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CANADA IN THE 21ST CENTURY

I. SCENE SETTING

NORTH AMERICAN ECONOMIC INTEGRATION: 25 YEARS BACKWARD AND FORWARD

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I. SCENE SETTING

NORTH AMERICAN ECONOMIC INTEGRATION: 25 YEARS BACKWARD AND FORWARD

By Gary C. Hufbauer and Jeffrey J. Schott
Institute for International Economics, Washington (DC)

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Comments should be addressed to:

Someshwar Rao
Director
Strategic Investment Analysis
Micro-Economic Policy Analysis
Industry Canada
5th Floor, West Tower
235 Queen Street
Ottawa, Ontario
K1A 0H5

Tel.: (613) 941-8187
Fax: (613) 991-1261
E-mail: rao.someshwar@ic.gc.ca

Table of Contents

PREFACE *i*

SUMMARY *iii*

INTRODUCTION 1

TWENTY-FIVE YEARS BACKWARD 3

BILATERAL TRADE AND INVESTMENT 3

BILATERAL ECONOMIC INITIATIVES 32

TWENTY-FIVE YEARS FORWARD 39

ECONOMIC INTEGRATION – THE EXAMPLE OF GERMANY AND THE BENELUX COUNTRIES 39

IMPLICATIONS FOR COMPETITIVENESS 50

THE TRADE POLICY OUTLOOK AND ITS IMPLICATIONS FOR THE NORTH AMERICAN ECONOMIC INTEGRATION 55

PROSPECTS FOR FREE TRADE IN THE AMERICAS 56

PROSPECTS FOR FREE TRADE IN APEC 60

PROSPECTS FOR GLOBAL FEE TRADE 60

CONCLUSIONS 63

NOTES 65

INDUSTRY CANADA RESEARCH PUBLICATIONS 67

Preface

As a new millennium approaches, Canadians are going through a time of dramatic economic change. Markets are becoming global, and economic activity across nations is becoming increasingly integrated. Revolutionary developments in computer and communications technology are facilitating globalization, and are also altering a great deal the workplace and the lifestyles of Canadians. At the same time, largely as a consequence of the information revolution, knowledge-based activities are becoming increasingly important within the Canadian economy and the economies of other industrialized nations.

These and related major transformations of the economic environment invite a comparison with the Industrial Revolution of the 1800s. As in the earlier time, major structural changes are giving rise to uncertainties. Firms and workers are struggling to find their place in the new economic order. Canadians collectively face the question of whether their nation's physical, human and institutional resources will provide a firm foundation for continued prosperity. Many see Canada's prospects as being much less secure than in earlier years, when the country's rich natural resources played a major role in shaping the Canadian economy.

To examine fully the medium to longer-term opportunities and challenges of these developments, the Micro-Economic Policy Analysis Branch of Industry Canada asked a group of experts to provide their "vision" for Canada in the 21st Century on a number of important issues. Each author was required to undertake two formidable tasks: first, to identify major historical trends and develop scenarios to illustrate how developments in his/her respective area might unfold over the next ten to fifteen years; and second, to examine the medium-term consequences of these developments for the Canadian economy.

The papers coming out of this exercise are now being published under the general heading of "Canada in the 21st Century". This series consists of eleven papers on different aspects of Canada's medium-term outlook. The papers are divided into three major sections. The first section, *Scene Setting*, focuses on important developments that are going to shape the medium-term economic environment in Canada. The second section, *Resources and Technology*, looks at trends among some important components of Canada's wealth creation and considers the actions needed to ensure that these factors provide a firm foundation for continued prosperity. The last section, *Responding to the Challenges*, explores individual, corporate and government responses to the medium-term challenges and offers some options for an appropriate course of action.

As part of the *Scene Setting* section, this paper by Gary Hufbauer and Jeffrey Schott, of the Institute for International Economics, focuses on the regional dimension of Canada's commercial relations. It traces the growth of trade, investment and other commercial links between Canada and the United States, and speculates on the evolution of North American economic relations.

The authors are optimistic about the prospects for further North American economic integration. They believe free trade forces will continue to prevail over protectionist sentiments within the United States and that economic progress in North America will bring about a further increase in Canada–U.S. trade, which by 2005 or 2010 could be 20 to 30 percent above what it would have been in the absence of recent trade agreements. Meanwhile, economic reforms in Latin American countries are laying the foundation for NAFTA expansion and the gradual emergence of the Free Trade Area of the Americas.

SUMMARY

THIS REPORT OFFERS A RETROSPECTIVE AND PROSPECTIVE VIEW of the process of economic integration in North America. It begins with a history of the past 25 years of bilateral economic relations, and then speculates on how U.S.–Canada economic relations are likely to evolve over the next 25 years.

TWENTY-FIVE YEARS BACKWARD

THIS SECTION EXAMINES THE ROOTS OF THE "SILENT" INTEGRATION of the past generation. On the basis of this analysis, in the second part we draw some insights about the future course of bilateral economic relations.

Bilateral Trade and Investment

Canada is among the most trade-dependent of the OECD countries, while the United States is one of the least. Each country is the other's best customer, but the United States has no foreign rivals in the Canadian market while Canada is first among equal trading partners in the U.S. market. In simple terms, the U.S. market is more important to Canada than the Canadian market is to the United States.

Over the period from 1970 to 1995, bilateral trade in goods and services has grown faster than GDP, increasing at an average annual rate of about 11 percent. Machinery and transportation equipment dominate two-way trade, accounting for roughly 40 to 45 percent of total bilateral trade. In contrast, bilateral flows of direct investment have been less robust and direct U.S. investment in Canada has slowed markedly since 1990. Firms seem to be expanding output at their most efficient sites and phasing out smaller facilities formerly necessitated by trade barriers.

These aggregate trends mask the significant growth of a series of regional market clusters along the border. In recent years, trade between the U.S. states bordering Canada and their Canadian counterparts has grown substantially faster than national bilateral trade.

Macro-economic Policy Issues

Canada and the United States share many economic values but differ markedly in the role of government in the national economy. While central government spending as a percentage of GDP is roughly the same in both countries, Canadian provinces outspend American states by about two to one. Canada's external debt exceeds 100 percent of GDP (compared to under 20 percent for the United States), and its budget deficit as a percentage of GDP is roughly twice that of the United States. As a result, Canadian policy makers

are caught in a vise between the huge expense of social programs and the substantial political support for their continuance.

