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Sergio Marchi

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ENGAGING CHINA: UNDERSTANDING THE CHALLENGE AND SEIZING THE OPPORTUNITIES

Hon. Sergio Marchi

ADDRESS TO THE SYMPOSIUM ON RESPONSES OF THE UNITED STATES AND CANADA TO THE ECONOMIC CHALLENGES POSED BY CHINA

WASHINGTON D.C.

December 8, 2006

Introduction

Good afternoon ladies and gentleman.

Thank you for your thoughtful invite. It is a pleasure to be here today and to share some thoughts on how the U.S. and Canada can best engage China.

The histories of the United States and Canada have been closely tied to one another. Our politics and economies have influenced each other greatly, and our peoples have been good neighbours and friends. Of course, while there have been disagreements along the way, the relationship has been strong and mutually beneficial.

For many years, Canadians have been proud to underline that Canada and the United States are each other's largest trade partners – and we felt slighted when Japan or Mexico were cited as the U.S.'s largest partner![1] So when it was announced in 2005 that for at least one month, China had surpassed Canada as the United States' largest trade partner, it was an economic signal for Canadians.[2] It reflected a fundamental paradigm shift in the global

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[*] Remarks occurred at an event entitled The Economic Challenges of China: US & Canadian Responses, held on December 8 2006, and sponsored by Steptoe & Johnson, LLP and Kaye Scholer.

[1] *See Canada-U.S. Trade Relationship*, U.S. Commercial Service, http://www.buyusa.gov/canada/en/traderelationsusacanada.html (last visited Feb. 9, 2008).

[2] *See China to be Biggest Trading Partner of US This Year: Former Trade*

economy, namely, that of an economically vibrant and influential China, which is forcing Canadians to rethink their position in the North American and global economies. And we are certainly not alone.

In 1972, Richard Nixon surprised the world with his visit to China. While Nixon and Kissinger were euphoric with the overall success of their trip, Nixon also noted the following words in his personal diary:

> "Not only we, but all the people of the world, will have to make our very best effort if we are going to match the enormous ability, drive and discipline of the Chinese people."[3]

Almost 25 years later, this observation is particularly true and captures very accurately, the core of the so-called "China Challenge."

How do we, in North America, then respond to the challenge of a focused and ambitious China? How do our companies meet the challenge of the realities of a changing global economic order with China being a major engine? How do Canadian companies, which are export-oriented, incorporate a focus on the Pacific, when for so long, they have been so continentally focused? How can Canadian companies remain globally competitive and relevant?

These are all good questions, looking for equally good answers.

In addressing the Canadian challenge, in the context of our relationship with the United States, let me touch on four areas:

1. Some bilateral trends and developments.

2. How Canada has responded to date.

3. The need to change mindsets.

4. And finally, China, the opportunity.

I. Some Bilateral Trends and Developments

Canada-China trade has grown dramatically. Today, China is Canada's second largest trade partner.[4] However, a central concern is the growing

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Representative, People's Daily Online, (Apr. 25, 2005), http://english.people.com.cn/200504/25/eng20050425_182637.html [hereinafter *China to be Biggest Trading Partner*].

[3] RICHARD M. NIXON, THE MEMOIRS OF RICHARD NIXON 572 (1978).

[4] *In Depth: China Milestones in Chinese-Canadian Relations*, CBC News, Nov. 16, 2006, http://www.cbc.ca/news/background/china/china-canada-relations.html.

disparity. While Canadian exports to China have grown, Chinese imports have grown even faster.[5] Between 2001-2005, our exports to China grew 65%.[6] During the same time period, our imports grew an astonishing 115%![7]

As well, Canada has traditionally been an exporter of resources and commodities, and it's no different with China – about 80% of our exports to China consist of resources.[8] We have benefited significantly from their rapid industrialization, which has put upward pressure on commodity and energy prices.[9] Our exports have reflected China's development needs and have also shifted, as China adds value to their production and manufacturing.[10]

