the remaining obstacles to inter-provincial trade in services and promoting more vigorous competition in services, for example through mutual recognition of occupational and professional qualifications, and a shared administrative system for recognition of credentials (Chapter II(3) and Chapter IV(9)).
- Introducing employer experience rating for unemployment insurance to remove the significant and persistent cross-subsidy to firms that repeatedly use that system to cover their seasonal and temporary workers. Alternatively, this subsidy element could be reduced by tightening the relevant eligibility criteria to limit access for seasonal and temporary workers.

The OECD also notes that more efficient financial markets would contribute to the rate of growth. Although Canada’s financial sector is well developed and diversified and has performed reasonably well, some policies, such as bank ownership restrictions and political approvals for bank mergers, may impede gains in efficiency (Chapter IV(6)). It pointed out that further streamlining entry requirements in banking would make it easier for new players, foreign or domestic, to enter the market, thereby adding to competitive forces in the sector.

Source: WTO Secretariat, based on OECD (2006), *Economic Survey of Canada*, Paris.

10. The Bank of Canada attributes the recent sluggish performance of labour productivity to the economy's structural adjustment in the face of large movements in commodity prices, the appreciation

[2] International Monetary Fund (2006).

of the Canadian dollar, and external competition.[3] According to the Bank, in general capital and labour tend to be less productive during such an adjustment, which involves a reallocation of labour and capital towards commodities with higher prices, and towards non-tradable goods and services.

(ii) Monetary policy, exchange rates, and prices

11. Canada's monetary policy is aimed at keeping a low and stable inflation rate. To this end, and to increase public accountability, the Federal Government and the Bank of Canada jointly announce an inflation-control target range. The inflation target is 2%, as measured by the consumer price index, with a control range of 1% to 3% around this target. In November 2006, the Federal Government and the Bank of Canada agreed to renew the inflation-control target for a five-year period ending in December 2011.[4] The Bank of Canada considers that low inflation contributes to better economic growth and moderates cyclical fluctuations in output and employment. Inflation targeting has been in place in Canada since 1991.

12. The Bank of Canada's main monetary policy instrument consists of changes in the target for the overnight interest rate, which is the middle of the operating band for overnight financing. Rate changes are announced on eight pre-specified dates each year.[5] The Bank of Canada has adjusted the policy interest rate several times in recent years (Table I.2).

13. Inflation has remained within the inflation target of 1-3% set by the Bank of Canada (Table I.2). The annual increase in the consumer price index (CPI) averaged slightly above 2% in the period 2003 to the third quarter 2006, which is the middle level of the inflation target range. The appreciation of the Canadian dollar has been a positive factor in maintaining low inflation, dampening the effect of increasing commodity prices. Core inflation has, on average, increased by less than the CPI since 2003.[6]

14. The Canadian dollar appreciated by about 40% in nominal terms against the U.S. dollar between 2002 and the third quarter of 2006. There was real effective appreciation of the Canadian dollar of some 36% during the same period. This has had an impact on the real side of the economy and on trade. The Canadian authorities consider that Canada has taken on a "disproportionate burden" in the context of global external imbalances, by allowing the exchange rate to appreciate and real net exports to contract.[7]

[3] Bank of Canada (2006b).
[4] Bank of Canada (2006d).
[5] Bank of Canada (2006c) and (2001).
[6] 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.
[7] International Monetary Fund (2006).

