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POLICY BRIEF

Canada-China Economic Relations: Beyond Petroleum

Taxis in Shenyang, China, using domestic auto brands. (D. Poon photo)

With the U.S. economy stalled and the Eurozone entangled in sovereign debt crises, there are increasing calls for Canada to engage more deeply with China to compensate for the weakness of those traditional trading partners. If Canada is to benefit, however, from booming mainland demand not just for energy commodities but more value-added products and services, a shift in economic strategy will be in order.

This will not be easy. Owing to the highly integrated nature of the Canadian and U.S. economies, the role of Canadian manufacturers has increasingly been to supply inputs to goods exported from the U.S. This strategy of indirect global trading intermediated through U.S. production chains might have been suitable in the decades leading up to the crash of 2008-2010, but the global setting is materially different today. Exacerbating the problem for Canada is a steady and ongoing decline in the share of high value-added outputs in its export basket, as demand for its raw materials grows. Might China, known as the most influential BRIC country, offer a solution to these malaises?

This policy brief argues strongly that it does. While many dismiss China's efforts to move up the technological ladder, there is growing empirical evidence that it is doing exactly that. This brief urges Canadian policy makers to actively and directly engage with the Chinese as the process unfolds, to help alleviate structural weaknesses for the benefit of both economies.

Ample opportunities exist for strategic and pragmatic partnerships that leverage Chinese ambitions. To benefit from these, Canada must carve out a strong and committed presence in China's transformative process. In addition to bolstering the Chinese economy as it moves up the development curve, such a move is crucial to Canada's long-term prosperity in a next phase of globalization that is likely to be less U.S.-centric.

With much attention recently fixated on the shifting balance of power towards Asia, this brief analyzes the state of Canada-China economic ties as a key plank in any strategy to engage the Asia region.

This brief belongs as part of NSI's ongoing research focus on emerging markets and is based on a forthcoming working paper available at: www.nsi-ins.ca

The North-South Institute
55 Murray Street, Suite 500
Ottawa, Ontario Canada
K1N 5M3

Telephone: (613) 241-3535
Fax: (613) 241-7435
Email: nsi@nsi-ins.ca

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Growing trade, but what kind?

Canada-China trade flows have grown quickly: according to Industry Canada, in 2003 China became Canada's second-largest trading partner (treating the Eurozone as individual countries), displacing Japan. While the U.S. remains its largest partner, two-way trade flows as a share of total trade fell from 76.3 percent in 2001 to 62.6 percent in 2010. Over the same period, trade with China grew from 2.3 to 7.2 percent of Canada's total. As a recent report notes, Canada's trade with China increased by more than 350 percent from 1998 to 2007, while its trade with the rest of the world expanded at the more pedestrian pace of 33 percent (Tiagi and Zhou 2009).

Canada's trade with China appears imbalanced, however. While Canada has consistent trade surpluses with the U.S., the situation with China is the reverse. Chinese exports to Canada have long been growing at a faster rate than Canadian exports to China. By 2010, Canada's largest trade deficit – amounting to C$31.3 billion, on the back of C$13.2 billion in exports – was with China.

What is more distressing is a general trend in Canada's export basket towards a higher share of natural resources and raw materials. As Chart 1 illustrates, these low-value-added exports grew from 25.8 percent of Canadian trade with China in 2001 to 42.1 percent in 2010. Trade with other Asian countries shows a similar pattern.

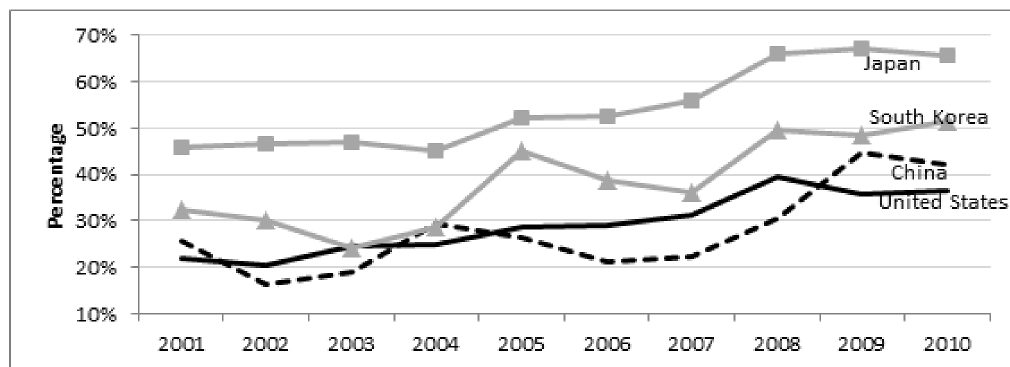
With decades of close trade ties, the composition of trade between Canada and the U.S. is quite different – although it, too, reflects a disturbing trend away from higher-value-added outputs. In 2010, Canada's top 25 exports (by HS6 codes) to the U.S. included such items as motor vehicles and parts, aircraft and pharmaceutical products, in addition to natural resources. In contrast, Canada's top 25 exports to China in the same year did not contain one item that was not a natural resource or raw material. Nonetheless, even Canada's exports to the U.S. have seen growth in the share of natural resources, from 21.9 percent in 2001 to 36.7 percent in 2010.

China: Workshop of the world, forever?

It is often assumed that China has joined the global economy on terms that reinforce its dependence on foreign technology, thus restricting its potential as an industrial and technological competitor with more advanced economies. To support their assumption, some observers point to research showing that fully 80 percent of China's export value comes from imported inputs, with only 20 percent added by its processing. Others still see no reason why China will be any more successful than other large developing countries like Brazil, Mexico, and Russia in becoming a high value-added (and high wage) economy (Babones 2011).