Since 1970, Canada and the United States have also diverged in terms of the percentage of GDP claimed by income and profit taxes: the share has increased in Canada and decreased in the United States. In 1993, the figures diverged by a full three percentage points of GDP. Canadian taxes on goods and services have consistently been about double those in the United States.

The Canadian economy tends to move in tandem with the U.S. economy but not in lock step. The degree of correspondence is highest in the money markets, where there is an extremely close correlation between U.S. and Canadian long-term (10-year) interest rates. Except for the early 1990s, there has also been a close correlation between inflation rates. In contrast, the exchange rate continues to fluctuate extensively.

Perhaps the biggest difference concerns labour. Until the late 1980s, Canadian unemployment followed the U.S. pattern with a lag of about a year. Since then, however, it has increased markedly while the U.S. rate has gently declined. The divergence is probably due to the fact that, in the early 1990s, the recession came later and was much deeper in Canada than in the United States. Because Canadian labour markets are less flexible than the U.S. markets, Canadian wages continued to increase in step with U.S. wages. Under the circumstances, Canada's drive for zero inflation would have required much lower wage gains to avert an increase in unemployment.

Trade and Investment Frictions

Among the impediments to integration of the North American economies are unilateral trade actions that can distort trade and investment flows and undercut business strategies seeking to rationalize production across the region. In this paper, we review three types of measures: anti-dumping or countervailing duties, U.S. Section 301 actions and economic sanctions.

Anti-dumping or countervailing duties have been imposed relatively rarely given the overall volume of bilateral trade, but they have drawn considerable attention in Canada because a few U.S. cases covered big-ticket sectors, such as softwood lumber. The United States has initiated more than 70 cases over the past three decades but the incidence has declined sharply in recent years. The new dispute settlement procedures of the Canada-United States Free Trade Agreement (FTA) deserve credit for mitigating the tensions created by these cases.

Could future regional and/or multilateral negotiations curb abuses of the anti-dumping regime? Past attempts do not offer optimism; indeed, recent GATT accords added to the dense regulatory guidelines for administrative agencies. We are wary of new efforts in this area; it may be better to let anti-dumping practices wither on the vine rather than try to prune them back. Past pruning has led to new grafts that have strengthened anti-dumping rules.

Countervailing duties will remain a problem as long as governments remain fixated on subsidizing economic sectors to redistribute income and promote employment. Both countries have tried unsuccessfully to rein in subsidy practices at the sub-federal level, where states and provinces compete with each other to attract new investments to their jurisdictions. Regional and multilateral negotiations have also failed to discipline these domestic subsidy practices. The only effective policy for curbing subsidies is likely to be budget constraint or taxpayer revolt.

Section 301 cases have not been a major concern, with the notable exception of cultural industries. Section 301 refers to Section 301 of the Trade Act of 1974. This statute authorizes the President to retaliate against "unfair" foreign trade practices. Unilateral Section 301 actions are still possible if contested policies are not covered by World Trade Organization rules. Canada's insistence on exempting cultural industries from regional and WTO obligations thus makes it easier to use Section 301 to contest trade practices in this area. This could be a growth area for North American trade lawyers.

***Economic sanctions*:** Until the recent U.S. Helms–Burton Act, the United States and Canada differed infrequently on the use of sanctions in support of foreign policy objectives, and sanctions have not impeded regional trade and investment flows to a significant degree. However, the trend toward invoking sanctions through legislation rather than executive order (as in the Cuba, Iran and Iraq sanctions) is worrisome. If this trend gathers strength, the United States could find itself increasingly embroiled in rancorous disputes with Canada and other countries over the imposition of U.S. sanctions.

Bilateral Economic Initiatives

U.S.–Canadian bilateral economic initiatives over the past generation reflect an emerging understanding that negotiated approaches to conflict resolution are more constructive than unilateral actions. We review briefly the landmark agreements of the period: the Auto Pact, the FTA and the NAFTA.

The Auto Pact spawned a huge network of cross-border trade and spurred investment in the Canadian auto sector. In a conceptual sense, it also proved to be the forerunner of the Free Trade Agreement since the Auto Pact was the first significant departure by the United States from its postwar strategy of pursuing trade liberalization on a multilateral basis.

The FTA strengthened bilateral trade relations and created new rights and obligations regarding investment, services and dispute settlement; these have provided models for subsequent trade talks both regionally and multilaterally. Bilateral trade in financial services has grown at an annual rate of 21 percent since the FTA was implemented, while trade in closely related computer and information services has grown by almost 30 percent. In turn, the FTA largely provided the institutional underpinning for further liberalization achieved in the NAFTA.

Twenty-Five Years Forward

Economic Integration: the Example of Germany and the Benelux Countries

This section examines the economic convergence between Germany and the Benelux countries over the past three decades as a way to derive insights into future convergence between Canada and the United States. Integration in Northern Europe was particularly far-reaching because of shared borders and close linguistic ties (French and English are common second languages). By 1960, the Benelux states and West Germany had reached a degree of formal integration that Canada and the United States did not achieve until 1990.

On the basis of this European experience, we draw several conclusions:

First, the importance of trade in North America is likely to grow relative to GDP. While rising trade ratios are the natural consequence of globalization, in the 1960s and 1970s trade-to-GDP ratios rose faster in Europe than elsewhere; we attribute the extra growth to integration efforts.

European integration generated a 50-percent increase in intra-regional trade (above levels that would probably have been achieved otherwise). Because barriers to North American trade started at a lower level, we would not expect trade growth comparable to that achieved in Europe, but increases of 20 to 30 percent seem quite possible.

By the same token, it seems probable that trade-to-GDP ratios for Canada and the United States will also rise. In 1993, the ratio of trade in goods and business services to GDP was 60 percent for Canada and 22 percent for the United States. These numbers could well rise to 80 and 35 percent respectively over the next two decades.

The development may be expressed in another way: the rising ratio of trade to GDP means that U.S. and Canadian import markets should grow at least one percentage point faster per year than real GDP.

Second, for several key macro-economic variables, North America has already achieved as much convergence as Northern Europe. The two areas where greater convergence might occur are the exchange and unemployment rates. If exchange rate stability increases in future, it will probably reflect fundamental forces (particularly synchronized inflation rates) rather than a policy decision by the Bank of Canada. In contrast, the force of open markets for goods and services will probably create more flexible labour practices throughout Canada and a closer match with U.S. unemployment levels.