Table I.2
Selected monetary and exchange rate indicators, 2002-06

	2002	2003	2004	2005	2006 Q1	2006 Q2	2006 Q3
Monetary aggregates (end of period, per cent change)[a]							
Gross M1	7.0	9.6	11.0	10.7	10.9	10.5	12.0
M1++	8.2	7.6	10.4	7.4	7.1	6.5	7.6
M2++	3.9	3.9	5.5	6.3	6.4	6.5	7.1
Interest rates (%)							
Overnight rate (policy instrument)	2.75	2.75	2.50	3.25	3.75	4.25	4.25
Prime lending rate	4.2	4.5	4.0	4.4	5.3	5.9	6.0
90-day commercial paper	2.74	2.75	2.50	3.24	3.73	4.25	4.30
Prices (per cent change)							
CPI (end of period)	3.9	2.0	2.1	2.2	2.2	2.5	0.7
Core CPI (excluding eight most volatile items and indirect taxes)	2.7	2.2	1.7	1.6	1.7	1.7	2.3
Exchange rate (yearly average)							
C-6 Trade-weighted exchange rate[b]	79.2	92.9	97.9	104.1	103.3	107.2	108.0
Canadian dollar effective exchange rate index (CERI)[c]	80.5	93.3	99.2	106.1	106.3	109.8	109.5
Real effective exchange rate (2000=100)	96.0	106.7	112.5	119.3	125.0	127.5	126.8
Can$ per US$	1.57	1.40	1.30	1.21	1.16	1.12	1.12
Can$ per Euro	1.48	1.58	1.62	1.51	1.39	1.41	1.42
Monetary conditions							
Monetary conditions index (1987=100)[d]	1.96	0.20	0.00	-3.02	-4.68	-9.80	-10.94

a Gross M1 is currency outside banks plus personal checking accounts plus current accounts plus some adjustments to M1; M1++ is 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.
c The Canadian-dollar effective exchange rate index (CERI) is a weighted average of bilateral exchange rates for the Canadian dollar against the U.S. dollar, the European Union euro, the Japanese yen, the U.K. pound, the Chinese yuan, and the Mexican peso. The CERI replaced the C-6 index in October 2006.
d The Monetary Conditions Index; (MCI) is a weighted sum of the changes in the short-term interest rate (the 90-day commercial paper rate) and the exchange rate (as measured by the C-6 index) from a given base period. The weight of the exchange rate is one-third that of the interest rate. A change in the MCI gives a measure of the degree of tightening or easing in monetary conditions.

Source: Bank of Canada, *Monetary Policy Report*, October 2006, and other online information, viewed at: http://www.bankofcanada.ca/en/graphs/a1-table.htm and http://www.bank-banque-canada.ca/pdf/wfs.pdf.

(iii) Fiscal policy

15. As a result of a prudent fiscal policy, Canada has posted federal surpluses since its last Review, and the government debt has been falling. Between 2001/02 and 2005/06, Canada posted operational surpluses of between 2.8% and 4.3% of GDP, while budgetary balances (taking into account public debt charges) were in the 0.1% to 1% range (Table I.3). Throughout this period, Canada followed an informal fiscal rule to maintain "balanced budgets or better", and maintained a 0.25% of GDP contingency reserve.[8] The continued overall fiscal surplus of the past few years and the Government policy of debt reduction have allowed a reduction in federal debt as a share of GDP, to 35.1% in 2005/06, down from 46.2% in 2001/02.

[8] International Monetary Fund (2006).

16. The Federal Government plans annual fiscal surpluses of between Can$2 billion and Can$4.2 billion between 2006/07 and 2011/12, and annual federal debt reductions of Can$3 billion.[9] The Government seeks to reduce the federal debt-to-GDP ratio to 25% by 2012/13. It also intends to use the interest savings from debt reductions for personal income tax reductions. The Federal Government has indicated that it will keep the average growth of programme expenses below the average growth of the economy over the medium-term.

Table I.3
Selected fiscal indicators, 2001-06

	2001/02	2002/03	2003/04	2004/05	2005/06
Federal fiscal balance (per cent of GDP)					
Revenues	16.6	16.5	16.4	16.4	16.2
Tax revenue	13.7	13.6	13.6	13.5	13.6
Spending	-12.3	-12.7	-12.7	-13.7	-12.8
Operating balance	4.3	3.8	3.7	2.8	3.4
Public debt charges	-3.6	-3.2	-2.9	-2.6	-2.5
Budgetary balance	0.7	0.6	0.8	0.1	1.0
Non-budgetary transactions	-0.7	0.2	-0.1	0.4	-0.5
Financial requirements	0.0	0.8	0.6	0.5	0.5
Provincial fiscal balance	0.0	-0.2	-0.3	0.5	1.0
Federal debt (Can$ billion)	511.9	505.3	496.2	494.7	481.5
Federal debt (% of GDP)	46.2	43.8	40.9	38.3	35.1

Source: Department of Finance (2006), *Fiscal Reference Tables.* Viewed at: http://www.fin.gc.ca/purl/frt-e.html.

