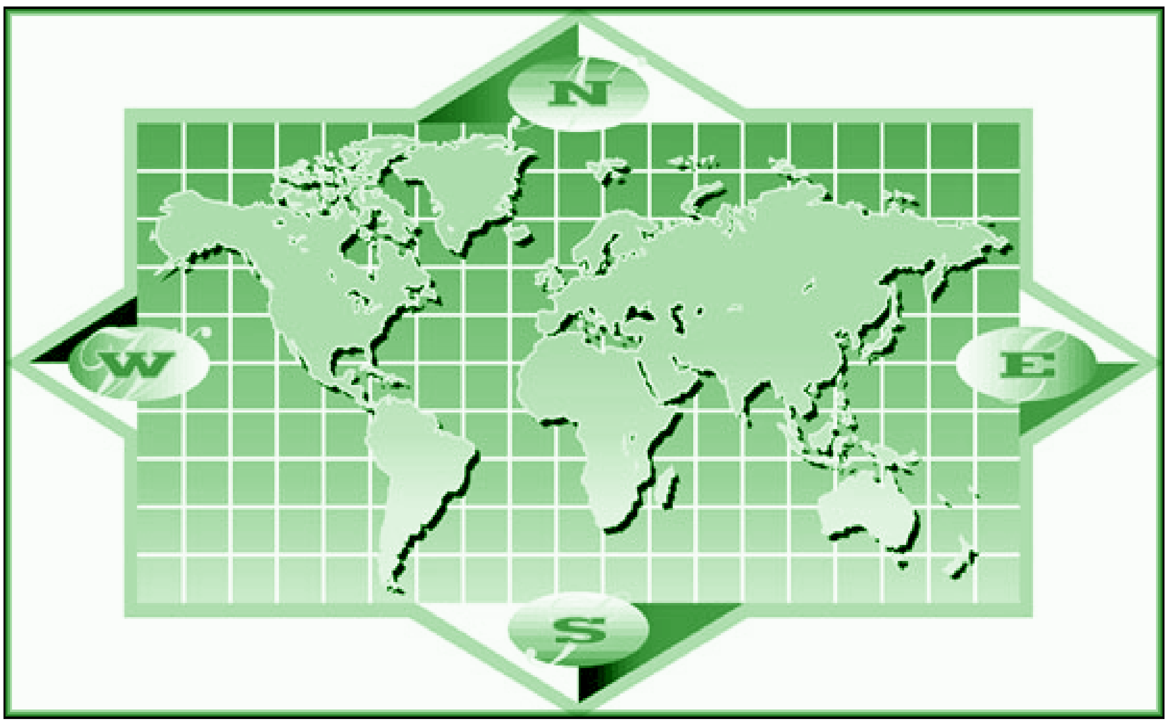
# "Canadian Business Goes Global For Growth"

## Globalization: Peril or Panacea for Canadian Business?




June 2004

TD Bank Financial Group

# "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***

TD Bank Financial Group

# TD Economics

## Special Report

June 14, 2004

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

Always one of the most open economies of the world, Canada has benefited greatly from its heavy orientation towards international trade. In the early years of the country's history, colonists from Europe built an economy based on exports of natural resources and imports of finished products from abroad. As the country matured, a vibrant domestic economy developed, which was less reliant on commodities, but the emphasis on trade was never lost – its focus simply shifted. Canada's proximity to the much larger U.S. economy saw its trade ties with the British Empire wane, as Canadian businesses discovered that there were profits to be had from the shipment of goods and services along north-south lines. And, while high tariffs were initially used to encourage the creation and expansion of a domestic manufacturing sector, they have come down over time – a trend that has intensified in recent years, as rounds of international trade talks and free trade agreements with other countries have progressively lowered barriers to trade. At the same time, technological advances have significantly reduced transport costs and created opportunities to profitably import and export goods and services that previously were not tradeable. As a result, Canadian trade has expanded rapidly – particularly with the United States, but also with other countries – such that exports and imports now make up the largest share ever of Canada's GDP. Of course, globalization and the openness of the Canadian economy have also created challenges for domestic businesses – in particular, exposing Canadian industries to heightened competitive pressures in foreign and local markets. Nevertheless, Canadian businesses have adapted quite successfully to these changing market conditions and are well positioned to continue to reap the benefits of expanding trade.

Although discussions about globalization and trade tend to focus on the increased flow of goods and services, the movement of people has been just as crucial for Canada. During the early colonial period, immigration accounted for the bulk of the growth in Canada's population, and while its contribution to population growth lessened in subsequent centuries, immigration flows have always remained strong – and they have made a significant mark on Canada's economy and society. In contrast to the U.S. "melting pot", Canada has promoted a policy of multiculturalism. This approach places an emphasis on diversity and should help Canada to attract more immigrants in the years to come, which could be key for the prospects of the Canadian economy. With Canada's population aging, immigration is once again becoming the driving force behind population growth, and this, in turn, will have a significant effect on Canada's labour market and on consumer preferences for goods and services in the future.

The impact of rising trade and immigration on the Canadian economy has been written about extensively, but the effect on the country's small and medium size enterprises (SMEs) is often overlooked. SMEs are an integral

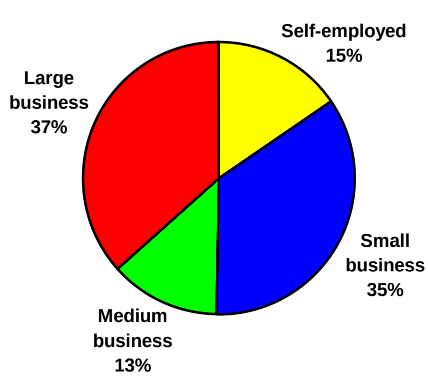
**CONTENTS**

part of the Canadian economic landscape, which means that they cannot insulate themselves from global trends. As a result, it should come as no surprise that SMEs have participated in globalization – but, in some cases, they may not be aware of just how involved they are. For SME exporters and importers, the impact of globalization is clear. However, even businesses selling into local markets are being affected, either through their ties to other trade-oriented Canadian firms or through the competition they face from foreign businesses importing to or operating in Canada. SMEs have been quite successful at changing with the times and many have profited handsomely from globalization. But, there are still opportunities to be exploited. This paper examines some of the ways in which globalization has affected the Canadian economy and assesses the obstacles that SMEs may face in continuing to unlock the potential gains from increased trade in goods and services and the movement of people across international borders.

### Defining small and medium size business

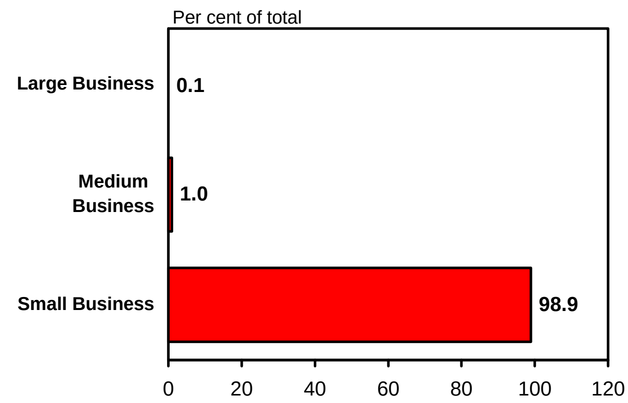
Before delving into any economic analysis, it is important to clarify what is meant by small and medium size enterprises (SMEs). Although one might think that the definition should be straightforward, many organizations, institutions and economists use different parameters to identify small and medium size businesses. For example, Industry Canada uses a definition based on the number of employees. Firms in goods-producing industries are considered to be 'small' if they have fewer than 100 employees; firms in services-producing industries qualify as 'small' if they have fewer than 50 employees; and, firms in both goods- and services-producing industries who are not 'small' but employ 500 individuals or less are deemed to be medium-sized. As for self-employed individuals, the general treatment is to include them in the category of small business, but this is not always the case.

**CANADIAN EMPLOYMENT BY FIRM SIZE**




Note:SB < 100 emp, MB 100-499 emp, LB > 500 emp
Source: Statistics Canada's SEPH and LFS surveys

**DISTRIBUTION OF CANADIAN FIRMS BY SIZE**




Note: SB < 100 emp, MB 100-499 emp, LB 500+ emp
Source: Statistics Canada, Business Register, June 2003
TD Economics

Another common approach is to define SMEs on the basis of revenue. For example, the federal and provincial governments have small business tax rates. The federal rate is applied to firms with incomes of $250,000 or less in 2004, and the income threshold is similar at the provincial level, although there is some variation across jurisdictions.

Complicating matters further, some institutions use varying definitions in different publications. For example Statistics Canada often uses an employee distinction, but at times uses a revenue limit.

Lastly, the Canadian Federation of Independent Business (CFIB) is often viewed as representing the interests of SMEs. While this is a fair assessment, it should be noted that some 'independent' businesses are quite large. The requirement to meet the definition of 'independent' is that the company is not listed on a stock exchange.

The lack of a clear-cut, universal definition of small- and medium-size enterprises limits the comparability of the data that are available. For our purposes, unless otherwise stated, we have defined small firms as those with fewer than 100 employees plus the self employed, and medium firms as those with 100 to 500 workers. Readers are asked to bear with us when the analysis below uses estimates, draws inferences from the limited data available, or at times must use alternative definitions of SME.

### SMEs a key part of the economy

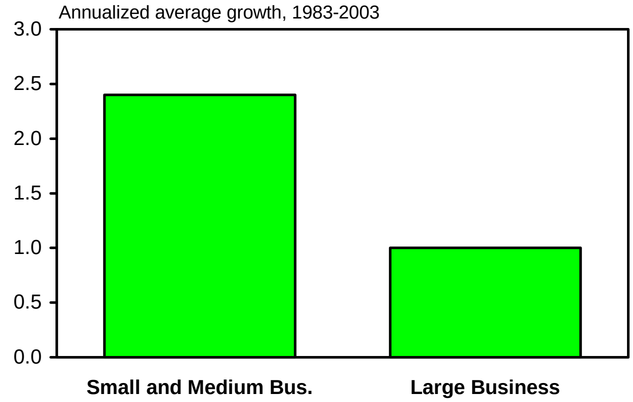
While obtaining a comprehensive picture of the SME sector is problematic, there is no disputing that small and medium size businesses are a critical part of the Canadian economy. Of the more than 2.2 million firms in Canada, only 2,773 companies have a staff of more than 500. Thus, small and medium size businesses together represent more than 99 per cent of all establishments. And, while their share of total employment is significantly less, SMEs are still the dominant employers. Small firms, including the self-employed, account for 50 per cent of all employment (7.9 million), medium firms represent 13 per cent (2.1 million) and large firms make up the remaining 37 per cent (5.8 million). Moreover, in recent years, SMEs have been an engine for employment growth, with job creation running at twice the pace as that of large businesses.

The traditional way of evaluating a sector's importance to the economy is by considering its contribution to overall economic output, as measured by Gross Domestic Product (GDP). Regrettably, only rough estimates exist for the share of output attributable to SMEs. Nevertheless, the CFIB put this share at 45 per cent, which is significantly less than the 63 per cent share of employment, but is still considerable.

Regionally, SMEs are found in every province and territory across Canada. On a per capita basis, Prince Edward Island and the western provinces of Alberta, Saskatchewan and British Columbia have the highest density of small and medium sized establishments. Conversely, Ontario has the lowest share of SMEs relative to population, which reflects the concentration of large firms in the province – particularly in the auto, financial and public sectors. Nevertheless, in absolute terms, Ontario has the largest number of SMEs, representing more than 98 per cent of all businesses in the province.

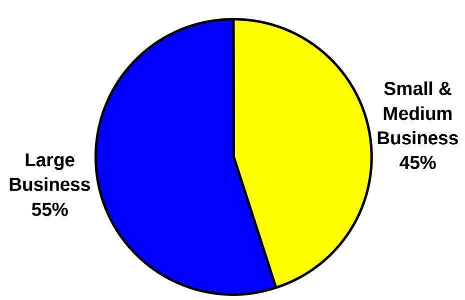
SMEs are also well represented in virtually every goods-producing and services-producing industry. From the perspective of sheer numbers of workers, the two largest SME industry groups are manufacturing and retail trade. The most SME-intensive industries are construction, accommodation and food services, real estate, professional services and wholesale trade, with SMEs accounting for over 70 per cent of all jobs in each of these industries.