Third, integration does not require convergence of tax policies. In Europe, after far-reaching integration, national tax structures actually diverged more than they had in 1965. In brief, the smaller partners were able to carry on with a more extensive social agenda than the largest partner. We expect current disparities between U.S. and Canadian tax structures to endure for some time, and see no reason why economic convergence by itself should force

Canada to the mode of lower taxes and reduced public spending preferred by the United States.

Implications for Competitiveness

The European experience suggests that there is considerable scope for further economic convergence between the United States and Canada in the next generation. This scenario suggests four lessons for Canadian firms and government policy:

- Corporations must follow the high-quality, low-cost leader or go out of business. Firms must have a lean staff and keep costs to the minimum.
- Firms should be very sensitive to workforce availability and habits in making decisions on new locations.
- Governments may well find that targeted subsidies are effective in attracting individual firms. Given budget constraints, however, officials will have to juggle priorities between general programs (such as better schools) and targeted programs (such as road links to specific industrial sites).
- Government officials should place greater emphasis on goods and services taxes that can be adjusted at the border, and on income tax systems that are fairly uniform so as to avoid driving away highly skilled people or especially profitable but mobile industries.

The Trade Policy Outlook and its Implications for North American Economic Integration

This final section offers our vision of future U.S. trade policy and how it could directly and indirectly affect U.S–Canadian economic relations. We argue that U.S. policy is likely to follow the script of the past two decades and continue to be based on a mixture of domestic legislative actions, regional trade initiatives and multilateral negotiations in the WTO. We describe the likely evolution of ongoing integration initiatives in the Western Hemisphere and the Asia-Pacific regions, as well as new efforts in the WTO.

The United States and Canada are committed to eliminating barriers to trade with the major trading nations of Asia-Pacific and Latin America. If barriers really are removed, free trade and investment in both regions will yield a rich harvest of reforms in the dynamic economies of East Asia and South America, but only modest changes will be required in North American policies affecting most manufacturing sectors (with the important exception of apparel). Agricultural reform will be a sticking point in both regions, as it has been in the

United States–Canada context. These commitments hold three main implications for the North American economies:

- increased adjustment pressure on the apparel sector;
- additional competition in meat and dairy products from Argentina, Australia and New Zealand, and in sugar from Brazil and potentially Cuba; and
- increased export opportunities in the markets of regional partners, as a result of trade-spurred growth.

Western Hemisphere: We are optimistic about the prospects for a Free Trade Area of the Americas (FTAA), for several reasons. First, economic reforms continue throughout the hemisphere, strengthening the foundations for economic growth over the medium and long term. Second, the Summit of the Americas process is working. Third, the process of integration has continued advancing in various sub-regional pacts.

What is the most likely course of development for the FTAA? We believe that a FTAA will evolve from a pragmatic, *ad hoc* approach that combines the continuation of sub-regional integration efforts (including the expansion of the NAFTA region) with hemisphere-wide efforts to harmonize national and/or sub-regional trading rules that could potentially erect obstacles to the FTAA. The NAFTA will play an important role in future hemispheric integration since the NAFTA area accounts for more than 85 percent of the hemisphere's output. Stronger ties between the expanding NAFTA and MERCOSUR areas will also be critical.

Negotiations on Chilean accession to the NAFTA should proceed quickly in 1998, once U.S. fast-track negotiating authority is renewed. The main challenge will be to devise solutions for the WTO-plus features of the NAFTA (e.g., investment, intellectual property, services and labour/environment side agreements).

Asia-Pacific: The United States and Canada have committed to achieving free trade and investment in the Asia Pacific Economic Co-operation (APEC) region by the year 2010. How this will be done is still unclear since the Asian-style negotiating process adopted by APEC creates uncertainty about the depth and timing of national trade reforms. While APEC members seem committed to eliminating border trade restrictions, they have not clarified how deep into domestic policies they will extend their commitments, although discussions have covered a broad range of issues, including investment and competition policy.

Nonetheless, it is difficult to imagine APEC reforms going beyond the comprehensive free trade obligations covered by the NAFTA. U.S.–Canadian norms are thus likely to represent the high water mark for APEC efforts. The one area where APEC could forge ahead is in competition policy, where regional and multilateral efforts in other forums are in their infancy.

In simple terms, we do not expect APEC's government-to-government negotiations to serve as a catalyst for North American integration. Instead, the lure of expanding Asian markets and the challenge of competing in those markets will provide a more powerful impetus for North American industry to restructure.

WTO: If regional free trade initiatives are sustained, they are likely to become linked in new WTO negotiations under the banner of global free trade.

The main question for these prospective WTO talks is whether negotiations in this forum can lead to the same deep integration (i.e., convergence or mutual recognition of domestic regulatory policies) achieved in Europe and now evolving in North America. The difference is that the WTO talks will balance EU norms with those of other regions. In some areas the U.S.–Canadian norm may not be the most stringent and North American policies could be strengthened to meet EU norms.

Conclusion

Over the next 25 years, the economic integration of North America will advance markedly:

- The border between Canada and the United States will be no more intrusive than the German–Dutch border today. Border trade measures will be a relic of the past; declining resort to anti-dumping duties and other border measures will be replaced by regulatory competition and investment subsidies.
- Trade will play an even larger role in both economies, and two-way trade flows will continue to expand sharply.
- Trade with Asia will take a much larger share of U.S. and Canadian exports and imports, spurring further development of west coast ports.
- Regardless of developments in Quebec, we will continue to see the devolution of power from federal governments to states and provinces. In both countries, provinces and states will play a larger role in shaping the direction of future integration. This trend will constrain growth of the federal tax base and will thus continue to squeeze budgets for social services.

INTRODUCTION

CANADA AND THE UNITED STATES SHARE THE LONGEST UNPROTECTED BORDER in the world and are each others' main trading partner. From colonial times through the signing and implementation of the North American Free Trade Agreement (NAFTA) in the 1990s, the two economies have been deeply linked. Since the mid-1800s, numerous efforts have been made to codify these linkages in bilateral free trade pacts, but politics trumped economics until quite recently.