17. After posting a deficit in 2002/03 and 2003/04, the overall provincial fiscal balance (taking into account debt repayments) was in surplus in the following two years. In 2005/06, provincial governments posted a combined surplus of Can$13.2 billion, or 1% of GDP. Alberta was responsible for about two thirds of this surplus, and British Columbia for almost a quarter. The only province or territory to post an operational deficit in 2005-06, albeit small, was Prince Edward Island; Quebec's public finances were balanced, while the other provinces registered surpluses in their fiscal accounts.

18. From 2006/07, Government decisions in the budget are over a two-year planning horizon. The 2006/07 Budget proposed comprehensive tax relief for individuals, valued at almost Can$20 billion over the next two years.[10] The goods and services tax (GST) was reduced by 1 percentage point as of July 2006, and the general corporate income tax rate will fall to 19% (from 21%) by 2010. The corporate surtax will be eliminated for all corporations as of January 2008. The 12% tax rate applying to qualifying small business income will fall to 11.5% in 2008 and 11% in 2009. Personal income taxes were reduced. The Budget 2006/07 allocated an additional Can$2 billion over two years to the farming sector, including Can$500 million for farm support, plus a one-time payment of Can$1 billion to assist farmers in the transition to more effective programming for farm income stabilization and disaster relief (see Chapter IV(2)(iii)).

19. To improve the transparency and accountability of government operations, the Federal Accountability Action Plan, released in April 2006, introduced a set of wide-ranging reforms, including establishing the position of a Parliamentary Budget Officer and a commitment to provide quarterly updates of the fiscal outlook for the current fiscal year.

[9] Department of Finance (2006d).
[10] Department of Finance (2006c).

(3) BALANCE OF PAYMENTS

20. The current account of the balance of payments has been in surplus throughout the period under review (Table I.4). The surplus reached Can$31.8 billion in 2005, or some 2.2% of GDP, but narrowed in the first half of 2006. While the trade in goods balance showed a surplus between 2001 and the first half of 2006, the services balance was in deficit (see below). The capital account continued to post a surplus throughout the period under review. The deficit in the financial account increased sharply in 2004 and 2005, mainly due to a surge of Canadian direct and portfolio investment abroad, triggered by the strong real currency and higher yields abroad.

Table I.4
Canada's balance of international payments, 2002-06[a]
(Can$ million)

	2002	2003	2004	2005	2006 QI	2006 Q2
Current account						
Total receipts	**514,913**	**496,301**	**537,943**	**574,293**	**146,193**	**148,323**
Exports of goods and services	477,522	460,088	492,984	518,028	128,457	132,553
Goods	414,039	398,954	429,121	453,060	113,598	116,103
Services	63,483	61,134	63,863	64,968	14,859	16,450
Travel	16,741	14,776	16,745	16,460	2,899	4,219
Transportation	11,060	9,896	11,024	11,632	2,624	3,143
Other services	35,681	36,462	36,093	36,877	9,335	9,089
Investment income	30,502	29,469	37,532	48,199	14,692	13,698
Direct investments	13,766	12,706	20,677	25,944	8,468	7,140
Portfolio investments	8,859	8,955	10,182	12,644	3,505	3,700
Other investments	7,877	6,807	6,673	9,561	2,720	2,858
Transfers	6,890	6,744	7,427	8,066	3,044	2,072
Total payments	**495,135**	**482,197**	**510,310**	**542,491**	**138,118**	**144,859**
Imports of goods and services	427,434	415,672	440,218	466,896	117,812	125,336
Goods	356,727	342,692	363,639	388,210	96,958	104,749
Services	70,707	72,980	76,580	76,686	20,854	20,586
Travel	18,401	18,727	20,747	22,260	6,858	6,017
Transportation	14,438	14,366	16,001	17,528	4,442	4,750
Other services	37,868	39,887	39,831	38,898	9,553	9,819
Investment income	60,799	59,403	62,346	67,010	16,834	17,870
Direct investments	21,529	23,744	27,489	30,953	6,618	8,411
Portfolio investments	30,804	29,041	28,139	27,192	6,151	6,147
Other investments	8,466	6,618	6,717	8,865	4,066	3,312
Transfers	6,902	7,122	7,746	8,585	3,471	1,653
Current account balance	**19,778**	**14,103**	**27,633**	**31,802**	**8,076**	**3,464**
Goods and services	50,088	44,416	52,765	51,132	10,645	7,217
Goods	57,311	56,262	65,482	64,850	16,641	11,353
Services	-7,224	-11,846	-12,717	-13,718	-5,996	-4,136
Investment income	-30,297	-29,935	-24,814	-18,811	-2,142	-4,173
Transfers	-12	-378	-319	-519	-427	419
Capital and financial accounts, net	**-17,208**	**-15,697**	**-32,507**	**-29,177**	**-9,427**	**-1,324**
Capital account, net flow	4,936	4,171	4,449	5,932	1,007	998
Financial account, net flows	-22,144	-19,868	-36,956	-35,109	-10,433	-2,322
Canadian assets, net flows	-83,631	-66,287	-88,039	-115,116	-48,213	-52,314

