THE CANADIAN CHAMBER OF COMMERCE
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Advancing our economic ties with China:

Three priorities for Canadian business

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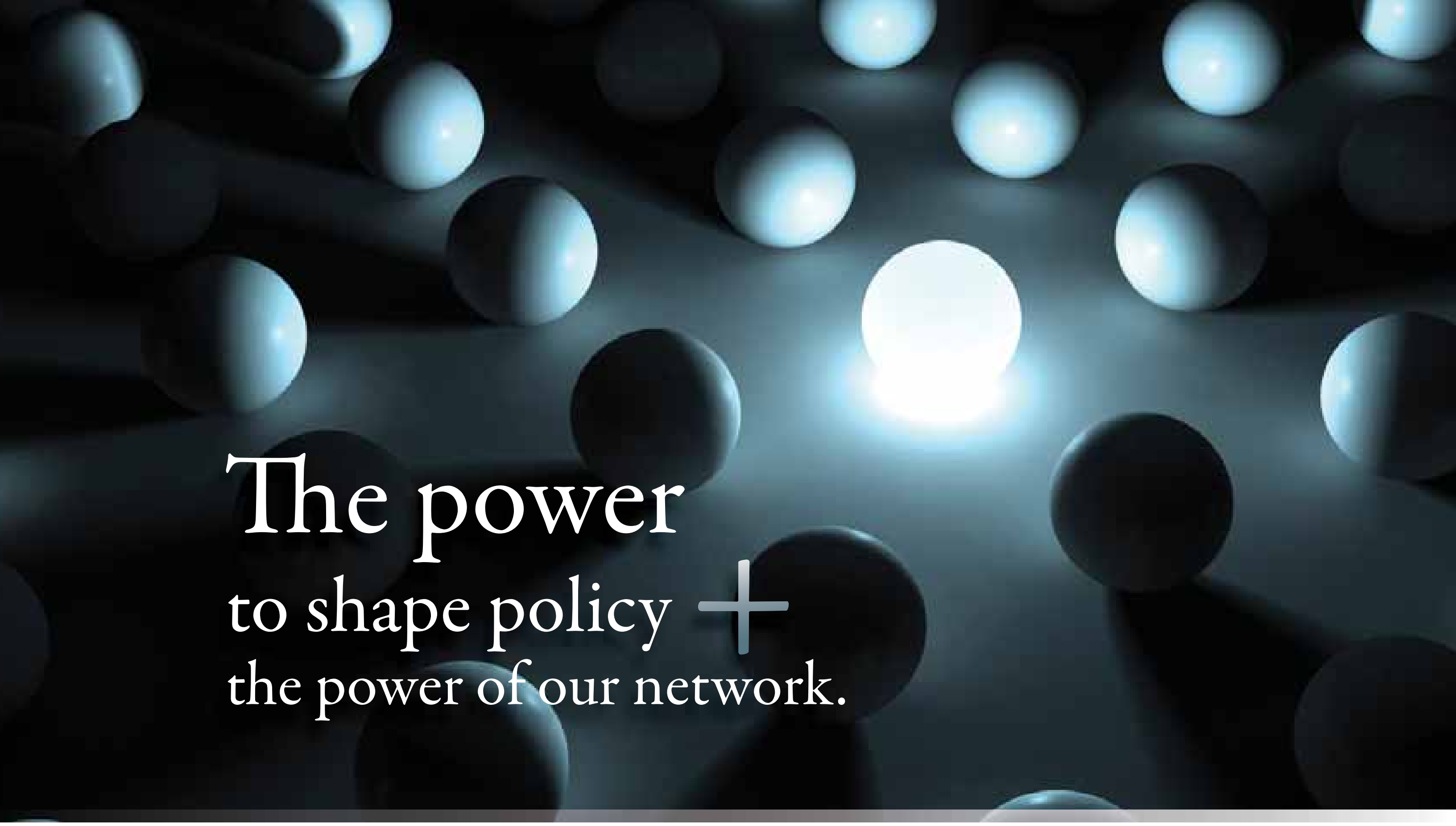

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Executive Summary

While the United States will remain Canada's top economic partner, its tempered growth has made more Canadian companies realize they should diversify their trade and investment, and many companies are now looking to do business with Asia. The rapid, ongoing growth witnessed in China and the rest of Asia is part of a pivotal transformation in the global political and economic landscape. That transformation represents both opportunities and challenges Canada cannot afford to ignore.

There are opportunities for Canadian businesses to provide China with the goods and services it requires to sustain its own development. These include energy, raw materials, food, financial and engineering services, aerospace and transportation, and higher education. There are opportunities to plug into value chains—to provide expertise and business services to multinationals involved in trade and investment between the United States and China, China and India, China and Brazil, and so forth. Then, there are untapped opportunities to draw investment to Canada and to invest in China; of course, there are barriers in both countries that must be removed in order to open access to those opportunities and build a partnership of shared growth and prosperity.

Canada-China relations are evolving amidst change. The world economy has changed drastically in just one decade and especially since 2008. China is shifting its economic development model to speed up urbanization, move its industries into higher value-added production and boost domestic consumption. Political ties between Ottawa and Beijing are on solid footing, and Canada, with its first majority government in seven years—a government with a robust economic agenda—has the means to steer ties with China forward in our country's best interest.

In its report, *Canada-China: Building a strong economic partnership* (2010), the Canadian Chamber of Commerce outlined its recommendations for

strengthening the economic partnership between the two countries. The report noted the opportunities as well as the undeniable challenges China represents for Canada: Chinese competition against Canadian products in Canada and abroad; trade and investment irritants that need to be rectified for economic ties to improve; insufficient trust between the two countries; and Canada's visibility shortfall in China's expansive and complex markets.

Based on consultations with Canadian Chamber members and opinion leaders, this document lays out three policy priorities for advancing Canada-China ties over the next few years.

Priority 1: Implementing a Canadian strategy of political engagement with China

Ties with China are becoming one of Canada's most politically-intensive external relationships, in light of the many areas where the two countries' interests intersect. As Canada's trade and investment with China continue to expand, Canada's political engagement with China will need to keep pace with the interests in play for Canada. To help open the doors of opportunity to Canadian businesses and to uphold Canadian economic interests, the government of Canada should implement a long-term strategy of political engagement with China.

Such a strategy must foster a constructive bilateral relationship between the two countries and include dialogue between government representatives from the most senior level down. These exchanges generate goodwill and credibility for Canada in China and help recast “Canada, the cold Australia” as “Canada, the development partner.” We look forward to Prime Minister Harper making a second visit to China soon. To add substance to Canada’s role as a development partner, the federal government should continue ministerial contacts and department-level dialogue, through which it can impart its valuable experiences in governance and regulation, which are of interest to China as it works to improve its own regulatory system and institutions.

While there are Canadian interests on which China’s positions differ—sometimes acutely—bilateral political engagement at the leadership level, done with an eye on deepening strategic trust, allows both sides to deal practically with unavoidable difficulties and differences that arise. Leadership-level engagement is also a platform for the federal government to put the limelight on Canadian excellence in China and to provide moral—versus financial—support to Canadian companies active on the ground (in the face of foreign governments’ support for their own companies in China).Visits to China by Canadian premiers are also helpful to provincial and territorial business communities, and to Canada overall, as long as they are coordinated with federal initiative.

Finally, Canada’s interests with regards to China are tied to its broader interests in the Asia-Pacific region. As many countries in the Asia-Pacific region already rank among our top 10 trade partners, and as our economic exchanges with these countries will continue to grow, Canada will have a direct and deeper stake in Asia-Pacific stability and economic sustainability; political tensions or economic disruptions within the region could hurt Canada. To ensure consistency in its ties with individual Asian countries, the government of Canada’s China strategy must, therefore, be part of a holistic Asia strategy. Canada is already a member of the Asia-Pacific Economic Cooperation (APEC) forum and Canadian Foreign Affairs Minister Baird recently participated in the Association of Southeast Asian Nations’ (ASEAN) Defence Ministers’ Meeting. Joining the East Asia Summit and the Trans-Pacific Partnership (TPP) would transform Canada from an outsider to an insider in the building of regional order and the advancement of its interests within that order.

Priority 2: Pursuing more trade and better trade with China

There is a need for *more* and *better* Canada-China trade. To improve the quality of Canada’s trade ties with China (i.e. to reduce the trade deficit with China), Canadian businesses must better match their value proposition with China’s needs and the barriers and irritants to trade and investment in China must be overcome.

Over the past three decades, China has made progress in opening its economy to trade and investment, in conforming more fully with its World Trade Organization (WTO) obligations and in allowing more market-based mechanisms to take hold. However, serious trade and investment irritants have yet to be rectified for a truly win-win commercial relationship to emerge. For example:

- **Weak intellectual property protection and enforcement**

  The Chinese government has taken steps to strengthen its intellectual property (IP) regime in China's own interest, but IP rights protection remains lacking. Enforcement of IP rights protection at the local level is insufficient, the seizure and disposal of counterfeit goods within China and at the Chinese border is inadequate and Canadian (and other foreign) companies' concerns around the theft of IP, trademarks and trade secrets remains deep. Canada must also do its part as it has fallen behind in global terms when it comes to the protection and enforcement of IP rights.

- **Trade restrictions on goods and services**

  In recent years non-tariff restrictions on foreign goods and services in China have stiffened. Restrictions include standards that differ from common international practice, rules that discriminate between foreign and domestic enterprises, sudden or arbitrary changes in regulation, and barriers on the expansion of business activities in China. Some barriers shield sensitive domestic economic interests from foreign competition. Others stem from China's differing regulatory traditions. Many Canadian sectors, including financial services, agri-food, mining, aerospace and transportation, are impacted.

- **Unfair competitive practices**

  There is concern in Canada (and in other countries) that China significantly understates the extent to which it subsidizes its industries, and notably state-owned enterprises, by providing direct or indirect financial support or preferential access to competitiveness-enhancing technologies and know-how.

Mechanisms such as the WTO Dispute Settlement will remain an important part of the toolkit to defend legitimate Canadian trade interests, but it is necessary to look beyond these. The government of Canada should pursue political agreements with China sector-by-sector, followed by close monitoring of the outcomes. The Foreign Investment Promotion and Protection Agreement (FIPA) with China should also be successfully concluded, but Free Trade Agreement (FTA) negotiations with China would be premature.

There are barriers Canada needs to deal with at home to do more and better trade with China. For instance, the stalling of progress on the Northern Gateway pipeline is of concern. That pipeline, along with the Pacific Trails pipeline, would transform Canada into a major energy exporter. Other countries including the United States are weighing the trade potential of their own oil and gas (e.g. shale gas) reserves. If Canada is to live up to its vocation of being an energy superpower, in terms of both conventional and renewable energies, it needs to become a major supplier of reliable energy to China and to the other Asia-Pacific countries, while growing its role as a supplier to the United States in tandem. Finding a path forward to get the pipelines done, in cooperation with Alberta, British Columbia and affected Aboriginal communities, is critical.

Similarly, to build on the vision and potential of the Asia-Pacific Gateway and Corridor Initiative (APGCI) as a logistics and business bridge between North America and Asia, the free flow of legitimate goods and people across the Canada-U.S. border must be enhanced. The Canadian Chamber of Commerce therefore applauds the border agreement just recently announced by the governments of Canada and the United States and looks forward to its timely implementation.

Priority 3: Improving the investment relationship with China

Investment is an undersold component of Canada–China economic exchanges. It is an area where Canadian business believes improvements can and should be made. Here is where:

Foreign direct investment in Canada

Chinese companies are interested in investing in Canada. National security concerns about foreign direct investment (FDI) exist in sensitive areas, notably when it comes to investments by state-owned enterprises. Investment and geopolitics are linked. However, it would be mistaken to frame *all* Chinese capital as incompatible with Canada's best interests.