**JOB GROWTH BY FIRM SIZE**



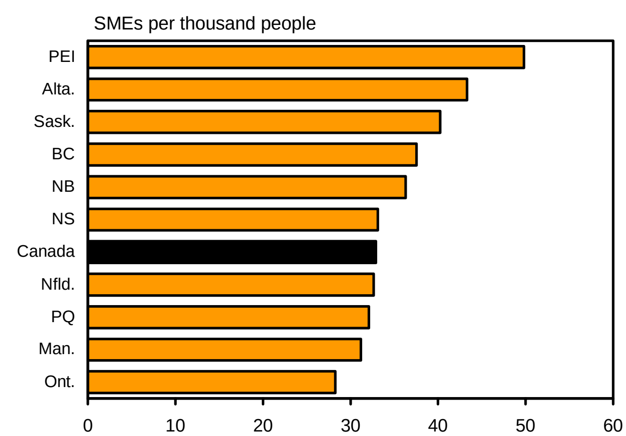

Note: S&MB < 500 emp., LB >=500 emp.
Source: Bank of Montreal

**CANADIAN GDP SHARE BY FIRM SIZE: 2003**




S&MB < 500 emp.
Source: Canadian Federation of Independent Business

**SMALL AND MEDIUM-SIZED FIRMS PER CAPITA: 2002**




Source: Statistics Canada, TD Economics

The fastest growing SME-intensive industries in recent years have been construction, mining & oil and gas, administration, and arts & entertainment. But, in terms of the number of jobs created, construction, retail sales and administration have led the way. The proliferation of SMEs across Canada's provinces and industries means that their performance is affected by the same factors influencing the broader economy, such as globalization.

### Globalization has shaped Canada's economy

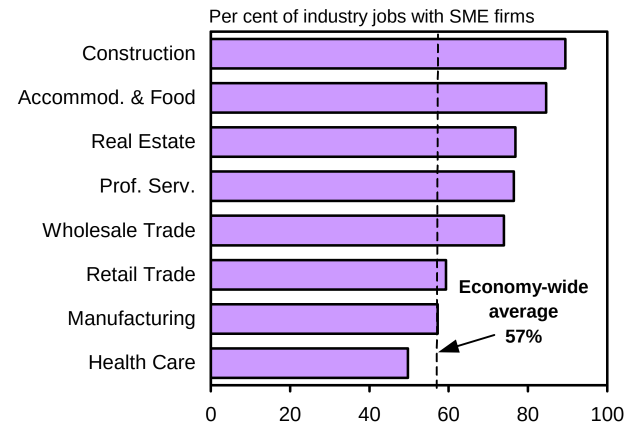
The spread of globalization in recent years has seen Canada become even more plugged into the world economy. The effects are visible in the increased free flow of goods, services, capital, and workers across international borders.

### Exports and imports have grown rapidly

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. As a result of this explosive growth, the size of Canada's trade sector as a share of the economy has increased even faster than the global average, with world trade having risen from 20 per cent of world GDP to about 26 per cent over the same period.

Some argue that trade is not becoming more global, but rather more regionalized, as geographically proximate countries increase trade with each other at the expense of more distant nations. At first glance, Canada's export performance would seem to back up this assertion. Fully 85

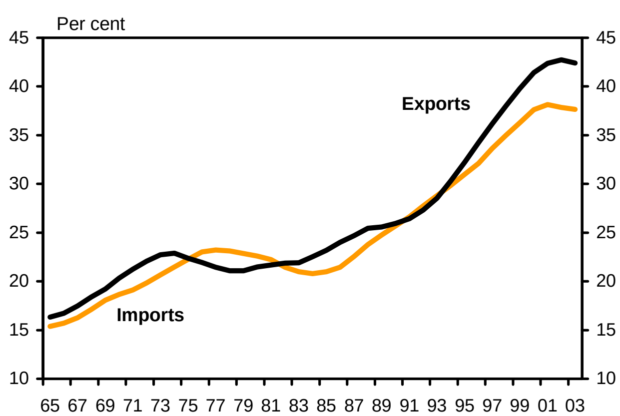
**SME CONCENTRATED INDUSTRIES**




Note: SME <500 emp. excluding self employed
Source: Statistics Canada, TD Economics

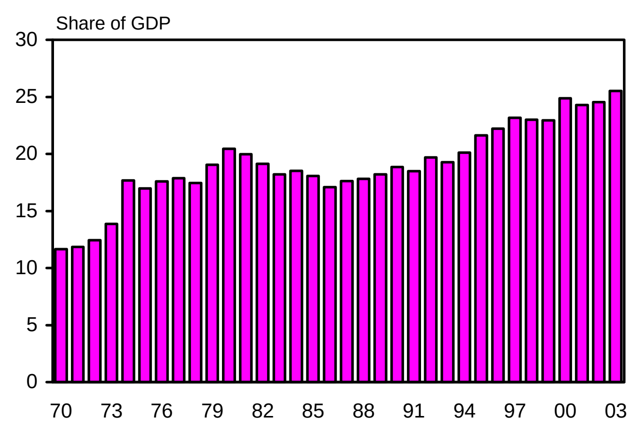
per cent of Canadian exports of goods and services are destined for the United States. This reliance on the U.S. has been rising over time and has increased by approximately 10 percentage points over the last decade alone. Not that this southern orientation should be surprising – the two countries share a border, and the U.S. is the world's largest economy. Moreover, the two countries are more than territorial neighbours – Canada and the United States have a common language, similar cultures, highly educated workforces, democratic political systems, and open financial markets. And, over the course of their long history of trade, substantial infrastructure has been developed to facilitate the north-south movement of goods and services between the two nations. Canada is an important market for U.S. exports and imports, although U.S. trade is

**REAL EXPORTS AND IMPORTS AS A SHARE OF CANADIAN GDP**




Source: Statistics Canada, TD Economics

**TRADE AS A SHARE OF WORLD GDP**



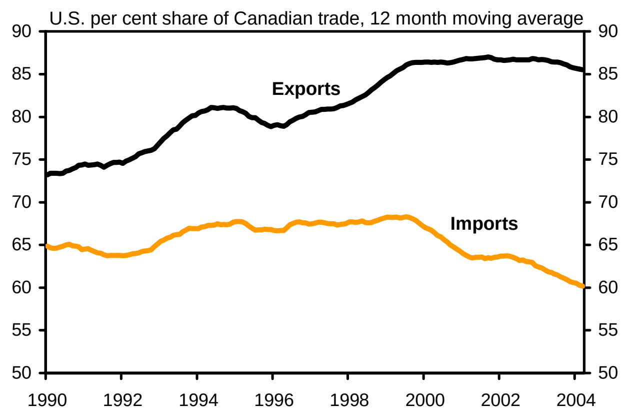

Source: International Monetary Fund (IMF) much more diversified around the globe than Canada's.

Nevertheless, Canada's undeniably strong trade ties with the United States should not obscure the fact that Canada has also been expanding trade with the rest of the world. Exports from Canada to the rest of the world rose by an average annual pace of 3.5 per cent over the last decade, about half the 7.1 per cent annual growth in exports to the United States. Over the past ten years, this has amounted to a cumulative increase of 42 per cent and 100 per cent, respectively.

The data on the import side of the ledger tell an even clearer story of globalization. While Canadian imports from the U.S. have risen at an average annual rate of 4.5 per cent over the last decade, imports from the rest of the world have soared by 7.9 per cent on average each year. Thus, over the last ten years, imports from the U.S. rose by a cumulative 60 per cent, trailing the 110 per cent increase in imports from the rest of the world. As a result, the share of Canadian imports that come from the U.S. has fallen to 61 per cent from 68 per cent a decade ago.

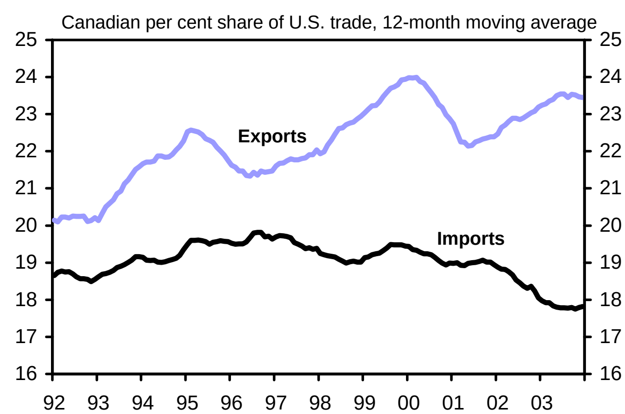
The decline in U.S. imports as a share of total Canadian imports might seem curious, but it has a very logical explanation. Many developing economies around the globe have experienced dramatic export growth. China is a case in point, with economic growth running at an average of 14.6 per cent and exports rising at an average annual pace of 16.9 per cent over the last decade. So, while Canadian merchandise exports to China have grown at a solid average annual 7.4 per cent pace since the early 1990s, Canadian merchandise imports from China have surged by a

CANADIAN EXPORTS AND IMPORTS WITH U.S.



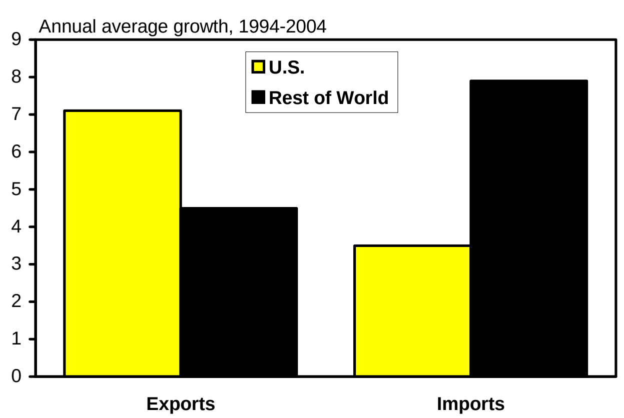

Last month plotted: March 2004
Source: Statistics Canada, TD Economics

U.S. EXPORTS AND IMPORTS WITH CANADA



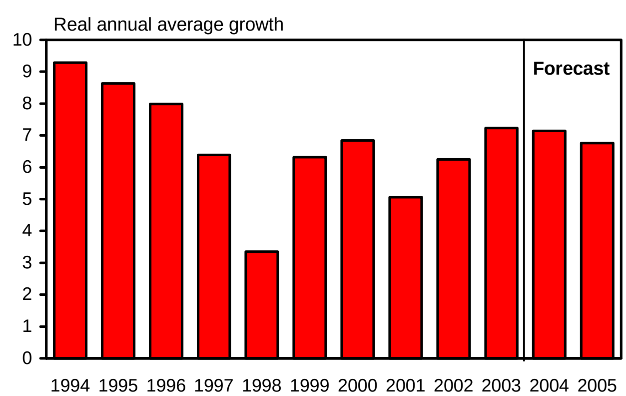

Source: U.S. Bureau of the Census

CANADA: INTERNATIONALTRADE




Source: Statistics Canada

NON-JAPAN ASIA GDP GROWTH




Forecast by TD Economics as at June 2004
Source: IMF, International Statistical Agencies

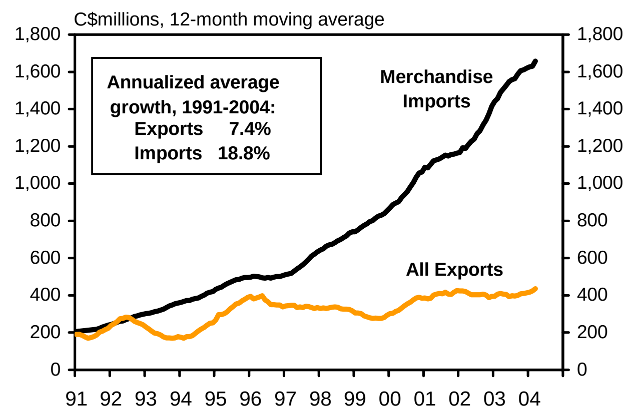
whopping 18.8 per cent per year on average. Canada's trade with other Asian nations, while not exhibiting quite such rapid growth, has also expanded briskly, with Canada now importing more than twice as much from Asia as it exports to the region.

