"CANADIAN BUSINESS GOES GLOBAL FOR GROWTH"
GLOBALIZATION: PERIL OR PANACEA FOR CANADIAN BUSINESS?

Executive Summary

Canada has always been one of the most open economies in the world. It has a long history as a trading nation and immigration has continually been a key source of population growth. Thus, it is little wonder that the ongoing trend of globalization has had a major impact on Canada. This is evident from the increased international flow of goods, services, capital and labour to and from Canada in recent years. Many small and medium size enterprises (SMEs) have already taken advantage of the opportunities that globalization presents. Many others have successfully adjusted to the increased foreign and domestic competition that globalization brings. However, all of the potential gains have not yet been unlocked, implying that SMEs can profit from thinking globally. Moreover, it is important that businesses consider international trends when forming their business plans. For example, demographics and immigration will have a greater impact on Canada's economy over the next two decades. And, in order to cope with the increasingly competitive global marketplace, SMEs must strive to improve their productivity performance, as it is the only way to succeed over the long-run.

Globalization has shaped Canada's economy

Globalization has resulted in Canada becoming more plugged into the world economy. Canada's exports and imports have grown dramatically over the past two decades, surging from roughly 22 per cent of GDP in 1980 to well over 40 per cent today for exports and over 35 per cent for imports. Exports have become more focused on the United States. Indeed, the U.S. share of Canadian exports has climbed by 10 percentage points to 85 per cent over the last decade. However, this masks the fact that Canada has also been expanding its trade ties with the rest of the world. Over the past ten years, Canadian exports to countries other than the U.S. have increased by a cumulative 42 per cent. Meanwhile, Canada has become less dependent upon the U.S. for imports. Canadian imports from the rest of the world have increased by 110 per cent over the last decade, with the U.S. share of Canadian imports falling from 68 per cent to 61 per cent.

Both goods and services are increasingly being traded, with both recording average annual growth of 9.6 per cent from 1993 to 2001, and growth in exports of high-value added services (such as high-tech services, finance, insurance and business services) has been even stronger.

Globalization has also transformed capital markets. Foreign direct and portfolio investment have taken flight. Canadian foreign direct investment has increased at an average annual rate of 24 per cent since 1990. Over that same time span, foreign direct investment into Canada has climbed at an average annual pace of 21 per cent.

Globalization has also heightened the international mobility of workers. Immigration (foreigners moving to Canada) has averaged over 200,000 people per year since 1990, while emigration (Canadians moving abroad) has averaged about 50,000. Despite the net inflow of individuals, the outflows have created concerns about the "brain drain" to the U.S. and, more recently, the outsourcing of jobs.

Increased international competition has also helped to constrain the increase in prices for traded goods and services. This has reduced the pricing power of businesses, but has represented a windfall to consumers.

SMEs benefit from thinking globally

With SMEs found in every industry, it should not be surprising that small and medium size businesses cannot insulate themselves from the impact of globalization. Consequently, many have taken advantage of the opportunities presented, either by exporting to foreign markets or by importing goods and services for resale in the domestic market or as inputs in a domestic production process. This is evident from statistics showing that small businesses alone make up 85 per cent of all Canadian exporters and account for 44 per cent of all Canadian goods and services shipped abroad.

While some SMEs have developed business models to succeed in the international arena, others have taken a passive approach. Fully 46 per cent of exporting independent businesses reported that they became exporters because of unsolicited inquiries about their willingness to sell to foreigners, while only 37 per cent indicated that they began exporting as part of a planned market expansion.

It is important to recognize that Canada is only 1.9 per cent of the world economy and has only 0.5 per cent of the world's population. Moreover, the Canadian market is likely to grow at a slower pace than the world average in the years ahead. From 2002 to 2015, the World Bank estimates that Canada's population will expand at an average annual rate of 0.5 per cent – half the 1.0-per-cent growth expected in the world overall. And, this will impact on Canada's relative economic performance. Economic growth requires higher labour productivity or a larger labour force. Even allowing for stronger productivity growth in response to additional capital investment, Canada's long-term potential economic growth rate is likely to dip from its current 3-per-cent annual pace to around 2 per cent by 2020. This may not sound dramatic, but it represents a one-third reduction in the long-term pace of expansion. Thus, businesses will find it increasingly difficult to rely on their local markets for growth.

Obstacles to trade can be overcome

Although many SMEs have been successful in the international arena, some have been deterred by perceived risks and obstacles, but these challenges may loom larger in perception than in reality.

1. Products or services not exportable

It is hard to imagine many goods that cannot be shipped abroad, although it may be the case that transportation costs make exporting some products unprofitable. And, while numerous services cannot be exported, times are changing, as technological advances are increasingly facilitating trade in selected business services.

2. Satisfied with current market

Since most business activities offer economies of scale, there are profits to be made from expansion into new markets and from larger production runs.

3. Lack of resources

There are abundant resources available to potential exporters and importers. Many organizations stand ready to help SMEs, including the Export Development Corporation (EDC), the Business Development Bank of Canada (BDC) and the Department of Foreign Affairs and International Trade (DFAIT).

4. Lack of financing

With respect to financing, institutions like the TD Bank Financial Group, the EDC and the BDC stand ready to help businesses obtain financing and manage the risks.