Canada needs to attract FDI from a variety of source countries. The government of Canada should continue articulating this. The federal government should fully implement the new thresholds for government review under the Investment Canada Act amendments, which the Canadian Chamber supports. At the same time, maintaining a national security review process to safeguard Canadian interests is well-founded and needed.

To date, most inbound investment from China went to the extractive sector. Canada welcomes this sort of FDI when done on a commercial basis. Canada seeks win-win investment that contributes to the development or co-development of new technologies and brands, including greenfield investment, as opposed to FDI that is short-term-oriented or geared to acquire existing technologies or supply networks without building value in Canada.

Removing caps and controls on capital transactions

The investment relationship with China involves portfolio investment as well as FDI. Private Chinese enterprises are multiplying quickly, and they are great drivers of innovation. However, the private sector tends to be crowded out by the state-owned sector in China's formal capital markets. As a result, many Chinese private companies want to tap into offshore capital to finance their growth.

Given Canada's record of sound financial oversight, Chinese entities have expressed an interest in listing in Canadian stock markets and in using Canadian financial institutions as intermediaries. Canada's stock markets, for instance, are specialized in the sort of financing solutions that Chinese small- and medium-sized enterprises seek. Also, Canada's insurance cluster and the products it sells are likewise recognized as among the best and most reliable in the world.

Similarly, many Chinese individual and institutional investors would like to bring their capital to Canada to diversify their portfolio. Given investment restrictions, stores of wealth currently available to Chinese individual and corporate savers are quite limited. Loosening capital restrictions with Canada would be win-win. It matches China's objectives of boosting home-grown innovation, spurring consumption, tempering fixed asset frothiness and inflation, and opening the Chinese financial system. The governments of Canada and China should explore the loosening of investment restrictions and caps governing Chinese individual and institutional investors who want to transfer capital to or from Canada, on a bilateral basis.

Foreign direct investment in China

Investment, like trade, is a two-way street. For China, openness to investment is essential to its economic diversification and competitiveness. While China has gradually opened over the past decades, the Canadian business community finds that China's investment environment has tightened in recent years, and FDI restrictions remain in several sectors the Chinese government considers strategic. While some sectors of the economy are justifiably strategic, Canada and Canadian companies are not a threat to a large country like China. If anything, Canadian FDI has offered China expertise it needs for its own development purposes. The government of Canada should press China to loosen restrictions on Canadian FDI in China, particularly in the financial services, mining, aerospace and transportation sectors.

Conclude the Foreign Investment Promotion and Protection Agreement

To get the investment relationship right for both sides, Canada and China must conclude the Foreign Investment Promotion and Protection Agreement (FIPA). The FIPA is needed to provide a solid, long-term framework for two-way investment that includes comprehensive, high standards of protection for investors and recipients in both countries.

Introduction

Over the last decade, Canadian businesses have grown more aware of the trade and investment opportunities in rapidly developing Asia. Budding Asian demand for energy, raw materials, food, financial and engineering services, high-tech products (e.g. aerospace and transportation) and higher education—the goods and services in which Canada excels—has fuelled that awareness. Given its size and proximity to Canada, the United States will remain our country's top economic partner. Even so, with the hit taken by U.S. demand following the 2008 global financial crisis and given the slow U.S. recovery, more Canadian companies want to tap into the opportunities presented by Asia. They need to diversify their business dealings—to have more and bigger eggs spread around different baskets.

In Asia, many Canadian businesses eye China. Certainly, China's spectacular economic development since 1978 presents Canada with undeniable challenges: Chinese competition against many Canadian products both in Canada and abroad; irritants to trade and investment between Canada and China that need to be rectified for economic ties to improve; business niches that need to be secured in the fast-paced markets of a continent-sized country like China; and Canada's home-grown challenge of becoming more competitive internationally in business.

However, China also presents Canada with opportunities: tapping into Chinese consumer demand directly or by supplying multinationals active in China; plugging Canadian goods and services into supply chains linking China with other trade partners; attracting more Chinese students to Canada's excellent universities and colleges and tourists to our shores; and drawing commercial Chinese investment to build up Canadian sectors in return for strong returns on capital, diversified assets and secure supplies.

A new era in Canada-China relations is being ushered in against a backdrop of change. China is shifting its economic development model to speed up urbanization, make its industries more high-tech and boost domestic consumption under the country's new Five-Year Plan. China's political establishment is also transitioning from its fourth to its fifth generation of leaders—a decade after its last leadership transition—which heralds policy adjustments. Canada, with its first majority government in seven years—a government with a robust economic agenda for a prosperous Canada—has the wherewithal to steer our country's ties with China forward in Canada's best interest.

Ties between Ottawa and Beijing are on solid footing. The government of Canada is advancing ties with Asia, in recognition of that region's increasing linkages with our country's prosperity and security. While there will be agreement with China in certain areas, there will also be disagreement on difficult subjects—on economic, political, security and social matters; on values and worldviews.

The benchmark for forward-looking Canada-China ties is not that they be feel-good. Rather, it is important that the relationship remain firmly rooted in realism. It is important that the principles Canadians value be articulated in our country's foreign policy, through political engagement. At the same time, a constructive relationship with China must continue to pursue shared economic, security and other interests, to encourage China to develop as a responsible fellow-stakeholder in the very international system that has enabled its economic growth, and to promote more and better economic exchanges with China in the interest of both countries. Canadians saw this constructive relationship at work during Prime Minister Harper's visit to China in 2009, President Hu's visit to Canada in 2010, and during recent visits to China by Minister Baird, Minister Fast and Minister Flaherty.

The Canadian Chamber of Commerce is clear about Canada-China ties. It is one of Canada's most important external relationships because what happens in China and in the rest of Asia bears ever more heavily on Canada—as both a challenge and an opportunity. It is an intensive relationship in terms of the political engagement involved. It must build on the positive and deal with the inevitable difficulties in a constructive manner. Also, Canadian foreign and trade policy must approach the Asia-Pacific region more holistically than in the past.

With China, the Canadian Chamber wants to see a win-win economic relationship develop—Canada and China can be partners who create prosperity together rather than mere clients of each other. Canada must show China what it is—a reliable source of raw materials, food, services and technological products that help sustain China's social and economic development. Canada is open to commercial investment that creates quality jobs in Canada and can provide China with a more diverse and reliable investment portfolio. Canada also expects China to further open itself to Canadian goods, services and investment. Also, many skilled immigrants from China will continue to see Canada as an excellent place to study, settle, raise families, invest, work hard and succeed.

Private enterprises do business and do it best—not governments. Yet having a constructive government-to-government working relationship with China is imperative; it literally enables Canadian companies to do business with Chinese partners on the ground. The government of Canada does help move Canada-China economic ties forward in removing barriers to trade and investment, in flattening the competitive playing field for Canadian companies and in defending Canadian trade interests when these are infringed upon. It removes home-grown barriers to business competitiveness which Canadian businesses need to succeed internationally. Canada's continued political engagement with China, and its work with our international friends and partners and the World Trade Organization (WTO), are the channels through which Canada-China ties advance.

To build stronger ties, the government will need the right playbook. In its July 2010 report, *Canada-China: Building a strong economic partnership*, the Canadian Chamber of Commerce suggested some elements for that playbook. This piece, resulting from consultations with members and thought leaders, focuses on three top priorities:

- Implementing a Canadian strategy of political engagement with China
- Pursuing *more* trade and *better* trade with China
- Improving the investment relationship with China

Part I: China today and tomorrow—the challenges and opportunities

1. China's economic renaissance

The East is red—with economic growth

China has experienced three decades of spectacular economic growth following nearly a century and a half of decay going back to the Opium War and the late Qing Dynasty. China's gradual economic reforms and policy of opening-up to the world since 1978 have spurred the entrepreneurship of the Chinese people, the emergence of globally competitive Chinese industries that are rapidly climbing up the rungs of the value-added ladder, and the country's transformation into an international trade and investment titan.

China's GDP expanded thirtyfold, from under US$150 billion (current dollars) in 1978 to nearly US$5 trillion in 2009, representing annual GDP growth in the region of 10 per cent. It surpassed Japan to become the world's second largest economy in 2010—second only to the United States.[1] China, whose worldwide commercial footprint was minute when its reforms were first implemented, has since become the world's second-largest trading nation behind the United States, with trade representing nearly two-thirds of its GDP.

In 1999, China entered the international trade system by acceding to the World Trade Organization (WTO). WTO accession not only granted Chinese exporters greater access to world markets, but also compelled China to further open its own markets to global competition—a process of levelling the competitive playing field which is ongoing but far from complete. With the integration of value chains in Asia and internationally, many manufactured end-products traded in the world today involve China at some stage, whether in financing, production, assembly or sales.

Trade has generated a series of expanding current account surpluses for China year-on-year, which have surpassed four per cent of its GDP annually, the result being that its foreign exchange reserves are the world's largest at more than US$3 trillion in 2011.[2] These surpluses are recycled in U.S. and other sovereign debt obligations. Increasingly, Chinese state-owned enterprises (SOEs) and the China Investment Corporation (sovereign wealth fund) are also investing in productive assets abroad, as China seeks to secure reliable access to raw materials, diversify its asset holdings, obtain higher returns and acquire technologies or global brands. Chinese institutional investors and individuals also dispose of vast savings with considerable overseas investment potential, and many Chinese private companies would be interested in accessing foreign capital markets, though this is restrained under current Chinese regulation.

Equally, large-scale direct investment by Western and other Asian firms in China since the 1980s has contributed enormously to the expansion of the Chinese economy. Beginning with China's coastal Special Economic Zones (SEZs) in the 1980s and then spreading out across China during the 1990s and 2000s, this foreign direct investment (FDI) has helped develop productive facilities and industrial clusters that put local resources to use, injected managerial and technological expertise into China and plugged Chinese companies into global value chains.

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1 World Bank

2 *China's forex reserves pass 3 trillion USD for first time* (People's Daily, April 15, 2011). Also available online at http://english.peopledaily.com.cn/90001/90778/90862/7351620.html

Foreign companies have benefitted by tapping into efficiencies found in China that have allowed them to focus on expanding higher value-added activities back home, by getting more direct access to regional inputs and by securing enhanced access to Chinese and Asian regional markets. However, many sectors in China remain off-limits to foreign investment, and over the past half decade, China has been tightening restrictions on foreign direct investment in the country rather than opening its markets further. Given the win-win nature of FDI, growing curbs on foreign investment are as concerning as they are counterproductive.

Free enterprise meets controlled economy

China's economy has become increasingly market-driven over the past three decades—the recipe of its success since 1978. The Chinese government has progressively loosened state control on the functioning of the micro-economy to enable a dynamic private-sector economy to emerge, compete and flourish. It reformed public enterprises in the 1990s to make them more commercially driven and financially independent and opened numerous sectors to trade and investment following its WTO accession in 1999. China has also strengthened the legal protection of property and has made some—albeit insufficient—progress in protecting intellectual property rights, opening the domestic financial system, and so forth.

However, the Chinese state does continue to wield considerable influence and control over the domestic economy and business environment. The economy is, therefore, best described as a mixed private-public or market-non-market economy, where the private economy's footprint is growing but is still at the margin of the overall economy. The Chinese state still influences the general direction of state-owned enterprises' (SOE) growth—for instance by directing their involvement in infrastructure projects and export industries. Policies tend to favour SOEs rather than small- and medium-sized players (which include many foreign-invested entities in China).