Historically, Canada's major export to China was wheat.[11] But once China started producing its own crop, and also decreased their consumption of wheat, Canada's wheat exports fell sharply.[12] As a consequence in part, our exports of fertilizers, meat and seafood grew.[13] Exports of industrial material such as nickel, iron, steel, copper, and aluminum also grew rapidly in the 1990s to feed China's manufacturing boom.[14] Paper was once a major export of Canada to China – but as China established its own mills, paper exports have dropped, while pulp exports have grown.[15]

As you can note from some of these examples, developments in China's economy impact the kinds and volumes of Canadian exports. In some instances, Canada has moved down the value chain, while in others, we created and added value. However, when China acquires and develops its own fertilizer production, for instance, will Canada still be able to add value? Or will Canada move down the value chain and just supply the raw material? And with China's increasing exports to the U.S., Canadians are becoming aware that this comes at the expense of our own.

While our exports to China continue to be resource heavy, our imports have shifted dramatically in the last few years. In the 1990s, imports from

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[5] Francine Roy, *Canada's Trade and Investment with China*, CAN. ECON. OBSERVER, 3.1, 3.7 (2005) [hereinafter *Canada's Trade*].

[6] *See id.*

[7] *See id.*

[8] *See* Dennis & Sandi Jones, *China: Opportunities from East to West*, Aug. 11, 2005, http://exportsource.ca/gol/exportsource/site.nsf/en/es03259.html.

[9] *See* Steve Grunau, *Analytical Paper – Feeding the Dragon: Canadian Exporters and a Booming China* 5, STAT. CAN. 3, *available at* http://dsp-psd.pwgsc.gc.ca/Collection/Statcan/11-621-M/11-621-MIE2006037.pdf (last visited Mar. 25, 2008).

[10] *See id.* at 3.

[11] *Canada's Trade*, *supra* note 5, at 3.4.

[12] *Id* at 3.6.

[13] *See generally* Francine Roy, *Insights on the Canadian Economy: Canada's Trade with China*, STAT. CAN. 4, *available at* http://dsp-psd.pwgsc.gc.ca/Collection/Statcan/11-624-M/11-624-MIE2004007.pdf (last visited Mar. 25, 2008).

[14] *Id.*

[15] *Id.*

China were largely made up of consumer goods, shoes, toys and textiles.[16] However, in recent years, there has been a dramatic shift toward productivity-enhancing goods, that is, electronic products including laptop computers, telecommunications equipment, industrial machinery, measuring equipment, and automotive parts.[17]

China is now a major source of low-priced industrial equipment for North American firms.[18] In the case of some of these products, the shifts have been quite dramatic. Moreover, Canada's imports from China have now surpassed those of Japan and Mexico, and more recently, U.S. imports have begun to level off as well.[19]

In short, we can expect these trends to continue, and as China's industry continues to move up the value chain, this presents Canadian industry with some real challenges in adapting to these new economic realities.

II. How Has Canada Responded to the China Challenge So Far?

(As mentioned) earlier this year, I became the President of the Canada China Business Council, a private membership association that works with Canadian firms in China. In the last number of years, the Council has emphasized the importance of understanding the impacts of China for Canadian companies in our own market, in China, and globally.

The central lesson is that no matter how big or small, every Canadian firm needs a China strategy. It may be active or passive, depending on the company's resources, but it is absolutely crucial to understand how China is changing the global economy and develop an effective response.

In a survey of Canadians conducted this year by the Asia Pacific Foundation of Canada, Canadians are most aware of the potential of China, with 42% of respondents saying China showed the most export potential, while 29% chose the U.S.[20] In fact, Canadians expressed a belief that the Chinese economy will surpass that of the U.S. in 20 years or so.[21] That may or may not be the case, but that's the perception today.

Yet, another survey involving Canadian automotive parts makers is very revealing:

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16 *See Some Familiar Patterns Developing In Trade Between China and British Columbia*, Bcstats.gov.ca 4 (2000), *available at* http://www.bcstats.gov.bc.ca/pubs/exp/exp0008.pdf.

17 *See Canada's Trade*, *supra* note 5, at 3.2.

