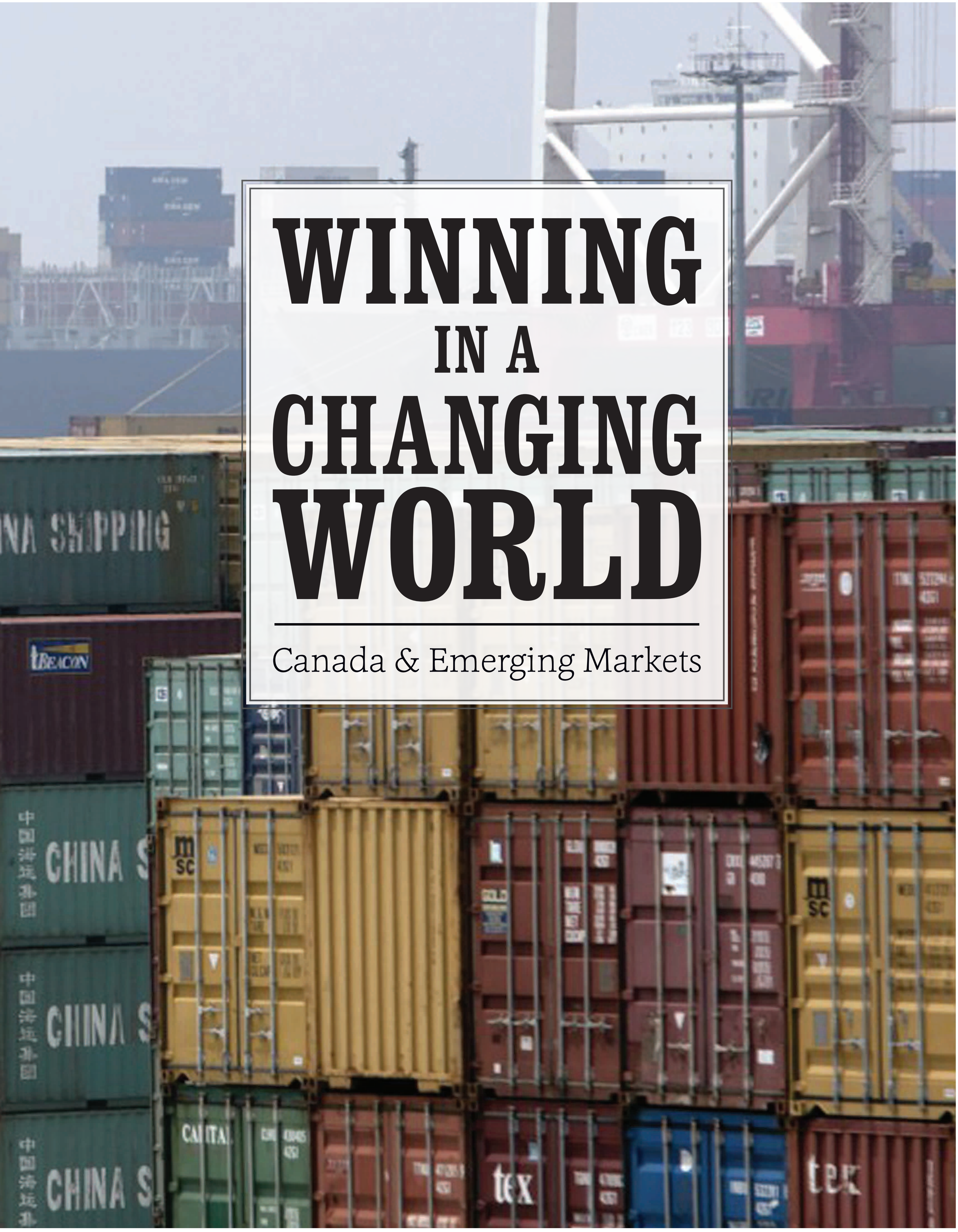
WINNING IN A CHANGING WORLD

Canada & Emerging Markets



Changing Global Reality

Since 2009, nearly all the world's growth has come from emerging powerhouses led by China, India, and Brazil, and include dynamic economies such as Mexico, Korea, Turkey, Poland, Indonesia, and South Africa · Less than eight per cent of Canadian exports and four per cent of outward investment go to these emerging markets · Canadian participation in non-North American value chains remains low · The U.S. share of Canadian exports of goods and services declined from a high of 87 per cent in 2000 to 75 per cent in 2010 · Global trade volumes will quadruple by 2030 · By 2020, China's GDP is projected to be the world's biggest · By 2030, the individual GDPs of Turkey, Indonesia, Mexico, Vietnam, and Nigeria may surpass Canada's GDP · By 2050, emerging markets will be home to 60 per cent of the world's wealth and 70 per cent of global trade · By 2050, less than eight per cent of global trade will take place in North America, compared to 15 per cent today · In the next 10 to 15 years, there will be one billion middle class consumers in Asia and Africa.

Executive Summary

The global economy is changing dramatically. Canada is not keeping pace. The Chinese, Indian, Brazilian, Colombian, Mexican, Korean, Turkish, Vietnamese, Indonesian, and South African economies are expanding at more than twice the rate of Canada's more traditional markets. By the middle of this decade, emerging economies are expected to account for more than half of the world's production and consumption of goods and services.

That is the urgent finding to emerge from roundtables with a selection of Canada's business leaders, policymakers, and academics that were recently held across the country under the auspices of the Norman Paterson School of International Affairs and co-chaired by Derek Burney, Thomas d'Aquino, Leonard Edwards, and Fen Osler Hampson.

Although Prime Minister Stephen Harper and his ministers have made significant strides to boost Canada's ties with emerging economies, both business and government efforts to harness these new economic opportunities are still largely unfocused and episodic. With some notable exceptions, Canadian firms have made little progress in penetrating new markets while losing market share in traditional ones. Unless Canada dramatically ups its game and changes the way it does business, it assuredly will not be a significant player in these new markets.

The rise of emerging economies signals a profound shift in the global economy. They have become integral to the success of new production strategies focused on global value chains, as well as important markets in their own right. The postwar trade and investment architecture is inadequate to deal with these new challenges. We will see more volatility going forward as fast-developing countries exercise newfound power. The quasi-market nature of these newer global players poses unique challenges and requires innovative approaches and different negotiating, trade, and investment strategies from those Canada is now pursuing.

Canada's negotiators require full authority to act in the national interest, supported by a new provincial and private-sector consultative network. As these newer players in the global economy come to invest in Canada, we need more coherent and focused rules on foreign investment. We must identify our key sources of comparative advantage and respond to the unique challenges posed by foreign state-owned enterprises and sovereign wealth funds.

Federal and provincial governments must ensure this country's successful players are not handicapped in their quest to become global champions. And while the federal government should not be picking winners, it must create an environment at home and abroad that enhances the capacity of Canadian businesses to be successful international players. These firms should not be disadvantaged in the domestic market, and their concerns about market access should be central to our negotiating strategy. Our governments must also step up the fight to protect their intellectual property rights (IPR) in foreign markets.