Also, the state extends financing to the SOEs through the state-owned banking sector as well as other forms of assistance to what are deemed to be strategic pieces of the Chinese economy. Conversely, foreign-invested entities face shareholding restrictions that limit their growth in the local market. More recently, there is a push to see more SOEs become global champions with innovative products and brands—similar to what the Japanese *keiretsu* and Korean *chaebols* (conglomerates) achieved in the 1970s and 1980s.

One of the great challenges for China in developing a more market-driven economy is that of achieving greater transparency, predictability and impartiality—in judicial matters, in the development and enforcement of regulation, and in terms of the accuracy of public information. Transparency and predictability in these areas are critical to the proper functioning of a market-driven real economy and financial sector. Also, there is the trust factor—so critical to business. Trust is still greatly vested in personal relationships and peer networks (*guanxi*) developed over long periods of time rather than in legal contracts and institutions. *Guanxi* is a prerequisite for getting business done—for foreign as well as domestic companies. China has made progress in modernizing both its legal and regulatory systems, and its institutional capacity to manage these is also advancing. Even so, the path ahead remains long.

Land and people transformed

Three decades of economic growth has transformed the country's physical appearance. To sustain its growth, China has invested massively over the last two decades in the modernization of its hard and soft infrastructure across the board. It has invested in everything from urban high-rises, utilities, transportation systems, telecommunications and ports, to education, domestic regulation, internal distribution and the domestic financial sector. Much remains lacking, including its legal and regulatory systems, mentioned earlier.

Unbridled economic growth in a country of 1.3 billion people has also put tremendous strain on China's natural environment. Air, soil and water pollution are a growing problem, as are desertification and drought in northern and central China. The country's urbanization and continued industrialization will, if anything, add to that strain. This is fuelling Chinese demand for clean-technology solutions; for example, for improving the efficiency of energy use per unit of GDP—solutions it cannot do without if it is to achieve sustainable development. Those same environmental and development factors, combined with the growing domestic demand for diversified, high quality food products, are also amplifying China's appetite for imported processed and unprocessed foods.

China's profile as a society has also changed. Some 600 million of its people—a population equivalent to 20 times that of Canada or twice that of the United States—were pulled out of poverty since the late 1970s.[3] Disposable incomes have grown, notably in the coastal Chinese cities, which have benefitted the most from three decades of growth. China's per-capita income today is over US$4,400 in 2010, or $7,600 when looking at real purchasing power.[4] The size of the middle class is projected to hit the 340 million person mark just five years from now.[5] Where everyone once wore the homogeneous "Mao suit" and few consumer goods were to be found on store shelves, today, international and local brand stores and retail outlets line the shopping streets of major Chinese cities. Consumption is growing, but it is nowhere near the levels found in North America or the levels needed to make Chinese economic growth more sustainable. Consumer spending remains tempered by a high propensity to save for the majority of the population.

While Chinese society is becoming more prosperous, at the same time, income disparities within China have also ballooned to become some of the largest in the world. The wealth gap between urban and rural residents and between residents of coastal areas and those in the country's underdeveloped western region are among the widest in the world. This fuels domestic tensions and instability and hangs a question mark on the country's development model. The Chinese government has sought to redress these imbalances over the past decade by encouraging more economic development in western and rural areas.

Increasingly, China's population is living in cities and suburban areas. The country is urbanizing at breakneck speed. In 2010, China's urban population is set to surpass its rural population by 2015 for the first time in its history. McKinsey recently predicted that by 2025, an additional 350 million people will have settled in cities and their suburbs, more than the populations of the United States and Canada combined. There is also a floating population of 100 to 200 million migrant workers originating from rural areas, many of whom work in cities but are unable to settle there permanently due to the limits imposed by China's internal residency permits (*hukou*).

2. China today, tomorrow

China in 2012

China came out of the 2008 financial crisis and subsequent global recession with strong growth figures.

To head off a sharp slump in Western demand for Chinese exports in late 2008 through 2009, the Chinese government injected a two-year, US$586 billion stimulus into the Chinese economy beginning in November 2008. Much of the stimulus was composed of credit extended by state-owned banks and local governments to projects across the country.

3 *UN and China mark International Poverty Eradication Day with major forum* (UNDP, Oct 17, 2008)

4 CIA World Factbook

5 Kheehong Song and Allison Cui, *Understanding China's Middle Class* (Monitor Group, China Business Review, Jan-Feb 2009)

Advancing our economic ties with China

The bulk of that stimulus was destined to fixed assets, notably infrastructure megaprojects such as railways (including high-speed railways), highways, airports, power grids and urban infrastructure across the country. These expenditures aimed to generate demand for domestic industrial output, create jobs to offset the tens of millions of layoffs in China's export industries and grease the wheels of future productive growth by patching up infrastructure deficiencies. That demand has also benefited other countries, including Canada, by sustaining upstream demand for high-tech machinery and equipment, raw materials as well as financial, engineering and other commercial services. Portions of the stimulus were also earmarked for low-cost housing and social safety net development (including healthcare) so as to boost domestic consumption and industrial revitalization projects to move several Chinese industries up the value-added scale.[6]

The stimulus brought China's GDP growth up to 9.2 per cent and 10.3 per cent for 2009 and 2010 respectively, surpassing the country's growth targets. The International Monetary Fund estimated Chinese GDP growth of 9.6 per cent in 2011.[7] However, strong growth does not imply sustainable growth. The stimulus has not resolved a number of economic challenges facing the country—challenges which China is hard-pressed to address and overcome.

Problems looking for solutions

First, China's growth remains too dependent on investment and net exports. Domestic consumption remains the weakest link of the Chinese economy. While consumption has grown in absolute terms, in relative terms it has actually declined over the past two years, and it currently represents only 35 per cent of GDP versus investment which accounts for over 50 per cent of GDP.[8] The result is a Chinese economy which has significant internal imbalances to address and redress. Chinese growth can no longer rely on Western demand to the extent it did before the crisis. Even as the United States recovers economically, its household savings rates will likely remain higher and credit less readily accessible than in the past decade. European demand is being pinched by that continent's volatile macroeconomic situation in late 2011. Also, too much Chinese reliance on Western demand has aggravated global trade imbalances which contributed to the 2008 financial crisis and stoked tensions with trade partners who suspect Chinese trade policy of mercantilism.

Chinese households continue to save a large portion of their income, much of it for precautionary reasons due to the lack of a social safety net and limited access to private insurance. Most Chinese households' inability to purchase homes (where prices are very inflated) further dampens

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6 *China's stimulus package: A six-month report card* (Economist Intelligence Unit, July 2009); pp 9-10

7 International Monetary Fund, "*World Economic Outlook Update,*" also available online at http://www.imf.org/external/pubs/ft/weo/2011/update/02/pdf/0611.pdf [cited June 2011]

8 Linda Yueh, *A Stronger China* (International Monetary Fund, June 2010)

consumption. While China is experiencing rising wage pressures that ought to boost domestic consumption, domestic prices are growing faster than nominal wages, thereby eroding purchasing power rather than increasing it. Private sector saving also remains high, as the state-owned sector crowds out private companies in the domestic financial market, prompting private companies to recycle more of their profits as investment for their own use or that of other companies.

Second, China's very high savings rate (the flipside of insufficient consumption) and successive current account surpluses, coupled with restrictions on capital flows into and from China, have contributed to a binge of domestic investment. The problem is that a significant portion of that investment has landed in projects with questionable long-term returns—fixed assets such as domestic real estate priced well-above most Chinese families' means, industrial overcapacity or redundant infrastructure. This has raised concerns over the frothiness of China's property market and the emergence of non-performing loans on the balance sheets of local Chinese governments and the state-owned banks which financed them.

Third, while the Chinese leadership aims to move the Chinese economy into higher value-added manufacturing and services, China simply does not have an efficient market mechanism to allocate capital efficiently to industries that add value and away from industries that do not. China is challenged to modernize its financial services sector by freeing up room for capital transactions between China and the world and allowing for more foreign participation in China's financial markets to better connect China with global financial markets and financial expertise.

Fourth, China is experiencing high inflation—evaluated at over five per cent in 2011. The credit extended by state-owned banks as part of the 2008 stimulus expanded the money supply sharply in 2009-2010, contributing to inflation. Rising global commodity prices, including energy and foodstuffs, and domestic real estate prices also fed into inflation.

Fifth, China's workforce is aging as a result of the country's long-standing One-Child-Policy. This means that China's era of plentiful cheap labour, especially in coastal provinces, is coming to an end. China's labour shortage has led to rising wage pressures and to the migration of many low-value-added industries from coastal China to inland areas or to nearby countries such as Vietnam, Bangladesh or Pakistan where labour costs are far lower. China is now focusing on generating growth through greater productivity gains and the development of high-value-added industries based on innovation and brand names. This requires vigorous intellectual property protections which have been so utterly lacking in China to date.

Finally, as mentioned earlier in this section, China is pressed to narrow the economic development gap between its poorer regions and richer ones, lest it fuel domestic unhappiness and unrest, to improve its environmental situation and to manage its rapid urbanization.

Whither China?

Every time China faces a major economic challenge, it sparks talk of Chinese collapse in the West. One only has to remember the SOE reforms of the mid-1990s, and the 1998 and 2008 Asian and global financial crises. Each time, China has managed to deal with its problems pragmatically and further modernize its economy. Some economists point to the risk of a Chinese hard landing (and hedge funds have shorted China on this premise), while many others believe the landing will be of a softer kind. No matter the magnitude of the economic correction, it will likely be an inflection point in China's ongoing economic growth story rather than a downward turn. In other words, even if the more bearish scenarios came to pass, China would be less like Japan in the early 1990s and more like the United States in the late 19th century, which experienced economic corrections and then transitioned to healthier, more sustainable economic growth.

China's GDP growth may be slowing down as recent figures show (and will perhaps move from double digit growth to 6-8 per cent annually within the next five years), but this is to be expected given where the Chinese economy is in its development process. As history shows, the Asian tiger economies, Japan, Europe and the United States also decelerated as their economies moved up the value-added ladder and their population growth slowed.

Notwithstanding economic slowdown, there remains much to build in China and the potential for economic development is not even half-tapped. While the larger coastal cities are prosperous and modern, most of the smaller cities along the coast and the vast interior regions have yet to reach that stage. Also, trade and investment between China and other developing countries is increasing rapidly. Chinese entrepreneurialism is alive and kicking, and the growth of the subsequent decade will look somewhat different than that of the precedent one.

China's 12th Five-Year Plan (2011-2015) will put a premium on encouraging brand development and a value-added transition toward high-tech industries, modernizing sectors, like agriculture, through foreign investment, and growing the services sector. Rising incomes, accelerating urbanization, financial sector development and a shift in younger generations' spending behaviour are viewed by many as precursors to more domestic consumption of goods and services—from a current all-time low. China will remain challenged in addressing growing income disparity that adds to social tensions. Also, China appears to be moving toward an internationalization of the role of the yuan, though getting there will mean floating the currency and greatly loosening capital controls at some point along the way. China's Five-Year Plan hints to the country becoming an even more globally-oriented economy rather than one more inward-looking.

Politically, China remains a one-party state. The organs of the Chinese Communist Party (CCP) preside over the functions of state and military, and the CCP decision-making hierarchy is mirrored in both the state and military leaderships. Even so, the power structure has experienced incremental change over the past three decades, having moved from a concentration of power in the hands of a charismatic leader (during the Mao era) to a complex technocracy involving governing factions representing the country's various regional, political, economic and military interests, headed by the Standing Committee of the Politburo at the top. It is a peer-balanced power structure in which no single leader wields overwhelming clout over policy, but where the collective does. While the mechanics of policymaking in China remain largely opaque to the outside world, decision-making is known to involve complex negotiations, balancing and consensus-building between influential factions.