This report offers a retrospective and prospective view of the integration process. It begins with a history of the past 25 years of bilateral economic relations, and then speculates on how U.S.–Canadian economic relations are likely to evolve over the next 25 years. By examining the roots of the "silent" integration of the past generation, along with the much-trumpeted trade diplomacy of the period, we attempt to draw some insights into the future course of bilateral economic relations.

Twenty-Five Years Backward

Bilateral Trade and Investment

Canada has long been preoccupied with its bilateral trade relationship with the United States. Twenty-five years ago, bilateral merchandise trade totaled approximately $20 billion, and it represented about 65 percent of total Canadian trade and about 24 percent of total U.S. trade. From 1970 to 1995 Canadian exports became increasingly reliant on the U.S. market, despite the diversification efforts of the Trudeau era, while U.S. goods maintained a fairly constant share of the Canadian import market. By 1995, bilateral trade had grown more than tenfold to $260 billion. Canada's dependence on U.S. trade increased to represent 74 percent of its total trade, while the Canadian share of U.S. trade fell to 20 percent (Table 1).

In simple terms, the U.S. market is more important to Canada than the Canadian market is to the United States. The importance of the U.S. market to Canada is underscored by the fact that just over 25 percent of Canada's trade and economic relations staff personnel posted at bilateral missions abroad are located in the United States. The disparities in respective trade destination shares reflect the fact that the United States has a population and GNP roughly 10 times that of Canada (Table 2).

Bilateral Trade

Canada is among the most trade-dependent of the OECD countries; the United States is one of the least. Each country is the other's best customer, but the United States has no foreign rivals in the Canadian market while Canada is first among equal trading partners in the U.S. market. In 1995, Canada sent about 80 percent of its merchandise exports to the United States, and U.S. goods made up about 66 percent of Canada's imports. In contrast, the United States shipped 22 percent of its merchandise exports to Canada, and Canadian goods accounted for 19 percent of the U.S. import market.

Trade between the two countries continues to grow faster than GDP. From 1970 to 1995, both U.S. merchandise exports to Canada and imports from Canada grew at an average annual rate of about 11 percent (Table 3). These trade figures are in nominal dollars. In comparison, U.S. nominal GDP grew at an annual rate of only about 8.5 percent over this period.

Table 4 shows the composition of bilateral trade over the last 25 years. Machinery and transportation equipment dominate two-way trade, as would be expected in the countries that crafted the original managed trade regime in those sectors. They accounted for roughly 40 to 45 percent of total bilateral trade during the period (except for the high-oil-price, high-inflation bust of the late 1970s to early 1980s). Mineral fuels have accounted for a declining share

Table 1

Bilateral Merchandise Trade Shares, 1960-95
Percentage

	1960	1965	1970	1975	1980	1985	1990	1995
Canada								
(U.S. Share of Total)								
Imports	70	68	66	66	68	69	63	66
Exports	58	62	62	62	61	75	75	80
United States								
(Canada Share of Total)								
Imports	23	28	22	22	16	19	22	19
Exports	20	21	20	20	16	22	18	22

Source: Direction of Trade Statistics Yearbook, IMF.

TABLE 2

BASE ECONOMY COMPARISON, UNITED STATES AND CANADA, 1965-93

		1965	1970	1975	1980	1985	1990	1993
United States								
Population	M	194.3	205.1	216.0	227.8	238.5	249.9	257.8
GDP (real, 1987)	US$ M	2,436,653	2,828,484	3,166,350	3,732,761	4,244,497	4,863,689	5,132,829
GDP (real, 1987) per capita	US$	12,540	13,794	14,661	16,389	17,799	19,461	19,907
GDP (nominal)	US$ M	704,094	1,011,563	1,587,563	2,708,147	4,016,650	5,489,600	6,259 899
Export (goods and non financial services)	US$ M	36,742	59,087	136,993	277,525	296,384	548,900	647,800
Import (goods and non financial services)	US$ M	31,529	55,760	122,729	293,896	417,623	628,500	724,300
Export and import of goods and business services as a percentage of GDP	%	9.7	11.4	16.4	21.1	17.8	21.4	21.9
Canada								
Population	M	19.7	21.3	23.2	24.6	25.9	27.8	28.8
GDP (real, 1987)	US$ M	171,476	215,308	275,314	332,522	383,484	441,722	446,132
GDP (real, 1987) per capita	US$	8,714	10,097	11,862	13,520	14,782	15,894	15,500
GDP (nominal)	US$ M	52,867	84,438	167,236	263,192	347,379	568,072	546,350
Export (goods and non financial services)	US$ M	9,915	19,165	38,297	74,904	98,807	144,773	161,405
Import (goods and non financial services)	US$ M	10,020	17,019	40,664	70,075	90,362	146,750	164,726
Export and import of goods and business services as a percentage of GDP	%	37.7	42.9	47.2	55.1	54.5	51.3	59.7

Source: World Data 1995, World Bank, 1995.

TABLE 3

MERCHANDISE TRADE BETWEEN CANADA AND THE UNITED STATES AND WITH THE REST OF THE WORLD, 1961-95
BILLIONS OF US$

	1961	1965	1970	1975	1980	1985	1990	1995	Average Annual Growth 1970-95
Canada									
Imports from the U.S.	3.9	5.6	9.5	23.1	41.2	54.1	75.3	109.0	10.3%
Total imports	5.8	8.0	14.0	35.2	61.0	78.7	119.7	164.3	10.4%
Exports to the U.S.	3.2	4.7	10.4	21.2	41.1	68.3	95.4	152.8	11.3%
Total exports	8.0	8.1	16.7	34.1	67.7	90.8	126.4	190.2	10.2%
United States									
Imports from Canada	3.3	4.9	11.1	22.8	42.0	69.4	85.3	148.3	10.9%
Total imports	14.8	21.4	40.0	103.4	257.0	361.6	39.3	770.9	12.6%
Exports to Canada	3.7	5.6	9.1	21.7	35.4	47.3	93.8	126.0	11.1%
Total exports	21.0	27.4	43.2	107.6	220.8	213.1	517.0	582.5	11.0%

Source: Direction of Trade Statistics Yearbook, IMF.

