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NOT JUST THE FTA: FACTORS AFFECTING GROWTH IN CANADA-UNITED STATES TRADE SINCE 1988

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TABLE OF CONTENTS

Page

INTRODUCTION 1

CANADA'S TRADE PERFORMANCE AND THE FREE TRADE AGREEMENT 2

OTHER FACTORS INFLUENCING THE CANADA-U.S. TRADE RELATIONSHIP 3

A. Continuation of Long-term Trends 3
B. Macroeconomic Factors 5
C. Changing Trade Flow Patterns 6

CONCLUSION 8

REFERENCES 10

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NOT JUST THE FTA: FACTORS AFFECTING GROWTH IN CANADA-UNITED STATES TRADE SINCE 1988

INTRODUCTION

By most accounts, the Canada-U.S. Free Trade Agreement (FTA) has been a tremendous success for Canada. Since the agreement was implemented in 1989, trade and investment levels between Canada and the United States have soared, leading to strong economic growth and historically low levels of unemployment in both countries. Supporters of the FTA, including the Canadian federal government, point to these facts as evidence of the benefits of liberalized trade in North America.(1)

At the same time, however, there is a tendency amongst some FTA advocates to ascribe *all* trade growth with the United States since 1988 directly to that agreement. While the FTA may indeed have played an important role in promoting trade between the two countries, it is misleading to suggest that the increase in trade over the past 14 years is due solely to the removal of tariff and non-tariff barriers in 1989.

Indeed, several factors not directly related to the outcome of the FTA's trade liberalization agenda also play a role. These include the fact that trade between the two countries had been increasing for decades before the FTA was implemented; a number of macroeconomic factors in the 1990s, including a declining Canadian dollar; and the possibility that, in making the United States more attractive relative to other markets, some Canadian trade may have been diverted to the United States from other destinations.

To what extent, then, is the FTA responsible for Canada's trade and macroeconomic performance through the 1990s and into the present? Unfortunately, this question is easier to pose than it is to answer. The increase in Canada-U.S. trade since 1988 occurred in the context of a complex and evolving economic environment. As a result, it is

(1) See, for example: Foreign Affairs and International Trade Canada, *NAFTA at Seven: Building on a North American Partnership*, 2002.

difficult to isolate the specific effects of trade liberalization from the wider economic context in which that event took place. This paper examines some elements of this broader economic context to demonstrate that the implementation of the FTA was not the only factor that contributed to the growth in Canada-U.S. trade since 1988.

CANADA'S TRADE PERFORMANCE AND THE FREE TRADE AGREEMENT

There is little doubt that trade liberalization has contributed to Canada's recent rapid growth in trade with the United States. As one researcher has stated, it would be quite a coincidence if the explosion in Canada-U.S. trade since 1988 had nothing to do with the implementation of the FTA.(2) Since that time, Canada has seen a remarkable shift in economic structure and orientation. The Canadian economy has become considerably more export-oriented and at the same time has become more integrated into a collective North American economy. While the precise extent to which this is due to the FTA is difficult to assess, there is certainly evidence that the dominant role already played by the United States in Canada's international trade portfolio has been further enhanced since the FTA was signed.

Specifically, the trade ties between Canada and the United States have grown considerably tighter in recent years. Since the FTA was implemented, Canada's two-way merchandise trade with the United States has more than tripled, compared with a 172% increase in Canada's bilateral merchandise trade with all other countries. The difference between these two growth rates has strengthened the United States' position as Canada's foremost trading partner. The United States accounted for 76% of Canada's total bilateral merchandise trade worldwide in 2002, up from 68% in 1988.

In addition to the fact that Canada's trade with the United States has grown faster than its trade outside the United States, the *rate* of trade growth between the two countries has accelerated since the FTA was implemented. In the immediate pre-FTA period – from 1979 to 1988 – merchandise exports to the United States grew by an average of 2.7% per year in real terms (i.e., after accounting for the effects of inflation), while real merchandise imports grew at an average rate of 0.6%. Once the FTA was in place, however, trade growth picked up. From 1988 to 2002, Canadian real merchandise exports to the United States grew by an average of 6.6% per year, while merchandise imports grew by an average of 4.3%.

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(2) John McCallum, "Two Cheers for the FTA: Tenth-year review of the Canada-U.S. Free Trade Agreement," *Econoscope*, Royal Bank of Canada, Toronto, 1999, p. 7 (available on-line at: http://www.freetradeat10.com/impact.html).