Also, China is currently undergoing a leadership transition. Xi Jinping is all but certain to succeed Hu Jintao as General Secretary of the Chinese Communist Party in 2012 and as President of China after that. There is general concern in China with the accumulation of internal "contradictions" (e.g. yawning wealth inequalities, endemic corruption, non-uniform application of the rule of law, insufficient domestic checks and balances, food safety, lack of societal civility), and how these could impact the economic gains and stability of the past two decades. The question of how the incoming leadership will tackle the contradictions, and how the country will evolve politically even as it transforms economically and socially, remains an open one. The next decade could be decisive.

Part II: Three policy priorities—political ties, trade and investment

Canada-China economic exchanges have grown significantly since 2000, and China is now Canada's third largest trade partner behind the United States and the European Union.

A number of larger Canadian companies and their upstream suppliers—for instance in the raw materials, agri-food, high-tech manufacturing, engineering, financial services and hospitality sectors— have long been active in China. TMX, Manulife, Port Metro Vancouver, Bombardier, SNC Lavalin and Fairmont are just a few Canadian businesses that are active and relatively well-known in China. Other Canadian enterprises have approached China more recently and are working vigorously to develop their trans-Pacific business.

The Canadian companies that are enjoying success in China's eclectic and fast-paced markets, have devoted many years and resources to understand the local business environment, develop relationships with local partners, deliver their products to Chinese users, target specific Chinese regional markets and consolidate their long-term presence. Rewarding though China may be, it also represents a challenging business environment—one unlike the North American business environment that Canadian firms know well. To succeed, even the most well-established foreign companies must skilfully navigate China's constantly shifting competitive and regulatory environment. They must have a good understanding of how China's internal and foreign policy impact doing business.

It is up to businesses to do business, but in China's case, fostering a solid government-to-government working relationship literally enables Canadian companies to do business with Chinese partners on the ground. Part of the federal government's role is to engage and work with the Chinese government and its other international partners to remove the key obstacles in Canada and in China that stand in the path of Canadian business success and a more vibrant Canada-China economic partnership. The Canadian Chamber of Commerce sees three top priorities:

- Implementing a Canadian strategy of political engagement with China
- Pursuing *more* trade and *better* trade with China
- Improving the investment relationship with China

1. Implementing a Canadian strategy of political engagement with China

The Canadian Chamber of Commerce anticipates Canada's trade and investment with China—and with other Asian countries—to continue to expand over the course of the present decade, given current trends. As Canada's trade and investment with China continue to grow, so must Canada's political engagement with China, given the economic interests in play for both countries.

Ties with China will become *one* of Canada's most politically-intensive external relationships over the coming decades, possibly second only to the United States. The relationship is already many-sided, involving international trade and investment as well as finance, security, immigration and other areas where the two countries' interests intersect. Ministers responsible for several cabinet portfolios have become active participants in two-way ties between Ottawa and Beijing. Also, many of the issues on the Canada-China policy agenda overlap with Canada's international policy more broadly.

Advancing our economic ties with China

The growing importance of Canada-China political ties is a reflection of China's rapid ascent as a global economic and political power, which along with the economic rise of Asia as a whole relative to the United States and Europe, represents a major economic and geopolitical shift in the world. Asia's ascent represents the most significant redistribution of wealth, power and influence between nation-states since the end of the Cold War. Some go so far as to say that the shift is the first of its kind since Christopher Columbus landed in the Americas, which inaugurated five centuries of Western economic, political and technological pre-eminence in world affairs relative to the non-Western rest.

To ensure solid foreign policy stewardship that will help open doors of opportunity to Canadian businesses and safeguard Canadian economic interests, the government of Canada will need to implement a strategy of political engagement with China. The government of Canada is very well-positioned to put such a strategy in place. After all, Canada-China political ties are on solid footing and are marked by mutual respect and a sober recognition of mutual differences. Also, the Canadian government—the first majority government since 2003—has put Canada's global economic competitiveness at the top of its priority list, which requires long-term thinking.

So what are the components of a strategy of political engagement with China? What should it seek to achieve?

The bilateral relationship

A strategy of political engagement begins by nurturing a constructive bilateral relationship between the two countries—in other words a constructive government-to-government relationship involving exchanges between leaders from the top level down. Regular visits between Prime Minister Harper and President Hu Jintao, dialogue between the two leaders on the margins of other summits and cooperation between cabinet ministers are the right way to go.

First, constructive political engagement helps drive national visibility in China. China's radar screen is very crowded, as befits a rapidly developing country of 1.3 billion people with a broad domestic and international agenda. China looks out to the world for economic opportunity to sustain its growth: export markets for its products; secure supplies of resources; and know-how to bolster its industrial competitiveness. Likewise, virtually every country in the world seeks to provide goods and services that China needs to develop sustainably and that increasingly sophisticated Chinese consumers demand. Given fierce global competition, obtaining a share of visibility for one's value proposition in China is a challenge many foreign companies and countries face.

Both Chinese political officialdom and end users of foreign products are acutely sensitive to other countries' areas of excellence and how foreign expertise can help improve their personal wellbeing, business competitiveness or local economic development. In China, raising awareness of a foreign country's value proposition and how it both differs from and excels its competitors facilitates businesses' success in securing contracts and selling to Chinese end users.

For the United States whose corporate brands and pop culture are ubiquitous, visibility is less of a challenge. Other countries have made their own mark. Japan is associated in Chinese minds with precision industries and consumer electronics, Germany with engineering prowess and luxury vehicles, and France with cultural products and fashion. Australia was an afterthought for China until the late 1990s, but has since made itself known by leveraging its political visibility, tourism brand and affordable English-language education. Korean conglomerates are uniquely successful in meshing their brand appeal in China with "Korean wave" pop-culture icons.

In China, the popular perception of Canada is positive: Canada never colonized China and it is known as an immigration destination and the home of Dr. Norman Bethune. Even so, the image of Canada remains bland and unsophisticated; some see Canada as a "cold Australia." Raw materials and energy, financial and engineering services—the things Canada is good at—lack the pop-cultural or consumer appeal that helps many other countries become more visible in China. Political engagement at the top leadership level helps cover the visibility shortfall by providing a much-needed limelight to showcase Canadian excellence.

Second, political engagement earns Canada credibility by reframing economic ties as a development partnership. Foreign firms that approach Chinese markets for quick profit usually fail on the ground. Conversely, those firms that match their offer with the development needs of Chinese local jurisdictions and that establish a long-term relationship with local customers are treated as serious players. Political cooperation with China across files of shared interest, such as financial regulation, governance, education and healthcare (which are relevant to China's development), earns Canada credibility and goodwill. The trickle-down effect is that it becomes tangibly easier to do business in China.

Third, political engagement between the two governments is an essential conduit for dealing with divergences in the two countries' economic and non-economic interests. There are issues that are of great importance to Canada where China's position is at odds with Canada's; for example, dealing with rogue states, mitigating trade imbalances, adhering to the rules of fair international trade and advancing civil liberties. Also, for the Canadian business community, China is not only a potential opportunity but also a challenge: there are serious issues such as curbs on market access and anti-competitive measures that do not correspond with Canadian interests (see Part II).

These differences are real, often deep, and cannot be whitewashed. Nevertheless, progress on contentious issues is made through sustained personal contact between political leaders at various levels and senior bureaucrats. Fostering relationship-building and frank communication, which the Chinese know as *guanxi*, is the bedrock upon which trust, respect and a sense of mutual responsibilities are established. It provides an opportunity for enhancing strategic trust, with which practical solutions to problems are more readily found. When Canadian economic or other interests are infringed upon, we can expect the government to leverage the full extent of its relationship with China—economic and political, bilateral and multilateral—in a constructive manner.

Political engagement needs to continue happening from the top level down; i.e. regular visits between the Canadian Prime Minister and the Chinese President and Premier. Deeper strategic trust requires ties at the highest level. Moving down, interaction between cabinet ministers and senior bureaucrats across key portfolios and their Chinese counterparts is ongoing and of equal importance. Several bilateral working groups facilitate these ties. The government of Canada has the right tools of engagement and should continue to deploy them. The Canadian business community looks forward to the upcoming visit to China by the Prime Minister. As the Chinese leadership transition is just over the horizon, a first visit to Canada by China's incoming leader, Vice-President Xi Jinping, in 2012 would be productive.

Political leaders' visits provide an invaluable opportunity to market Canadian excellence and how Canadian excellence dovetails with China's development and consumer needs. Leveraging Canadian tourism and higher education in China is also important. Given that Canadian products have limited pop-cultural and mass-consumer appeal, encouraging more Chinese to see and experience Canada first-hand is one of the best ways for Canada to become better known. This is what Australia (whose challenge a decade ago was similar) did, and it worked. Also, articulating top-level political and moral support—as opposed to financial support—at summit meetings with China's leaders, remains essential for Canadian companies to clinch major deals involving state-owned corporations or government clients in China.

Political engagement involves pursuing cooperation across areas where the two countries' interests intersect. China is interested in learning about foreign experiences in governance and statecraft, for instance Canada's approach to financial regulation, healthcare and education. These are good experiences for Canada to continue imparting, so as to encourage China's integration as a responsible fellow stakeholder in the international system.

Political engagement also needs to happen horizontally, between Canadian provincial and territorial governments and their Chinese local-level equivalents. Here too, Canada has done well, with numerous premiers having visited China and received Chinese delegations at home. The right approach is to target areas of China that have a demonstrable interest in Canadian excellence, not limited to the well-beaten path between Beijing, Shanghai and Hong Kong. However, this horizontal engagement must be done in coordination with federal government efforts and in keeping with a spirit of pan-Canadian collaboration, which is indispensable when going to China. A country has one foreign policy, not fourteen.

While it is critical for political leaders in Canada and in China to maintain a healthy working relationship, it is up to Canadian business, academic and civil society leaders to reach out to their counterparts in China. A number of them have been doing so for some time. For example, the University of Alberta's China Institute has actively engaged its peers in China to reflect on two-way ties and conduct academic and research exchanges. This broader non-government engagement is essential to raise awareness of Canada in China, and more of it needs to happen.

The broader political relationship

Canada-China political ties are more than purely bilateral. After all, China's impact on the world is increasingly far-reaching, and there are few areas of global activity—whether in the economy, politics or security—where China does not have a growing presence and impact.

China, like India, is rising in a U.S.-led international system that has been in place for six decades and that provides global public goods like governance, rules and standards for fair and open trade and investment, and collective security. These public goods enable peaceful economic growth and open markets and serve to level the playing field of commerce between nations. It is a system that has allowed the Canadian economy to prosper. The system has also facilitated China's economic growth, and China is a member of many of the institutions that underpin it, like the World Trade Organization (WTO), the International Monetary Fund (IMF) and the World Bank and forums such as the G20.

The debate on what kind of leadership role China will assume as it rises is an intense one in policy circles both within China and without. China's leaders have stressed that their country's rise will be peaceful and that it will be a motor for growth beyond its borders. Nevertheless, power shifts of this sort are invariably accompanied by tensions. For instance, trade disputes and disputes on contentious political-security matters in Asia and elsewhere occasionally stoke tensions between regional players, notably the United States and China. At the same time, vigorous efforts are being undertaken by the United States, China and the other countries of the Asia-Pacific region to advance regional security, strengthen regional cooperation (economic growth, anti-terrorism, combating organized crime, etc.) and to mould frameworks for trade and investment in the region that complement the international rules-based trade system watched over by the WTO.

