NAFTA@10

John M. Curtis and Aaron Sydor
Editors

Foreword

The research assembled in this volume has been undertaken by academic and government researchers writing in a personal capacity. Foreign Affairs and International Trade Canada managed and assembled this volume with the objective of contributing to, and encouraging, debate on an issue of major importance to the Department, to the Government of Canada, and to Canadians. The views expressed in this volume, however, are those of authors and do not reflect the views of the departments represented in this volume or of the Government of Canada.

© Minister of Public Works and Government Services Canada 2006

Cat: IT5-1/2006E

ISBN: 0-662-43036-0

(Publié également en Français)

Editors' Overview

John M. Curtis & Aaron Sydor
Foreign Affairs and International Trade Canada

Introduction

It has been more than ten years since the implementation of the North American Free Trade Agreement (NAFTA) and fifteen years since its precursor, the Canada-U.S. Free Trade Agreement (Canada-U.S. FTA), came into force. For Canada, those two agreements were important, and hotly debated, turning points in its trade and in its economic policy more generally.

The Canada-U.S. FTA was the first major bilateral trade agreement for two countries that were founding members of the post-war multilateral system and regarded it as the cornerstone of their respective trade policies. The expansion of that agreement to include Mexico, five years later, was significant in that it was the first major free trade agreement between the "rich north" and "poor south", a highly innovative initiative at the time and still controversial in several sectors of society in each of the countries involved.

Part 1: A Look Back

A considerable amount of analysis has taken place evaluating the effects of the Canada-U.S. FTA and the NAFTA from a Canadian perspective. Harris, in the opening chapter, provides an overview of this work. In economic terms, Canada is a small open economy, therefore free trade agreements, he argues, must be primarily seen as economic agreements with the goal of improving the standard of living for Canadians. Although the popular press often engage in job counting exercises in order to evaluate the impact of a trade agreement, this is a fool's errand. As Harris points out, trade agreements, although potentially shifting the composition of production and employment and thus temporarily dislocating workers, have no impact on employment levels in the long run. Rather, trade agreements improve economic efficiency through a better allocation of resources; they contribute to increased competition; they provide access to a greater variety of goods and services; and they improve productivity through greater innovation and economies of scale.

Evaluating the Canada-U.S. FTA and NAFTA in this context, Harris provides a review of the literature. He finds that the two agreements did result in an adjustment in employment and output for the sectors most affected. While domestic macro-economic policies, including the Bank of Canada's move to a low inflation environment and the government's fiscal tightening, were primarily responsible for the protracted downturn of the early 1990s, the Canada-U.S. FTA did play a role in the downturn and provides a cautionary tale for policy coordination. The lasting impacts of the agreement, however, are of greater interest. Harris argues that the Canada-U.S. FTA and NAFTA did indeed have a significant and positive impact on the Canadian economy. The estimates of the direct impact on Canadian exports range from a low of 10 percent to a high of over 50 percent. Increasing trade, however, is not the goal of a trade agreement.

Citing work by Trefler (1999) Harris shows that the Canada-U.S. FTA produced a productivity gain of 0.6 percent per year within the manufacturing sector and 3.2 percent per year for those sectors most affected (Those that experienced a drop in average tariff rates of more the 8 percentage points) for the years examined. It is these gains that improve the standard of living of Canadians and allow for Canadian-based businesses to compete successfully in the global marketplace.

Through his analysis, Harris also identifies areas for further work. One such area is the impact of trade agreements on the access to increased variety of products. Trade theory predicts that, through the creation of a larger market and with greater competition, the number of varieties of goods and services available to consumers increases. This greater variety of products allows producers to meet individual tastes and thus improve the standard of living for those involved. Difficulties in measuring product varieties, however, have led to few quantitative estimates of the impact of free trade agreements on the variety of goods available. In chapter 2, using data on trademarks, Chen finds that not only did the Canada-U.S. FTA increase the variety of products available to Canadians by 60 percent per year, but also because of the size difference and a positive relation between the size of a market and the number of varieties available in that market, Canada benefited more in terms of number of new products available as a result of trade, gaining access to three times as many new varieties as did the U.S. This finding has important implications for smaller countries entering into trade agreements with larger partners.