Table I.4 (cont'd)

	2002	2003	2004	2005	2006 QI	2006 Q2
Canadian direct investments abroad	-42.052	-30,146	-56,274	-41,300	-8,143	-11,552
Canadian portfolio investments	-29.319	-19.054	-24,369	-51,652	-19,817	-20,528
Other Canadian investments	-13,951	-17,088	-7,396	-22,164	-20,252	-20,235
Canadian liabilities, net flow	61,487	46,419	51,083	80,008	37,780	49,991
Foreign direct investments in Canada	..	10,669	1,995	40,984	14,767	7,442
Foreign portfolio investments	..	19,362	54,267	8,472	8,534	10,720
Other foreign investments		16,389	-5,179	30,551	14,478	31,829
Statistical discrepancy	-2,570	1,594	4,874	-2,625	1,351	-2,140
Current account balance/GDP	**1.7**	**1.2**	**2.1**	**2.3**	**1.5**[b]	**0.7**[b]

a Not seasonally adjusted.
b Annualized estimates.

Source: Statistics Canada. Viewed at: http://www40.statcan.ca/l01/cst01/econ01a.htm.

(4) TRADE AND INVESTMENT PATTERNS

(i) Merchandise trade[11]

21. Canada is among the world's top exporters and importers of merchandise. In 2005, its exports accounted for 3.4% of total world exports, and its imports for 3% of total world imports. After a noticeable decline over the 2000-02 period, both exports and imports recovered, with exports reaching US$360 billion in 2005 and imports totalling US$314 billion.

22. The composition of exports has changed significantly since Canada's last Review. Fuels, particularly oil and natural gas accounted for just over 20% of total exports in 2005, up from 14% in 2001 (Table AI.1). For crude oil, this is the result of higher world prices and increased export volumes; for natural gas, the share increase is the result of higher world prices, as the volume of exports declined slightly between 2001 and 2005. In 2005, exports of natural gas amounted to US$30 billion and of crude oil to US$25 billion. The United States was the main destination for virtually all oil and gas exports. The share of manufactures declined from 62% of Canada's exports to 57% between 2001 and 2005, partly reflecting the falling share of automotive exports. However, during the same period manufacturing exports increased by around 28% in absolute terms, to US$206.1 billion. Similarly, exports of automotive products amounted to US$66.8 billion in 2005, up 21% from 2001; passenger vehicles remain Canada's top manufacturing export category. The share of agriculture, including agricultural raw materials such as wood and wood pulp, has also fallen since 2001, to 11.4% in 2005.

23. The share of manufactures in Canada's total imports has tended to decrease, falling to just under 80% in 2005 (Table AI.2). However, manufacturing imports increased in absolute terms, from US$182.6 billion in 2001 to US$248.1 billion in 2005. The share of machinery and transport equipment in total imports fell, while the share of chemicals and iron and steel increased. Fuels accounted for another 9% of total imports in 2005, up from 6% in 2001. The share of agricultural products in total imports has remained relatively constant, at around 7%.

24. Canada's exports continue to be highly concentrated in terms of destination. The United States accounted for 84% of total exports in 2005, slightly less than in 2001 (Table AI.3). All other trading partners accounted for less than 1% of total exports (taking EC members individually),

[11] Data in this section are from UNSD, Comtrade database (SITC Rev.3).

except Japan (2.1%), the United Kingdom (1.9%), and China (1.6%). The EC accounts for 5.7% of Canada's total exports.