Canada and Canadian companies have an obvious stake in the evolution and proper functioning of the global rules-based trade system under the WTO. But rules and institutions do not always have the final word and relative power between states being what it is, Canada must continue complementing its bilateral ties with *all countries* by cooperating with other like-minded international partners as needs arise.

Canadian business also has an important long-term stake in what happens in the Asia-Pacific region. Canada is a Pacific country, and Canadian economic interests with regards to China are tied to its broader economic interests in the region. The Asia Pacific Foundation of Canada and a number of other Canadian research organizations recently underscored the importance of having a holistic Canadian strategy of engagement with Asia, which would ensure consistency in Ottawa's ties with all Asian capitals.

The Asia-Pacific region includes heavyweights like the United States, China, India, Indonesia, Japan and Russia as well as influential countries such as Australia and South Korea. The United States, China, Japan and South Korea already rank among Canada's top 10 trade partners, and it is anticipated that our economic exchanges with these countries will continue to grow. Canada will have a direct and deeper stake in the security, political stability and economic sustainability of the Asia-Pacific region, as political tensions or economic disruptions within the region could directly impact Canada economically in terms of trade disruptions or financial shocks. What happens in Asia matters more to Canadian interests than many today imagine.

The Asia-Pacific Economic Cooperation (APEC) forum, the East Asia Summit, the Shangri-La Dialogue, the ASEAN Regional Forum and Defence Ministers' Meetings and the Trans-Pacific Partnership (TPP) negotiations are some of the vehicles in place to negotiate and manage tensions, ensure regional peace and stability and advance fair and open trade between Asia-Pacific countries. These are not multilateral talk shops that achieve few concrete results on anything. They are results-oriented networks for building regional order, similar to the institutions and forums that underpin European and North Atlantic security and economic prosperity.

Canada is already a constructive member of APEC, and Minister Baird recently sent a signal of Canada's interest in Asia by participating in the ASEAN Defence Ministers' Meeting in Bali, Indonesia. As a next step in its Asian political strategy, Canada should seriously explore joining the other key political-security and economic policy platforms of the Asia-Pacific, beginning with the East Asia Summit and the TPP process. It would move Canada from the outside to the inside and provide it with an insider's voice and credibility in regional matters in line with Canadian interests in the regional order. Though the TPP is at an early stage, Canada must join it lest it finds itself locked out of a framework that will consolidate trade and investment rules in the Asia-Pacific over the course of the next decade. To that effect, the Canadian Chamber of Commerce welcomed Prime Minister Harper signalling Canada's intention of joining the TPP at the recent APEC Summit in Hawaii. Joining the East Asia Summit may mean initially joining as an observer and would require the support of the current member countries.

Recommendations

- **That the government of Canada continue ongoing bilateral engagement between political leaders on both sides from the Prime Minister's level down through cabinet.** Bilateral engagement boosts Canadian visibility and credibility in China which helps Canadian businesses succeed on the ground, provides moral support for Canadian companies operating in China, expands space for strategic trust between our two governments and provides a vehicle for effectively addressing economic, political security and other differences between the two countries.

- **That the government of Canada implement a holistic strategy of engagement with Asia to ensure Canada is an insider in the building of the Asia-Pacific regional order, and to ensure consistency in Canada's political engagement with individual Asian countries.** As Canada's trade and investment with China and other Asian countries grow, our country will have a deeper stake in the political stability and security of the region and in the frameworks for rules-based trade and investment in the region. Canada's rightful place is as an insider in the Asia-Pacific: it is already an active member of APEC and should seek to join the East Asia Summit and Trans-Pacific Partnership negotiations.

2. Pursuing *more* trade and *better* trade with China

During President Hu's visit to Ottawa in June 2010, Prime Minister Harper and the Chinese leader spoke of doubling two-way trade between Canada and China by 2015. A 2009 Fraser Institute study found that there is a long way to go to tap the full potential of the commercial relationship between the two countries.[9]

While the value of Canada's merchandise (goods) trade with China has expanded from C$47.3 billion in 2007 to C$57.7 billion in 2010,[10] and although China became Canada's third-largest trade partner after the United States and the European Union in 2007 (and its third-largest export market), China still represents only seven per cent of our country's overall merchandise trade. China absorbs only some three per cent of Canadian merchandise exports, versus 75 per cent to the United States.

Moreover, Canadian merchandise exports to China continue to be dominated by processed and unprocessed commodities, including wood pulp, nickel, oil seeds and grains, organic chemicals, minerals (salts, sulphur, earths, stone and others), machinery, boilers and mechanical appliances, ores and fertilizers. Chinese demand reflects China's ongoing push for infrastructure and real estate development, as well as the Chinese manufacturing sector's need for raw materials and machinery to produce higher value-added goods for export, including to Canada. Imports from China range from machinery and equipment, electrical appliances to toys, furniture and apparel.[11]

9 Raaj Tiagi and Lu Zhou, *Canada's Economic Relations with China* (Fraser Institute, Feb 2009); p 1

10 Canada's State of Trade: Trade and Investment Update – 2011 (Foreign Affairs and International Trade Canada, June 2011)

11 Industry Canada

On the commercial services side, Canada's trade with China (including Hong Kong) has grown in recent years, from C$586 million in 2000 to C$692 million in 2007. However, Canadian commercial services exports to China fell from C$440 million in 2000 to C$379 million in 2007, representing less than one per cent of Canadian commercial services exports, while our commercial services imports from China rose from C$146 million to C$313 million during the same period.[12]

Turning to the balance of trade, Canada has registered a ballooning deficit with China in both goods and services. Canada's deficit with China ballooned by 400 per cent from 1998 to 2007 to become the largest Canadian trade deficit with any single country. This deficit had stabilized at a little under C$30 billion after 2007 but has grown since as a result the 2010 economic recovery.

The Canadian Chamber of Commerce advocates the need for *more* Canadian trade with a vast market such as China's, but it also advocates the need for *better* trade. By better trade, the Canadian Chamber means a rebalancing of trade and a reduction of the year-on-year current account deficit with China. An imbalanced commercial relationship with China is not in Canada's long-term interest and it is neither good nor sustainable for the Canadian economy. What can be done about it?

Rectifying China's barriers and irritants to trade

Closing the door to trade is tantamount to sliding down a slope of successive tit-for-tat measures. Protectionism is lose-lose and is not the solution. Especially not for a country like ours that depends on open, rules-based cross-border trade.

To be fair, if Chinese imports to Canada have outstripped Canadian exports to China, it is partly due to the fact that, barring a dream team of mostly larger companies, Canadian businesses have not focused on China as the U.S. economy next door offered an abundance of easier-to-reach opportunities. What is more, the Canadian business community is mostly made of small- and medium-sized enterprises that dispose of limited resources to explore opportunities in complex, distant and unfamiliar markets such as China's—let alone travel to them. Some Canadian exports to China are also masked by trade statistics (e.g. Canadian inputs supplied to U.S. clients who then export finished products to China). That said, the reverse is also true (Chinese inputs in U.S. imports to Canada). Attitudes have changed post-2008, and more Canadian companies of various sizes have expressed interest in developing markets such as China's.

To improve the quality of trade ties with China, Canada's private sector must better match its value proposition with China's needs. Canadian businesses are looking to boost their competitiveness in global

12 Statistics Canada

trade and investment. The Canadian government has made incenting business competitiveness and promoting value-added activity on Canadian soil a hallmark of its economic agenda and has taken many positive policy moves to that end. It must continue on that track through additional measures, which the Canadian Chamber of Commerce will discuss in its initiative on competitiveness.

Even so, business behaviour is not the full explanation for imbalanced trade. After all, Canadian sectors such as the financial and engineering services industries, the extractive sector and the aerospace and transportation sector have long histories of partnership with China and a good understanding of the country, yet they too face challenges in China's markets. The United States and several European countries have also experienced bulging trade deficits with China despite their private sectors being very active there. China continues to register large current account surpluses.

Over the past three decades, and especially following the country's accession to the WTO, China has made good progress in opening its economy to cross-border trade and investment and in allowing more market-based mechanisms. While the government and public sector (state-owned enterprises and banks) still hold sway over the national economy, the private sector is vibrant and growing (though still at the margin of the economy).

However, Canadian companies—like their foreign counterparts—face barriers and irritants to trade and investment in China that impede or hamper their real market access by making the delivery of goods and commercial services in China and the expansion of business activities unduly complicated, costly or inequitable for companies. For many small- and medium-sized enterprises that have limited resources, the presence of such barriers and irritants makes China a no-go business proposition. It is, therefore, important for the government of Canada to intensify efforts to remove these barriers and irritants and better level the competitive playing field for Canadian businesses by engaging with the Chinese government directly, and by engaging our other international partners and WTO when appropriate.

The Canadian business community is aware that quick solutions do not come by easily. Other jurisdictions including the United States have found obtaining solutions to trade and investment issues to be challenging. Nevertheless, the Canadian government's efforts to that end should continue.

Key issues include:

- **Weak intellectual property protection and enforcement**

  Having and enforcing high standards of intellectual property (IP) rights protection is crucial to well-functioning, fair and open trade and to healthy economic growth. Without it, healthy inter-company competition through innovation disappears, and what is left is a commercial race to the bottom. Both Canadian and a growing number of Chinese businesses view IP rights protection as crucial to their success. The Chinese government is cognizant of the need to strengthen its IP regime if China is to move from an economy of lower value-added manufacturing to one based on research and development (R&D) in innovation and the development of brand value in goods and services. It is also aware that insufficient IP protection deters many foreign companies from contemplating China as a destination for direct investment that could bring benefits to China in the form of jobs and a trickle-down of skills and experience.

  China has had to pay more attention to IP issues following its entry into the WTO. It has joined the World Intellectual Property Organization (WIPO) and signed its Copyright Treaty and Performances and Phonograms Treaty. In 2008, China released a National IP Strategy calling for a culture of IP protection, the revision of laws on patents, trademarks and copyrights and enforcement practices that would make China a country with a high level of IP protection by 2020. More recently, Chinese authorities have sequestrated counterfeit goods in a number of high-profile cases.

Despite the progress made to date, IP rights infringements in China remain rampant. They are a deep concern for Canadian businesses since they deter entry into the Chinese market. They erode company value both in China and other markets (including Canada) as a result of illicit profit-making and because sub-par counterfeit products dent brand value. For instance, there is concern with substandard copyrighted or Chinese-made counterfeit products sold in Canada that create real safety risks for Canadians. There is also concern that foreign businesses may receive lesser IP protection than that received by their Chinese counterparts.

China's National IP Strategy is full of good intentions but lacks teeth to be effective. The consistency and effectiveness of IP enforcement remains inadequate, notably at the local level where certain local governments turn a blind eye to counterfeit industries in which they have vested interests. While Chinese law prosecutes IP infringements, many prosecutors and police officials lack thorough experience in recognizing such infringements and handling IP rights cases. Criminal penalties for IP violators are often lax and, therefore, do not deter effectively.

Seizures of counterfeit goods within China and at the Chinese border (on their way out as exports) are sporadic, and the disposal of these goods is inadequate. Seized counterfeit products are not systematically destroyed, and some find their way back into the market. Likewise, downloading pirated material off the internet in China is not systematically punished. Then there is the serious issue of the illicit squatting of foreign trademarks, brand names, web domain names and patents in China. Also, patent-term restoration is not sanctioned under current Chinese patent law.

There is a deep and growing concern in Canada and in other countries around the theft of IP and other trade secrets by unscrupulous company employees as a result of the sub-par protection of sensitive foreign company information obtained through official licensing and certification procedures and through cybercriminal activity. Theft of IP and trade secrets is an issue involving many countries and it is not a Chinese issue per se. However, China is consistently singled out in terms of the frequency with which this issue arises. The Canadian Chamber of Commerce hopes the Chinese government will treat the issue with utmost urgency.