Before all else, Canada must defeat the "culture of comfort" that comes from an all-too-easy dependence on the United States. Doing so is the key to innovation — more important than subsidies or tax credits — and vital to stimulating a more competitive business environment.

Canada is uniquely placed to capture new trade and investment opportunities in emerging economies, much as Australia did more than a decade ago, provided we work together and set concrete objectives based on our comparative advantage. The task demands clear and consistent leadership, particularly from the federal government, and an over-arching, coherent strategy that aligns the strengths of all governments with the private sector to ensure success in the world of new markets and globally disaggregated production.

Twenty-five years ago, the federal government moved to safeguard and bolster trade and investment with Canada's major market — the United States. The Canada-U.S. Free Trade Agreement (FTA) was born out of a need to seek strategic advantage. It jolted Canadian companies and policymakers out of a cocoon of complacency. At the same time, Canada put its fiscal house in order, made price stability the goal of monetary policy, and reduced the burden of regulation. Bold moves led to strong, sustained economic growth.

The challenges of this young century demand that Canada once again demonstrate such leadership, initiative, focus, and commitment. Depending almost exclusively on domestic and U.S. markets for future prosperity is not sustainable. Canadian firms must aggressively reach out to the world's most promising and dynamic markets and become active players in globally integrated production strategies. The federal government must lead and provide direction to align Canada's strengths to its trade and investment objectives. It must redress the uneven playing field Canadians face in emerging economies. More than anything else, business and government must forge a concerted partnership that upholds the national interest.

This report examines these rapidly changing trends and recommends a new approach to our trade and investment strategies for engaging emerging markets.

Sommaire

L'économie mondiale est en pleine transformation. Le Canada ne suit pas. Les économies chinoise, indienne, brésilienne, coréenne, mexicaine, indonésienne et turque se développent deux fois plus vite que les marchés plus traditionnels du Canada. Au milieu de cette décennie, les économies émergentes devraient compter pour plus de la moitié de la production et de la consommation mondiale de biens et services.

C'est là la conclusion des dirigeants de grandes entreprises, décisionnaires et universitaires réunis en tables rondes aux quatre coins du pays sous les auspices de la Norman Paterson School of International Affairs et la coprésidence de Derek Burney, Thomas d'Aquino, Leonard Edwards et Fen Osler Hampson.

Bien que le Premier ministre Stephen Harper et ses ministres aient beaucoup fait pour développer les liens entre le Canada et les économies émergentes au cours de la dernière année, les efforts des entreprises et du gouvernement visant à exploiter ces nouveaux débouchés restent essentiellement sporadiques. Les entreprises canadiennes n'ont pas réellement pénétré ces nouveaux marchés et ont perdu du terrain sur les marchés traditionnels. Si le Canada ne change pas sensiblement sa façon de faire et ne parvient pas à rattraper son retard, il ne pourra prétendre jouer un rôle important sur ces marchés.

L'ascension de ces économies émergentes marque une transformation profonde de l'économie mondiale. Elles sont devenues un élément intégral du succès des nouvelles stratégies de production axées sur les chaines de valeurs mondiales tout en représentant elles-mêmes des marchés importants. La conception du commerce et des investissements d'après-guerre ne permet plus de faire face aux nouveaux défis. La volatilité devient la norme alors que ces pays en développement rapide se découvrent de nouveaux pouvoirs. Représentant des quasi-marchés, ces nouveaux acteurs internationaux présentent des défis uniques, et le Canada se doit d'adopter des démarches novatrices et des stratégies différentes en matière de négociation, de commerce et d'investissements.

Les négociateurs canadiens doivent avoir pleins pouvoirs dans leur défense de l'intérêt national, et doivent pouvoir compter sur un nouveau réseau consultatif provincial et privé. Alors que ces nouveaux joueurs de l'économie mondiale commencent à investir au Canada, nous devons nous doter de règles plus cohérentes et mieux ciblées concernant les investissements étrangers. Nous devons repérer quelles sont nos principales sources d'avantages comparatifs et réagir aux défis uniques que posent les sociétés d'État étrangères et les fonds souverains.

Les gouvernements fédéral et provinciaux doivent veiller à ce que nos entreprises florissantes ne soient pas handicapées dans leurs efforts d'internationalisation. Même si le gouvernement fédéral ne doit pas choisir les gagnants, il doit créer un environnement national et international qui accroisse la capacité des entreprises canadiennes à réussir sur la scène internationale. Ces sociétés ne devraient pas être désavantagées sur le marché intérieur, et les problèmes qu'elles rencontrent en essayant d'accéder aux marchés étrangers devraient être au centre de notre stratégie de négociation. Nos gouvernements doivent en outre faire plus pour protéger leurs droits de propriété intellectuelle (DPI) sur les marchés étrangers afin qu'elles puissent maintenir leur avantage concurrentiel.

Avant tout, le Canada doit cesser de se montrer nonchalant quant à sa dépendance confortable vis-à-vis des États-Unis. C'est alors, et alors seulement que l'on fera preuve d'innovation - mieux que les investissements ou les crédits d'impôts - et que l'on stimulera un environnement commercial plus compétitif.

Le Canada est parfaitement placé pour profiter de nouveaux débouchés et de possibilités d'investissements dans les économies émergentes, tout comme l'a fait l'Australie il y a plus de dix ans. Mais nous devons nous serrer les coudes et nous fixer des objectifs concrets reposant sur nos avantages comparatifs. Ceci exige que nous maintenions un cap clair, en particulier le gouvernement fédéral et que nous ayons une stratégie globale cohérente qui mobilise toutes les forces de tous les ordres de gouvernement et du secteur privé afin de garantir notre réussite sur les nouveaux marchés dans le contexte d'une production mondiale désagrégée.

Il y a vingt-cinq ans, le gouvernement fédéral décidait de protéger et de renforcer le commerce et les investissements avec notre principal marché - les États-Unis. L'Accord de libre échange Canada - États-Unis (ALE) est né de la nécessité de poursuivre un avantage stratégique. Les entreprises et les dirigeants canadiens ont dû sortir de leur cocon trop confortable. Parallèlement, le Canada a remis de l'ordre dans ses finances, s'est doté d'une politique monétaire visant la stabilité des prix et a procédé à une certaine déréglementation. Cette action ferme a engendré une forte croissance économique durable.