**Trade in goods remains dominant, but services increasingly being shipped abroad**

Trade in services is much smaller than trade in goods. Despite the fact that the service sector accounts for a massive 69 per cent of Canadian GDP, services only make up a quarter of all Canadian exports and roughly one-sixth of Canadian imports. The simple reason for this is that many services are virtually impossible to export or import. As an extreme example, considering trying to export a haircut to another country. Nevertheless, Canada's goods and services sectors saw exports increase at a similar pace over the 1993-2001 period, with both recording growth of 9.6 per cent per year on average. More importantly, the high-value subset of the service sector experienced somewhat stronger export growth, averaging 10.3 per cent annually. These high-value services are produced by industries such as information and culture (which includes many high-tech information technology firms), finance and insurance, and business services. Growth in these industries is a tribute to the rapid rate of technology change in Canada, as well as the country's increasingly skilled labour force.

While global trade may be dominated by the shipment of goods rather than services, trade in goods has an impact on service-oriented industries like retail trade. While retail firms are in the business of providing a service, the physical products they sell to customers are actually goods, many of which are imported. This means that this service industry's bottom line is subject to the worldwide availability and price of goods. The same is true for the wholesale trade and the food services industries, to name just a few other sectors.

**CANADIAN TRADE WITH CHINA**

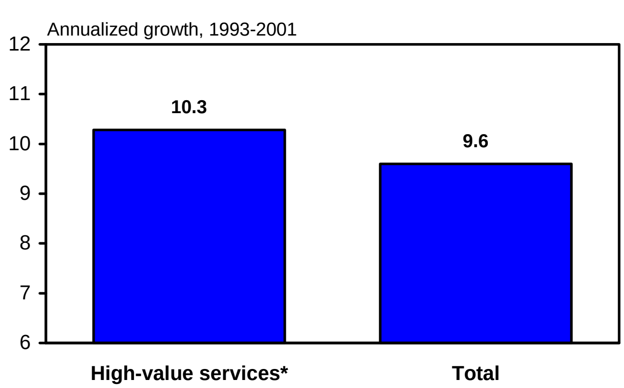



Last month plotted: March 2004
Source: Statistics Canada

**Virtually all industries engage in trade to some degree**

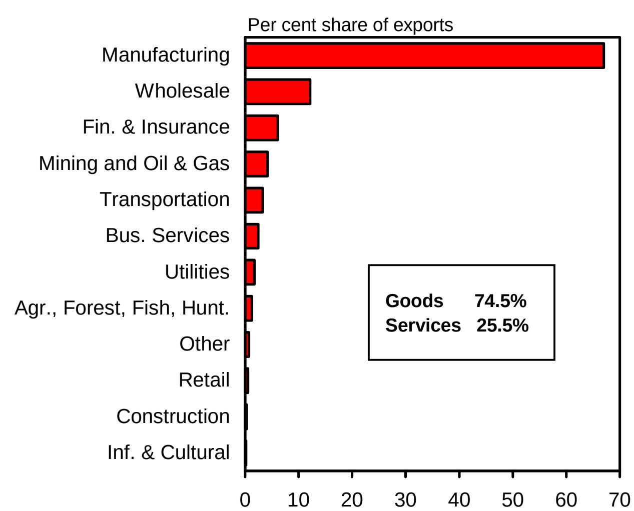
From a sectoral perspective, Canada's biggest exporter is the goods-producing manufacturing industry, which is responsible for 60 per cent of all exports and 80 per cent of all goods shipped abroad. However, this should not

**NOMINAL DOMESTIC EXPORTS**

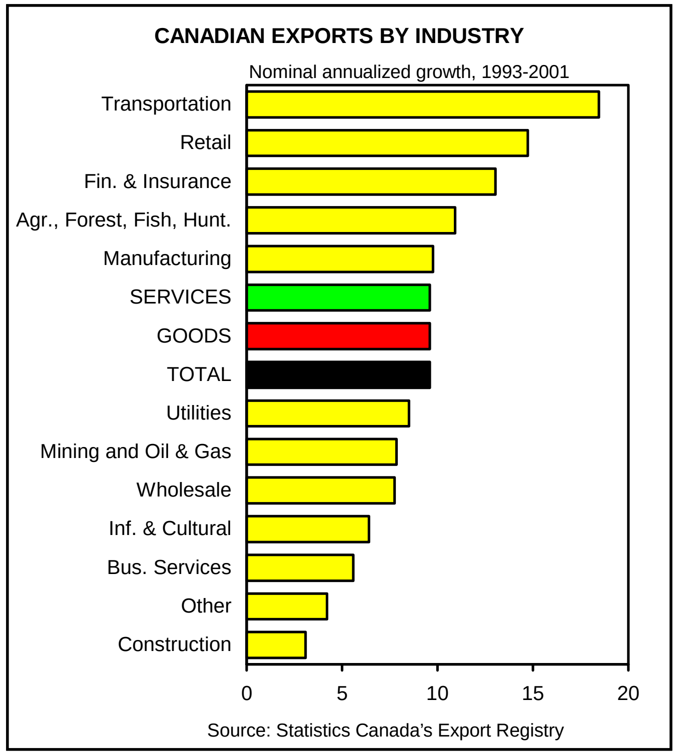



*High-value services: Information & Cultural, Finance & Insurance, and Business Services
Source: Statistics Canada, TD Economics

**CANADIAN EXPORTS BY INDUSTRY: 2001**



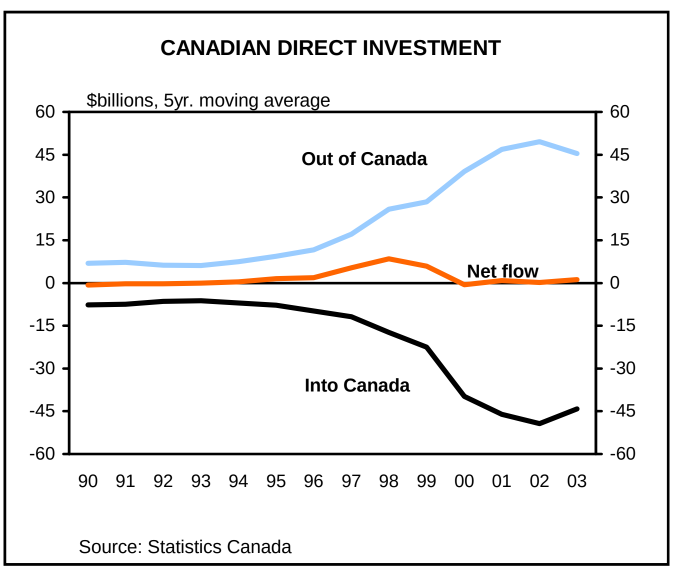

Source: Statistics Canada's Export Registry, TD Economics minimize the importance of Canada's service exports, the bulk of which come from wholesale trade, finance & insurance, transportation, and business services. The service sector also shines brightly when one examines the export performance of individual industries. Transportation, retail trade, and finance and insurance were the fastest growing export industries between 1993 and 2001, turning in average annual growth rates of 19 per cent, 15 per cent and 13 per cent, respectively.

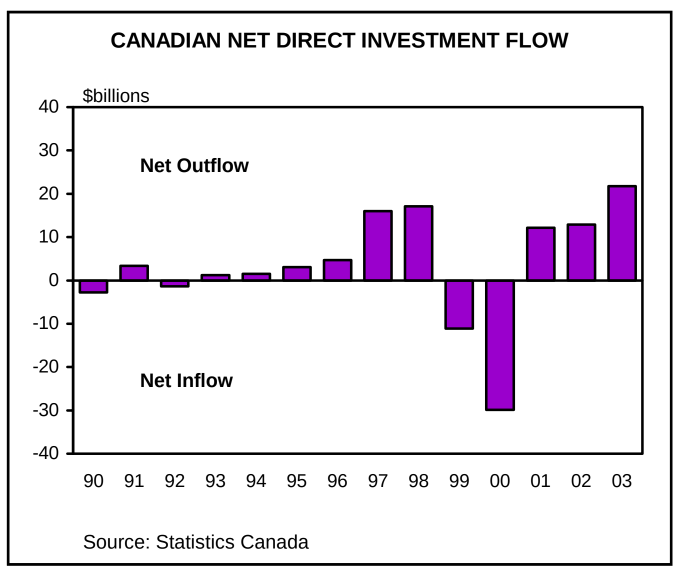



## Globalization leads to increased international capital flows

Globalization has also transformed capital markets. Foreign direct investment and portfolio investment have grown substantially over the years, as financial markets have become more open and as firms and individuals have broadened their investment horizons. Recently, Canada has become a net lender to the rest of the world through direct and portfolio investment, meaning that more Canadian funds are being sent abroad than foreign funds are coming to Canada, which is a natural offshoot of Canada's international trade and current account surpluses.

Direct investment abroad can involve either buying a foreign firm or setting up operations for an existing domestic firm in a foreign country. Canadian foreign direct investment has increased at an average annual rate of 24 per cent since 1990, raising it from close to 1 per cent of GDP to more than 4 per cent today. Over that same period, foreign direct investment into Canada has expanded annually by 21 per cent. As a result, Canada is presently running a substantial direct investment surplus of $21 billion. As with Canada's exports, the U.S. is the major destination for Canadian direct investment, but its share has declined over time from almost 70 per cent of the total in the late 1980s to an average of 43 per cent over the last five years. A similar decline has occurred with Great Britain. In contrast, the share of Canadian direct investment with the rest of Europe and developing nations around the world has increased. Direct investment into Canada continues to come primarily from the United States, which has accounted for two-thirds of the inflow in recent years.



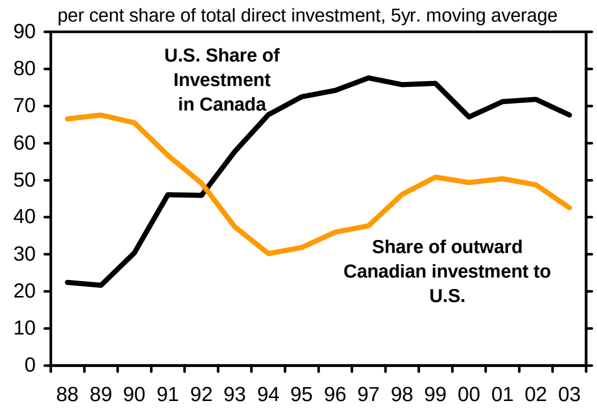



International capital also flows through portfolio investment. This involves the purchase of foreign assets without direct control over ownership – for example, buying foreign equities or foreign bonds. Like foreign direct investment, foreign portfolio investment has surged in popularity. After forty years during which foreigners bought more Canadian portfolio assets than Canadians purchased abroad, the tide turned in 1996 and Canada has been, on average, in a surplus position ever since. Indeed, on average, Canadian purchases of foreign portfolio assets have exceeded foreign purchases of Canadian portfolio assets to the tune of more than $7 billion annually. The rising popularity of foreign investment can be partly attributed to an increase in RRSP limits on foreign asset holdings, but the bulk of the growth in foreign portfolio investment likely reflects the activity of large-scale institutional investors. Increased portfolio investment abroad is also indicative of a growing appreciation of the importance of diversification. With Canada representing only 2-3 per cent of the world's capital market, there is clearly an incentive to have significant investment exposure to foreign assets.

**International movement of workers**

Historically, immigration has been an invaluable source of highly educated individuals who add value to Canadian industries, and this continues to be an important driver of the Canadian economy. The overall rate of immigration has ebbed and flowed over the years, in response to changes in foreign supply and local demand for labour, as well as in reaction to changes in government policy. In recent years, immigration (foreigners moving to Canada) has averaged over 200,000 people per year, whereas emigration (Canadians moving abroad) has averaged around 50,000.