18 *See id.*

19 *The Daily, Canada's Trade with China*, Statistics Canada, Jun. 8, 2004, http://www.statcan.ca/Daily/English/040608/d040608a.htm.

20 The Asia Pacific Foundation & Globe and Mail, *Canadian Views on Asia: A Report to The Asia Pacific Foundation of Canada and the Globe and Mail*, 7 (2006).

21 *Id.* at 12.

- Asian facilities accounted for only 0.29% of their production,
- Asian suppliers represented only 5% of their inputs/supply needs, and
- Asian buyers accounted for only 1.6% of their customers. [22]

While Canadians seem to be aware of the China challenge and opportunity, this second survey would indicate that we still have much work to do. In this sector, we need to accelerate this industry's integration into the Asian market; otherwise, we run the risk of losing significant ground.

Some Canadian economists have made a link between foreign investment and Canada's lagging trade performance vis-à-vis China. They have argued that the traditional concept of bilateral trade – measuring who benefits by looking at the trade balance – is not as relevant in today's global economy. This is because so much of the trade is now within companies. The new mantra is integrative trade. "Integrative" encompasses all the emerging elements of international business: exports, imports used in exports, FDI, use of foreign affiliates for sales, and globalized production and distribution.

The international economy has become a global workshop, where products are sourced from multiple points, assembled at the most convenient locations, and sold into the global marketplace. In this global workshop, for example, nearly half of all U.S. imports represent American companies buying from their own foreign affiliates.[23] And foreign affiliates of Canadian companies generate sales of about U.S. $400 billion each year – roughly the same amount as Canadian exports.[24]

Indeed, more than half of China's exports originate from multinational firms operating in China.[25] In an attempt to remain globally competitive, many foreign firms are investing in China so as to integrate China into their global supply chains.[26] They are also, of course, trying to gain access into their huge market. Yet Canada's investment in China is relatively low, which means that we will need to establish stronger integrated trade links with China.[27] In the long run, given the changing and competitive nature of the marketplace, exporting alone won't suffice.

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[22] Asia Pacific Foundation of Canada, *The East Asian Automobile Industry: Opportunity or Threat?*, CAN. IN ASIA 6 (2005).

[23] Stephen S. Poloz, Senior Vice-President and Chief Economist, *The New Global Trade Game: Will Canada be a Player, or Just a Spectator?* Jan. 20, 2005, (transcript available at http://www.edc.ca/english/docs/speeches/2005/mediaroom_7001.htm.

[24] *Id.*

[25] *Id.*

[26] *See id.*

[27] *See Canadian Ambassador Calls for Canada, China to Expand Investment Scale*,

At the same time, while China's accession into the WTO opened opportunities for foreign investment, it also gave Chinese firms a clear timeline to establish manufacturing centres and companies that could compete globally. And not just in labour intensive cheap consumer goods, but also in the value-added and hi-tech sectors. In other words, the WTO has also pushed Chinese firms towards global competitiveness, and we in North America need to recognize that these up-and-coming Chinese firms will be highly competitive both in China and around the world.

III. Third, We Need to Change Mindsets

Former Prime Minister Trudeau once compared being neighbours with the United States to sleeping next to an elephant.[28] No matter how friendly and even-tempered the elephant is, we are affected by every twitch and grunt. As our economies became so interconnected, Canadians have become very accustomed to sleeping next to the elephant.

As you well know, the elephant is our major trade partner, our major customer, and our major buyer. Despite an increasingly global economy, the main priority for Canadian companies remained on anticipating and adjusting to the elephant's every move. They have traditionally been focused on the U.S. market and U.S. customers. Despite the government's plea for diversification, 85% of our exports go to the U.S.[29] This is particularly true of central Canada, the heartland of our industrial and manufacturing output. And yet, it is perhaps in this region, that the most dramatic impacts of China's economic boom are being felt, especially by lower tier suppliers to U.S. customers, who are feeling the pressure to produce more cost effective product or risk losing their U.S. customer base.