À l'aube de ce siècle, le Canada doit, encore une fois, faire preuve d'audace, d'initiative, de concentration et de détermination. Nous ne pouvons continuer à dépendre exclusivement des marchés canadien et américain. Les entreprises canadiennes doivent se montrer beaucoup plus dynamiques dans leur poursuite des marchés les plus effervescents et prometteurs du monde et jouer un rôle nettement plus actif dans les stratégies mondiales de production intégrée. Le gouvernement fédéral doit montrer la voie en tenant compte des forces du Canada dans la détermination de ses objectifs en matière de commerce et d'investissements. Il doit rétablir l'équilibre entre les Canadiens et les économies émergentes. Surtout, le secteur privé et le gouvernement doivent réaliser un partenariat concerté qui oeuvre dans l'intérêt national.

Ce rapport examine ces tendances très évolutives et recommande une nouvelle stratégie pour le commerce et les investissements sur les marchés émergents.

Seizing Opportunities

A significant portion of the world's growth now comes from a group of fast-developing, dynamic economies led by China, India, and Brazil, and includes Colombia, Mexico, Korea, Turkey, Vietnam, Indonesia, and South Africa. Each has achieved more than double the growth rates of advanced economies during the past decade, as noted by the World Bank. All now enjoy rapidly growing middle classes, high savings rates, and more stable regulatory regimes — three solid pillars for continued growth. Canadians are minor players in these markets: less than 10 per cent of Canadian exports and less than four per cent of outward investment go to these emerging markets.

Global trade rebounded in 2010, largely in trade involving developing economies. Canadian trade has continued to under-perform, largely reflecting anemic demand in Canada's traditional markets. As a result, trade has not played its historic role as an engine of growth, leading to the weakest post-recession recovery since the Second World War. Exports of goods and services as a share of GDP have steadily declined since they hit a high of 45 per cent in 2000, falling to 29 per cent in 2010. On the import side, there has been less of a decline to 31 per cent from 41 per cent of GDP. Mark Carney, the Governor of the Bank of Canada, observes that:

> Since 2000, Canada's export growth was almost five percentage points slower than global export growth on average per year. Our share of the world export market fell from about 4.5 per cent to about 2.5 per cent, and our manufactured goods export market share has been cut in half. Consistent with this drop, employment in Canada's manufacturing sector has fallen by more than 20 per cent, representing nearly half a million jobs.

The Governor concludes that three factors contributed to Canada's export malaise: a loss of competitiveness due to changes in the exchange rate, wages, and relative productivity; the failure of Canadian firms to adapt quickly enough to changing global demand; and a lack of focus by Canadian firms on the best markets. While all three factors need urgent attention, in Carney's view Canada's "underperformance was more a reflection of who we traded with than how effectively we did it."

In anticipation of the 1989 Canada-U.S. FTA, many Canadian firms adjusted and became more competitive to better serve the more integrated cross-border market. They now need to retool to serve a more dynamic global economy. The transformation of Canadian trade, production, and investment patterns in the 1980s and 1990s flowed not only from more liberal terms of access to the U.S. market, but also from new technologies and corporate strategies. The development of more dispersed production through value chains and other co-operative, inter-corporate arrangements helps to explain the rapid rise in cross-border trade during the 1990s.

The structural changes in the North American market have spread to other parts of the world, bringing more players into global production. The right approach to trade, services, investment, intellectual property rights,

government procurement, and domestic regulatory regimes have become key contributors to success in the global economy. Many Canadian firms, however, were lulled into complacency because the United States had become such a reliable market. Canada's share of the U.S. merchandise import market fell to 14 per cent in 2010 from 19 per cent in 2000. In the other direction, the U.S. share of Canada's merchandise imports fell from 64 per cent to 50 per cent during the same period, representing 23 versus 19 per cent of U.S. merchandise exports. On the basis of conventional trade statistics, China has overtaken Canada as the leading merchandise supplier to the U.S. market and is now the second largest national supplier to the Canadian market.

The Bank of Canada believes U.S. demand will remain weak for the foreseeable future. TD Economics projects that by 2020 the U.S. market will account for only two-thirds of Canadian exports. The inability of the U.S. to address its fiscal problems remains a major drag on its economy and will continue to slow down full recovery in other economies.

The decline in Canada's trade performance involved more than a decline in bilateral trade with the United States. The robust export growth of the 1990s ended in 2001, with Canada dropping from sixth to 10th as a global trader. The International Monetary fund (IMF) calculates that Canada's share of world markets fell more than any other member of the G-20 except for that of the U.K.

Canada's Foreign Investment Performance

Unlike trade, Canada's investment has been both more active and more imaginative during the past decade. Canadian direct investment abroad and foreign investment in Canada grew steadily in the 2000s.

Canadian Bilateral Trade and Investment Relationships (2011)

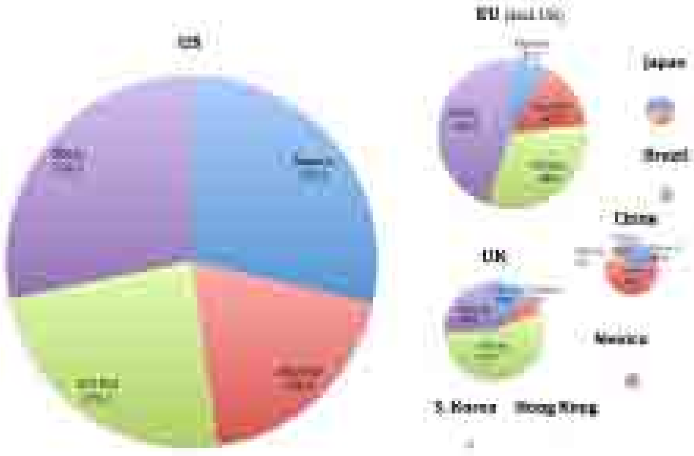
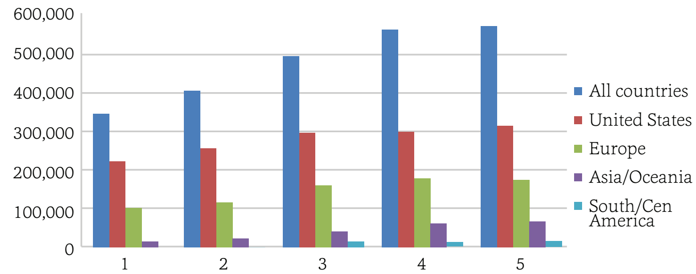
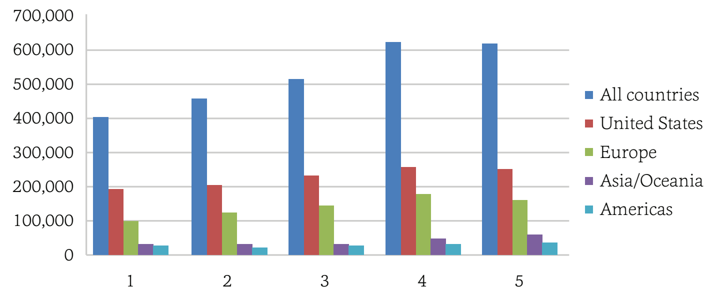


Chart in millions of Canadian dollars | Source: Statistics Canada

FDI into Canada



FDI from Canada



Canada's International Investment Position, Selected Years (millions of current CAD dollars). | Source: Statistics Canada, CANSIM Table 376-0051 — International investment position; 2010 figures preliminary.