Perhaps the most convincing evidence of the FTA's contribution to an expansion of the Canada-U.S. trade relationship is provided by a comparison of trade growth in products liberalized by the agreement with trade growth in goods that were already exchanged tariff-free.(3) In all, an estimated 35% of Canada-U.S. trade was tariff-free prior to the implementation of the FTA.(4) If the FTA did indeed have a positive effect on trade, then one would expect that bilateral trade growth in liberalized sectors should exceed growth in sectors where tariffs did not change.

This is indeed the case. Studies have shown that following the implementation of the FTA, trade growth between Canada and the United States accelerated overall; but trade in goods that had been liberalized by the agreement grew considerably faster than trade in goods that were unaffected.(5)

OTHER FACTORS INFLUENCING THE CANADA-U.S. TRADE RELATIONSHIP

While agreements such as the FTA undoubtedly improve conditions for trade by lowering tariff barriers and creating an environment of stability and security for trade and investment, they represent only one of several factors influencing the exchange of goods and services between countries in any given year. In the case of Canada and the United States, the growth in two-way trade since 1988 can be partially explained by three factors over and above the direct trade-liberalizing effects of the FTA: the continuation of a long-term trend towards closer ties between the two countries; the macroeconomic environment in the 1990s; and a shift in Canadian trade flow patterns. Each is discussed below.

A. Continuation of Long-Term Trends

Although the level and proportion of Canada's trade with the United States have increased considerably in the post-FTA period, trade between the two countries had in fact been

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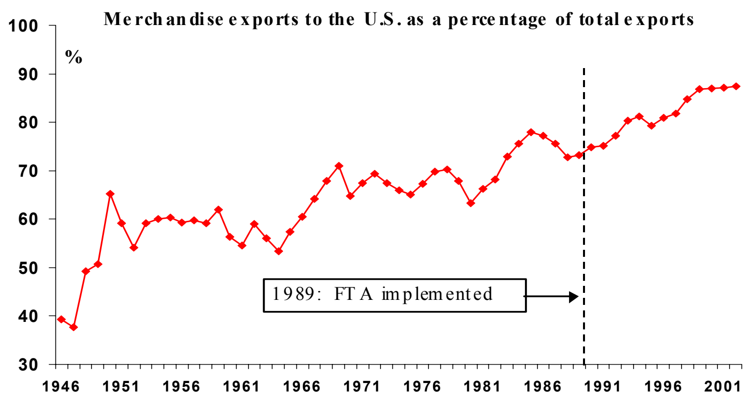
(3) This methodology was used in Daniel Schwanen, *Trading Up: The Impact of Increased Continental Integration on Trade, Investment and Jobs in Canada*, Commentary 37, C. D. Howe Institute, Toronto, 1997 (available on-line at: http://www.cdhowe.org).

(4) Marcel Côté, "Is Free Trade Good for Canada? Ten years later, the balance is positive," *Cité Libre*, Vol. 26, April/May 1998, pp. 48-60.

(5) Schwanen (1997).

growing rapidly long before the FTA was signed. Indeed, when considered in the broader context of Canada's trade performance following World War II, the growth in trade since 1988 appears to be part of a long-term trend of growing economic linkages and interdependence.

Chart 1 – Growth in the U.S. Share of Canada's Merchandise Exports, 1946-2002



Source: Author's calculation using Statistics Canada data.

In the early 1960s, about 55% of Canada's merchandise exports were destined for the U.S. market. This proportion began to rise later in the decade when the Auto Pact liberalized trade in automobiles and auto parts between the two countries. Since that time, not only have Canadian exports to the United States risen steadily, but so too has the proportion of Canadian exports intended for sale in the United States. In 1988, immediately prior to the implementation of the FTA, 75% of Canadian exports went to the United States. Fourteen years later, that proportion had reached 87%.

The long-term growth in trade between Canada and the United States was aided in part by the fact that, as mentioned above, a significant proportion of trade between the two countries was tariff-free even before the FTA was implemented. In addition to automobiles and auto parts, tariffs on aircraft and related parts, pulp, paper and wood products, and crude oil, petroleum and natural gas – some of Canada's most significant export products – were unaffected by the FTA.(6)

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(6) The FTA could even be interpreted as being a result of the growth in Canada-U.S. trade since the 1960s. In other words, the FTA was a manifestation of the extent to which the economic relationship between the two countries had evolved.

B. Macroeconomic Factors

The FTA was not the only factor affecting trade between Canada and the United States. Independent of the trade agreement, a number of macroeconomic variables also played a role. Two, in particular, not only influenced growth in trade between the two countries during the 1990s, but also had a significant effect on the balance of trade.