TABLE 4A

U.S. EXPORTS TO CANADA, 1970-95
BILLIONS OF US$, F.A.S.[a] VALUE

	1970	1975	1980	1985	1990	1995	Average Annual Growth
0—Food and live animals	547.6	1,042.0	1,451.2	1,305.3	4,467.5	6,144.0	10.2%
1—Beverages and tobacco	8.8	13.8	89.4	65.4	133.9	215.4	13.6%
2—Crude materials, inedible, except fuels	535.9	906.9	1,826.2	1,487.4	2,986.6	4,413.1	8.8%
3—Mineral fuels, lubricants and related materials	271.3	866.5	1,843.1	1,604.7	2,167.9	1,472.5	7.0%
4—Animal and vegetable oils, fats and waxes	21.8	48.3	32.4	32.6	58.8	130.5	7.4%
5—Chemicals and related products, n.e.s.[b]	553.8	1,222.7	2,134.4	2,698.1	6,139.3	10,652.5	12.6%
6—Manufactured goods classified chiefly by material	1,137.6	3,023.0	3,773.3	3,937.0	10,096.7	16,252.3	11.2%
7—Machinery and transportation equipment	4,869.6	12,360.1	17,993.8	26,900.6	45,294.2	69,717.2	11.2%
8—Miscellaneous manufactured articles	574.8	1,292.8	2,427.2	2,757.0	7,926.9	12,686.7	13.2%
9—Commodities and transactions n.e.s.	270.5	531.4	2,397.1	4,240.9	3,694.7	4,339.8	11.7%
Total	8,791.8	21,307.4	33,968.0	45,028.9	82966.5	126,024.1	11.2%

a Free alongside ship value.
b Not elsewhere specified.
Source: U.S. Department of Commerce.

TABLE 4B

U.S. IMPORTS FROM CANADA, 1970-95
BILLIONS OF US$, CUSTOMS VALUE

	1970	1975	1980	1985	1990	1995	Average Annual Growth
0—Food and live animals	463.1	673.6	1,393.4	2,376.4	3,768.1	5,655.3	10.5%
1—Beverages and tobacco	181.9	246.4	387.7	495.8	594.9	680.1	5.4%
2—Crude materials, inedible, except fuels	1,679.2	2,770.2	5,239.0	5,583.1	7,481.6	10,920.2	7.8%
3—Mineral fuels, lubricants and related materials	1,000.1	4,708.8	7,114.0	10,071.2	9,846.2	13,686.4	11.0%
4—Animal and vegetable oils, fats and waxes	1.2	4.8	5.8	20.5	92.4	339.2	25.3%
5—Chemicals and related products, n.e.s.[a]	361.6	795.3	2,493.6	2,912.9	4,305.0	8,150.4	13.3%
6—Manufactured goods classified chiefly by material	2,222.5	3,625.6	8,175.5	10,716.6	15,778.4	25,389.1	10.2%
7—Machinery and transportation equipment	4,404.8	7,966.2	12,304.9	29,396.8	40,754.4	63,794.9	11.3%
8—Miscellaneous manufactured articles	282.4	475.7	1,642.5	2,997.5	3,593.8	7,760.9	14.2%
9—Commodities and transactions n.e.s.	494.1	903.2	2,698.9	4,435.6	5,157.2	8,742.2	12.2%
Total	11,091.1	22,169.8	41,455.4	69,006.3	91,372.0	14,5118.7	10.8%

a Not elsewhere mentioned.
Source: U.S. Department of Commerce.

Table 5

Top 10 Purchasers of U.S. Manufactured Products, 1989-95
Percentage of Total U.S. Exports of Manufactured Goods

	1989	1990	1991	1992	1993	1994	1995
Canada	25	23	22	22	23	24	23
Japan	9	10	9	8	8	8	9
Mexico	7	8	8	9	9	10	8
United Kingdom	7	7	6	6	6	6	5
Germany	5	5	6	5	4	4	4
South Korea	3	3	3	3	3	3	4
Taiwan	3	3	3	3	3	3	3
Singapore	2	2	2	2	3	3	3
Netherlands	3	3	3	3	3	3	3
France	4	4	4	4	3	3	3

Source: U.S. Department of Commerce.

of trade since the first oil shock in the 1970s; trade in food and beverages has been basically flat at 5 to 6 percent of total trade. Canada consistently tops the U.S. Department of Commerce's list of major foreign purchasers of U.S. manufactured products (Table 5), buying close to a quarter of the total — slightly higher than its share of total U.S. exports.

Trade in services between the two countries has grown at about the same pace as trade in goods: Canadian exports to the United States of commercial services have grown by 13 percent per annum since 1982, and U.S. exports to Canada have increased by 10 percent annually (Table 6). Not surprisingly, two-way trade in computer and information services has been robust throughout the period and has been the fastest-growing sector in the 1990s. However, the leading U.S. service export remains management services, with revenues of about C$2.5 billion in 1994. Moreover, this figure does not reflect the growth of Canadian sales from subsidiaries of American management consulting companies — firms that have proliferated in Toronto, Vancouver and other large Canadian cities.

TABLE 6

U.S.-CANADA TRADE IN COMMERCIAL SERVICES, 1982-94
MILLIONS OF C$

	1982	1986	1990	1994	Average Annual Growth 1982-94	Average Annual Growth 1990-94
Canada to United States						
Communications	87	126	210	324	12%	11%
Insurance	264	569	725	828	10%	3%
Other financial services		144	229	489	17%	21%
Computer and information services	44	110	155	608	24%	41%
Royalties and licence fees	15	47	69	20	24%	31%
Commissions	247	358	516	863	11%	14%
Equipment rentals	105	165	156	198	5%	6%
Management services	49	161	451	497	21%	2%
Advertising	30	21	55	32	1%	-13%
Research and development	122	465	755	793	17%	1%
Architectural and engineering services	105	194	212	589	15%	29%
Miscellaneous business services	608	966	973	1,375	7%	9%
Personal, cultural and recreational services	74	147	267	269	11%	0%
Total	1,732	3,452	4,920	7,336	13%	11%
United States to Canada						
Communications	7	31	78	121	27%	12%
Insurance	360	686	1,157	1,064	9%	-2%
Other financial services	54	292	385	521	21%	8%
Computer and information services	69	109	513	989	25%	18%
Royalties and licence fees	761	989	1,450	1,810	7%	6%

Table 6 (cont'd)

Commissions	218	333	390	595	9%	11%
Equipment rentals	333	328	260	356	1%	8%
Management services	685	976	1,525	2,447	11%	13%
Advertising	53	122	171	288	15%	14%
Research and development	287	978	761	850	9%	3%
Architectural and engineering services	130	136	253	512	12%	19%
Miscellaneous business services	864	1,353	1,048	1,490	5%	9%
Personal, cultural and recreational services	127	138	263	334	8%	6%
Total	3,961	6,431	8,690	11,812	10%	8%

Note: Numbers in column may not add to total because of omission of certain categories.
Source: Statistics Canada.