One of the greatest differences between the Canadian and U.S. economies is the number of large international firms. With the internationalization pressures of the 1990s, many U.S. companies had the size and depth to go abroad, make mistakes, and correct them. By contrast, in Canada, few firms could afford early entry errors.

While Canada certainly has a number of large companies with the resources to compete globally, many of Canada's firms are smaller and lack sufficient resources to be in every market. Combined with a traditional focus

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People's Daily Online, Feb. 18, 2006, http://english.people.com.cn/200602/18/eng20060218_243712.html.

[28] *Canada and the World: A History, The Trudeau Years*, Foreign Affairs and International Trade Canada, June 8, 2007, http://www.international.gc.ca/department/history/canada9-en.asp.

[29] *See The World Factbook – Canada*, Central Intelligence Agency, Feb. 12, 2008, https://www.cia.gov/cia/publications/factbook/geos/ca.html.

on the U.S. market, these companies have shown a preference "to ride the coattails" of U.S. customers into new markets, including China. They view themselves as suppliers of inputs within an integrated North American economy. And there is a confidence that the supplier-customer relationship that worked in North America could be duplicated elsewhere. However, while this strategy might work in the short term, it may not be viable for the long haul. We need to realize that Chinese suppliers are moving up the value chain very quickly, are becoming as innovative as the top western firms, and threaten to supplant Canada's position in supplying the U.S. and others.[30]

The rise of China is forcing Canadian companies to shift mindsets, to move from a continental outlook to a more global one, and to evaluate where to best position themselves in the global supply chain. In order to grow their business internationally, they will increasingly have to look at investing abroad. The ultimate goal is to maintain competitiveness.

In doing so, our private sector will need to address some fundamental issues. How has the rise of China affected their relationship with U.S. customers and their place in the supply chain? How has the rise of China affected the North American economy? What kind of value can Canadian companies continue to deliver to its U.S. customers and the global supply chain? What kind of adjustment will be required to be relevant in the U.S. and other markets important to Canadian firms?

With the news that China became the U.S.'s largest trade partner for at least one month in 2005, also came the projection that China may likely one day become the U.S.'s largest trade partner.[31] This projection should force a cold analysis of where Canada stands in the global economy and what our country needs to do in an effort to remain competitive. I don't want us to wake up one day to find that the elephant was an early riser and had moved on – perhaps over to the dragon's pen. Sure, it may have been a bit intimidating sleeping next to the elephant all of these years, but it could be even more frightening to discover that the elephant might, one day, no longer be there.

IV. China: The Opportunity

As much as the changes have created new challenges, China has also brought new opportunities. Massive economic reforms and obligations under the WTO, for instance, have created new openings in China.[32] Those that are

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[30] *Economic Relationships Between the United States and China: Hearing Before the H. Comm. on Ways & Means*, 109th Cong. (2005) (statement of Douglas Holtz-Eakin, Director, Cong. Budget Office).

[31] *See generally China to be Biggest Trading Partner, supra* note 2.

[32] Susan Hamrock, Corey Whiting, Christopher Baha, & Heather Clark, *China's Entry into*

able to understand these changes and adapt successfully will be well placed to take advantage of these ever changing circumstances. And these changes are irreversible. There is no going back.

There is also no magic recipe to success. We at the Council advise our members to objectively assess their advantages and weaknesses, and the value they can bring to the global supply chain. Companies need to ask:

- Where do we fit in the global supply chain? Can we build parallel networks outside of North America? Can we build them in Europe and Asia?

- How can my company increase productivity, add value, and be innovative?

- What is my company's competitive advantage in the global marketplace, as distinct from Canada and North America?

- How is the global economy affecting my customers' decisions and what do we have to do to continue to service our customers?

- What does the rise of China mean for my industry and my company both in Canada and globally?

China is a tough market, which demands resources. It can also be unforgiving. That's why as a minimum, companies need a passive China strategy. They need to consider how China affects the Canadian market and what they can do to survive and be relevant.

Whatever it may be, the China challenge is an opportunity for firms who can develop innovative responses, leverage their strengths against potential weaknesses in Chinese firms, create solutions for China's development needs, and continue to deliver value.