25. Import sources have diversified since 2001 (Table AI.4): although imports from the United States have increased in absolute terms since 2001, the U.S. share in total imports fell from 64% in 2001 to 57% in 2005, reflecting primarily the falling share of imports of machinery and transport equipment. Within machinery and transport equipment, imports of office machines and telecommunications equipment from the United States decreased both in absolute and relative terms. China has replaced Japan as Canada's second largest source of imports: its share increased from 4% in 2001 to almost 8% in 2005, while Japan's share declined slightly (from 4.3% in 2001 to 3.9% in 2005). Machinery and transport equipment account for a larger share of Canada's imports from China than from the United States. Imports of office machines and telecommunications equipment from China have expanded particularly rapidly, and represented almost 27% of Canada's total imports from China. The EC accounted for 12% of total imports.

(ii) Trade in services

26. Canada continues to be a net importer of services. The overall deficit in services transactions widened by Can$1 billion in 2005, to Can$13.7 billion (Table AI.5). This was Can$5.9 billion more than the deficit posted in 2001. Over half of Canada's transactions were in commercial services, with transportation and travel accounting for most of the remainder. Although Canada has deficits in these three services, it is a net exporter of computer and information services; architectural, engineering and other technical services; communications services; and research and development.

27. Canada's services trade has diversified away from the United States during the period under review, although the United States remains Canada's principal trading partner with around 56% of services exports and 59% of imports (Tables AI.6 and AI.7). The EC accounts for about 17% of Canada's services exports and the same share of imports, while Central and East Asia accounts for 9% of exports and 10% of imports.

(iii) Foreign investment

28. Canada is an active investor abroad, as well an important recipient of foreign direct investment (FDI), and of portfolio and other kinds of investment. During the period under review, the growth of Canadian investment abroad has by far exceeded that of foreign investment in Canada.

29. Canada is a net investor with respect to FDI, but remains a net recipient with respect to other kinds of investment and overall foreign investment. FDI is the only type of investment where inflows grew more rapidly than outflows during the period under review. Between 2001 and 2005, the outward FDI stock increased by 16.5%, while inward FDI grew by 22.1% (Table AI.8). Total investment assets reached some 74.4% of GDP in 2005, up 10.2% from 2001, while Canada's liabilities reached 83.4% of GDP in the same year, up 5% from 2001.

30. The stock of FDI in Canada totalled some Can$415.6 billion in 2005. Energy and metallic minerals accounted for 26% of FDI stock in 2005, and the financial services for another 45%. Other areas where FDI is important include other services and retailing, food and beverages, chemical products, textiles, transportation equipment, and electrical and electronic products. The United States is the largest source, accounting for 45% of total FDI flows into Canada in 2005, followed by the EC (15%), among which the United Kingdom is the largest investor (7%), and other OECD countries (14%). U.S. investors held 64% of Canada's stock of FDI in 2005, followed by investors from the United Kingdom and France, with about 7% each.

31. The United States is Canada's main investment destination, for both FDI and other kinds of investment, particularly portfolio investment, accounting for some 46% of total outward direct investment, followed by the EC (24%).

(5) OUTLOOK

32. GDP growth is expected to slow down to 2.5% in 2007, compared with an estimated growth rate of 2.8% for 2006, according to the forecasts of the Bank of Canada. Growth should be supported by strong domestic demand, in particular private consumption, while the contribution of net exports to GDP growth is expected to continue to be negative. GDP growth is estimated at 2.8% for 2008, driven again by domestic demand; the contribution of net exports is forecast to be neutral. Labour productivity is expected to grow at around 1.5% a year, slightly above the recent average. CPI inflation is estimated at 1.5% for the first half of 2007 and slightly above 2% for the second half, remaining at that level in 2008, as the effects on housing price pressure and excess demand diminish.[12] In the context of this Review, the authorities indicated that the risks to the outlook remain largely external, and include uncertainty about commodity prices, the risk of a larger-than-expected correction in U.S. house prices, and the risk of a disorderly adjustment to global imbalances.

[12] Bank of Canada (2006b).