Growth was most evident in bilateral investment flows between Canada and the Asia-Pacific region. While absolute numbers remain modest, the rate of growth is encouraging.

There has also been a significant increase in two-way investment with Europe, but with an important difference. Most of the two-way investment flows across the Pacific are trade-creating, either involving value-chain production in Asia or investment in resource exploitation in Canada. Transatlantic investment, on the other hand, tends to be a substitute for trade, with Canadian and European firms locating in each other's markets to serve those markets.

Citigroup projects that by 2020 China will be the world's largest economy. Canada is already off the list of top 10 traders and is the 13th ranking exporter and 11th ranking importer. PricewaterhouseCoopers projects that by 2030, the GDPs of Turkey, Indonesia, Mexico, Vietnam, and Nigeria are each likely to have surpassed Canada's GDP. Some of these countries, while growing quickly, face serious challenges — uneven observance of the rule of law, poor governance, corruption, and cronyism. Many, however, are finally building economies that offer their populations decent standards of living and hope for the future. They will become formidable competitors and markets of opportunity.

Global trade volumes will nearly quadruple by 2030 (Citigroup), but competition will be fierce as developing-country firms fight for market share — at home and abroad — against suppliers from more advanced economies. By midcentury, it is expected that emerging markets will be home to 70 per cent of the world's wealth and 60 per cent of global trade. According to the Asian Development Bank, Asian economies will account for 50 per cent of world production and have 50 per cent of the world's population. By then, North America will account for less than 8 per cent of global trade compared to 15 per cent today. The opportunities are enormous, as are the challenges.

The above evidence of changing Canadian and global trade and investment patterns points to the inescapable conclusion: It's time for major efforts that strengthen Canada's relationships with emerging markets, especially in Asia. While not without risks, these relationships will prove much more rewarding than those with our traditional trade and investment partners.

The Australian Experience

CHART 1

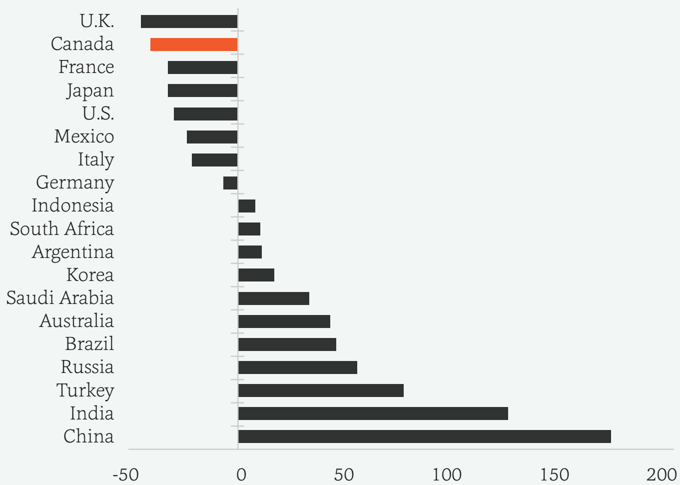


Chart 1: Per cent change in share of world exports, 2000-2010: G-20 countries. Source: Mark Carney, "Exporting in a Post-Crisis World," Remarks to the Greater Kitchener-Waterloo Chamber of Commerce, April 2, 2012.

CHART 2

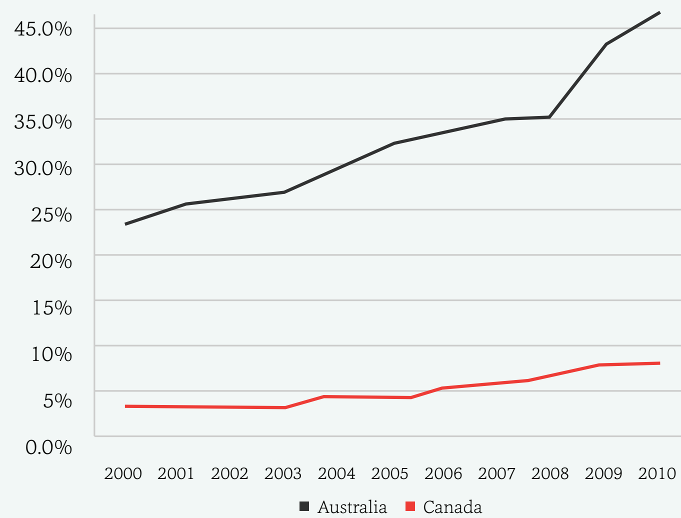


Chart 2: Exports to Non-Traditional Trading Partners as a Percentage of Total Exports: Canada vs. Australia. | Source: Statistics Canada and Australia Bureau of Statistics.

Australia is the only G-20 developed country that experienced growth in its trade during the past decade, nearly doubling its share while Canada saw its portion nearly halved (Chart 1). Much of Australia's growth came from exports to rapidly growing, emerging economies, as Australian firms nearly doubled their presence in these markets from an already stronger base than Canadian firms (Chart 2).

While Canadians embarked on free trade with the United States in the 1980s, Australians accepted their geographic destiny next door to the rapidly growing markets of southeast and northeast Asia. They pursued a program of unilateral reforms symbolized by the transformation of the inwardly focused Industries Assistance Commission to the outwardly oriented Productivity Commission.

Australian resource and service firms responded by aggressively pursuing markets in emerging Asia. In the 1990s, even Australia's dairy industry convinced the government to work with it and phase out supply management. Australia's meat and dairy industries have become the leading suppliers of protein to Asian markets. Australia also developed an aggressive, comprehensive program to attract Asian students to Australian universities, building relationships that are now paying dividends.

More recently, Australian firms, backed by government

CHART 3

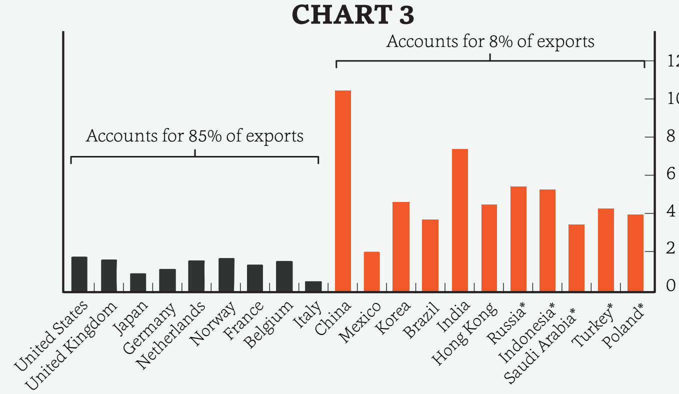


Chart 3: Canadian trade and emerging economies: Average growth rates of trading partners, 2000-2010, annual data. | Source: Mark Carney, "Exporting in a Post-Crisis World," Remarks to the Greater Kitchener-Waterloo Chamber of Commerce, April 2, 2012. The * indicates that the country is not one of Canada's top 15 trading partners.

policy, are using the base built in Asian economies during the 1980s and 1990s more strategically to better secure Australia's economic future. Australia's trade with Asia is now 50 per cent of total trade, and almost half of that is with China (Chart 3).