IP rights protection remains fairly new for China, and the Chinese government is still working to improve its IP regime and the enforcement thereof. In light of this, the Canadian Chamber of Commerce looks forward to greater collaboration between the Canadian and Chinese governments in view of improving IP rights protection.

Canada must also do its part as it has fallen behind in global terms when it comes to the protection and enforcement of IP rights, in particular of trademarks, copyrights and patents. The Canadian Chamber of Commerce looks forward to the Canadian government swiftly passing an improved Copyright Bill, introducing legislation that strengthens enforcement of IP rights at the border and implementing stronger data protection measures in the life sciences sectors to protect innovation.

- **Trade restrictions on goods and services**

  China has lifted many tariff and non-tariff barriers on goods and services as part of its WTO commitments. As a result, its market access improved markedly after 2000. However, in recent years, non-tariff restrictions on foreign imported goods and services to China and investment activities have stiffened.

  China's trade restrictions include: regulatory standards that hinder the import, sale or end-use of foreign products in China; standards that differ from common international practice and norms; rules and standards that differentiate or discriminate between foreign and domestic enterprises; sudden or arbitrary changes in regulation and regulatory processes; excess red tape that makes it difficult for small- and medium-sized enterprises to operate; and barriers on the expansion of business activities in China. A number of these restrictions raise the cost of doing business for Canadian companies or deter smaller companies with limited disposable resources from pursuing potentially lucrative trade opportunities in China.

  Some non-tariff barriers appear to be in place to shield sensitive domestic economic interests from foreign competition and to incubate growth and limit foreign participation in industries deemed to be of strategic importance to China. These, along with a number of unfair competitive practices, have fuelled suspicions in the West that China is pursuing a mercantilist trade agenda—suspicions that have found their expression in trade disputes between China and advanced economies such as the United States and the European Union and that have generated rising protectionist pressures.

  There are also barriers resulting from China's particular regulatory and legal traditions. Certain regulatory standards are in place for legitimate reasons like consumer safety or environmental protection—considerations that are of growing importance to Chinese authorities and consumers. Even so, it is important to adopt a reasonable approach to these measures so as to mitigate their impact on legitimate trade.

  Canadian companies are cognizant of the political complexity surrounding the Chinese trade restrictions in place and the challenges faced in implementing regulation systematically at the local level throughout China. For its part, the Chinese government recognizes the value of greater transparency in the implementation of regulation as a way to fight corruption. As a large trading nation, China is aware that dealing with trade restrictions is a necessary step to restore its trading partners' confidence in the win-win nature of open, rules-based trade and investment between nations.

  For Canadian businesses, it therefore remains critically important that the reduction of restrictions on real market access remain a priority on the Canada-China political agenda. Many Canadian sectors, such as financial services (insurance and banking), mining, aerospace, transportation and agri-food face barriers in selling and delivering their products in China. The two countries should continue to work closely to find solutions to these issues.

- **Unfair competitive practices**

  China has made considerable progress since joining the WTO. In less than a decade, China has gone from a closed economy to becoming a world-class player, witnessing extraordinarily rapid change with numerous positive outcomes for its citizens. It speaks very clearly to what a more open China can mean in terms of economic development, not only for the people of China, but for the rest of the world. Long-term economic development needs to be driven by two key conditions: a *free* and *fair* market.

China is bound to conform to the norms and disciplines that govern all WTO members. Despite progress, there is concern in Canada and in other countries that China significantly understates the extent to which it subsidizes its industries, notably state-owned enterprises, by providing direct or indirect financial support or preferential access to competitiveness-enhancing technologies and know-how.

Uncompetitive measures include the following:

- Provision of subsidies to sectors and industries deemed sensitive or strategic;
- Extension of government loans (from state-owned-banks) to state-owned enterprises at below-market interest rates;
- Provision of subsidies for technology upgrades and marketing purposes;
- Promotion of foreign investment in state-owned enterprises;
- Use of technology transfer requirements for foreign invested companies that benefit local competitors;
- Protection of indebted state-owned enterprises through the removal of non-performing loans from balance sheets and other measures;
- Use of trade- and price-distorting export restrictions on inputs used by domestic industries; and
- Undervaluation of the yuan which provides Chinese companies with an artificial competitive advantage.

For examples of tariff and non-tariff barriers and uncompetitive measures that harm foreign and Canadian goods and services in China, please consult the annex to this paper.

In capital-intensive industries, policies that artificially sustain inefficient facilities that would otherwise be commercially unviable can have a significant and long-lasting impact on global markets. Canada must work with its WTO partner countries, and directly with China, to do away with subsidies, market barriers and discriminatory trade policies in China. Canada must encourage China to build on its achievements to date by further strengthening its market-based system and adherence to international trade rules.

To achieve this, Canada should work with China on a series of political agreements, sector-by-sector, to remedy those trade (and investment) irritants that are of greatest concern to the Canadian business community, followed by close monitoring of the outcomes by the Canadian government in consultation with the business community.

In *Canada-China: Building a strong economic partnership*, the Canadian Chamber of Commerce noted that some sections of the business community suggested comprehensive economic negotiations with China. This would be a very complex undertaking. Among advanced economies, Australia and Norway are currently in FTA negotiations with China. However, those negotiations met complications and slowed down. The Canadian Chamber of Commerce considers a bilateral Canada-China FTA to be a premature undertaking. The Canadian government should focus its energy on concluding the Foreign Investment Promotion and Protection Agreement still under negotiation between Canada and China and on targeted agreements redressing specific trade irritants sector-by-sector, whose results can be measured.

Finally, where trade practices are at odds with WTO obligations, Canada must be vigilant in defending its legitimate interests. It must continue ensuring that trade-remedy mechanisms work well and that their use is timely and cost-effective for business.

At the same time, the government must avoid applying artificial market barriers that are self-defeating, since competitive pressures rarely diminish. When NAFTA was implemented, many Canadian companies and the communities on which they depend were compelled to make painful yet necessary adjustments, but in the end, they came out of the process stronger and more globally competitive. Transition assistance may be a more effective solution than short-term protective measures.

Rectifying barriers and irritants to trade in Canada

Barriers to more and better trade with China are not limited to those Canadian companies face in China. There are barriers Canada needs to deal with at home.

One such obstacle is the stalling of progress on getting the Northern Gateway pipeline approved and done, which once completed will provide an outlet to supply Canadian oil to the dynamic economies of the Asia-Pacific—including China, India, Japan, South Korea and the ASEAN countries—whose thirst for reliable energy is strong and growing. Countries such as Russia, Australia, Kazakhstan and the Gulf states are already actively supplying the region with oil and / or gas. The United States is weighing the potential of its own shale gas reserves. If Canada is to live up to its vocation of being an energy superpower, in terms of both conventional (oil, gas) and renewable energies, it needs to become a major supplier of reliable energy to China and to the other Asia-Pacific countries, while growing its role as a reliable supplier to the United States in tandem.

The Northern Gateway pipeline, just like Pacific Trails, is a great opportunity for Canada—but Canada must move quickly. The Canadian Chamber of Commerce applauds the federal government's efforts to engage the provinces of British Columbia and Alberta as well as affected Aboriginal communities to work toward an agreement that allows the pipeline to be built while favourably addressing legitimate concerns relating to the environment and Aboriginal communities' rights. The Canadian Chamber hopes provincial and other parties involved in the process will show similar determination to find an acceptable path forward.

Another significant obstacle is that of the Canada-U.S. border. The Canadian government has demonstrated exceptional vision in undertaking the Asia-Pacific Gateway and Corridor Initiative (APGCI) since 2006, which has refurbished and expanded maritime ports, airports, rail, roads and pipeline infrastructure connecting Canada and the United States with East Asia via Canada's western seaboard. Canada's geography, coupled with the right infrastructure and an appealing domestic investment environment, can allow our country to become a trade logistics and business corridor between North America and Asia.

For years, businesses and travellers have identified high costs and delays at the border as a major irritant for the cross-border movement of people and goods. Given our integrated supply chains, the Canadian economy needs a more efficient and trade-friendly border. In particular, the Canadian Asia-Pacific Gateway cannot reach its full potential as a logistics and business bridge between North America and Asia without the free flow of legitimate goods and people across the border. The Canadian Chamber of Commerce therefore applauds the border agreement just recently announced by the governments of Canada and the United States and looks forward to its timely implementation.

Recommendations

Recommendations

- **That the government of Canada continue to remove the obstacles to competitiveness in Canada and incentivize commercial innovation and value-added economic activity in Canada.** The government has achieved a lot in this area with more to come, and more businesses should look to take advantage of a domestic business environment which is conducive to competitiveness. A competitive Canada is requisite for more and better trade with China.

- **That the government of Canada and its Chinese counterparts and international partners work to make progress on IP rights protection in China.** Lack of IP rights protection in China is a major hurdle to open, rules-based trade between nations. Also, Canada must do its part to rectify its own IP record.

- **That the government of Canada work with its Chinese counterparts to remove the barriers to trade, including the non-tariff barriers and unfair competitive practices in China that are harmful to Canadian businesses in the goods and services sectors**.

- **That the government of Canada continue to effectively use WTO mechanisms, where necessary, to deal with trade issues that harm Canadian economic interests.**

- **That the federal government continue to work with the provinces of British Columbia and Alberta and affected Aboriginal communities to find an acceptable path forward on the Northern Gateway pipeline.** The Northern Gateway pipeline, like the Pacific Trails pipeline for gas and renewable energy technology exports, is crucial to Canada becoming a reliable energy supplier to the Asia-Pacific region, including China.

- **That the governments of Canada and the United States fully implement the joint action plan for the border, without which the Asia-Pacific Gateway cannot reach its full potential.**

3. Improving the investment relationship with China

In *Canada-China: Building a strong economic partnership*, the Canadian Chamber of Commerce found investment to be an undersold component of Canada–China economic exchanges. It is an area where Canadian business believes improvements can and should be made.

Foreign direct investment in Canada

Canada boasts a strategic location next to U.S. markets, to which it has preferential access under NAFTA. Canada's macroeconomic fundamentals are sound, its business tax regime is competitive and its workforce is highly skilled. Many Canadian small- and medium-sized enterprises and research institutes in colleges and universities incubate innovative ideas whose road to commercial fruition is deterred by insufficient access to venture capital. These are components of Canada's draw as an international investment destination.

Canada's stock of outbound foreign direct investment (FDI) to China, including Hong Kong, grew from C$4.6 billion in 2005 to C$9.6 billion in 2008.[13] This last figure appears large until one considers that the United States and the European Union together held 70 per cent of Canada's total C$637 billion stock of outbound FDI in 2008. That year, China held only 1.5 per cent of that stock.[14] Similarly, mainland Chinese FDI in Canada represented only C$2.7 billion of the total stock of inbound FDI in Canada, equal to C$505 billion in 2008.[15]

The United States and the European Union will likely remain Canada's two largest sources of inward FDI going forward, as the U.S. and larger European economies slowly revive their overseas investment activities. Yet, just as Canada needs to intensify and diversify its international trade, so too does it need to have eggs in different baskets when it comes to direct investment. After all, the financial crisis of 2008-2009 has left a harsh mark on U.S. and European capital markets and reduced appetites for risk. On the contrary, Asian (and some non-Asian) capital markets are awash with liquidity, and enterprises from China (but also India, Brazil, Japan, South Korea) are actively courting investment opportunities around the globe in a bid to enhance their access to resources, markets and brands. Looking to Asia, it is in Canada's interest to draw FDI from a *diversity* of source countries, including but not limited to China.