The first of these is the performance of the Canadian dollar. Since the mid 1970s, the Canadian dollar has been in a long-run decline relative to the U.S. dollar. From 1976 to 1986, the Canadian dollar fell from about US$1.01 to US$0.76. The decline was temporarily abated in the late 1980s when, to control inflation, the Bank of Canada adopted a policy of high interest rates at a time when a slowing economy was leading the U.S. Federal Reserve to lower its rates. The resulting gap between Canadian and U.S. interest rates caused the Canadian dollar to appreciate relative to the U.S. dollar, rising to over 87 cents in 1991. This increase proved to be an aberration, however, and the Canadian dollar resumed its downward trend the following year, reaching a monthly low of US62.5 cents in January 2002.

The drop in the Canada-U.S. exchange rate had an important effect on trade between the two countries. Specifically, it reduced the price of Canadian export products in the U.S. market while making U.S. goods more expensive to purchase in Canada. This has placed downward pressure on import growth in Canada while making Canadian products more competitive in the U.S. market, thus boosting exports.

The drop in the value of the Canadian dollar through the 1990s was due more to the strength of the U.S. dollar than to the weakness of the Canadian currency. Relative to most other major currencies, the Canadian dollar performed comparatively well in the latter half of the decade. With the Canadian dollar holding or gaining value abroad but losing value in the United States, there was a clear incentive to divert exports to the United States, where a more favourable exchange rate made Canadian goods more competitive than in other major world markets.

The second key macroeconomic variable was the fact that, following the recession of the early 1990s, the United States entered one of the longest periods of uninterrupted economic expansion in its history. A combination of factors including productivity growth, falling commodity prices, equity market gains and a strong U.S. dollar allowed the economy to expand, creating jobs, raising incomes and attracting investment, all without triggering inflationary pressures. This allowed the U.S. Federal Reserve to keep interest rates low, further extending the expansion. Beginning in the fourth quarter of 1991 and ending in the first quarter of 2001, the U.S. witnessed 38 consecutive quarters of economic growth.

The strength of the U.S. expansion contributed to Canada's export growth over the 1990s. As Americans' wealth increased, so too did consumption levels, buoying demand for foreign goods, including products from Canada. Since the Canadian economy did not perform as well, Canadian demand for U.S. goods did not grow as quickly and as a result, Canadian exports to the United States outpaced import growth from that country.

C. Changing Trade Flow Patterns

Another factor that probably contributed to Canada's strong trade growth with the United States was the reduction in Canada-U.S. tariff barriers, which may have changed the countries' patterns of trade flows. This is known as trade diversion. From the Canadian perspective, there are two forms of trade diversion to consider: Canadian exports could have been rerouted from other countries to the United States; and trade between Canadian provinces could have been deflected to the United States.

Through multilateral negotiations at the World Trade Organization (WTO) and its predecessor, the General Agreement on Tariffs and Trade (GATT), tariff and non-tariff barriers to trade have been in decline worldwide. However, the Canada-U.S. Free Trade Agreement lowered and eliminated tariffs between those two countries at a much greater rate. As a result, it has become easier for Canadian exporters to compete in the U.S. marketplace compared to the rest of the world. This raises the possibility that Canadian trade patterns that otherwise would have responded to world market signals were deflected in response to differential tariff rates.

Indeed, given the extent to which Canadian export growth to the United States has exceeded export growth to other countries, it is probable that at least some of the difference is due to exports shifting to the United States from other international destinations. Statements of how much Canada-U.S. trade has grown since 1988 do not distinguish between trade *created* as a result of the FTA and trade *diverted* from other countries. The creation of trade yields economic benefits for Canadians, while the diversion of trade from other countries in response to differential tariff rates may simply lead to economic inefficiencies.(7)

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(7) There is an extensive debate in the economic literature over whether regional free trade agreements are beneficial to the long-run goal of global free trade. Proponents of regional agreements maintain that agreements such as the FTA or NAFTA simplify multilateral negotiations by reducing the number of players at the global level. Critics believe that regional agreements are artificially trade-distorting because they could divert trade from outside the regional bloc to within that bloc for non-economic reasons.

Chart 2 - Contribution of International and Interprovincial Trade to the Canadian Economy, 1981-2001

Source: Author's calculation using Statistics Canada data.