Canadian firms, on the other hand, have focused most of their trade-development efforts on slow-growth economies (Chart 3). This is a recipe for slow growth in Canada and reduced prosperity and, ultimately, reduced well-being. While circumstances may not be the same, there is much Canada can learn from the Australian experience.

Major Challenges

A major challenge facing Canadian firms is that governments and firms in major emerging markets (China, India, and Brazil) may not always play by conventional, market-based rules. The Economist reports that 28 per cent of the emerging world's 100 biggest companies are state-owned enterprises (SOEs). In some cases, as with China, most of the major players are SOEs.

The other reality is that in emerging economies the state may use its power to direct major companies to act in its interest rather than in the firm's interest. The super-charged industrial policies of emerging economies thus pose a major challenge for those doing business there and for SOEs doing business here. China and Brazil, for example, have become important new sources of foreign direct investment in Canada through entities that are subject to influence by the policies and objectives of their home governments, i.e., by non-market considerations. Canadian policy needs to take account of firms that benefit from access to publicly funded low-cost capital and seek ways to level the competitive playing field.

Canadian firms must adapt to the new reality of quasi-market economies and leverage their strengths in an exacting manner to advance their interests. Governments — federal and provincial — need to work out rules and arrangements that account for this new reality and that ensure that Canadian firms can succeed globally.

Prescription for Global Success

The key to success in global markets is a new, enlightened partnership among all levels of government and the private sector. Such a partnership must:

- Lead to more focused trade and investment negotiations
- Create a more competitive business environment in Canada
- Build public awareness of the importance of global markets to Canadian prosperity
- Concentrate on agreements tailored to the risks and opportunities of specific markets
- Focus diplomatic skills and capital more strategically
- Enhance skills development and educational linkages

Guiding Principles

Canada must now mark a generational shift by forging an engagement strategy for emerging markets. Such a joint project requires co-ordination among governments, business, academic, and other key stakeholders. Governments, regardless of the party in power, must organize to provide leadership.

Focus: Canada should target markets with significant potential instead of those with which agreements are easy to conclude. A smart engagement strategy invests political and negotiating capital in talks that deliver real benefits and clear results. In the long term, the hectic pursuit of "announceables" serves neither public nor private interests.

Leverage: Canada has what emerging markets need. We must negotiate customized trade and investment arrangements with this in mind and use our comparative advantage to advance strategic objectives.

Balanced Exchange: When Canada engages with emerging markets on trade and investment, it should only give equivalent value for what it can gain in terms of access.

Alignment: The federal and provincial governments must work more closely and deliberately with each other and with the private sector to align domestic and international policy strategies and resources based on a shared vision and commitment to the priority of expanding Canada's presence in emerging markets. To that end, government and business need to be prepared to share market information, analysis, data, and success stories to inspire a more concerted approach by Canadian firms to tap new markets.

Performance-based Agreements: When Canada engages emerging markets on trade and investment, it should negotiate agreements that contain performance parameters. With countries in which formal barriers are less important than informal ones, conventional free-trade provisions and metrics may not ensure that Canadian firms can capture the potential benefits and opportunities.

Build on Strength: Canada's federal and provincial governments must pursue domestic policies that will lead to the growth of competitive, outward-oriented firms, recognizing that success at home is essential to winning globally. Governments should not be picking winners. They should, however, create a supportive domestic and international environment in which enterprising Canadian firms can compete and grow, and should nurture those sectors that are critical to our future prosperity.

Retool: Governments and business need to identify impediments to trade and investment and bring Canada's tax, border, trade, investment, competition, industrial, and related policies into line with the challenges posed by many new players operating in the global market.

Recommendations

Recommendation 1: Trade negotiators must be guided by a clear sense of priorities and strategic direction and must have comprehensive authority to act in the national interest.

Canada needs to tailor its approach and its negotiating strategy and tactics to each market of opportunity and build the internal capacity in the federal government to support and sustain effective negotiations.

Given the quasi-market nature of some of the most attractive new markets, the government needs to consider what kinds of provisions are most likely to meet Canadian objectives. The federal government must avoid agreements that fail to discipline politically determined outcomes favouring local over foreign competitors. Government procurement is an issue that is ripe for more outcome-oriented commitments. Equally, Canada must negotiate proper protection for intellectual property in non-rules-based economies before doing business with them.

The federal government must align the focus of its trade negotiations with market potential. It has not yet managed to conclude an agreement with a single high-growth Asian country. Recent agreements promise little commercial value. For example, the export value of the recently concluded free-trade agreement with Honduras in a full year is equal to 71 minutes of Canada's daily exports to the United States. Canada must avoid entering into trade and investment agreements that serve purely symbolic or short-term political objectives.

Canada's current and pending trade initiatives should be subject to a proper cost-benefit analysis, and government-business consultations should lead to a credible and sustainable rationale. Negotiations that do not offer significant benefits should be overhauled or shelved. The federal government must focus its efforts and negotiating resources on concluding meaningful agreements with the countries that offer the greatest potential gains.

Canada's trade negotiators must be provided with clear, national mandates that preclude interprovincial and interdepartmental squabbling during trade talks. Establishment of a trade-negotiating secretariat that works across departments and is headed by a top-notch trade negotiator with full cabinet authority.

Recommendation 2: Canadian competition and investment policies should welcome foreign participation in the Canadian economy, but ensure that foreign investors face clear rules regarding national security interests and standards of behaviour in the Canadian market.

Canadian competition and investment policies often work at cross-purposes. Administration of both the Investment Canada Act and the Competition Act has created uncertainty in the Canadian investment market. Foreign mergers and acquisitions are currently subject to burdensome and redundant reviews by two regulatory bodies delivering opaque decisions. Ideally, the government should consider melding the two into a single statute with clear guidelines for review by a single commissioner.

Rather than relying on the vague "net benefit" provisions of the Investment Canada Act, Canadians may be better served by a clearly defined national interest test that includes an examination of the market capitalization and transparency of foreign firms engaged in the acquisition of Canadian assets, a determination of the degree of access permitted in the investor's own country, and an analysis of the effects of any mergers and acquisitions on Canada's competitive position in the global marketplace. In a recent analysis of this approach by Chinese SOEs, Theodore Moran concludes:

> Application of this framework in Canada and elsewhere would help to dampen politicization of individual cases, enabling swift and confident approval of those acquisitions from which genuine national security threats are absent.