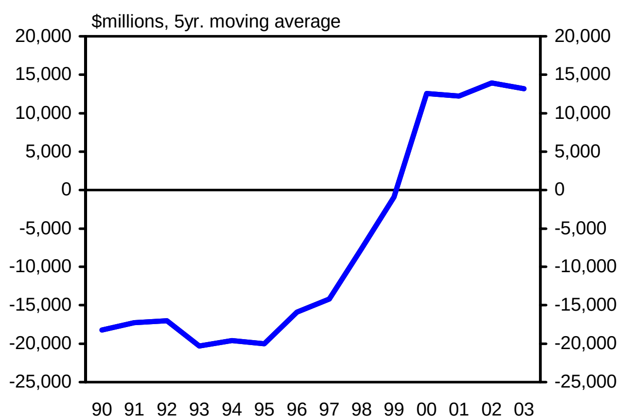
CANADA - U.S. DIRECT INVESTMENT




Source: Statistics Canada

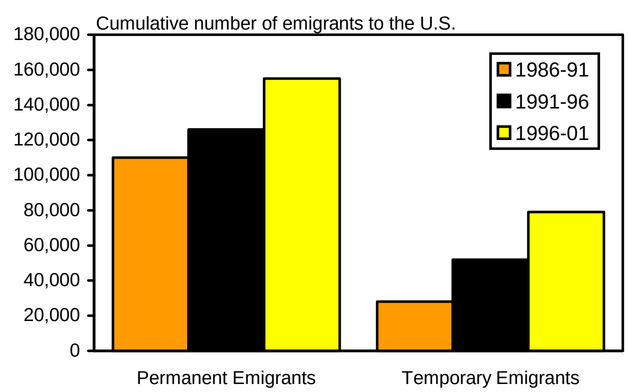
Although emigration flows are only a quarter of the size of immigration flows, they have attracted considerable attention in light of recent concerns about the "brain drain" to the United States. There is no question that emigration to the U.S. increased substantially over the 1990s, by 41 per cent for permanent emigrants, and by 182 per cent for temporary emigrants, with many of the latter taking advantage of the one-year work permit created as part of NAFTA. Moreover, while the absolute number of emigrants pales in comparison to the number of immigrants, emigrants are disproportionately the cream of the crop from a skill perspective. This attests to the increased globaliza-

CANADIAN NET PORTFOLIO INVESTMENT FLOW




Source: Statistics Canada

TEMPORARY EMIGRANTS HAS ALMOST TRIPLED

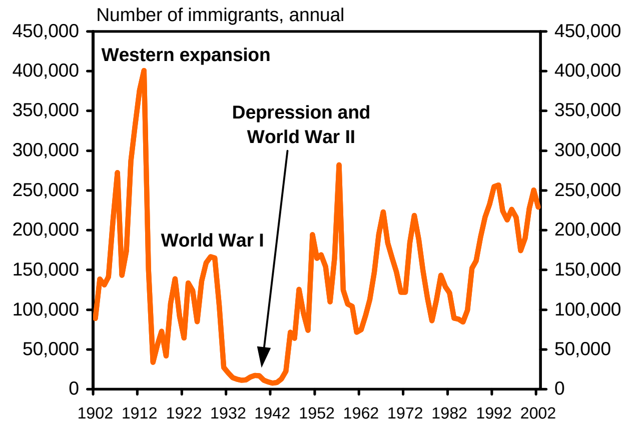



Source: Statistics Canada, (Zhao, Drew, Murray, "Education Quarterly Review" (2000, vol. 6 #3 page 12)); TD Economics tion of labour markets and wages – Canadian firms are increasingly finding that they cannot pay substantially less than American firms and expect to retain their workforce.

The globalization of labour markets has also been in the spotlight due to concerns about the international outsourcing of jobs from the U.S. over the last couple of years. As global competitive pressures intensify, some companies have sought out cost savings and higher profit margins by shifting payrolls to countries with less expensive labour. This is not unambiguously good or bad, as it depends on one's perspective. Certainly, for the workers who lose their jobs, this is not a positive development, but for consumers a benefit is derived from cheaper goods and services. And, the company involved usually reaps higher profits, which is good news for investors.

In fact, the trend toward outsourcing has existed for many decades. However, in the past it has been largely restricted to the manufacturing sector, whereas technological innovation has now made it possible to transfer a variety of white collar jobs, particularly in software and call-centre positions to developing nations, like India and China. At present, the total number of jobs that have been lost to outsourcing from the U.S. is relatively small. Indeed, in recent years America has lost an average of 3 to 4 million jobs each quarter, but created more than that number, revealing that there is considerable churn in the labour market. In contrast, the total number of U.S. service jobs expected to have been outsourced by the end of 2005 is 830,000 positions, a small percentage of even a single quarter's job losses. Regrettably, it is difficult to quantify the offsetting benefit that is derived by cheaper products

**IMMIGRANT FLOW INTO CANADA**




Source: Citizenship and Immigration Canada, Statistics Canada

and higher corporate profits, thus rendering the net overall effect upon the economy unclear.

In Canada, the issue is muddied further by the fact that Canada has been a net recipient of U.S. outsourcing for many years. And, with Canada's employment rate running at close to a record level, the transfer of some jobs overseas has not been a major issue. Nevertheless, the spotlight that has been put on outsourcing in the U.S. has increased corporate awareness of the advantages and possibilities of moving some activities overseas. Accordingly, outsourcing in Canada is likely to increase somewhat over the coming years, with both manufacturing and services participating in the trend. However, so long as domestic job creation remains healthy, the issue is unlikely to draw considerable attention. Nevertheless, increased outsourcing implies more intense cost competition, suggesting that Canadian firms will have to continue moving up the value added production chain, investing in new technologies, and hiring more skilled workers – themes we will return to later in the report.

**OUTSOURCING IN CANADA**

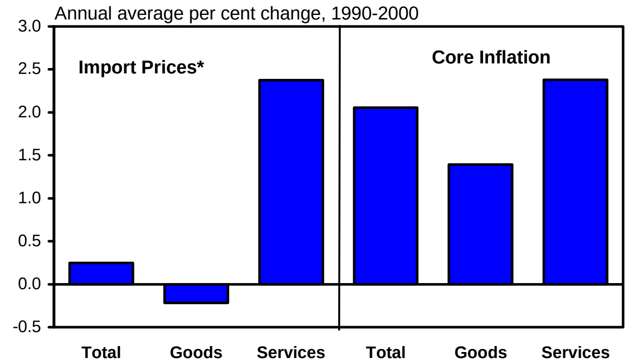
- Canada has benefited greatly from the outsourcing of U.S. jobs
- Canada will lose jobs to overseas producers in the years ahead
- SMEs will have to cope:
  - by moving up the value added production chain
  - by hiring a more skilled workforce
  - by investing in more capital

### Globalization impacts prices

The increased international flows of goods, services, capital and labour unleashed by globalization also affect prices. In practice, this means that a change in demand or supply for a product in one country has ramifications around the globe. A prime example is the surge in steel prices that has occurred this year. An investment boom in China created significant additional demand for steel and for the raw materials required to manufacture steel. Consequently, in the first quarter of 2004, global steel prices soared to 50 per cent above year-earlier levels. This price spike has created challenges for businesses around the world that are major consumers of steel. Another illustration, this time on the supply side, is the rapid expansion of semi-conductor manufacturing plants in Asia during the late 1990s, which contributed to a dramatic decline in prices for these products.

International competition can also influence prices. This is evident from the past trends in Canadian import prices and consumer prices. Over the 1990s, prices for imported goods, excluding the impact from changes in the Canadian dollar fell at an average annual rate of 0.2 per cent, while prices for imported services rose 2.4 per cent. Meanwhile, the average annual rate of core inflation in Canada for consumer goods was just 1.4 per cent, while the core rate of inflation for consumer services was a higher 2.4 per cent. In both cases, it seems likely that part of the differential between goods and services inflation can be explained by the relative ease with which goods are traded as compared to services, which are subject to significantly less foreign competition. However, many other factors also influence prices, so this 1 percentage point difference between goods and services core consumer inflation cannot be attributed solely to globalization. The faster increase in prices for services also relates to rising demand for social services like health care and education. Furthermore, goods industries tend to be more capital intensive and are, therefore, better able to capture productivity gains, which in competitive markets tend to be partially passed along to consumers and result in slower price increases.

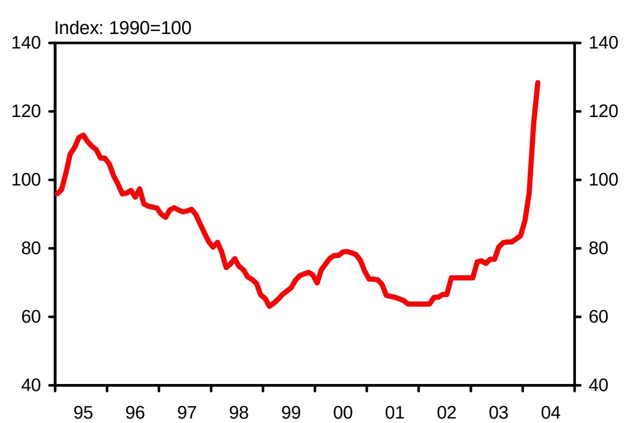
CANADIAN INFLATION




*Excluding effect of exchange rate changes based on C-6 exchange rate
Source: Statistics Canada, TD Economics

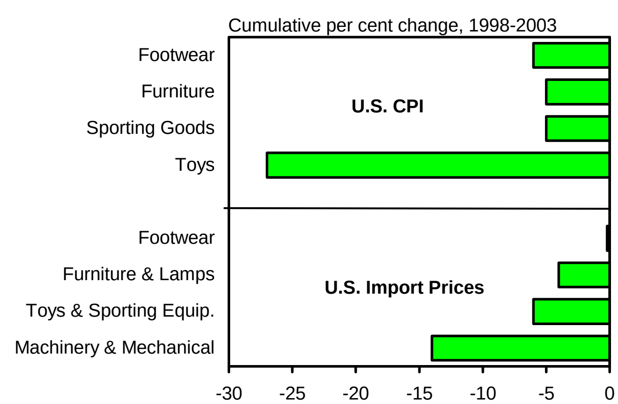
Still, there is no disputing that international competition has helped to temper goods prices. Consider the past performance of prices in the United States for goods that are primarily imported from China. Shipments from China account for close to two-thirds of all imports of toys and sporting goods, footwear, and leather and travel goods in the United States. They also represent close to one-quarter of all imports of machinery and appliances, and furniture and lamps. Since 1998, the import prices for all of these products have fallen. Specifically, prices declined by 14 per cent between 1998 and 2003 for machinery and mechanical appliances, by 6 per cent for toys and sporting equipment, and by 4 per cent for furniture and lamps – and these price declines were to some extent passed along to U.S. consumers. For example, the details of the U.S.

WORLD BANK'S STEEL PRICE INDEX




Last plotted: April 2004; Source: World Bank

PRICES IN THE U.S. FOR PRODUCTS CHINA EXPORTS



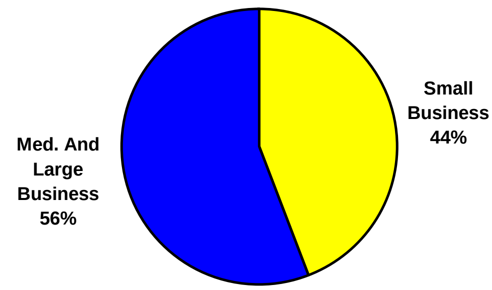

Source: U.S. Department of Labor

consumer price index show that prices for toys dropped by 27 per cent from 1998 to 2003, while footwear prices fell by almost 7 per cent and sporting goods and furniture prices dipped by more than 5 per cent.

Many companies may not be aware of the extent to which they are indirectly affected by prices set in global markets. Consider the purchase of a domestically-assembled cash register bought for use in a corner store. On the face of it, global markets would seem to have little to do with this transaction, but the price of the cash register is actually affected by a myriad of world prices. These include the world price for the base metals used in the manufacture of the shell of the register, the international cost of various electronic components for it, and the cost of the energy (which is set in global markets) needed to transport the cash register from factory to store. Moreover, the domestic labour costs associated with assembling the cash register are affected by wages in other countries. And, in the end, if the domestically-produced cash register has too high a price tag, the potential purchaser may opt to buy the item from a foreign cash register manufacturer.

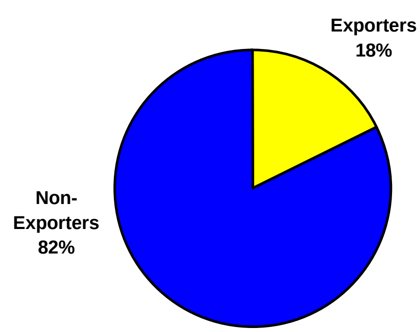
The main message is that all firms are affected to some degree by the increasing integration of the world economy. In some cases, the impact is obvious. In other cases, it is less visible. But, there is no question that globalization – through the increased flow of goods and services, and the movement of capital and labour – has shaped the Canadian economy and influenced the prices that Canadians pay and receive.