In his analysis, Chen argues that scale effects from the Canada-U.S. FTA have been surprisingly small. As a result, much of the gains from trade, in his opinion, have come from the increase in the variety of products traded. In chapter 3, Acharya evaluates the various theoretical motivators for trade, including scale effects, in the context of the NAFTA. According to his findings, for most industries, a number of factors play a role in determining the composition of trade. He finds that economies of scale play the most important role in industries that require significant capital expenditures and also involve product differentiation, and are therefore limited to only a few industries such as the Aerospace and Automotive industries. Relative abundance of either capital or labour (as per the Heckscher-Ohlin theory) and technological advantage (as per Ricardian theory), on the other hand, were important for most industries to some degree. These results are useful for policy-makers evaluating the potential benefits and adjustment costs of trade liberalization

Gu and Rennison examine, in the subsequent chapter, the impact of trade on skills and wages within Canada. The authors find that, somewhat surprisingly, despite Canada having one of the highest rates of post-secondary educational attainment among the OECD, this does not appear to be a source of comparative advantage for Canada as one might expect. Canada’s skill content of exports was not substantially different from that of imports and only somewhat higher than the business sector average. Further, they find that there has not been a significant change over time. The authors provide a number of possible explanations for this result including that our primary trading partner, the U.S., has an even higher skills profile, particularly in university education.

Capital intensity, on the other hand, does appear to be a source of comparative advantage for Canada, with the capital intensity of exports exceeding imports by 53 percent. Linked to this, labour productivity in the export sector was found to be not only twice as high as the over-all business sector but also growing twice as fast. It is therefore not surprising that wages were also, on average, eight percent higher in the export sector.

Included in the NAFTA, were side agreements on labour and the environment. Kirton, in a chapter devoted to one of those side agreements evaluates the effectiveness of the environmental side agreement (the North American Agreement on Environmental Co-operation or NAAEC) in meeting its objectives from a Canadian perspective. He concludes that the agreement has, for the most part, lived up to its objectives, although meeting some more successfully than others.

Part 2: The Way Forward

Part 2 moves away from a historic evaluation of the impact of the Canada-U.S. FTA and the NAFTA for Canada to be more forward looking. While titled “The Way Forward”, this analysis does not reflect the intentions or policy directions of the government of Canada as such; rather, the chapters in this part explore some possible scenarios that have been put forward for deeper integration with North America.

One such scenario has been that of a common currency being instituted within North America. While interest in this form of closer integration has subsided somewhat, the debate was based on the premise that operating different currencies within and integrated North American production system imposes unnecessary costs and frictions. It is within this context that Laidler examines the issue of increased cooperation in monetary policy between Canada and the U.S. providing an assessment of the entire spectrum of alternate monetary orders from increased exchange of information up to and including a common currency.

Professor Laidler acknowledges that there may be efficiency gains to be had from increased monetary integration resulting from reduced frictions to trade. Separate and floating currencies, however, also allow for a cushion in adjusting to shocks, and Canada and the U.S. still have significantly different industrial structures that face separate shocks. Probably the most convincing argument put forward by Laidler, though, is the simple fact that for any common currency arrangement, U.S. cooperation would be required and this does not seem likely at this point in time, especially as it relates to cooperation in setting policy or in sharing seignorage revenues. Without this cooperation, Canada would be required to give up a significant degree of policy control and revenue which would substantially reduce, if not eliminate, any potential efficiency gains.

It has been argued that, short of a common currency, better coordination of monetary policy could achieve similar gains. This could potentially include a greater sharing of information to a dual goal for monetary policy of price stability and exchange rate stability. Professor Laidler shows, however, that there is already a relatively high level of information sharing at both formal and informal levels and it is difficult to see what additional gains can be achieved on this front. As for dual goals for monetary policy, Laidler argues quite convincingly that

attempts to influence the exchange rate have been largely ineffective in the past. He also suggests that having two goals for monetary policy would only make its operation less transparent and thus less effective.

Rao and Sharma, in "International Competitiveness and Regulatory Framework: A Canadian Perspective" explore the role of regulations in contributing to Canada's much cited innovation and productivity gaps with the U.S. Using data from the OECD and the Institute for Management Development (IMD), they show that Canada has a more restrictive regulatory environment than the U.S. in a number of areas including product market regulations and labour market regulations. Using a very simple reduced form equation for their estimation, the authors find that two areas of regulation in particular; intellectual property rights and restrictions to foreign direct investment, explain about one-third of the gap in R&D intensity and 55 percent of the labour productivity gap between Canada and the U.S. Even if one questions the precise estimates of these regulations on innovation and productivity performance, the sheer size of these impacts deserves greater attention by researchers and policy makers.