Canada's current mechanism for foreign-investment approvals is not designed to facilitate the use of leverage. Obscure and often confusing, the approvals process provides most foreign investors virtually unfettered access to Canadian assets and markets without demanding much in return. Foreign investments in Canadian resources and technology, for example, could be better used as valuable bargaining chips to obtain reciprocal access to the investors' markets.

More generally, however, improvements in the tax regime and appropriate review procedures based on national security considerations offer a better approach than current practice. Both methods can be useful if woven together: when other governments impose damaging trade and investment limits on Canadians, exploiting available leverage might be helpful. In most instances, however, relying on transparent, market-based tax and competition laws will be sufficient to ensure the beneficial allocation of inbound investment capital.

Canada could also take a page out of the book of several emerging-market countries, particularly those with large resource-based export industries. Identifying sensitive firms and sectors should be done systematically rather than in response to ownership bids from non-Canadians.

Canada also needs clearer rules for corporate behaviour. It is important, for example, to consider ways to keep key elements of head office functions in Canada and to allow publicly traded companies more discretion to resist unwelcome takeovers by state-owned enterprises and sovereign wealth funds.

Table 1: Post-NAFTA Canadian Bilateral and Regional Trade Initiatives

Country/Group	Status	Two-Way Trade 2010 (millions)
Israel	Invited 1995/Signed 1997	1,392
Chile	Invited 1996/Signed 1997	2,460
Costa Rica	Invited 2000/Signed 2002	536
Colombia	Invited 2007/Signed 2008	1,362
Peru	Invited 2007/Signed 2008	4,128
Jordan	Invited 2007/Signed 2009	85
Panama	Invited 2008/Signed 2010	298
EFTA	Invited 1996/Signed 2009	9,994
Honduras	Invited 2001/ Awaiting legal review	192
Guatemala	Invited 2001/Suspended	414
El Salvador	Invited 2001/Suspended	100
Nicaragua	Invited 2001/Suspended	255
Singapore	Invited 2001	1,972
South Korea	Invited 2005	9,856
Dominican Republic	Invited 2007	545
Caricom	Invited 2007	2,400
EU	Invited 2009	82,458
India	Invited 2009	4,212
Ukraine	Invited 2010	250
Morocco	Invited 2011	328
Japan	Invited 2012	22,645
Turkey	Study launched 2010	1,556
Thailand	Study launched 2012	306
China	Study launched 2012	57,755
Trans-Pacific Partnership	Interest indicated 2011	NA
Free Trade Area of the Americas	Suspended 2005	NA

Table 2: Canada's Foreign Investment Protection Agreements

Agreements in Force	Argentina, Armenia, Barbados, Costa Rica, Croatia, Czech Republic, Ecuador, Egypt, Hungary, Jordan, Latvia, Lebanon, Panama, Peru, Philippines, Poland, Romania, Russia, Slovak Republic, Thailand, Trinidad and Tobago, Ukraine, Uruguay, Venezuela
Agreements Concluded	Bahrain, China, India, Kuwait, Madagascar, Mali
Ongoing Negotiations	Cameroun, Côte d'Ivoire, Ghana, Hungary, Indonesia, Kazakhstan, Mongolia, Pakistan, Poland, Tanzania, Tunisia, Vietnam

Table 3: Canada's Double Tax Agreements

Agreements in Force	Algeria, (1999), Argentina (1993), Armenia (2004), Azerbaijan, (2004), Bangladesh (1982), Barbados (1980), Brazil (1984), Bulgaria (1999), Cameroon (1982), Chile (1998), China (1986), Croatia (1997), Denmark (1997), Dominican Republic (1976), Ecuador (2001), Egypt (1983), Guyana (1985), Hungary (1992), India (1996), Indonesia (1979), Israel (1975), Ivory Coast (1983), Jamaica (1978), Jordan (1999), Kazakhstan (1996), Kenya (1983), Malaysia (1976), Mexico (2006), Moldova (2002), Mongolia (2002), Morocco (1975), Nigeria (1992), Oman (2004), Pakistan (1976), Papua New Guinea (1987), Peru (2001), Philippines (1976), Republic of Korea (2006), Romania (2004), Russia (1995), Senegal (2001), South Africa (1995), Sri Lanka (1982), Tanzania (1995), Thailand (1984), Trinidad and Tobago (1995), Tunisia (1982), Ukraine (1996), United Arab Emirates (2002), Uzbekistan (1999), Venezuela (2001), Vietnam (1997), Zambia (1984), Zimbabwe (1992)
Agreements Pending	Gabon (2002), Lebanon (1998), Kyrgyzstan (1998), Kuwait (2002) Turkey (2012)

Recommendation 3: Canadian business and political leaders need to work together to build greater public awareness of the rewards of competing in emerging markets.

Canadian firms need to be much more closely involved in these negotiations and in the development of new strategies. The annual consultations on the federal budget for example, should be replicated to reinforce trade and investment priorities and strategies. During the negotiation of the Canada-U.S. FTA and the North American Free Trade Agreement (NAFTA), business and government developed a strong culture of working together to meet shared goals. A similar consultative culture needs to be nurtured to tackle the challenge of engaging with new, fast-developing markets.

For example, the Asia Pacific Foundation's 2012 update survey of Canadian attitudes toward the Asia-Pacific indicates a majority (63 per cent) see the importance of the region to Canada's well-being. Nevertheless, Canadian regard for most Asian countries remains well below that accorded to traditional partners.

Much of the long-term success of the Canada-U.S. FTA flowed from broad public awareness and debate of its benefits. Many small and medium-sized enterprises (SMEs) responded to this discussion by recalibrating their marketing priorities. The senior business community fostered positive public debate that was focused on the opportunities and worked to ease anxieties. The result was broad acceptance of the benefits of freer trade and a more competitive economy.

We must create similar conversations around the risks and opportunities of the emerging global trade and investment environment and Canada's place in it. Unless the public "gets it," governments will avoid the tough decisions required to make Canada, and

Canadian firms, more competitive and outward-looking. In forging a collaborative relationship between government and business, the broader public must also be engaged.

Recommendation 4: Canadian diplomacy should target key emerging markets.

Political capital — federal and provincial — should become more focused and dedicated to markets that hold the greatest potential for Canadian success. A new global strategy for trade and investment requires a recalibration of Canada's foreign political and commercial representation. Scarce resources should be directed toward markets in which there is significant growth potential and be geared to developing and delivering programs that meet the special needs of those markets, particularly for small and medium-sized enterprises.

The Business Challenge

Canadian business needs to accept that the rules and environment in emerging markets are not the same as in established markets. Canadian firms need to pursue strategies adapted to this reality by:

- Rejecting the culture of comfort
- Embracing their roles as standard bearers of the “Canada” brand
- Mentoring later arrivals
- Staying the course once established
- Strengthening their domestic base
- Working with local partners more familiar with local requirements

Recommendation 5: Canada needs a smart procurement strategy to help level the global competitive landscape. Canadian firms should not be disadvantaged either at home or abroad.