**SMALL BUSINESS SHARE OF EXPORTS: 2001**




SB < 100 emp.; Export values restricted to firms with annual exports >$30,000 at least once between 1993 and 2001
Source: Statistics Canada's Business Registry

**SME EXPORT ORIENTATION: 1999**




SME < 500 emp.
Source: Canadian Federation of Independent Business

### SMEs benefit from thinking globally

With SMEs found in every industry, it should not be surprising that many small and medium-sized businesses have taken advantage of the opportunities presented by globalization, 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.

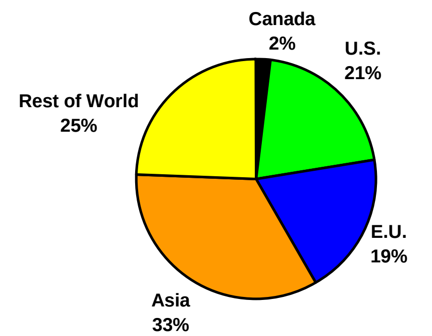
However, the data also suggest that larger businesses have been more inclined to engage in trade. For example, the 50 largest exporters in Canada accounted for 46 per cent of all merchandise exports in 2002. And, according to the CFIB, while a majority of Canada's exporters are SMEs, only a small share of SMEs are exporters – just 18 per cent of the total. Similarly, Statistics Canada data reveal that only 41,270 establishments in 2001 reported that they had annual sales of goods and services to foreigners of $30,000 or more in any single year since 1993. This implies that a mere 2 per cent of all Canadian firms, including the self employed, generate significant revenues from exports. (The difference in the percentages found in the CFIB and Statistics Canada is explained by the fact that for many SMEs, which have shipped goods or services abroad, the dollar value of the exports is quite small.) Lastly, the Statistics Canada data also show that just with respect to small business, only 1.5 per cent of small business exporters were responsible for 75 per cent of all small business exports. So, it is evident that only a handful of establishments dominate the exports done by small businesses.

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.

Given these observations, it is worth spending a moment stressing the potential gains to be had from thinking globally. It is important for businesses 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. In 2002, the economy of the United States was 11 times larger than that of Canada and its population was 9 times bigger. In the same year, the Euro-zone's economy and population were 10 times greater, while Japan's economy was 3.5 times the size of Canada's.

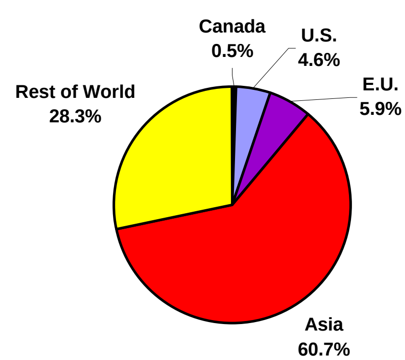
Moreover, the Canadian market is growing at a slower pace than some other regions. Over the last decade, Canadian economic growth has trailed slightly behind the pace of expansion in the world economy. At the same time, Canada's population growth has been running almost one-third slower than that in the rest of the world. And, this trend is likely to continue. 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 below the 0.8-per-cent growth anticipated in the United States. This will have an impact on Canada's relative economic performance. Economic growth requires higher labour productivity or a larger labour force. Even if increased business investment translates into somewhat stronger productivity growth in the coming years, the impact of slower labour force growth could see Canada's long-term potential economic growth rate 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. The main conclusion from this is that businesses will find it increasingly difficult to look to their local markets for growth, but instead need to think about how to access the larger and faster growing markets abroad.

**WORLD GDP SHARES: 2004**



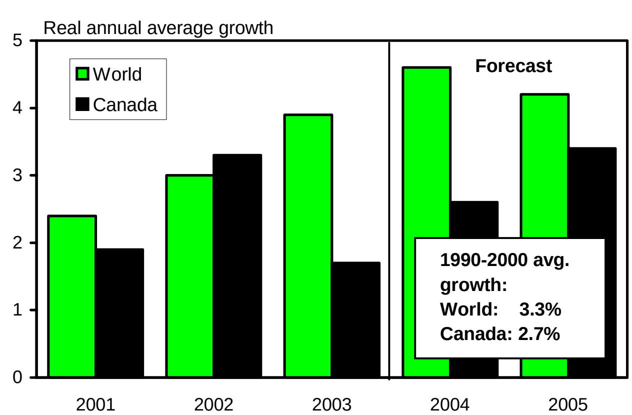

Source: International Monetary Fund

**WORLD POPULATION SHARES: 2005***




* Forecast by the United Nations
Source: United Nations, Eurostat

**CANADA VS. WORLD GDP**




Forecast by TD Economics as of April 2004
Source: Statistics Canada, IMF, International Statistical Agencies, TD Economics

#### Obstacles to exporting/importing can be overcome

While there are opportunities to be had from engaging in trade, SMEs are often unwilling to expand their horizons because of the perceived risks and obstacles. Among the factors that firms cite as deterrents to exporting are:

1. The firm's products or services are not easily exportable
2. The firm is satisfied with its current market
3. The firm doesn't have the expertise, resources, contacts or information to succeed in international markets
4. The firm lacks the necessary financing to enter foreign markets

While these explanations may be valid for selected firms, in many cases the perceived obstacles loom larger in perception that reality. Let's discuss why.

#### 1. Products or services not exportable

Today, 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. This implies that businesses that limit their focus to local markets may be choosing to ignore prospects for growth.

#### 3. Lack of resources

In terms of the required expertise, resources, contacts and information, these can all be obtained with time and effort. There are many institutions that provide help on this front. Export Development Canada (EDC), the Department of Foreign Affairs and International Trade, and the Institute of International Finance (IIF) – to name just a few organizations – all have relevant information and can help demystify various international trade issues. The internet also provides a wealth of information (albeit too much, at times), including how to get in touch with other people around the globe who can answer trade-related questions. For example, many foreign governments have trade-related materials on their web sites as part of an effort to attract business from foreign companies. Then, there are the conferences and symposiums held each year in Canada to promote trade. In fact, the following lists only a small portion of the resources available to potential exporters/importers:

- Team Canada Inc.
- Canadian Trade Commission Service – in Canada
- Canadian Trade Commission Service – abroad
- Team Canada
- Program for Export Market Development (PEMD)
- Canadian Agri-Food Trade Services
- International Trade Centres
- Export Source
- Export Development Corporation (EDC)
- Business Development Bank of Canada (BDC)
- Canadian Commercial Corporation (CCC)
- Ontario Exports Inc.
- Canadian Manufacturers & Exporters

#### 4. Lack of financing

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

#### Challenges to exporting

It is interesting to note that once SMEs are engaged in international trade, they tend to identify other challenges.

1. Duties, tariffs and non-tariff barriers
2. Shipping and other costs
3. Exchange rate uncertainty
4. Difficult customs processes
5. Language barriers and cultural differences
6. Competition from other businesses

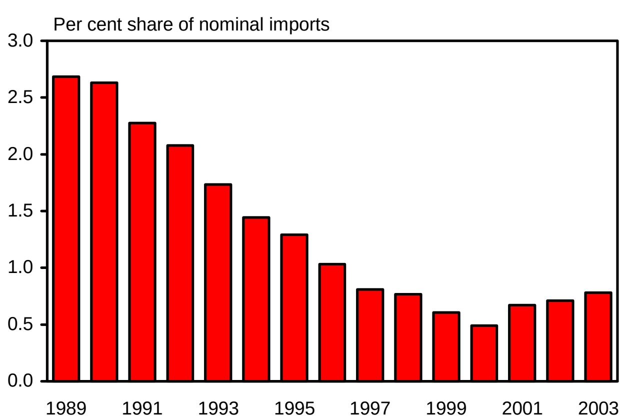
Since these issues might be also deterring some SMEs from engaging in trade or may be constraining the amount of trade being conducted, let's discuss each in turn.

### 1. Duties, tariffs and non-tariff barriers

Duties, tariffs and non-tariff barriers may have been significant obstacles in the past, but they have been declining over time. Various rounds of global trade talks through the General Agreement on Tariffs and Trade (GATT), and later, through the World Trade Organization have succeeded in reducing many barriers to trade. To illustrate, there has been more than a 50 per cent decline in the tariffs being levied by developed and developing countries since 1980.

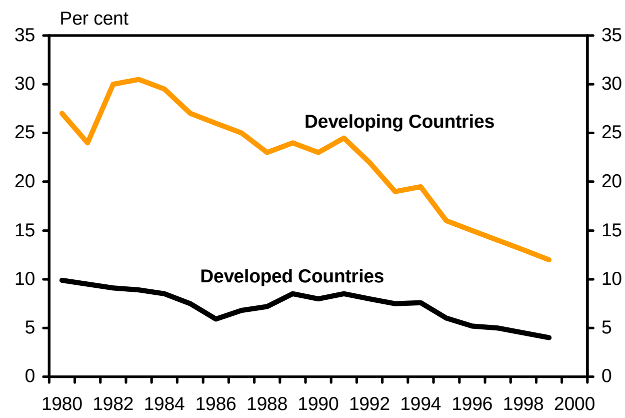
And, in addition to these multilateral initiatives, bilateral trade agreements between Canada and other countries have further reduced duties, tariffs and non-tariff barriers. Canada now has free trade agreements with Chile, Costa Rica, Israel, the United States and Mexico, and negotiations are underway to expand free trade to include the Americas (a collection of 34 democratic governments in North, Central and South America), the Central America 4 (El Salvador, Guatemala, Honduras and Nicaragua), the European Free Trade Association (Iceland, Norway, Switzerland and Liechtenstein) and Singapore. Canada was also a founding member of APEC (Asia-Pacific Economic Cooperation), an organization to promote economic and social development in the Asian-Pacific region, and the Government of Canada has an 'action plan' for Japan and South Asia (India, Sri Lanka, Bangladesh, Pakistan and Nepal). The plan targets sectors in those countries that offer the most promising opportunities for Canadian exporters, and commits enhanced levels of service to those sectors. So, while multilateral talks and various regional free trade agreements have grabbed the spotlight in the past, bilateral negotiations of a more modest nature have also played an important part in reducing the obstacles to trade.

**CANADIAN TARIFFS**




Note: Compositional changes explain illusion of recent higher levels
Source: Statistics Canada, TD Economics

**AVERAGE TARIFF RATES 1980-99**




Note: Tariff rates are based on the unweighted averages for all goods
Source: World Bank

This is not to say that trade disputes are a thing of the past. International trade practices in the areas of agriculture and other commodities, such as softwood lumber, remain a source of political friction. Nevertheless, there is a general recognition by virtually all governments that open borders and the free flow of goods and services is desirable, as it raises living standards in all of the countries involved. As trade shifts the allocation of resources (both capital and labour) from one set of industries to another, governments can periodically find themselves under pressure to protect certain domestic industries, at least temporarily, to facilitate the adjustment process. But, make no mistake, WTO and bilateral trade talks will continue to boost global and regional trade in the years to come.

### 2. Shipping costs

Shipping costs will always be an issue for exporters and importers. However, technological progress has been reducing the burden of these outlays, thereby helping to spur international trade. Since 1980, the real (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. So, while firms need to consider the cost of shipping when pricing their products or services, they also need to be aware that shipping costs are diminishing over time.

Accordingly, items that are currently prohibitively expensive to ship may become profitable in the future, and businesses that recognize this shift will benefit handsomely from being the first to market.

### 3. Exchange rate uncertainty

A variety of financial instruments are available to manage exchange rate risk. Hedging contracts (using instruments such as 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. But, 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.