Blair, Downs and Ndayisenga build on the theme established by Rao and Sharma and examine the potential gains from a specific regulatory reform: cooperation between Canada and the U.S. for human drug approvals. The authors suggest that increased cooperation with the U.S. would allow for economies of scale in drug approvals, resulting in shorter delays for drug approvals without requiring additional resources. According to their analysis, speeding up drug approval times by 6 months would contribute to increased output of 2.4 percent as well as employment of 4.1 percent and R&D of 2 percent for the human drug industry in Canada. Reducing delays by 12 months would essentially double these gains. Possibly more importantly, however, speeding up time to market would increase the availability of new drugs to Canadians; reducing health care costs and improving the quality of life of Canadians. The primary obstacle, as the authors note, would be that of accountability in the system.

Beaulieu and Emery, in the next chapter, examine whether there is any benefit to increasing the geographic diversification of Canada's trade, particularly exports. As has already been noted, even prior to the Canada-U.S. FTA, Canadian exporters were heavily dependant on the U.S. as a market. This, as would be expected, increased after the agreement, peaking with 87 percent of Canadian merchandise exports going to the U.S. in 2000. While the authors note that some risks increase with this concentration, especially those that stem from national economic power such as trade, national fiscal and monetary policy, the U.S. is not, in fact, one market. Rather, it is 300 million plus individual consumers, many different levels of government with many different interests and objectives. Possibly most importantly, the authors point out that Canada-U.S. trade is the summation of many individual argents making their own export, investment and consumption decisions.

Having noted this, Beaulieu and Emery ask whether, through some coordination of activities, would it be possible to make Canadians better off by diversifying trade? Specifically, they test whether incomes in Canada have become more volatile as a result of an increased concentration of exports on the U.S. and also, through a more diversified export pattern, would it be possible to

reduce the volatility of incomes in Canada. On both accounts they conclude that neither did the increased reliance on the U.S. as an export market increase income volatility nor would it be possible to reduce current levels of volatility through increased geographic diversification of export markets. Furthermore, they suggest that history has shown that policies designed to diversify trade simply do not work and by interfering with market system can result in lower incomes for Canadians without significantly impacting on income stability.

Kunimoto and Sawchuk examine the issue of rules of origin and the potential benefits of less restrictive rules of origin within NAFTA. They illustrate that NAFTA rules of origin are the most restrictive of any major free trade agreement and therefore there may be not insignificant gains to be had from reducing their restrictiveness. Rules of origin are necessary to the operation of any preferential trade agreement as they allow the benefits of the agreement to accrue to its members and allow signators the ability to maintain different tariffs to non-members (as opposed to a common external tariff and a defacto customs union). The cost of maintaining rules of origin can therefore be interpreted as an upper bounds to the gains from their elimination as they can not be eliminated completely. The authors place the costs of the status quo at about 1% of GDP. They also report a declining use of NAFTA which peaked in 1998, but have since fallen to 50% of Canada-US bilateral trade. This, the authors conclude, is largely as a result of the shrinking gap between MFN and NAFTA rates.

Papadaki et al examine the economic impact of two policy shocks using a CGE model. The first scenario involves the creation of a Canada-US customs union with a common external tariff for both countries set to either US MFN rates or the minimum rate of either Canada or the U.S. which the authors refer to as scenarios 1a and 1b respectively. In each of the two scenarios, the authors find a minimal impact for either country at an aggregate level. At a more detailed level, the impact for some sectors that had been protected by high tariffs is more significant, such as; the Agricultural and Forestry, Food Beverage and Tobacco, Textiles, and Clothing industries.

The second scenario explored involves the elimination of all “unobserved trade costs”. The authors make no distinction between the possible sources for these costs and interpret their results as the upper bounds for the potential gains from complete Canada-US economic integration. As would be anticipated, the expected gains from this experiment are quite significant, producing a welfare improvement in the range of 6-7% of GDP as well as a substantial increase in two-way trade flows.

Papadaki et al, also provide a useful comparison of computable general equilibrium (CGE) ex ante predictions for the Canada-U.S. FTA and the NAFTA based on a variety of assumptions. Early models, based on the assumption of constant returns to scale and perfect competition, showed modest gains for Canada. Later models, however, relaxing these assumptions and expanding the models to include such things as capital mobility, showed much larger gains. Comparing these predictions to the ex post results summarized by Harris, one might conclude that the early CGE models provided the lower bound to the impacts while later models provided an upper bound. Furthermore, while all of the CGE models consistently underestimated the impacts of the two agreements on

trade flows, the simplest assumptions may have come the closest to measuring impacts for GDP and welfare.

Conclusions

After ten and fifteen years respectively, we are now confidently able to say that the Canada-U.S. FTA and NAFTA did indeed have a significant and positive impact on the Canadian economy. They contributed to Canadian productivity growth which will allow Canadian-based companies to compete effectively in international markets and improved the standard of living for Canadians.