delivery and assembly. This is what economists refer to as vertical specialization, and imports are part of the process.

The level of vertical specialization provides an indication of how Canada benefits from increased trade by allowing our industries to specialize in areas where Canada has cost and production advantages over other countries. We note from Table 2 that the growth in vertical specialization has been more rapid in manufacturing than in the primary sector—3.3% versus 2.6% over 1965-1996, at average annual rates. Moreover, it is also evident from the table that growth in vertical specialization accelerated more rapidly over 1988-1996 compared to 1965-1988 in both the primary and manufacturing sectors. The increase in vertical specialization over this period is largely attributed to increased trade in industries benefiting from tariff reductions and/or elimination under the FTA/NAFTA agreements of the late 1980s and the early 1990s.[1] It is also of interest to note that two-way trade and vertical specialization have increased at a particularly rapid rate in industries previously protected, such as leather, textiles and clothing. On the other hand, the increased external orientation of industries facing very low tariffs prior to the FTA/NAFTA agreements—such as the electrical and electronic products industry—points to factors other than the FTA/NAFTA having contributed to increased trade exposure and vertical specialization.

It should be emphasized again that certain goods that Canada imports are used as inputs into other goods, transformed and, subsequently, exported. Tires, for example, are mounted on cars, trucks and vans that are sold to U.S. customers. A number of studies have examined the import content of exports.[2] Chief amongst their findings is that the import content of Canadian exports has been on the rise over 1986-1995, increasing from roughly one-quarter of the content to about one-third of the content. The import content of our exports increased in all industries, with the exception of mining, tobacco and miscellaneous manufactured goods. The automotive sector recorded the highest import content of exports in 1986 as well as in 1995, although the fastest growth in the import content of our exports over the entire period was recorded by the machinery and equipment and electronics sectors. Most interesting, however, is that the studies find that the increase in the import content of exports has been most notable in the sectors experiencing strong growth in exports. In hindsight, however, this is may be not that surprising in light of the trend towards globalization and increased specialization set out above.

Table 2: Evolution of Vertical Specialization in Canad

Vertical Specialization	1965	1988	1996	Av Ani Grc 196
Primary sector	0.052	0.086	0.113	2.:
Manufacturing sector	0.131	0.240	0.349	2.8

Source: R. Dion, "Trends in Canada's Merchandise Trade," Bank of Canada Review, *Winter 1999-2000*
(Data in current dollars from input/output tables.)

[1] Analysis undertaken by Trefler, Industry Canada, in Dion, "Trends in Canada's Merchandise Trade,"

[2] G. Cameron, and P. Cross, "The Importance of Exports to GDP and Jobs," *Canadian Economic Obser*
C. Coronel, "Import Benefits to Canada's Exporters," mimeo, DFAIT/EET, March 2001.

THE CANADIAN TRADE COMMISSIONER SERVICE

Hungary
- The Health Industries Market

Italy
- The Nutraceuticals Market

Slovak Republic
- The Health Industries Market

Slovenia
- The Health Industries Market

Turkey
- The Medical Devices and Pharmaceutical Markets

Latin America and the Caribbean

Chile
- The Pharmaceutical Market

Colombia
- The Health-care Industries Market

Guatemala
- The Medical Devices Market

Mexico
- The Health-care Products and Services Market
- The Pharmaceutical Products Market
- The Medical Device and Equipment Market

Peru
- The Health Industries Market

Trinidad and Tobago
- The Pharmaceutical Products Market

Venezuela
- The Health Industries Market

Sub-Saharan Africa

South Africa
- The Health-care Products and Services Market

United States of America

Atlanta, Miami
- Medical Devices

Dallas
- The Medical Research Market
- Medical Devices

Detroit
- The Telehealth/Telemedicine Market

Los Angeles, San Francisco, San Jose
- The Medical Devices and Health-care Services Market

New York
- Private and Institutional Home Care

Seattle
- The Telehealth/Telemedicine Market

* Produced by the Market Research Centre of the Canadian Trade Commissioner Service. To consult them, visit:

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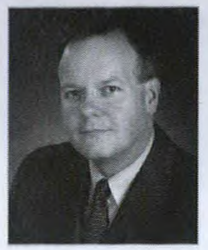
Recovery, yes, but still significant challenges

by Stephen S. Poloz, Vice-President and Chief Economist, EDC

The world economy is airborne again, even though cruising altitude won't be reached until 2003. Seatbelts should remain fastened at least until then, as the ride could be quite bumpy. Three challenges, in particular, lie ahead for Canadian exporting companies.

Challenges ahead



Stephen S. Poloz, Vice-President and Chief Economist, EDC

First challenge: the world has changed in the wake of the terrorist attacks of last September 11. The border is operating smoothly now, but at a much higher cost. Even so, the additional uncertainty has prompted companies to carry more inventory as they work to meet the "just in time" requirements of their foreign customers. Containers that are shipped abroad attract a terrorism tax of US$100. Many types of insurance cost more than before, some significantly so.

These costs associated with international trade are generally small relative to the value of the goods being shipped. But they can add up, and even a shrinkage in profit margins of 1-2% can be tough to absorb when margins are already thin because of ferocious international competition. Expect those stresses to linger at least until mid-2003, and the extra costs of international trade to become a permanent part of the business plan.

Second challenge: exporters face a resurgence of trade protectionism. Lumber, steel and a wide range of agricultural products all face new impediments to doing international business. Trade protectionism is always lurking just beneath the surface, because not everyone is convinced of the benefits of unrestricted trade. One of the reasons for this is that the beneficiaries of a trade restriction are easy to identify, whereas the price of protectionism is borne by the economy at large, and each individual pays only a fraction of those costs. Debate therefore focuses on those who benefit from the trade restriction, or who would lose if a trade restriction was removed, rather than the rest of the economy.

Trade protectionism comes to the fore at particular times, such as when economic growth is slow, foreign demand is weak, one's currency is strong, or when there is a looming election. All these conditions have emerged in the U.S. in the past year, including the mid-term elections coming this fall. The good news is that those conditions are now evaporating, so the trade negotiation atmosphere is likely to improve in the next six months. Moreover, the measures taken to protect the U.S. steel industry have had more negative consequences for U.S. consumers than anyone else, so expect the potential for an international trade war to ease in the coming months.

Third challenge: exporters must deal with the declining U.S. dollar. The mirror image of this trend, of course, is a rising Canadian dollar. This is welcome news, when put into the right context. The U.S. dollar has risen by about 30% in the past five years, as the world has staggered from one crisis to another and investors have sought the safety of U.S. dollar assets. As the world economy heals over the next 12-18 months — barring, of course, some other major crisis — global flows of funds should become more balanced and the U.S. dollar should decline. Therefore, this emerging trend is a sign that the world is returning to full health, and should be welcomed, especially by highly trade-dependent economies like Canada.

The Canadian dollar will probably rise by less than a lot of other currencies over the next year, because it declined by the least against the U.S. dollar during the past few years. In particular, our competitors in Europe, Asia and Australia will see their currencies rise by more than the Canadian dollar. Moreover, the rising Canadian dollar will arrive in the context of strengthening markets for Canada's exports.

The bottom line? No one should expect the global recovery to go in a straight line. There is plenty of potential for bumps along the way. But the healing process is well underway, and exports should grow by around 2% this year, and close to 9% next year. This gradual improvement in international business conditions will help Canadian companies deal with the challenges posed by trade frictions, protectionism and currency realignments.