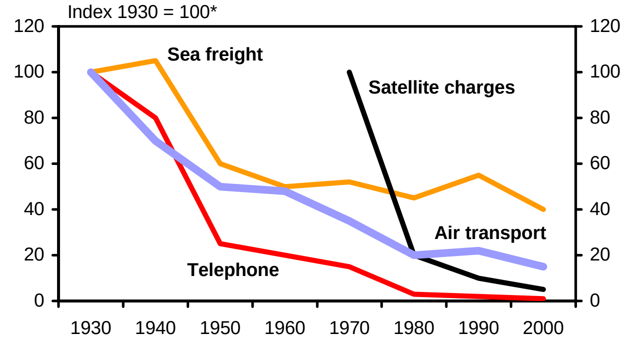
For Canadian SMEs, the last two years have been a case study in the virtues of hedging. The Canadian dollar soared from 63 U.S. cents in early 2003, to above 78 U.S. cents in early 2004, before pulling back recently. This volatility is likely to persist, though not to the same degree, as conflicting forces buffet the Canadian dollar. With the U.S. Federal Reserve expected to begin raising rates in June 2004 and with the Bank of Canada likely to stay on hold until September 2004, the Canadian dollar will face headwinds from declining Canada-U.S. interest rate

**APPROACHES TO AN ANCHOR FOR THE DOLLAR**

| | |
|---|---|
| Market View | No anchor |
| Productivity Gap: Canada/U.S. | 0.80-0.89 |
| Total Labour Compensation Gap: Canada/U.S. | 0.84 |
| Purchasing Power Parity (PPP) | |
| Statistics Canada | 0.83-0.85 |
| OECD | 0.84 |
| IMF | 0.845 |
| Fundamental Equilibrium Exchange Rate (FEER)* | 0.68-0.72 |
| Bank of Canada Equation | 0.72 |
| Big Mac PPP (*The Economist*) | 0.85 |
| Latté PPP (*The Economist*) | 0.82 |

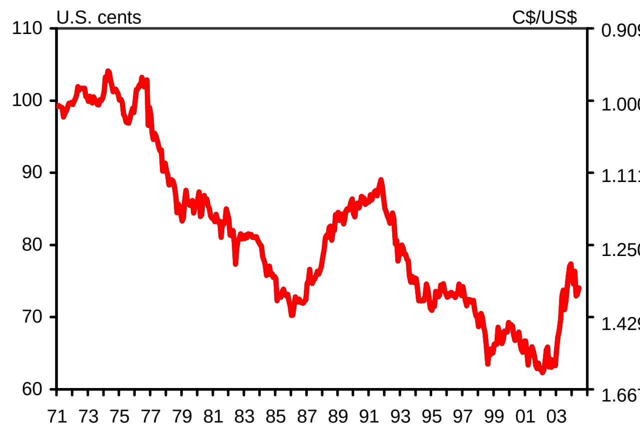
* As estimated by the C.D. Howe Institute in 1995.
It would undoubtedly be higher now.

**REALTRANSPORTATION AND COMMUNICATION COSTS: 1930-2000**



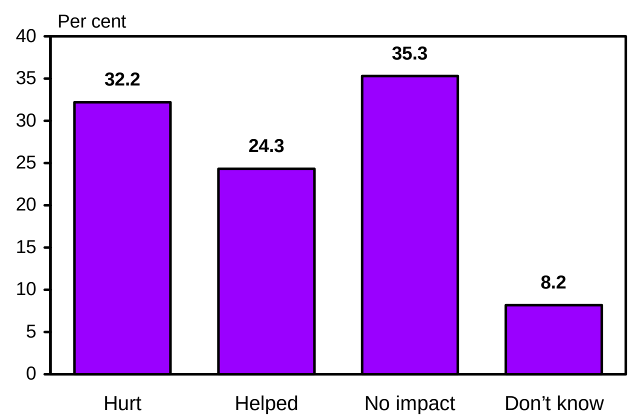

* Satellite Charges are 1980 = 100, Sea freight is average ocean freight and port charges per ton of import and export cargo; air transport is revenue per passenger mile, telephone is the cost of a three minute telephone call from New York to London
Source: Hamburg Institute of International Economics

**CANADIAN DOLLAR**




Most recent data: month to June 7, 2004; Source: Bank of Canada

**IMPACT OF THE HIGHER CANADIAN DOLLAR ON SMALL AND MEDIUM FIRMS**

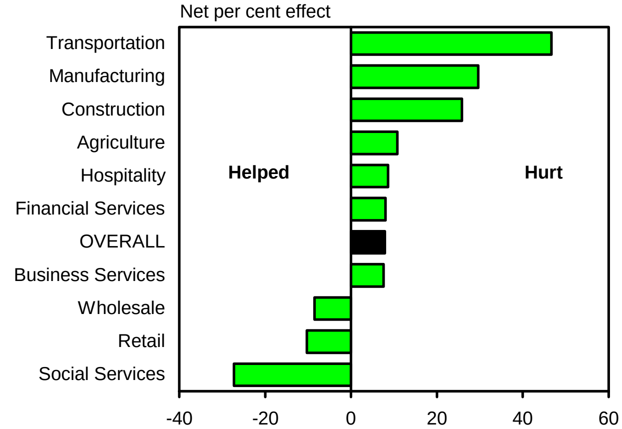



Source: Canadian Federation of Independent Business, Dec 2003 spreads. However, much of this relative shift in rates is already priced into currency markets. Meanwhile, commodity prices, which generally move in tandem with the Canadian dollar, are likely to only post modest gains from current levels. However, the massive and unsustainable U.S. current account deficit will eventually create renewed downward pressure on the U.S. dollar, from which the Canadian dollar is again likely to be a beneficiary, as it was last year. As a result, our base case scenario is for the Canadian dollar to tread water in the near term, before rallying to 78 U.S. cents by the end of the year. But, the currency could surprise us once again. Indeed, the loonie has no clear anchor. By some measures, the Canadian dollar's fair value is close to current levels. By others measures, fair value could be as high as 85 U.S. cents. Consequently, businesses should think about different exchange rate scenarios and give some consideration to protecting themselves from further currency fluctuations.

Another option for reducing the impact of foreign exchange movements on revenues is for businesses to match the currency denomination of their revenues with the currency denomination of their costs. For example, if a business exports to the United States and earns revenues in U.S. dollars, the company might be able to reduce the fallout on its bottom line from an appreciation in the Canadian dollar by purchasing the inputs for its production process from the United States. Thus, when the Canadian dollar rises, the firm's export revenues will fall, but so, too, will its input costs. Alternatively, instead of raising debt financing in Canadian dollars, the firm could choose to issue debt denominated in U.S. dollars. In this case, an appreciation in the Canadian dollar would reduce export revenues, but would also lower the firm's interest payments in Canadian dollar terms.

At this point it is worth spending a moment on the extent to which SMEs are impacted by foreign exchange movements. According to the Canadian Federation of Independent Business, 32 per cent of SMEs say that a higher Canadian dollar hurts their business, while 24 per cent report that a higher dollar helps them. And, not every type of firm is affected in the same degree. On average, transportation, manufacturing, and construction firms report being hurt most by the strong dollar, while wholesale, retail and social services firms report being helped by the stronger dollar. Regardless, since the currency will fluctuate in either direction over time, the implication is that more than half of Canada's small and medium size businesses should consider hedging.

SME EXPOSURE TO HIGHER DOLLAR, BY INDUSTRY




Source: Canadian Federation of Independent Business, Dec. 2003

**4. Difficult customs process**

Regarding customs processes, these may seem difficult and labyrinthine, but they can be overcome with time and effort. Like most bureaucratic administrative requirements, the actual individual rules are not that complex, but the quantity and detail of the information required, as well as the time needed to stay abreast of any changes to the customs processes, may seem daunting. However, SMEs can draw on the expertise of the accounting, legal and financial professions for help in navigating customs rules.

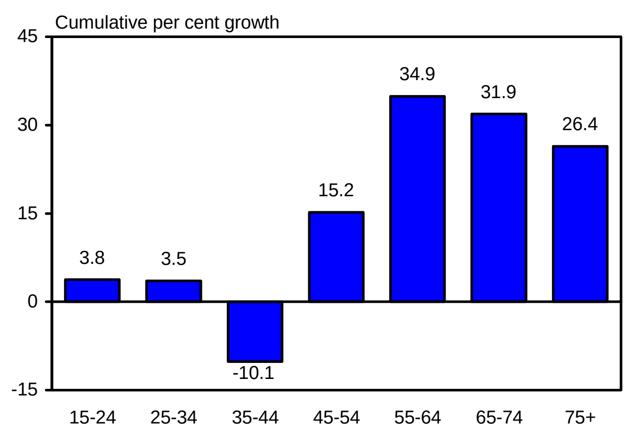
**5. Language barriers and cultural differences**

Language and cultural barriers are also being reduced over time. The use of English as the language for international business has been expanding – a trend that is sure to be bolstered by the fact that the internet is dominated by English-language web sites. At the same time, Canada's increasingly diverse workforce holds the possibility of allowing Canadian companies to overcome language and cultural obstacles to trade in the future. To illustrate, the share of visible minorities in the Canadian population increased from 9.4 per cent in 1991 to 13.4 per cent in 2001, and is forecast to rise to 21.1 per cent in 2020. This shift in the composition of the labour market will change the language and cultural mix at most companies and may make it easier to embark on trade initiatives.

### 6. Competition from domestic and foreign firms

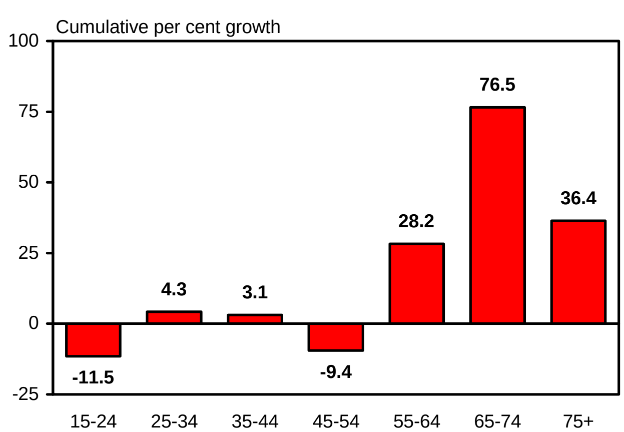
Many businesses cite increased competition from domestic and foreign firms as an obstacle to being a successful exporter. However, firms will always face stiff competition regardless of whether they choose to participate in international trade – so, this should not discourage SMEs from shipping goods and services abroad. And, their smaller size should not be a deterrent, as there is no evidence that globalization favours large businesses. In fact, it tends to force firms to become more specialized, more flexible and quicker to respond to market developments – characteristics that SMEs already possess. Globalization has also encouraged the downloading and outsourcing of many business activities, which can be a boon to SMEs looking to expand their operations. The implication is that success in the international marketplace may come from being a niche player.

**CANADIAN LABOUR FORCE GROWTH BY AGE: 2003-2010**



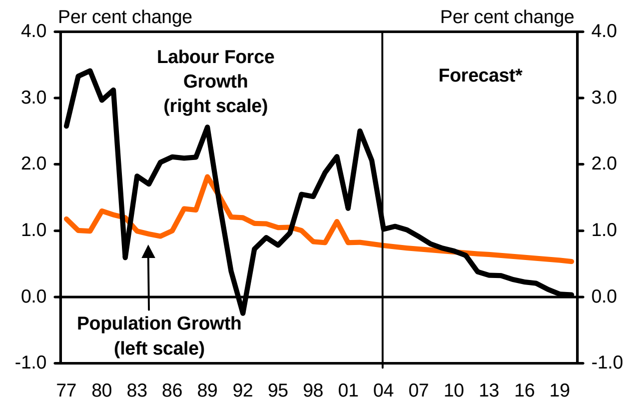

Source: Statistics Canada, TD Economics

**CANADIAN LABOUR FORCE GROWTH BY AGE: 2010-2020**




Source: Statistics Canada, TD Economics

**CANADA'S POPULATION AND LABOUR FORCE**




* Hypothetical scenario where participation rate for each age-sex cohort remains unchanged, Population forecast by Statistics Canada, Labour Force forecast by TD Economics; Source: Statistics Canada

### Demographics will have a big impact on SMEs in the coming decade

Demographic pressures are building in Canada, with the average age of the population rising. By 2011, the first baby-boomers will hit age 65, and by that time many will already have opted for early retirement. This is leading to slower population and labour force growth, and in the coming years, it will also result in a decline in the labour force participation rate. Statistics Canada projections show that from 2003 to 2010, the segment of the labour force consisting of individuals age 34 or less will grow by less than 4 per cent. At the same time, the number of workers age 55 and above will surge by more than 30 per cent. These trends will intensify from 2010 to 2020, with the size of the labour force composed of individuals ages 15 to 24 shrinking by almost 12 per cent, and the size of the labour force composed of individuals ages 25-34 and 35-44 rising by only 4 and 3 per cent, respectively. In fact, beginning in 2020, Canada's labour force may begin declining absolutely.