Procurement preferences have long been a popular industrial policy tool. However, experience has demonstrated that public procurement based on transparent procedures and value-for-money criteria provides better results. To this end, both the federal and provincial governments should adopt simplified, transparent procurement procedures that offer open access to qualified suppliers. At the same time, Canada also needs smart procurement policies and timely infrastructure investments that do not place Canadian firms at a competitive disadvantage.

Our own procurement policies are also a source of leverage to ensure Canadian firms are granted reciprocal access to foreign markets, such as China's government-sponsored infrastructure projects. Canadian enterprises are ideally suited to meet emerging demand for roads, bridges, ports, mass transit, power plants, and other major infrastructure. Governments must recognize that by engaging domestic firms in Canada's own infrastructure projects, they can enhance their global prospects.

Recent trade liberalization agreements do not cover most government purchasing. In emerging markets, foreign bidding is often at the discretion of the local buyer, and procurement is a hotbed for cronyism and corruption. In dealing with emerging economies that have chosen not to join the World Trade Organization (WTO) Government Procurement Agreement, federal and provincial governments should resist leveraging access to resources, labour markets, and foreign assistance in order to ensure fair access to government purchasing in these markets.

Domestic Pillars for Global Growth

The ability of Canadian firms to compete in the global economy is critically dependent on a productive domestic economy. To that end, business and government need to work together to ensure Canada has:

- A competitive tax base
- Clear investment rules
- Supportive, modern infrastructure
- More targeted skills development
- Modernized customs and regulatory regimes

In order to become more engaged in the broader global economy, particularly in the emerging economies, Canadian firms must have the confidence of being anchored in a strong domestic economy. The domestic foundations for global success rest on four pillars of public policy and business leadership:

- A tax system that promotes innovation and improved productivity, and that is competitive with other successful economies, including emerging markets.
- Regulatory reform that recognizes that some policies and practices of a bygone era have become drags on Canada's productivity growth and on its engagement in emerging markets with more nimble competitors. As the government moves to streamline regulatory approval of major infrastructure projects in the energy and mining sectors, it should not ignore sectors at the core of Canada's growth prospects, including aerospace, financial services, information technologies, and agriculture. Canadian SMEs will only thrive if larger, globally engaged firms continue to prosper.
- There is an urgent need to turn around Canada's productivity performance. The factors that will propel Canada to higher levels of productivity — and, as a result, to higher levels of trade and prosperity — reside in both the public and private sectors.
- The renewal and extension of Canada's national infrastructure — transmission grids, ports, pipelines, terminals, roads, and bridges — are essential to economic growth and Canada's ability to engage with new markets, especially those in Asia. Governments must embed environmental and social safeguards in more transparent, coherent, and streamlined project review procedures. In addition, better procurement practices, including public-private partnerships to serve infrastructure needs, will bolster opportunities for competitive Canadian industries.

None of these reforms will have the necessary impact unless the private sector is prepared to invest in capital and human resources to strengthen Canada's productivity performance and to make Canadian firms more successful competitors in emerging markets. There is thus a need for alignment and coherence in government policies and programs at all levels and for closer government-business consultation in advancing a new strategy for greater global engagement.

Recommendation 6: Canada needs new tax and investment treaties with countries where Canadian firms are actively investing.

Tax and investment treaties are necessary so that the foreign operations of Canadian firms are not unduly penalized. Typically, tax treaties allow for the repatriation of capital without the impediment of capital controls and excessive withholding taxes on foreign profits. In addition, countries with which Canada has well-structured tax treaties allow companies to repatriate foreign profits without double-taxation in Canada as in the case of our tax treaties with most OECD countries. By allowing companies to efficiently repatriate capital and profits, these funds are available for reinvestment in Canada or other jurisdictions.

As indicated in Tables 2 and 3, Canada has negotiated tax and investment protection treaties with many emerging economies. Some, however, are showing their age and need to be thoroughly vetted and revised to better protect Canadian investors in quasi-market economies where the political risks of doing business are high. When properly structured, investment treaties can mitigate the risks in emerging markets by including such provisions as protection from discriminatory expropriation of property; protection from arbitrary or capricious cancellation

of licences or concessions; guarantees against foreign-exchange controls; prompt and adequate compensation in the event of seizure; subrogation rights for government insurance agencies; reference for disputes to an independent arbitral tribunal; and enforcement rights for any award made against the commercial assets of the host jurisdiction in other countries.

Such treaties have been used successfully by foreign investors seeking compensation in foreign jurisdictions.

Recommendation 7: The federal government needs to bring its customs and regulatory regimes into the 21st century and into line with the realities of globally integrated production patterns, especially with emerging markets.

The contours of Canada's border regime were designed during the first half of the 20th century. In today's world of low-cost international transportation, instant communication, and globally integrated production, many of the remaining customs instruments have become barriers to productivity growth and to engagement with production platforms in emerging markets. They are particularly counterproductive for Canadian firms that are part of complex value chains and production networks, dependent on rapid international movement of components and key personnel. The time has come to phase out these instruments either unilaterally or in co-ordination with Canada's trading partners.

Business spends an inordinate amount of time and money on regulatory filings to all levels of government, some of them serving little purpose other than the bureaucratic hunger for information or the silencing of the squeaky wheels of special interests.

The burden is particularly heavy for SMEs. Business surveys report year after year that the regulatory burden is the No. 1 concern of SMEs. The 2004 report of the Smart Regulation task force made many recommendations to simplify and streamline Canada's regulatory structures and to align them more closely with international, particularly U.S., requirements. They should be implemented on a priority basis.

Recommendation 8: Universities and colleges must make significant investments in language training and exchange programs. Canadian educational institutions at all levels must do a better job of attracting students from the Asia-Pacific region and other emerging economies.

Canadian firms doing business in emerging markets are increasingly looking to hire Canadians who possess foreign language skills and are attuned to foreign cultures. Universities and colleges must greatly strengthen their internationalization programs, specifically by providing young Canadians with the knowledge and language skills to work overseas and in emerging markets. This means sending many more Canadians to study abroad.

At the secondary level, we need to introduce the study of those foreign languages — particularly Mandarin — that will open the doors to young Canadians in emerging markets.

The provinces, together with the federal government, should work with Canada's educational institutions on strategies to attract more foreign students to Canadian universities, not only to strengthen Canada's human resources, but also to build links and relationships that will pay dividends for decades to come.

Recommendation 9: Canadian businesses must reject their "culture of comfort" in order to expand into emerging markets.

Canada's biggest drawback, as a recent study by Marcel Côté and Roger Miller of the Centre for the Study of Living Standards attests, is a business environment infused with a culture of comfort that discourages risk-taking and causes businesses to spurn innovation in favour of easy profits.