As for interprovincial trade, studies have confirmed that at least a portion of Canada's trade with the United States has been diverted from interprovincial trade,(8) although it is difficult to attribute a specific value to the shift. Even as trade with the United States has soared since the 1980s, interprovincial trade has declined in importance to the Canadian economy. In 1981, interprovincial trade accounted for about one-quarter of economic output in Canada, while international exports (to all countries) made up about 20% of GDP. Twenty years later, interprovincial trade had fallen to one-fifth of GDP, while international exports accounted for 43% of GDP.

This trend holds true across Canada. In 1981, interprovincial exports made a greater contribution to the economy than international exports in seven of the ten provinces. Only British Columbia, Saskatchewan, and Newfoundland and Labrador exported more abroad than domestically. By 2001, however, Manitoba was the only remaining province where interprovincial exports were more important to the economy than international exports.

From a primarily east-west focus, the Canadian economy has gradually shifted to a series of north-south relationships. This change is reflected in the export patterns of individual provinces. As shown in Table 1, provincial exports to the United States tend to be concentrated

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(8) See, for example, John Helliwell, Frank Lee and Hans Messinger, "Effects of the FTA on Interprovincial Trade," in George Hoberg, ed., *Capacity for Choice: Canada in a New North America*, University of Toronto Press, Toronto, 2002.

in neighbouring or nearby states. The Atlantic provinces trade heavily with New England and the mid-Atlantic. Quebec and Ontario also export to the mid-Atlantic as well as the midwest, while Saskatchewan and Manitoba exports are largely destined for the U.S. plains as well as the midwest. Alberta's export distribution deviates from the trend somewhat, as its high volume of oil and gas exports follow major pipeline routes. Finally, British Columbia's export market in the United States is dominated by west coast states.

Table 1 -- Distribution of Canadian Exports to the U.S. by Region of Destination – 2002

	NF&L	PEI	NS	NB	PQ	ON	MB	SK	AB	BC
New England	25.5	53.1	45.5	56.0	13.9	3.5	1.5	0.5	3.4	1.8
Mid-Atlantic	40.0	21.3	13.1	22.5	31.8	16.2	14.1	5.5	15.0	7.6
Midwest	0.9	4.3	7.2	6.5	19.0	48.8	18.6	21.1	28.7	12.0
Plains	0.3	1.7	1.0	1.3	4.5	4.5	38.2	49.2	21.9	7.4
South	30.2	12.9	24.7	8.7	18.5	11.7	13.9	9.9	13.3	11.0
Northwest	0.3	1.2	3.7	0.2	2.1	1.8	4.1	5.8	11.8	38.8
West	1.1	4.0	2.8	2.3	8.3	11.8	8.0	6.2	6.3	17.7
Other (unspecified)	1.6	1.5	2.1	2.5	2.0	1.8	1.6	1.8	-0.4	3.7
Total	100	100	100	100	100	100	100	100	100	100

Source: Author's tabulations using Statistics Canada data.

Even so, economic analysis has shown that interprovincial trade linkages remain significantly stronger than the north-south relationships between individual provinces and states. Taking into account the size, wealth and proximity of Canadian provinces with respect to one another, and with respect to individual U.S. states, recent research estimates that interprovincial trade linkages are 12 times stronger than those between Canada and the United States.(9)

CONCLUSION

Canada has witnessed an explosion in trade with the United States since the FTA was implemented in 1989. Exports to the United States grew by 244% from 1988 to 2002, while imports increased by 154% over the same period. While some free trade advocates are quick to offer these statistics as evidence of the positive effects of the FTA, it is in fact somewhat misleading to do so. This is not to suggest that the FTA has not been beneficial to the Canadian

(9) *Ibid.*

economy. Indeed, studies have demonstrated conclusively that the FTA has contributed to the acceleration in trade between the two countries.

However, the tariff reduction and rules-based trading system created by the FTA is only one of several factors influencing Canada's trading relationship with the United States since the late 1990s. This paper highlighted a few of these factors, notably: the continuation of a long-run trend towards economic integration between the two countries; macroeconomic considerations such as the decline in the Canadian dollar during the 1990s and the relatively strong growth in the U.S. economy, feeding U.S. import demand; and the diversion of trade from other destinations, including both other countries and other provinces.

The magnitude and complexity of this subject make it impossible to isolate to any degree of certainty the individual contributions of these and other factors to overall trade growth between Canada and the United States. Suffice it to say, therefore, that many factors have affected the Canada-U.S. trading relationship since the late 1980s, and that the increase in trade between the two countries should not be attributed exclusively to the effects of the Canada-U.S. Free Trade Agreement.

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