Given, however, that China remains in the thick of economic reforms, such assessments may be premature. They may, in fact, presage a "black

Chart 1. Share of Agricultural and Mineral Goods (HS01-27) in Canada's Exports to Selected Countries, 2001-2010



Source: Industry Canada.

swan" event of the kind that happens when the received wisdom bangs up against messy reality (Taleb 2007). It is, of course, inherently difficult to predict the future, especially in a development process in China that is likely unfolding in a non-linear fashion, so contradictory evidence and opposing views are to be expected. Nonetheless, some recent reports suggest that dynamic shifts within the Chinese economy are allowing home-grown companies to indeed move up the value chain.

The Economist Intelligence Unit (EIU) forecasts, for example, that the share of Chinese exports produced by foreign-invested manufactures will fall below 50 percent by 2012 as domestic producers of mid- and high-range products take on a larger role. Chinese manufacturers in such areas as heavy construction equipment are increasingly gaining market share in their sectors globally, particularly in other emerging markets: in 2008, for instance, 71.5 percent of all machinery imports into Brazil, Russia, India and South Africa came from advanced nations. By 2010, their share had fallen to 63 percent, while China's share had risen from 17.5 to 21.8 percent (EIU 2011).[1]

The Boston Consulting Group (BCG) has identified five key drivers behind China's movement up the value chain: domestic market demand, cost advantages, government support, access to critical technology, and state-coordinated export strategy (Bouffault et al. 2011). Given this evidence, it is not inconceivable that China might one day dominate its own set of global supply chains as the U.S. has done for the past several decades.

What's a middle power to do?

A shifting balance of global economic power is seen to likely disrupt the relative influence of middle powers such as Canada. Some observers see this as inevitable: given weak direct Canada-China economic linkages, they suggest, Canada should simply rely on its traditional ties with the U.S. and other allies to help socialize China into global liberal norms (Gilley 2011).

Although Canada-U.S. ties should and will remain strong, accepting the advice that Canadian exporters should simply "continue to concentrate on the markets with which they are most familiar" (Hart 2011) would be a glaring strategic oversight. First, any leverage with China arising from Canada's relationship with the U.S. depends critically on the vitality of the U.S. economy, and at this point that vitality appears lacking. Second, given Canada's role as a reliable "junior partner" in U.S.-led global supply chains, Canada holds few direct bargaining chips with China and may be seen as too cozy with the U.S.

What makes more sense is to carry out a number of pragmatic hedging strategies, a common enough approach among Southeast Asian countries. As Lee Kwan Yew, former prime minister of Singapore, urged last year: "There is still time for the U.S. to counter China's attraction by instituting a free-trade agreement with other countries in the region. This would prevent these countries from having an excessive dependence on China's market." Vietnam, once a U.S. adversary, is now emerging as one of Washington's most important allies in countering China's growing clout in the region. An economy more tightly linked to China than ever has not stopped Australia from building closer security and intelligence ties with the U.S. Indeed, some of the country's leading analysts argue that "kowtowing" and "muscling up" are equally flawed strategies in dealing with China (Dupont 2011).

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Forging a real win-win

There is ample opportunity for Canada to forge a strategy that will benefit both its own economy and that of China. To do so, however, it must engage far more actively with China and other economies in Asia. Two specific "hot button" issues involving China and the broader international community suggest avenues that Canada could strategically explore:

- On the issue of intellectual property (IP), and recognizing that position along the value chain still matters, Canada must be mindful of China's plans to foster homegrown technologies and companies, often through aggressive policy initiatives such as its multi-faceted "indigenous innovation" campaign. The BCG outlines five common phases of IP development, suggesting that China is currently between phases 3 and 4, whereby the country's IP profile remains weak and efforts to manage and/or protect IP is at

1 EIU (2011). "Moving up the value chain", October 3.

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early stages (Chai et al. 2011). A recent major report by the Canadian International Council (CIC) deploring the Canadian government's apparent inattention to domestic IP retention and accumulation would also suggest that Canada is in a parallel phase of development where it needs to "get serious about IP". As such, rather than re-double efforts to lobby against such initiatives as China's indigenous innovation campaigns, Canada should attempt to address its own "junior partner" structural constraints by carefully crafting bilateral cooperation with China and leverage the latter's ambitions in a way that also favours Canada. Such a strategy is not without risk, but it is a rare opportunity for Canada to transform itself into a nation of what the CIC calls, "hewers of patents and drawers of rents." (Mazurkewich 2011).

- In its move to join the Trans-Pacific Partnership, which includes many Pacific Rim countries other than China, Canada has an opportunity to shape a more nuanced approach to the thorny issue of state-owned and state-supported enterprises. A key partnership principle is "competitive neutrality," developed by the Australian government, which "requires that government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership." Canada could push for partners to recognize the need for both pressure and flexibility when dealing with the issue – after all, despite the posturing of its politicians, even the U.S. boasts such significant state-owned or state-supported enterprises as the postal service, electric utilities and national mortgage providers.

By carving out such niche roles for itself in these and other emerging areas, Canada can build its stature as a reliable voice of reason within the geostrategic rivalries in the region, a stance likely to be warmly received by small to medium powers in Asia.

Above all, Canada must remember that its opportunities emanating from China's rise are far more than just about exporting energy and other commodities. By fostering and strengthening direct trade and investment linkages with China and other emerging markets, and by developing a flexible and pragmatic set of hedging strategies, Canada can successfully navigate the turbulent times ahead and address the structural weaknesses of its own economy by deftly leveraging China's development ambitions in its own favour.

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