Blurring the Distinction: U.S.–Canadian Commercial Integration

The majority of Canadians live in urban centres located within 160 kilometres of the U.S. border. Distance and the concentration of Canadian consumers is a compelling force in the Canada–U.S. relationship: within a day's drive from Southern Ontario there are over 100 million American consumers, and truckers can drive about 15 hours from Chicago to reach Winnipeg. Montreal, Toronto and Halifax are all well within a day's haul from Boston, New York or Philadelphia (Table 7). Shipping cargo by road from Vancouver to Los Angeles takes under two days, far less time than from Chicago to Los Angeles. An increasingly integrated North American cargo rail system is also strengthening the transportation links. In addition, Canada–U.S. air traffic is the heaviest between any two nations, with an estimated 13 million passengers per year. The new bilateral aviation agreement (known as the Open Skies agreement), concluded in February 1995, has already added another million passengers in the first year.[1]

The Open Skies accord has allowed Canadian carriers unlimited rights to fly from Canada to any point in the United States; U.S. airlines enjoy similar rights to destinations other than Montreal, Toronto and Vancouver. Total free access for U.S. carriers will be phased in by 1998. The agreement so far includes 23 new routes for Canadian carriers, 33 Canadian carrier charter routes and 46 new routes for U.S. carriers. On the same day as the signing of the Open Skies agreement, the United States and Canada signed the Canada–U.S. Accord on Our Shared Border, in which the governments pledged to work together to streamline routine traffic by land and air.

A series of regional market clusters have developed along the border. Many of Canada's economically most important cities are closer to their American than their Canadian neighbours. A highly trafficked landmark, the Ambassador Bridge (the world's longest international suspension bridge) con-

TABLE 7

TRUCK TRAVEL TIMES
HOURS

	New York	Chicago	San Francisco
Halifax to	24	56	144
Montréal to	18	25	120
Toronto to	12	20	108
Winnipeg to	72	36	84
Calgary to	82	46	58
Vancouver to	108	70	36

Source: Canada, Department of Foreign Affairs and International Trade.

nects Detroit to Windsor-Essex-Tilburg in Ontario, the center of Canada's automotive industry. Cargo haulers can also take the Windsor–Detroit tunnel. In the West, the provinces of Manitoba, Saskatchewan and Alberta have linked with Minnesota and North Dakota in a number of regional trade promotion initiatives, including the Central North American Trade Corridor Association and the Red River Trade Corridor.

In the last few years, trade between the U.S. border states and their Canadian counterparts has grown substantially faster than national bilateral trade (Table 8). Canadian-bound exports from the 10 U.S. states bordering Canada grew at an average rate of 42 percent between 1993 and 1995, considerably higher than the 26 percent growth rate for all U.S. exports to Canada during this period. The border states now account for about half of U.S. exports to Canada. Similarly, the border Canadian metropolitan areas of Vancouver, Windsor and Toronto probably ship more than half of Canada's exports to the United States.

About 23 million Americans visit Canada for a day trip every year, and about 35 million per year stay longer for an average of about three to four days.

TABLE 8

U.S. STATE EXPORT SALES TO CANADA, 1993-95
BILLIONS OF US$

	1993	1994	1995	Change 1993-95
Alaska	0.08	0.12	0.20	132.9%
Washington	1.72	1.86	2.29	32.8%
Idaho	0.16	0.21	0.29	86.6%
Montana	0.14	0.14	0.14	-3.2%
North Dakota	0.23	0.25	0.32	38.7%
Minnesota	1.95	2.11	2.44	25.2%
Wisconsin	1.95	2.44	2.81	44.2%
Illinois	4.86	5.76	6.45	32.8%
Indiana	4.26	4.59	4.59	7.7%
Michigan	11.43	20.81	21.94	91.8%
Ohio	7.67	8.50	8.88	15.7%
Pennsylvania	3.73	4.07	4.67	25.2%
New York	6.58	7.49	9.24	40.5%
Vermont	2.08	2.06	2.51	20.9%
New Hampshire	0.38	0.42	0.49	31.1%
Maine	0.36	0.41	0.40	29.7%
U.S. Total	100.19	114.25	126.02	25.8%
Total Border States	47.59	61.24	67.74	42.3%

Source: U.S. Department of Commerce.

About 54 million Canadians travel to the United States per year, and about 40 million of these trips are one-day trips. Since the total Canadian population numbers about 30 million, it is apparent that the average Canadian visits the United States more than once a year. It is getting easier to cross the border. No longer do U.S. citizens need a passport to enter Canada; a birth certificate or driver's licence will suffice. In a few years it will not be unusual for some border posts to be manned by people working for both countries' customs agencies.

Foreign Direct Investment

Investment is another significant form of economic ties. Many U.S. companies have chosen to build subsidiaries in Canada, and these have often outperformed their corporate parents. Canadian subsidiaries have the advantage of being close to their U.S. headquarters. According to the chief of Compaq Canada, "We [are able] to leverage the programs and thoughts and actions being taken in the United States when it applies.... We are three hours [from headquarters in Houston] by aircraft, so you are able to understand how the dynamic in the United States affects Canada and factor in what the Canadian market requirements are."[2]