This suggests that many small and medium size businesses will find it increasingly difficult to hire staff and may need to think about how to encourage older workers to stay on longer or work part-time during retirement. As a partial offset, firms may also find that using more educated workers allows their output to grow without increasing their workforce. This of course highlights the need for greater post-secondary education participation rates among today's youth.

At the same time, an aging population will also alter market demand for certain goods and services. Due to their sheer demographic dominance, baby boomers have created pressures for new products over their life cycle, and this will not change as they reach their retirement years.

As population growth slows, immigration becomes 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. This means that getting immigration policy right is absolutely critical if Canada is to have access to enough individuals with the right skill sets.

Moreover, it will be increasingly important to recognize the experience and abilities that immigrants bring to Canada. Over time, as more individuals have been arriving from developing countries and have less strong English and/or French skills, the immigrants have received lower real earnings. And, the compositional shifts in language and country of origin has made it increasingly difficult for firms to judge the value of foreign experience and educational training. As a result, the wage premium that immigrants receive for each year of foreign experience has been declining over time. This trend must be reversed in the decades ahead.

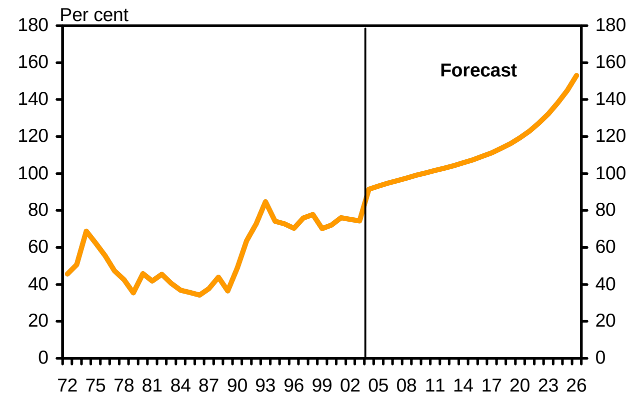
The increased role of immigration for population growth also means that visible minorities will form an ever greater share of the overall population. As previously noted, visible minorities are expected to make up a fifth of Canada's

**CANADIAN IMMIGRATION**
**Per cent of total by destination**

| | 2001-02 |
|---|---|
| GTA | 46.9 |
| Vancouver | 13.5 |
| Montreal | 12.9 |
| Calgary-Edmonton | 5.2 |
| Ottawa-Gatineau | 3.8 |
| Other | 17.9 |

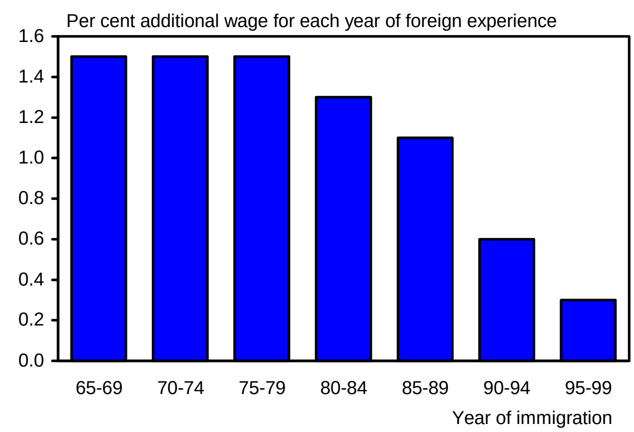
Source: Statistics Canada

**PER CENT OF THE TOTAL CANADIAN POPULATION INCREASE ACCOUNTED FOR BY IMMIGRATION**



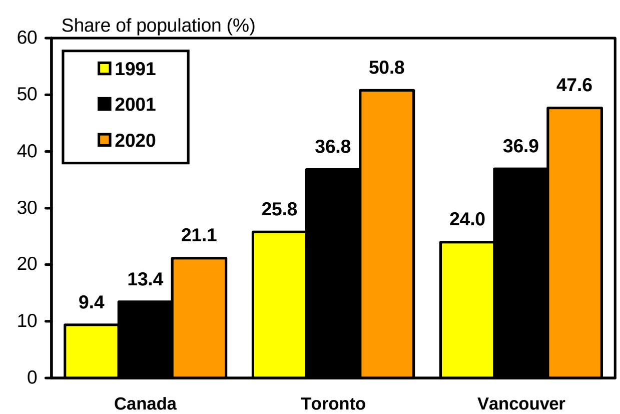

Forecast by TD Economics
Source: Statistics Canada

**WAGE PREMIUM PER YEAR OF IMMIGRANT FOREIGN EXPERIENCE**




Source: Statistics Canada

**CANADIAN VISIBLE MINORITIES**




Source: Statistics Canada, TD Economics

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, 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. For example, the Greater Toronto Area (GTA) is expected to account for about 20 per cent of Canada's population by 2020. 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, perhaps leading to upward pressure on wages. Lastly, the growth in the immigrant population will spur demand for different goods and services, thereby creating new business and profit opportunities.

Given the prospect of slower population growth and an eventual outright drop in Canada's labour force, significant productivity gains will be necessary to maintain even a shadow of Canada's present rate of economic growth.

### Productivity is key

Productivity is crucial regardless of whether an SME is an exporter, an importer or a local-market focused business. Productivity growth is not just the primary source of Canadians' rising standard of living, but also the dominant factor fuelling the long-term expansion of the economy. Over the last five decades, productivity growth has been responsible for two-thirds of Canadian real GDP growth. And, it is the key to individual firms' profit growth, especially in open markets where competition significantly constrains pricing power.

Much has been written about Canada's poor relative productivity performance compared to the United States.

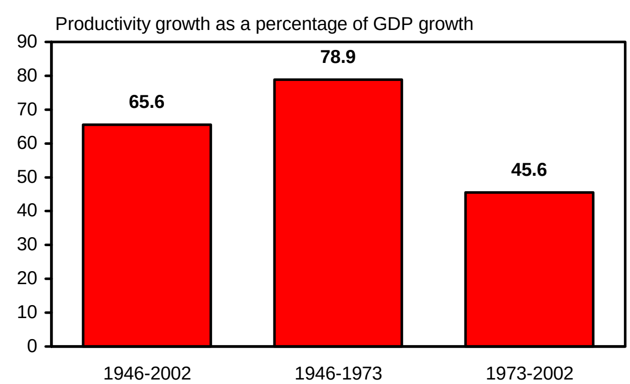
**SHARES OF TOTAL POPULATION IN CANADA**

| | 2003 | 2020 |
|---|---|---|
| GTA | 17.5 | 19.9 |
| Montreal | 11.3 | 11.1 |
| Vancouver | 6.7 | 7.4 |
| Calgary | 3.2 | 3.6 |
| Ottawa-Gatineau | 3.6 | 3.7 |
| Edmonton | 3.1 | 3.3 |
| Winnpeg | 2.2 | 2.1 |
| Hamilton | 2.2 | 2.2 |
| Halifax | 1.2 | 1.2 |
| London | 1.4 | 1.4 |
| Windsor | 1.0 | 1.1 |
| Quebec City | 2.2 | 2.1 |
| Kitchener | 1.4 | 1.5 |
| Victoria | 1.0 | 1.1 |
| St. Catharines-Niagara | 1.2 | 1.2 |
| Total | 59.5 | 62.9 |

Source: Statistics Canada, TD Economics

In the second half of the 1990s, Canadian total factor productivity (which includes the combined impact on output from additions of capital and labour) in the business sector rose at an average annual pace of 1.8 per cent. This was a respectable, but far from stellar, performance. Over the same time frame, U.S. productivity rose by 2.7 per cent per annum. Consequently, the level of productivity in Canada fell anywhere from 10 to 20 per cent below that in the United States (the estimates vary depending on the

**CONTRIBUTION OF PRODUCTIVITY TO ECONOMIC GROWTH**



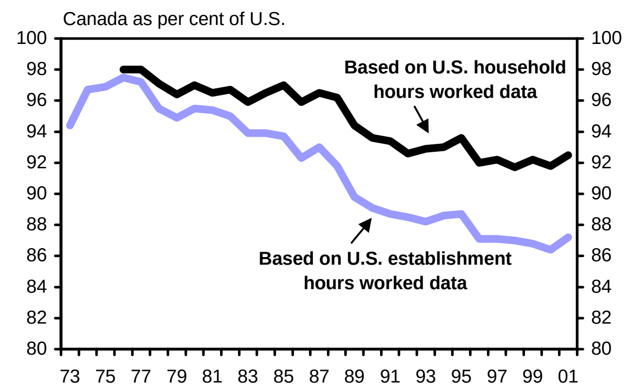

Source: Centre for the Study of Living Standards source used for hours worked in the United States).

There has been considerable debate over why the productivity gap with the U.S. has widened. It is generally agreed that part of the explanation is the different composition of the two economies. In the United States, the information and communication technology (ICT) industries make up a significantly larger share of the economy than in Canada, and it is the ICT sector that has been largely responsible for the U.S. economy's relative productivity outperformance. Stronger business investment in the U.S. also appears to have played a role. Indeed, as the U.S. capital-labour ratio climbed, so too did productivity growth. Less emphasis on research and development in Canada may have been a constraining factor, as well. In 2000, R&D in Canada amounted to 1.7 per cent of GDP compared to 2.7 per cent in the United States.

Drilling down to a lower level of aggregation, it is evident that virtually all Canadian industries, except for mining and construction, have been less productive than their U.S. counterparts. Scale seems to be a factor. Larger establishments have generally experienced stronger productivity growth. With the Canadian economy having a greater proportion of SMEs than the United States, this has likely contributed to our weaker productivity performance. Statistics Canada research shows that small and medium-sized manufacturing establishments accounted for 67 per cent of Canadian manufacturing output and 77 per cent of manufacturing employment in 1994. This compares with 54 per cent and 65 per cent, respectively, in the United States. Moreover, relative to manufacturing as a whole, small firms' productivity was one-third lower than the overall average. Medium-sized firms were close to the average, while large firms were almost 50 per cent more productive.

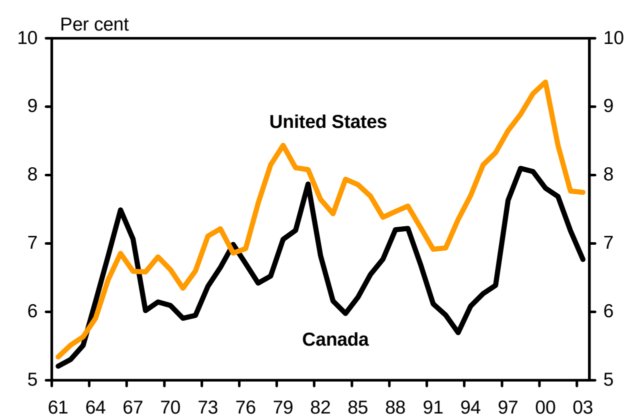
SMEs' lower productivity likely reflects a number of factors. First, their smaller size means that they are less likely to benefit from economies of scale and the cost savings to be had from larger production runs or greater divisions of labour. Second, SMEs conduct less research and development than their big business peers. In 2000, only 30 per cent of Canada's R&D was generated by SMEs. This lower R&D expertise may reduce the willingness and/or ability of some firms to implement new technologies developed outside the firm. Third, SMEs appear less likely to collaborate with other firms in developing new innova-

**CANADA TOTAL FACTOR PRODUCTIVITY RELATIVE TO U.S.**



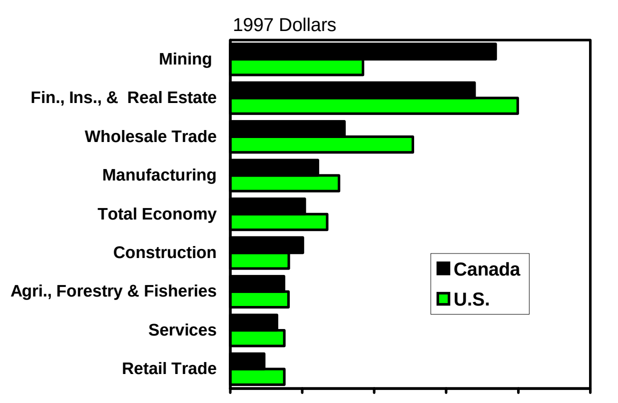

Source: Centre for the Study of Living Standards

**BUSINESS INVESTMENT AS % OF GDP**




Source: Statistics Canada, Bureau of Economic Analysis

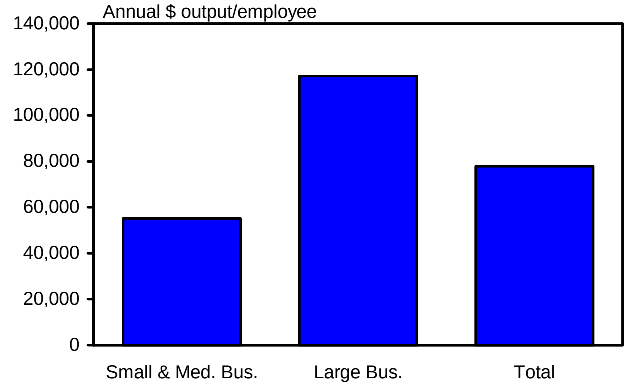
**REAL GDP PER WORKER (1999)**




Source: Centre for the Study of Living Standards tions. Lastly, smaller-scale firms are generally less inclined to acquire new machinery and equipment.