There is also significant complementarity between Canada and China. China is a resource hungry nation – and Canada is well regarded and blessed as a resource country, with both resources to explore and the expertise to do it.[33] Chinese firms have taken some initial investments in Alberta's oil patch

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the WTO: What it means for U.S. Industry, EXPORT AM. 23-25 (2002).

[33] *See generally,* Ann McLellan, Minister of Natural Res. Can. and Member of Parliament, Speech to the Canada-China Business Council (May 21, 1996) (transcript available at http://www.nrcan.gc.ca/media/archives/speeches/1996/199651_e.htm).

and it is no secret they are looking for more, as well as to secure sources of other commodities.[34]

As well, major Canadian financial services and insurance companies have long and established histories in China – and have successfully penetrated the Chinese market.[35] In China, Canada has a strong reputation as a source of environmental technologies and alternative energy sources. In addition, we have had notable successes in construction products and services, transportation, infrastructure, and education.

The future should also be about Canadian and U.S. firms jointly embracing Chinese opportunities. For instance, one of the CCBC's (the Canada China Business Council) members based in Vancouver is working on a joint venture partnership with a firm from Indiana to sell clean natural gas and liquified natural gas bus engines to China.[36] The partnership has been quite successful in Beijing, with over 2,000 buses being powered by their engines.[37] Hopefully, this can be replicated in other sectors, and build upon the many close synergies that our companies have created over many years of bilateral trade and investment flows.

Finally, there are also opportunities for Canadian and Chinese companies to work in both directions. Nortel, for example, has secured numerous contracts in China building up its communications infrastructure – and at the same time, has tentatively agreed to work on a joint venture based in Canada with Huawei, one of China's leading global firms.[38]

We clearly need to be candid about the challenges posted by China. But we also need to be positive and hopeful enough to recognize that the flip side of the challenge coin is opportunity.

Closing

In closing, I earlier made a reference to Mr. Trudeau's analogy of sleeping next to an elephant. Well, the rise of China has brought significant changes to our "global zoo." And China's economic energy and zeal will not

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[34] Robert Collier, *China Moves Fast to Claim Oil Sands*, S. F. CHRON., May 22, 2005, http://www.sfgate.com/cgi-bin/article.cgi?file=/c/a/2005/05/22/CHINA.TMP.

[35] *See* Julia Chan, *China Seeks More Aggressive Canadian Investment in Financial Sector*, INS. BUS. REV., Jan. 22, 2007, http://www.insurance-business-review.com/article_news.asp?guid=9D55F3B3-D0AF-4FD0-A29C-CACEE1DCC8A9.

[36] *See* Press Release, Westport Innovations, Inc., Cummins Westport Receives First Order for Lng-Powered Bus Engines in China (Jul. 30, 2003) (available at http://www.westport.com/news/newsdetail.php?id=201&return_to=index.php).

[37] *See id.*

[38] Press Release, Nortel Networks, Inc., Nortel, Huawei to Establish Joint Venture to Address Broadband Access Market (Feb. 1, 2006) (available at http://www2.nortel.com/go/news_detail.jsp?cat_id=-9721&oid=100194384&locale=en-US).

be reversed any time soon. Nor will their impacts on the North American marketplace. Our challenge is to fully understand what the changes mean, and embrace the new economic opportunities that are being created.

Our history in Canada, including the U.S., is rich with examples of our nations' economic resilience and the ability of our private sector leadership to adapt to changing economic forces. I remain hopeful that this spirit of entrepreneurship will continue to shape our future as a country, at a time in our history when China takes its place within the economic elite of the world.

As well, politically, it is important for both of our countries to engage China as one of our foreign policy priorities. There can be no question that the China relationship will be one of the most important of the 21st Century. It is in our interest, and in the interest of the international community at large, not to ignore or isolate this vast country, which currently represents one-fifth of humanity. Global stability, together with the promotion of our values and interests, will best come from a constructive and active engagement.

Thank you.