To date, Canada's presence in emerging markets rests primarily with a few large firms, which are risk takers and know how to compete globally. Canada's 100 largest companies account for 80 per cent of the total value of Canadian outbound investment. A handful of large firms — such as AGF, Barrick, Manulife, Bombardier, Brookfield, SNC Lavalin, CGI, CAE, RIM, CIBC, Scotiabank, Magna International — are Canada's most visible players abroad. They should be seen as models and potential mentors by Canadian firms that seek to succeed in emerging markets.

Canada's global champions have learned to work with local partners and local requirements. While they might prefer markets that are more attuned to North American market rules and standards, they accept the need to adapt. They also recognize that, particularly in Asia, productive relationships are as important as product and price.

Many more of our enterprises would be knocking out the lights in developed and emerging markets if they had a much stronger cadre of internationally experienced, multilingual, culturally adept managers.

Recommendation 10: Canadian firms should not hesitate to use the Canadian brand to establish their presence in emerging markets.

The first entrants in new markets "brand" Canada. Their actions, as much as Canadian symbols and slogans, establish who we are in the world. These successful firms become a key source of information, contacts, and expertise for newcomers. Canada's extensive diaspora has strong ties to home markets and should be an important source of business recruitment and a channel for cultural bridge-building.

Recommendation 11: Canadian firms must recognize that staying power is the key to success in emerging markets.

Many Canadian businesses have been criticized for their lack of perseverance in emerging markets. Absent instant success, too many have failed to commit the time and resources to succeed. Without a sustained presence, however, it is impossible to build long-term demand for goods and services. Canada's reliability, intelligence, and level-headedness are welcome virtues in a turbulent world. Emphasis on excellence and innovation is part of the national commercial character Canadians sell to the world.

Canada's larger, outward-oriented companies have demonstrated a willingness to take a position that is longer-term and goal-oriented in order to establish a presence in emerging markets. This means building relationships and partnering with local entrepreneurs and family firms. Small and medium-sized firms, on the other hand, remain preoccupied with the need for shorter-term returns and with the burden of domestic regulatory requirements and filings. For many SMEs, the U.S. market has provided as much of a challenge as they are willing to take on. Their presence in wider markets is limited to sales

of components and services to larger companies. Broader awareness and business-led mentoring programs for SMEs would lead to a more diversified Canadian presence in emerging markets.

Canada has seen remarkable growth in the number of successful SMEs, and their contribution to domestic economic growth remains critical. Their investors, however, should be prepared to let SMEs become large enough to play significant roles in the global economy. Policy barriers to that kind of growth, such as tax rates, should be identified and addressed.

Recommendation 12: Canadian firms need to improve their productivity if they want to become players in emerging markets.

They must ensure their domestic operations are as competitive as possible. Commodity prices will remain high for the foreseeable future, indicating no relief for the manufacturing sector from a more favourable exchange rate. Canadian corporate balance sheets, however, are in good shape, placing many firms in a position to upgrade plant, equipment, energy efficiency, and information and communications technology.

Canada's productivity performance during the past decade was among the worst in the OECD. Deloitte's recent analysis of this dismal record identified six key issues:

- Business leader risk aversion;
- Inefficient and insufficient private-sector support for innovation
- Lack of risk capital for start-up companies
- Chronic under-investment in machinery and equipment
- Sheltering of the Canadian economy
- Increasing competition for human capital

This record is particularly poor among SMEs.

Canadian firms must pay greater attention to the commercialization of Canadian R&D, transforming innovative ideas from universities into commercially successful enterprises in Canada.

To remain competitive with emerging-market firms at home and abroad, Canadian firms must innovate and make better use of human resources and scarce capital. In the words of Governor Carney, "the more Canadian businesses refocus, retool and retrain, the more they can take advantage of opportunities in Canada and around the world."

Recommendation 13: Domestically, tax policies should be neutral among firms and sectors, but competitive with other countries.

Governments have become increasingly aware that tax structures can be important determinants of economic growth. Tax efficiency and competitiveness are particularly important for the business sector. Corporate income and capital-based taxes can have the greatest negative effects on the allocation of capital investment and business operations, affecting job creation, economic growth, and revenue collection by government.

The federal and provincial governments have made significant progress in reducing corporate tax rates. During the past six years, Canada has moved from the least to the most tax-competitive member of the G-7. However, corporate tax rates in emerging market economies such as Brazil, China, and India, are lower than in most G-7 or OECD countries. It is critical to stay the course, avoid backsliding (as some provinces are doing), and keep corporate tax rates down.

Canada can do more to ensure Canadian-based firms are in the best competitive position to tackle global markets. R&D tax credits, for example, should not create incentives for innovative and globally competitive firms to shift employment to other jurisdictions.

Tax neutrality is among the most important considerations in maintaining an efficient and effective corporate tax regime. Using the tax regime to favour some sectors over others can distort the allocation of scarce resources and lead to sub-optimal economic performance. Canada's tax regime, for example, favours small over large, a policy that discourages SMEs from growing into larger companies better able to be globally competitive players.

Tax neutrality is more difficult to maintain in the face of companies that are active in multiple markets burdened with contrasting tax regimes in different jurisdictions. SOEs and firms benefitting from tax-reduced capital sources such as sovereign wealth funds (SWFs) and pension funds may further distort the ability of governments to maintain tax neutrality.

Experts such as Jack Mintz have made detailed suggestions for effective tax reform. The key is to achieve tax neutrality among SWFs, pension funds, and wholly private capital, which Vijay Jog and Mintz argue can be attained using mechanisms that restrict the ability of companies to deduct corporate taxable income payments to those companies who are otherwise exempt from taxes. Similarly, Canada could eliminate the withholding tax on dividends and royalties paid on cross-border trade in order to attract more foreign investment by avoiding the impact of double taxation on these dividends and royalties.

Recommendation 14: Federal and provincial immigration programs need to align Canada's labour force with global competitive challenges.

Provincial and federal education and immigration programs and policies are insufficiently focused on developing the human capital needed for economic growth. The chronic shortage of skilled workers in Canada is undermined by the lack of coherent apprenticeship programs in which, for example, the Federal Republic of Germany excels. A more co-ordinated strategy to develop and retain workforce skills and knowledge is also required for an economy that operates on the leading — not trailing — edge of the innovation cycle.

More rapid and transparent rules for accrediting skilled workers trained in other provincial or overseas jurisdictions are critical. Provinces and firms must work with SMEs to strengthen apprenticeship programs for the trades.

Conclusion

The challenges are obvious. The opportunities are huge. The need for strategy, focus, and leadership is critical. Canada cannot afford to continue to fall behind. Government and business must adapt and move quickly to seize the potential in key emerging markets. It will require a concerted and sustained partnership between the public and private sectors. Canada has the potential to meet the demands of a rapidly changing global economy. What is missing is a determined effort to leverage our strengths and to reshape Canadian policies and priorities to serve our national interest.

Securing Prosperity

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