5. Duties, tariffs and non-tariff barriers

Duties, tariffs and non-tariff barriers have been steadily reduced by multilateral and bilateral trade negotiations.

6. Shipping costs

Technological progress has dramatically reduced shipping costs. Since 1980, the inflation-adjusted cost of sea freight has fallen by 11 per cent, the cost of air transport has dropped by 25 per cent, and the cost of a 3-minute telephone call has plummeted by 67 per cent.

7. Exchange rate uncertainty

A variety of financial instruments are available to help manage exchange rate risk. Hedging contracts (using options, forwards and swaps) allow businesses to protect a portion of their revenues from the impact of currency movements. Some businesses argue that they lack the financial expertise to deal in these instruments, or dismiss hedging as a form of speculation. However, financial institutions that sell hedging contracts can answer any questions that businesses might have and can guide them through the process of building an effective hedging strategy. Moreover, far from being a speculative activity, hedging should be viewed as purchasing a form of insurance.

8. Difficult customs process

Customs requirements may seem complex and labyrinthine, but they can be overcome with time and effort. SMEs can draw on the expertise of accounting, legal and financial professions for help in navigating customs rules.

9. Language barriers and cultural differences

Language and cultural barriers are being reduced over time. The use of English as the language for international business has been expanding. At the same time, Canada's increasingly diverse workforce holds the possibility of allowing Canadian companies to more easily overcome language and cultural obstacles to trade in the future.

Demographics will have a big impact on SMEs

Demographic pressures are building in Canada, with the average age of the population rising. This is leading to slower population and labour force growth, suggesting that many small and medium size businesses will find it increasingly difficult to hire younger staff and will need to encourage older workers to stay on the payrolls longer. At the same time, an aging population will also alter market demand for certain goods and services.

As population growth slows, immigration will become more important as a means of filling the gaps in Canada's labour market. In the early 1980s, immigration accounted for around 40 per cent of Canada's population growth; today, that figure has risen to around 75 per cent, and by 2010, immigration will account for all of the population growth in Canada. With this backdrop, it will be increasingly important for businesses to recognize the experience and abilities that immigrants bring to Canada.

The increased role of immigration means that visible minorities will form a greater share of the overall population. Visible minorities are expected to make up a fifth of Canada's population in 2020. Since most immigrants tend to locate in major metropolitan centres, the trend will be even more pronounced in certain cities, with visible minorities expected to reach about 50 per cent of the population of Toronto and Vancouver by 2020, to cite just two examples. So, the minority will become the majority.

This has many implications for SMEs. First, visible minorities will make up an increasing share of the workforce. This may create language and cultural challenges that will have to be overcome, and diversity will be an even more important part of the business environment than it is today. Second, the labour force of cities will grow more rapidly than that of rural areas, and that of large cities will expand faster than that of many smaller ones. Since SME formation has traditionally been correlated with population growth, it appears likely that cities like Toronto and Vancouver will see the strongest pace of business creation. They are also less likely to encounter difficulty attracting immigrants to replace retiring employees. However, other regions may find that labour scarcity becomes a more pressing issue. Lastly, growth in the immigrant population will spur demand for different goods and services, creating new business and profit opportunities.

Productivity is key

Enhancing productivity is crucial regardless of whether an SME is an exporter, an importer or a local-market focused business. It is the foundation to an individual firms' long-term profit growth, especially in open markets where competition significantly constrains pricing power.

Much has been written about Canada's poor productivity performance compared to the United States. Indeed, the level of productivity in Canada has fallen to 10 to 20 per cent below that in the United States. It is generally agreed that part of the explanation is the different composition of the two economies. For example, the U.S. has a larger IT sector, which has above-average productivity growth. But, other factors are also at work. For example, scale seems to matter, as larger establishments generally have experienced stronger productivity growth. The Canadian economy has a greater proportion of SMEs than the United States, which has likely contributed to our weaker productivity performance.

The weaker productivity performance by SMEs reflects a number of factors. Their smaller size means that they are less likely to benefit from the economies of scale to be had from larger production runs or greater divisions of labour. SMEs conduct less research and development than their big business peers. This lower R&D expertise may reduce the willingness and/or ability of some firms to implement new technologies developed outside the firm. And, SMEs are generally less inclined to acquire new machinery and equipment.

Nevertheless, the push to become more productive will not diminish. Regrettably, there is no simple recipe for enhancing productivity. At the most basic level, firms must move up the value-added production chain -- shifting production towards goods and services that have greater profit margins, primarily due to more sophisticated production processes or greater technical expertise. Trying to compete with labour-intensive foreign imports is almost certain to leave domestic producers at a cost disadvantage. In order to increase value-added production, firms will have to employ more skilled staff and will have to invest in additional capital, including adopting new technologies. Moreover, businesses must strive to be as innovative and as adaptive as possible to changing market conditions.

Canada's various levels of government have a role to play in helping businesses to reap the economic gains to be had from increased trade and promoting productivity growth. Specifically, getting border arrangements and immigration policies right, ensuring adequate infrastructure, setting competitive tax rates, and fostering a solid education system are all priorities.

Craig Alexander, Senior Economist
416-982-8064

Eric Lascelles, Economist
416-982-6420