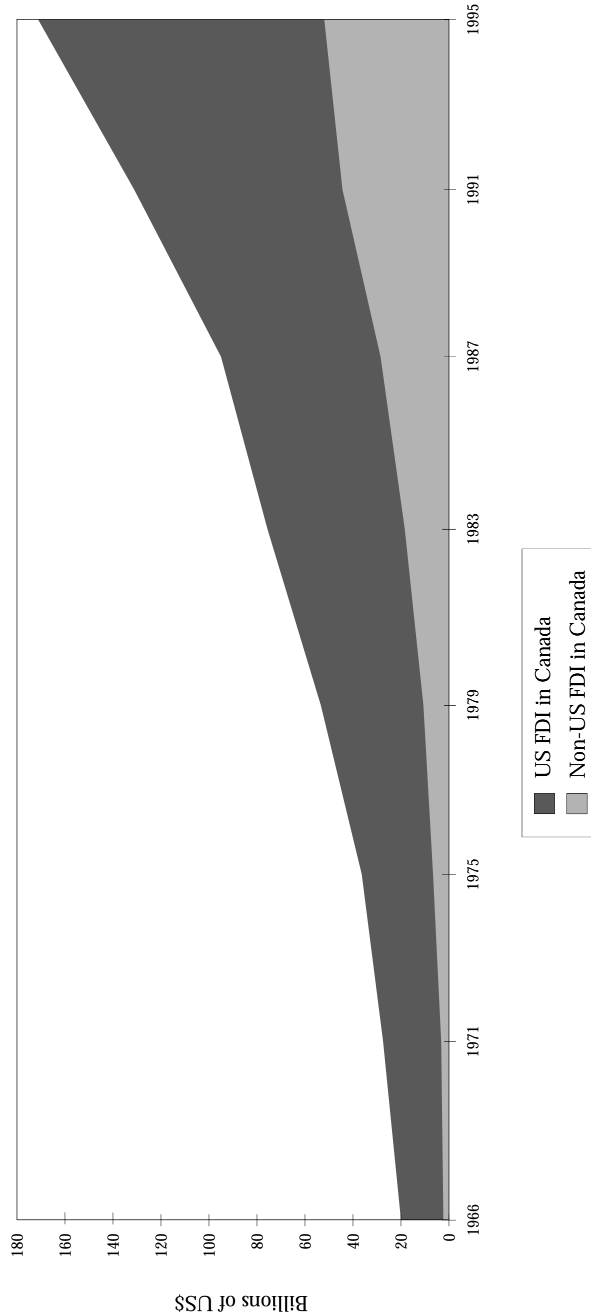
U.S. holdings of portfolio investment in Canada have been, and remain, a significant means by which the Canadian economy manages its fiscal deficits. The United States is the largest external source of portfolio finance, holding $138 billion (38 percent of the stock of Canada's portfolio investment) in 1991. This is more than double the $58 billion held by Japanese portfolio investors (about 16 percent).

Despite the historic role of cross-border foreign direct investment as the first corporate step into global investment, the U.S. share of the stock of FDI in Canada declined somewhat in the 1980s and 1990s (Figures 1 and 2). The only sector to experience a real increase in U.S. FDI in Canada has been the financial sector (Figure 3). In contrast, U.S. FDI in Canada in the petroleum and mining sectors has fallen in real terms since 1965. The ill-conceived National Energy Program (NEP) of the Trudeau government contributed to this decline, but a more important cause has undoubtedly been the poor investment climate in the petroleum and mining sectors since the early 1980s.

Unlike bilateral trade, which has expanded rapidly since 1990, bilateral direct investment has experienced much less robust growth (Table 9). Over the period from 1970 to 1994, Canadian FDI in the United States grew at an average annual rate of 11 percent, but U.S. FDI in Canada increased by only 5 percent per year in nominal terms. Since 1990, Canadian FDI has accelerated somewhat, but U.S. FDI has slumped to an average annual growth of about 2 percent. The conclusion suggested by the diverging trade and investment trends –– especially if we compare U.S. exports to Canada with U.S. FDI in Canada –– is that firms are expanding output at their most efficient sites and phasing out smaller facilities that were once required by trade barriers.

FIGURE 1

FOREIGN DIRECT INVESTMENT IN CANADA, 1966-95



Source: Statistics Canada.

FIGURE 2

U.S. SHARE OF STOCK OF DIRECT INVESTMENT IN CANADA

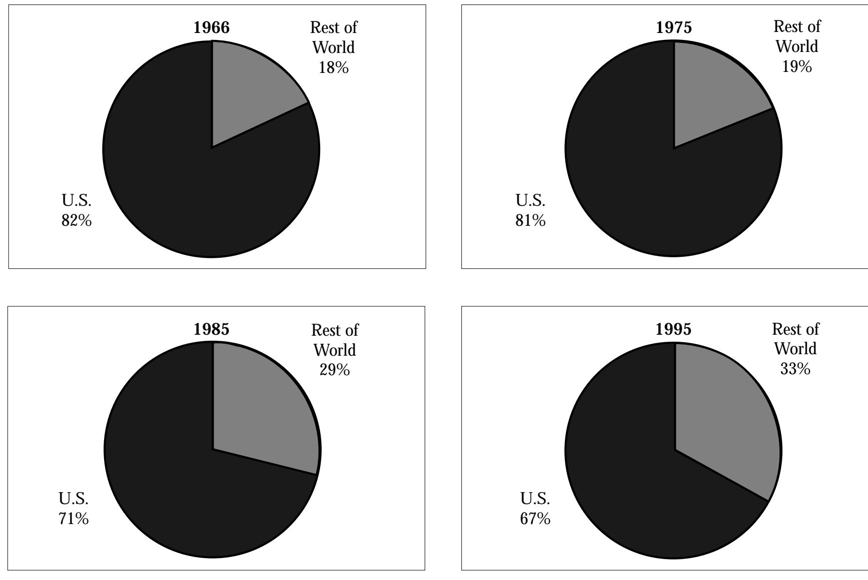
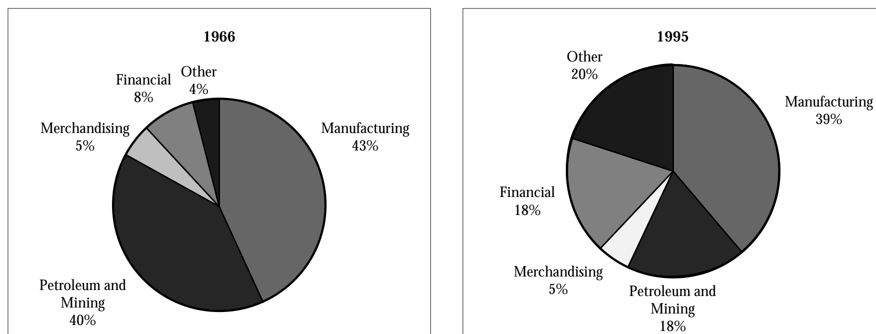


FIGURE 3

U.S. FDI IN CANADA BY SECTOR, 1966 VS 1995



Source: Statistics Canada.