Chinese interest in investing in Canada, while recent, is real and inbound investment has expanded since 2008. Canada is perceived positively for its openness to Chinese FDI and is ranked near the top alongside countries such as Australia. Chinese state-owned enterprises (SOEs) and China's sovereign wealth fund, the China Investment Corporation (CIC) have been active through a series of minority-stake investments in mineral and oil sands ventures in Western Canada and Northern Quebec. In 2010, the CIC opened its first overseas bureau in Toronto.

National security concerns about Chinese investment exist in sensitive areas, and there is considerable sensitivity around investments by SOEs versus Chinese private companies. Linkages between investment and geopolitics exist—China does have a strategic interest in securing access to natural resources and diversifying its foreign reserve holdings away from low-interest-rate-yielding U.S. debt and riskier European debt. Chinese companies do express interest in Canadian energy, natural resources, agriculture and biotechnology as promising sectors for investment.[16] Also, concerns have been raised around FDI in knowledge-intensive

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13 Foreign Direct Investment Statistics, Department of Foreign Affairs and International Trade

14 Michael Holden, *Overview of Canadian Foreign Direct Investment* (Parliamentary Information and Research Service, Library of Parliament, Jun 17, 2008)

15 Ibid.

16 *China Goes Global 2009: Survey of Outward Direct Investment Intentions of Chinese Companies* (Asia Pacific Foundation of Canada, Sep 2009)

industries that could result in targeted acquisition of know-how and swift market pullout, as opposed to FDI that also builds value and creates quality jobs in Canada.

These concerns are legitimate, but it would be mistaken to frame all Chinese capital as incompatible with Canada's best interests. Investments must be appraised on a case-by-case basis. First, the scale of investment is not large *yet*, and Chinese investors have exerted caution in pursuing minority stakes rather than seeking majority equity. Second, there are instances where Chinese investors pursuing their own best interests can also advance Canadian economic interests. The development of resources for export to world markets (at market prices) is an example.

The Canadian Chamber of Commerce welcomed the 2009 amendments to the Investment Canada Act, which raised the enterprise value thresholds for which foreign investments in Canadian assets are subject to government review. The federal government should fully implement the new thresholds. The Canadian Chamber appreciates the well-founded need for a national security review process to safeguard Canadian interests. By that same token, it is important for Canada to continue signalling its open and non-discriminatory stance toward commercial FDI, subject to its compatibility with Canada's national security interests.

To date, most inbound investment from China was absorbed by the extractive sector. Canada welcomes this sort of FDI in our country's raw materials sector if done on a commercial basis. More value-adding activities around the extractive sector should also be encouraged in Canada through the right incentives. At the same time, Canada can encourage more commercially-oriented FDI from China and other source countries in sectors such as services and high-tech manufacturing. These sectors have drawn little capital from Asia to date in comparison with the United States and Europe whose FDI in Canada is less skewed toward resources. One exception to the trend is the recent investment made by Huawei in a telecommunications research and development venture in the Ottawa region.

Canada is not seeking FDI that is short-term-oriented, politically-motivated or focused on the acquisition of existing technologies, know-how or distribution and supply networks. Businesses—and the federal government when investment thresholds apply—must be careful in evaluating whether or not an investment bid is of that nature (regardless of which country is investing)—hence unwelcome. Canada is seeking investment that contributes to the development or co-development of new technologies and brands and to the growth of industries in Canada. Greenfield investment is something more investors may find worthwhile to explore. New technologies and brand names developed together could be of benefit to both sides, and foreign investors in Canada's various sectors would stand to gain in terms of returns on their capital as their projects in Canada expand.

Removing caps and controls on capital transactions

Improving the investment relationship with China involves portfolio investment as well as FDI, and it goes beyond the direct investment currently undertaken by the China Investment Corporation (CIC) and a number of SOEs. Canada and China should work to broaden two-way flows of different types of capital between them on a bilateral basis—this means removing the caps and other restrictions in place on cross-border capital transactions involving Chinese institutions and individuals.

Canada can provide exceptional financing solutions to Chinese companies and it can also provide vast opportunities to Chinese individual and institutional investors looking to plug into North American and global capital markets. The Canadian financial sector is looking for a broader partnership with China—and in fact all of Asia. Its understanding of China's potential—and Asia's—is certainly nothing new, as demonstrated by Canadian financial companies' presence in China since the 19th century. Today, they are active on the ground and nurturing collaborative ties with local partners, including in China's emerging financial hubs of Hong Kong-Shenzhen and Shanghai.

Private Chinese enterprises are multiplying quickly, and they are great drivers of innovation and productivity growth—priorities of the Chinese government as outlined in its 12th Five-Year Plan (2011-2015). However, the private sector tends to be crowded out by the state-owned sector in China's formal capital markets. State-owned banks are obliged to extend loans at competitive (occasionally below-market) rates to state-owned companies and have an incentive for doing so since state-owned ventures are perceived as less risky (such ventures receive strong official support and a loan's non-performance risk is largely insured by the state).

This leaves less capital available to private companies. The meagre availability of competitive financing hinders the growth of private Chinese enterprises. It also contributes to the high-savings and low-consumption phenomenon seen in China, as much of the wealth generated finds itself recycled as investment to respond to companies' growth needs or injected into informal capital markets in the pursuit of lucrative rates of return, rather than being paid out as dividends or higher salaries that contribute to consumption.

Given the lack of available funds, thousands of Chinese private companies want to tap into offshore—and notably North American—capital to finance their growth. Chinese entities express a clear interest in listing in Canadian stock markets and in using Canadian financial institutions as intermediaries because of our country's record of sound financial oversight and the proven resilience of the Canadian financial sector during the financial crisis of 2008. Canada's stock markets are specialized in the sort of small- and medium-sized enterprise (SME) financing solutions that Chinese SMEs seek (TMX is the world's leading venture market and leading second-tier marketplace for SME financing), and they are global leaders in the financing of clean technology projects (clean-tech equity financing) and resources. Canada has been dubbed the up-and-coming global hub for mining and oil-gas financing. Also, Canada's insurance cluster and the products it sells are likewise recognized as among the best and most reliable in the world. Canadian insurance companies have a historic presence in China and are actively contributing to China's social development by providing world-class health-care and retirement-financing solutions that are not provided by the government.

In the same vein, many Chinese individual and institutional investors would like to bring their capital to Canada to diversify their portfolio and earn returns overseas. Given restrictions on international capital transactions, the stores of wealth currently available to Chinese individual and corporate savers are quite limited. As Chinese private wealth increases, much of it is driven into domestic fixed assets—notably Chinese real estate—in pursuit of higher returns. This has contributed to the frothiness of those fixed assets and to inflation in China, which the Chinese government is working hard to reduce. Loosening capital restrictions with Canada on a bilateral basis is a win-win for both countries. It matches China's economic objectives of boosting home-grown innovation, spurring consumption, tempering fixed asset frothiness and inflation, and opening the Chinese financial system as the yuan becomes more international.

Given the Canadian financial sector's stability and its expertise in SME financing solutions, Canada is both a safe and good place to work with in terms of progressively reducing capital controls and developing the Chinese financial system going forward. Rather than opening with all countries all at once, China can experiment (conduct a pilot project) with a select number of countries such as Canada.

Opening the investment relationship would mean loosening restrictions on which individual or institutional investors can draw from Canadian capital or invest in Canada, and how much capital is permitted to flow in either direction. Some progress has been made. The China Banking Regulatory Commission has designated Canada as a destination for Chinese wealth management under China's Qualified Domestic Institutional Investor (QDII) program which allows approved institutional investors in China, including banks, to invest in Canadian funds pooled from mainland clients. However, the QDII program still imposes a strict cap for the funds quota of just under US$80 billion annually. For Chinese individuals, there is a cap of US$50,000 that can be transferred annually overseas to non-investment accounts.

Therefore, in pursuing financial cooperation with China, the Canadian government should persuade its Chinese counterparts to relax both QDII restrictions concerning Canada and substantially raise the caps on individual capital transactions from China to Canada. Also, the Canadian government should continue working with its Chinese counterparts to share lessons on financial sector development, including the loosening of capital controls. China has an interest in the Canadian experience of prudent yet internationally-minded financial management.

Foreign direct investment in China

Investment, like trade, is a two-way street. For China, openness to investment is essential to its economic diversification and competitiveness. While China has gradually opened over the past decades, concerns have arisen within the Canadian business community that China's investment environment has tightened in recent years. Also, foreign investment restrictions remain in a number of Chinese sectors considered strategic. These sectors include aviation, coal, electric power and grid, oil and petrochemicals, shipping, telecommunications, automotive, chemical, construction, electronic information, equipment manufacturing, iron and steel, and non-ferrous metals.

According to the Organisation for Economic Co-operation and Development's (OECD) 2010 FDI Restrictiveness Index, China scored 0.457 on the index (where 1=closed to FDI and 0=open).[17] By comparison, the OECD average was 0.095 (Canada scored 0.153) whereas the non-OECD average was 0.157. China's FDI restrictiveness score was among the highest in the index.

The Canadian government should redouble its efforts to persuade China to loosen restrictions on Canadian FDI in China. While it is understandable that some sectors of the economy are strategic, Canada and Canadian companies do not pose a strategic challenge for a large country like China. If anything, Canadian FDI has provided China with the expertise it needs for its own economic and social development purposes. Canadian insurance helps Chinese households and businesses mitigate risk in the absence of comprehensive public social benefits and given the limits of the domestic insurance market. Canadian high-tech transportation products

17 Blanka Kalinova, Angel Palerm and Stephen Thomsen: OECD'S FDI Restrictiveness Index: 2010 Update (OECD Working Papers on International Investment, No. 2010/3, OECD Investment Division, www.oecd.org/daf/investment); p.19

(aircraft, rail vehicles) and sustainable engineering services have helped China develop its infrastructure sustainably, and Canadian multinationals operating in these areas are eager to develop investment partnerships with China. What is more, Canadian mining services companies have assisted China in prospecting mining opportunities and mining sustainably. Canadian FDI has clearly been a win-win for both Canada and China.

The Canadian Chamber of Commerce calls upon the governments of Canada and China to work together in view of removing FDI restrictions on Canadian companies and on ensuring that Canadian FDI is afforded fair and equitable treatment going forward. Below are some of the key FDI restrictions.

- **Mining**: In recent years, China has actively developed its domestic commodities sectors, notably in metal, mineral and coal mining, and oil and gas exploration, production and refining. This presents business opportunities for Canada's world-class mining companies and mining service providers. However, there are barriers: foreign companies must enter joint venture agreements with Chinese partners to engage in mining exploration and production; Canadian companies are often small- and medium-sized enterprises lacking the scale to compete for projects where Chinese enterprises seek a single, major foreign partner, and minimal capital requirements effectively prevent these SMEs from getting involved; foreign investors must grapple with restrictive, often unclear regulatory implementation at the local level; and there are issues around exploration-to-production license transfers, which have been used by local partners as a bargaining tool with their Canadian counterparts. The Canadian Chamber of Commerce hopes China can level the playing field for Canadian involvement in its mining sector.