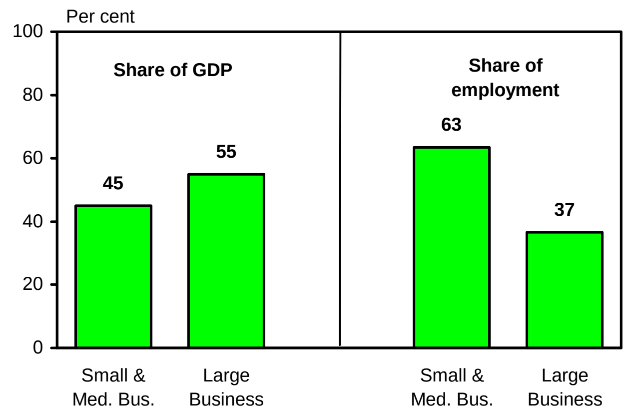
Nevertheless, the push to become more productive will not diminish in the coming years. Even for firms that remain focused on their local market, boosting productivity will be critical to meeting the challenge of rising foreign competition. Regrettably, there is no simple recipe for enhancing productivity. At the most basic level, firms must move up the value-added production chain. In other words, it is necessary to shift production towards goods and services that have greater profit margins, likely reflecting 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.

**PRODUCTIVITY BY FIRM SIZE: 2003**




S&MB < 500 emp.
Source: Statistics Canada, CFIB, TD Economics

**OUTPUT AND EMPLOYMENT BY FIRM SIZE: 2003**

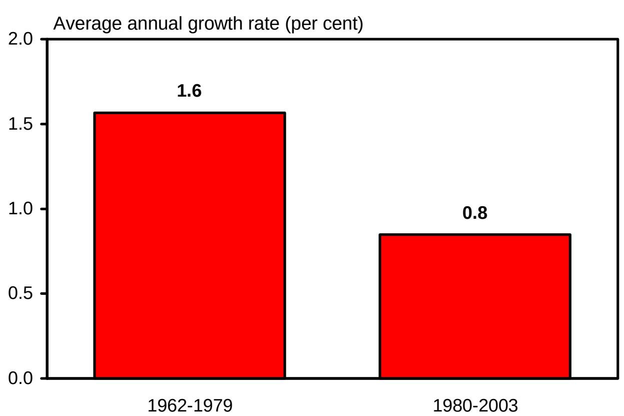



S&MB < 500 emp.
Source: Statistics Canada, CFIB, TD Economics

### Role for government

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 in promoting productivity growth. Border arrangements clearly fall under the umbrella of government policy and they are absolutely critical to ensuring that goods and services are able to flow as freely as possible across international borders, but not at the cost of safety or national security. As a result, it is necessary that governments put in place and maintain the necessary infrastructure to facilitate trade. This issue is becoming more pressing over time, as a quarter century of underinvestment has left Canada's public infrastructure - which includes transit systems, roads, highways, bridges, water and water works, education facilities and hospitals in a weakened state. Canada's governments must also maintain a good dialogue with foreign governments to encourage efficient customs rules and to reduce the risk of trade inhibiting policies. A recent report by the Ontario Chamber of Commerce emphasized the potential costs from border delays, which can result in increased shipping costs and reduced output, the latter of which occurs if just-in-time inputs are not delivered in a timely fashion. Indeed, the study estimated that delays at the border, which were made worse by increased security related to the war

**GROWTH IN REAL GOVERNMENT CAPITAL SPENDING PER CAPITA**




Source: Statistics Canada

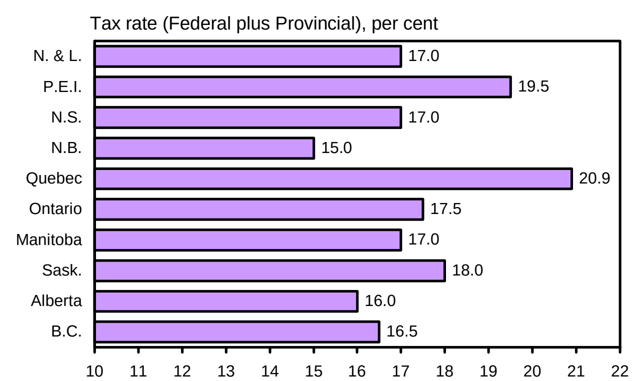
against terrorism, may be costing Canada more than $8 billion a year.

In terms of other government policies, there has been considerable talk in the past that Canada's federal government might enhance trade through the adoption of new arrangements, including a customs union or a monetary union with the United States or the adoption of a common currency. Clearly, a customs union could help reduce some of the administrative obstacles to trade that many businesses cite. However, the gains might be limited. For example, an Industry Canada study suggests that a customs union might raise the level of Canada's GDP by 1 per cent. This is significant, but not dramatic, which implies that Canada has already unlocked many of the benefits from trade with its current customs policies. Moreover, there is a drawback to a customs union, for while it would help trade with the United States, it would mean that Canada would have to adopt the same trade policies as the U.S. with respect to the rest of the world, such as common third-party tariffs. The implication is a loss of trade policy sovereignty by Canada. Nevertheless, the potential gains cannot be overlooked. For example, in recent years, there have been several country of origin labelling requirements proposed in the U.S. that could adversely affect various Canadian industries. However, a customs union would eliminate these issues. And, it should be said that Canada's increasing trade ties with the U.S. do suggest that we are inching towards a custom union in an informal way over time. Looking ahead, a major thrust in the next 5-10 years towards an explicit customs union is unlikely.

With respect to a monetary union or a common currency, the former is a non-start. Simply put, it does not pass the "what's in it for me test" in the United States. It is highly unlikely that the U.S. would be willing to give up the greenback in favour of a currency that is the hybrid of the U.S. dollar, the Canadian dollar and the Mexican peso. Moreover, it is difficult to see the U.S. giving the Bank of Canada a vote on the setting of monetary policy for the United States. A common currency, where Canada adopts the greenback, is a more plausible scenario. And, while it would eliminate currency risk, the gains to trade would be offset by the loss of foreign exchange changes as a buffer to shocks on the Canadian economy. For example, during the Asian financial crisis in 1997/1998, the fallout on the Canadian economy was limited by a sharp weakening in the Canadian dollar that helped moderate the impact on Canada's commodity sector. The implication is that so long as the structure of the Canadian economy is substantially different to that in the United States, there is a role for the flexible exchange rate to play in acting as a shock absorber to international developments.

Beyond customs and foreign exchange policies, governments should strive to enhance trade and productivity through a number of other channels. For example, Canada's federal and provincial governments must set tax rates at competitive levels that take into account rates in other countries. The good news is that the current level of small business tax rates is low and favourable for trade. However, once a business passes the revenue threshold to be eligible for the small business tax rate, the tax burden increases substantially. For example, the federal tax rate jumps from 12 per cent to 21 per cent once the $250,000 profit limit is passed. Therefore, many businesses with fewer than 500 employees (our definition of the SME sector) face the regular federal corporate tax rate. And, for those that are close to the threshold, the large increase in the tax rate may be a detriment to growth. Lastly, for those that pay the general corporate tax rate, the international comparison is less favourable. The corporate tax rate on capital (which includes federal and provincial income taxes, capital taxes and other taxes) in Canada is currently 31.5 per cent versus 20.1 per cent in the United States, although the Canadian rate will fall to 28 per cent by 2008. This puts SMEs with profits over the small business tax rate limit at an international disadvantage. And, to the extent that some SMEs are plugged into the production process of large firms, the less competitive tax environ-

**SMALL BUSINESS INCOME TAX RATES: 2003**




Note: U.S. Fed.-only average tax rate compares at 30% for a firm with $200,000 in profits
Source: Canadian Federation of Independent Business, Dept. of Finance, TD Economics

ment may constrain the growth in large business, which will filter down the supply chain.

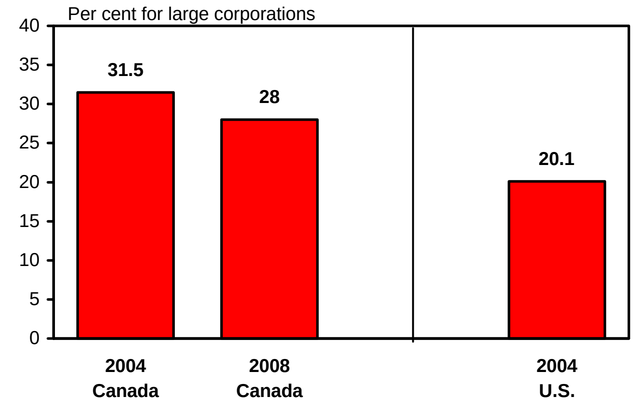
Public policy must also support a solid education system, both to increase the human capital and the productivity of its labour force, but also to encourage innovation. To illustrate, universities in Canada do 30 per cent of all research and development, the highest ratio in the Group of Seven most industrialized countries. And, if Canadian businesses are to boost productivity by producing higher value-added goods and services, they will need a well educated workforce and will need to implement the latest technologies.

Lastly, as mentioned, it is critical for Canada to have the right immigration policies to support Canadian labour markets in the future.

**Conclusion**

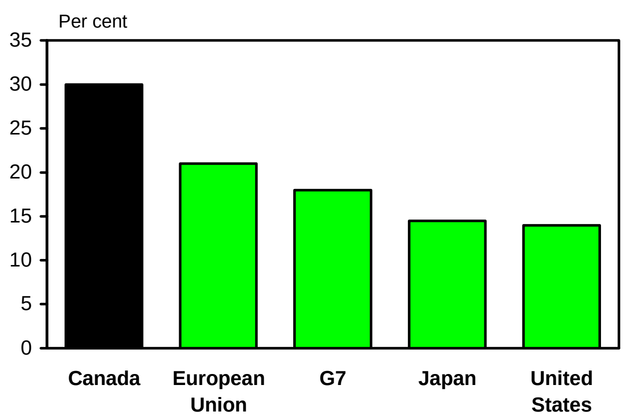
The main message is that globalization is here to stay and its influence will remain a dominant theme in the decades to come. In the past, Canada has benefited greatly from its openness to trade and it will continue to do so in the future. The international flow of goods, services, capital and labour will only increase in the years ahead. Many small and medium size business establishments 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 been unlocked, and we encourage SMEs to think globally. Moreover, it is important that businesses consider international trends when forming their business plans. For example, demographics and immigration will play an increasing role in shaping the Canadian economy over the next two decades. Lastly, SMEs must strive to improve their productivity performance. Indeed, it is the only way to succeed over the long-run. The changing global competitive environment suggests that firms will be rewarded by producing higher value-added goods and services, employing more skilled labour, investing in more capital and adopting new technologies. And, progress on this front carries fringe benefits. For example, it will also help to raise the standard of living in Canada. At the end of the day, small and medium size businesses are a core part of the economy and their success leads to higher employment and better economic conditions for Canada as a whole.

CORPORATE TAX RATE ON CAPITAL




Source: Chen & Mintz, C.D. Howe, 2004

SHARE OF R&D DONE BY UNIVERSITIES (1999)




Source: Statistics Canada, OECD

***Craig Alexander, AVP & Senior Economist***
***416-982-8064***

***Eric Lascelles, Economist***
***416-982-6420***