- **Financial services**: The licensing process is a sensitive topic for the insurance industry. In October 2008, China stopped giving out new licenses for regional sales offices without divulging why the moratorium was put into place and when it would be lifted. At the same time, foreign-invested life insurers are facing problems getting branch-expansion approvals. Despite assurances from the Chinese Insurance Regulatory Commission (CIRC) that companies are eligible for multiple branch approvals on a concurrent basis, these approvals can occur only on a consecutive basis. These measures favour domestic-owned insurance companies and are not in keeping with China's WTO commitment. Currently a foreign bank is permitted to invest in no more than two Chinese banks and the equity stake is capped at 20 per cent. The two-bank quota should be increased to at least three, given the large number of smaller banks that are not systemically important in China and the equity cap raised to 49 per cent to allow offshore investors to contribute more effectively. Also, foreign ownership restriction in the funds industry is also limited to 49 per cent; we hope that equity cap will be raised.

- **Manufacturing**: China maintains strict barriers on Canadian (and other foreign) FDI in its aerospace and transportation sectors, deemed to be of strategic sensitivity. There are also strict barriers in place on iron and steel. Foreign enterprises seeking to invest in Chinese iron and steel enterprises must possess proprietary technology or IP in the processing of steel, which constitutes a de facto technology transfer requirement. Canadians, like other foreign investors, are not permitted to have a controlling share in iron and steel companies. The national Steel Policy also appears to discriminate against foreign equipment and technology imports by supporting the use of steel manufacturing equipment and technologies provided by local suppliers.

- **Indigenous innovation**: There was deep concern with the Draft Notice Launching the National Indigenous Innovation Product Accreditation Work for 2010 as it would have closed access to public procurement for foreign-invested ventures in China whose intellectual property is not developed and owned in China. There was concern that this would pressure foreign companies to transfer and license their latest technologies for re-innovation by Chinese companies. The Canadian Chamber understands that the provisions are being reconsidered.

Conclude the Foreign Investment Promotion and Protection Agreement

To get the investment relationship right for both sides, Canada and China must conclude the Foreign Investment Promotion and Protection Agreement (FIPA). The FIPA is needed to provide a solid long-term framework for two-way investment that includes comprehensive, high standards of protection for investors and recipients in both countries. The agreement will protect foreign investors against discriminatory and arbitrary practices, provide appropriate recourse in the event of a dispute, ensure the equal treatment of foreign and domestic investors and ensure the free movement of capital between the two countries. The FIPA is to cover a range of investments, including movable and immovable property, portfolio investment, money claims, intellectual property and intangible rights to undertake commercial activities.

Progress in the FIPA negotiations has been gradual since 2004. Getting a high-quality investment agreement is more important than a deal done hastily. Even so, the Canadian business community looks forward to a timely and successful conclusion of the FIPA. However, concluding the FIPA is not the end of the road. Following the conclusion of the agreement, Canadian authorities will need to monitor investment progress and be prepared to intervene in substantive fashion, if required, to protect Canadian business interests.

Recommendations

- **That the government of Canada continue articulating that commercial FDI, including from China, that is compatible with Canadian national security is welcome in Canada, and that the new enterprise value thresholds under the 2009 Investment Canada Act amendments be fully implemented.** It is in Canada's interest to draw more FDI from a diversity of source countries, including but not limited to China, while at the same time maintaining a robust security review process for use when necessary.

- **That the government of Canada articulate support for commercial FDI from China and other source countries in areas other than resources, provided that investment contributes to the growth of value-added economic activity in Canada.** Canada welcomes FDI that builds up sectors in Canada, including but not limited to resources. FDI in an excellent investment environment like Canada's can provide foreign investors with the benefit of higher returns on capital, a diversified and solid investment portfolio, greater access to the U.S. market and the benefit of technologies developed jointly. Canada discourages short-term FDI whose aim is limited to the acquisition of existing technologies, know-how or supply networks rather than creating value *in* Canada.

- **That the government of Canada work with its Chinese counterparts to loosen restrictions and caps on capital transactions involving Chinese institutional and individual investors and Canadian financial companies.** In particular, the funds quota cap under the Qualified Domestic Institutional Investor program and the cap for Chinese individuals need to be raised where they concern Canada. It would be in both countries' interest for China to gradually ease capital controls through a pilot project with a financially stable and well-regulated country like Canada.

- **That the Canadian government work with its Chinese counterparts to loosen investment restrictions faced by Canadian companies in China, including those in the financial services, mining, aerospace and transportation sectors.** The Canadian business community also remains wary of the Indigenous Innovation provisions proposed by China and any similar measures that would hamper the ability of Canadian companies to compete in China on a level-playing field.

- **That Canada and China conclude the Foreign Investment Promotion and Protection Agreement (FIPA).** The FIPA is needed to provide a solid long-term framework for two-way investment that includes comprehensive, high standards of protection for investors and recipients in both countries.

Conclusion

The Canadian private sector, which propels job creation, innovation and economic prosperity in Canada, is fully aware of the need for greater trade and investment diversification and intensification. Better accessing worldwide demand for Canadian goods and services and mitigating our country's overdependence on U.S. markets (even as the United States remains our top trade and investment partner) is imperative at a time of global economic uncertainty. Growth markets in Asia that demand the goods and services that Canada excels at providing are on businesses' radar screens.

China is emblematic of those Asian growth markets. Its high-speed economic and social development fuel its demand for energy, raw materials, chemicals, food products, reliable financial and sustainable engineering services, post-secondary education and high-tech manufacturers, including aerospace and transportation vehicles. Canada is positioned to be a reliable supplier of what China, like much of Asia, needs to develop. This is why Canadian business is keen about a more vibrant economic partnership with China, as with Asia generally.

But, Canadian business also wants to see a more balanced, win-win partnership develop. China poses competitive challenges and the current playing field in trade and investment is not sufficiently level. Real market access (for Canadian exports and direct investment) is in many cases insufficient, and issues such as the protection of intellectual property rights are preoccupying to Canadian companies.

In order to build a vibrant and balanced partnership that sees both countries prosper, the Canadian Chamber of Commerce outlined three policy priorities which it believes should be pursued by the government of Canada as far as ties with China are concerned. Those priorities are:

- implementing a Canadian strategy of political engagement with China
- pursuing more trade and better trade with China
- improving the investment relationship with China

The government of Canada, which has established a constructive working relationship with China and has made Canadian prosperity the cornerstone of its policy agenda, is well placed to steer two-way ties going forward.

Canada's sound economic fundamentals, business-friendly environment, skilled workforce and greater proximity to markets in Asia and Europe (relative to all other countries in the Americas, including the United States), position it well to overcome the challenges of intensifying global competition and to plug into trade and investment opportunities in a rapidly mutating global economy. If Canadian businesses improve their productivity and innovation, if governments continue removing barriers to competitiveness in Canada and if the global competitive playing field is better levelled, Canada will prosper in this new century.

The Canadian business community looks forward to ongoing and active involvement in government consultations on Canada's international economic agenda.

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Annex: Examples of tariff and non-tariff barriers

Please note that this list is not exhaustive.

- **Financial services:**
  - Foreign Invested Insurers' (FIs) new branch (provincial license) and sub-branch license applications in China are not processed in the same manner as they are for domestic insurers, even though under China's WTO commitment, FIs were to be granted equal treatment as domestic insurers three years after accession in 2001. Applications for new branches by domestic insurers are handled simultaneously, while FI applications are handled sequentially. Additionally, domestic insurers can apply for sub-branches through provincial Chinese Insurance Regulatory Commission (CIRC) bureaus, while FIs must go through the CIRC's head office on a city-by-city basis. Consequently, FIs' geographical and market access is significantly slowed.
  - Equity restrictions on foreign investment in insurance and mutual fund companies limit the growth potential of Canadian insurers. The restrictions are currently set at 50 per cent for insurance companies and 49 per cent for mutual fund companies. Foreign ownership restrictions limit the ability of partners to maximize the value of their investments. Partners should be free to sell or dilute their stake, as part of an orderly continuation of the company, if they choose to redeploy capital.
  - Many aspects of foreign financial company operations in China, such as the introduction of new products, increases of capital and key personnel changes, require regulatory approval obtained through processes that are often complex and burdensome for both the companies and the regulators.
  - China has employed its lending quota to control the growth of renminbi (RMB) lending and the "offshore debt quota," which inhibits foreign banks' ability to profitably fund their assets.

- **Food products and beverages:**
  - Grains, sugar and beverages are subject to high tariffs.
  - Value-added-taxes (VAT) benefit Chinese domestic food processers who purchase domestic agricultural products rather than imports.
  - Registration in China for products derived through biotechnology cannot begin before registration is completed in the exporting country, resulting in lengthy delays. Registrations must also be renewed every three years.
  - China does not accept pork from animals fed the growth promotant Ractopamine, contradicting the science-based guidelines of the Codex Alimentarius and thus limiting export opportunity for Canadian pork producers.
  - Canadian beef imports are permitted following the staged removal of an import ban on all beef (due to isolated cases of bovine spongiform encephalopathy (BSE) several years ago), but are limited to those derived from cattle under 30 months of age in contradiction of international standards that advise against such age limits. The beef industry looks forward to greater openness to their exports.

- Canadian canola has faced restrictions due to allegations of “black leg disease.”

- Inspections and approval processes for food products and the use of food additives are protracted and occasionally deviate from standard international practices (e.g. the non-acceptance of food additives in China that are commonly used worldwide). Wheat, corn and derived products enter China under a tariff-rate quota, where imports exceeding the quota face high tariffs of 65 per cent ad valorem.

- **Raw materials:**
  - A non-negligible quantity of Chinese wood fibres and wooden cabinetry use material derived from trees that are not legally logged, thereby hampering the competitiveness of Canadian (not to mention Chinese) products derived from legally-logged trees in both China and third-country markets.

- **Aerospace:**
  - Foreign aircrafts weighing less than 25 tons are subjected to a hefty duty in the Chinese market. This discriminates against Canadian-produced aircraft which are in the under 25-ton class (most U.S.- and European-produced aircraft are in the above 25-ton class).

  - Rules of origin for aircraft and helicopters in China are currently based on regional value content (RVC) as opposed to tariff transformation.

- **Steel:**
  - China’s Steel and Iron Industry Development Policy favours the use of domestically produced steel manufacturing equipment and technologies over imports.

  - China’s overcapacity in steel production has resulted in concerns among North American producers in the unfair competition wrought by Chinese steel exports.

- **Government procurement:**
  - China is a signatory of the 1996 WTO Agreement on Government Procurement (GPA) and is set to make an offer on government procurement access this year. To date, much of China’s public procurement is done on a non-equitable basis through the use of narrow China-specific criteria that preclude Canadian and other foreign businesses from competing for projects.

  - In 2009, China put forth “Indigenous Innovation” provisions that would have tied access to government procurement with the ownership of IP in China, risking the expropriation of foreign suppliers’ IP.

- **Other non-tariff barriers on goods and services:**
  - China has committed to improve transparency by pre-releasing trade-related measures prior to their official implementation and to provide opportunities for public comment. Public consultations are critical for anticipating and resolving problems tied to the implementation of laws before they come into force.
  - Labelling requirements for imported products are overly complex and cumbersome and are often subject to sudden and unpredictable changes.
  - Customs procedures are not uniform and their application varies between Chinese provinces and individual ports of entry.
  - Many health and safety requirements for imports differ from commonly accepted international standards while the enforcement of such standards domestically is sometimes patchy.
  - Obtaining China Compulsory Certification (CCC) for imports requires the submission of IP-sensitive information and the inspection of the exporter's facilities at her / his expense. This certification process is costly, subject to delays and has left exporters vulnerable to IP theft.
  - Multiple ministries and government agencies are responsible for licensing, certification, and inspection, and they do not share information among themselves, leading to duplicative efforts and delays for exporters (versus a single-window). Licensing, certification and inspection processes also lack transparency.
  - Calculation of import duties makes use of reference prices for products. There are instances where wrong duties have been enforced due to a mistaken evaluation of imports by individual customs officials.

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