TABLE 9

UNITED STATES–CANADA FOREIGN DIRECT INVESTMENT STOCKS, 1970-94
BILLIONS OF US$

	Petroleum	Manufacturing	Services	Other	Total
Canada in the United States					
1970	0.5	1.9	0.5	0.4	3.3
1975	1.0	3.1	0.6	0.9	5.6
1980	1.5	3.5	1.1	5.6	11.7
1985	1.6	4.6	1.5	9.4	17.1
1990	1.4	9.3	2.4	14.6	27.7
1994	2.6	16.9	2.0	21.8	43.2
Average annual growth	7.1%	9.5%	5.8%	18.1%	11.3%
United States in Canada					
1970	5.3	9.2	1.8	5.1	21.4
1975	7.8	13.8	4.1	6.6	32.3
1980	10.4	18.8	6.0	8.2	43.5
1985	10.5	21.8	6.3	8.5	47.1
1990	10.7	31.6	13.1	10.2	65.5
1994	8.6	35.0	13.0	16.3	72.8
Average annual growth	2.0%	5.7%	8.6%	5.0%	5.2%

a For Canadian investment in the U.S., the data represent wholesale trade.
For U.S. investment in Canada, the data represent banking and finance.

Source: U.S. Department of Commerce.

Macro-economic Policy Issues

Canada and the United States are both wealthy industrialized countries, with market-oriented capitalist economies and democratic political systems. In terms of economy and population, Canada is roughly one tenth the size of the United States; its per capita income is only slightly lower. Despite their many similarities, the two countries diverge on fundamental points. In the United States, the government plays a far smaller role in the economy. A strict line has been drawn between government and private sector. Canadians, on the other hand, value their national health care system, education subsidies and prolonged unemployment benefits.

Table 10 shows the difference in government spending in Canada and the United States. While central government spending as a percentage of GDP is roughly the same in the two countries, Canadian provinces spend about twice as much as American states.

In the past few years, proportionally the budget deficit has been about twice as high in Canada as in the United States. Canadian external debt exceeds 100 percent of GDP, whereas the U.S. figure is under 20 percent. These factors are worrying to Canadians and constrain Canadian policy makers, who are caught in a vise between the burdensome expense of social programs and the substantial political support for their continuance. Government expenditure on social programs accounts for about 30 percent of Canada's GDP.[3] Public debt service payments account for another 25 percent of government spending. The government is thus left with the choice of either reducing spending in politically difficult areas such as defence, regional development and agriculture, or else continuing to run deficits. Parliamentary debates have sounded much like the budget tirades in the U.S. Congress. The Chrétien government pledged to reduce the deficit to 3 percent of GDP by the 1996-97 fiscal year, and many provinces have been hard at work reducing their own deficits.

In 1970 the percentage of GDP claimed by income and profit taxes was the same in Canada and the United States (Table 11). Since 1970, however, the percentage has increased in Canada and declined in the United States. In 1993, the figures diverged by a full three percentage points of GDP. Canadian taxes on goods and services have consistently been about double those in the United States, thereby providing another reason for Canadians to enjoy crossing the border. The Goods and Services Tax (GST) — a multi-stage 7-per-cent value-added consumption tax — provides a large stream of revenue but is extremely unpopular with Canadian consumers. In the 1993 elections the Liberal Party pledged to replace the GST with a system that would generate equivalent revenue flows but would be kinder to consumers and small businesses. So far, this pledge has not been carried out. Meanwhile, politicians on the right complain bitterly about the business costs of Canada's policies.

As the aggregate expenditure figures indicate, Canada's federal and provincial governments both play prominent roles in the country's economy.

Canadian governments have pursued industrial policy objectives, stimulating manufactures in order to seek diversification from natural resources. The result of industrial targeting over time has been a shift in Canada's exports from forestry and natural resources to more highly processed goods. Canada traditionally employed tariffs to promote industrial development, and it generally had higher tariffs than the United States. This feature is, of course, disappearing under the NAFTA for bilateral trade. But the tariffs also impose significant costs on Canadian producers (and consumers) who import from non-North American sources, and in some sectors the tariffs make Canadian firms less competitive than other North American companies. Recognizing that problem, Canada reduced its MFN tariffs on certain textile products soon after the conclusion of the NAFTA to help domestic apparel producers compete against U.S. and Mexican firms.

Although the two economies are highly integrated, the exchange rate continues to fluctuate significantly (Figure 4). Since 1975, Canada has not attempted to peg the value of its currency to the U.S. dollar. The exchange rate is important to the Bank of Canada but is not itself the decisive consideration in setting monetary policy. Between 1985 and 1990, a strong Canadian dollar in real terms put considerable pressure on Canadian firms that had to compete with American businesses. Since 1990, the exchange rate has been more favourable to Canadian firms.

The Canadian economy tends to move in tandem with the U.S. economy, but not in lock step. The degree of correspondence is highest in the money markets. Figure 5 shows an extremely close correlation between U.S. and Canadian long-term (10-year) interest rates. In fact, in five of the six periods examined, the correlation is 0.90 or higher. Share prices (Figure 6) also exhibit a strong correlation in most 5-year periods, averaging about 0.60 (though the correlation was under 0.40 in the period from 1991 to 1995).

In the early 1970s and 1980s, there was a close correlation between inflation rates in the two countries. In the early 1990s, however, the Bank of Canada instituted a policy geared toward very low inflation, and in 1994 the inflation rate was driven practically to zero. It has climbed somewhat since then, settling closer to the U.S. rate of around 2 percent (Figure 7).

Until the late 1980s, Canadian unemployment followed the U.S. pattern with a lag of a year or so. Around 1990, however, the unemployment rate in Canada experienced a sharp upswing, while the U.S. unemployment rate gently declined (Figure 8). What was the cause of the divergence? Both economies experienced a recession in the early 1990s, but in Canada it came later and was much deeper than in the United States (Figure 9). Nevertheless, Canadian wages (as shown in Figure 10) continued to increase in step with U.S. wages. Moreover, labour markets are less flexible in Canada than in the United States. Under the circumstances, Canada's drive for zero inflation would have required much lower wage gains, especially for new entrants to the labour market, to avert an increase in unemployment. This did not happen.

TABLE 10

GOVERNMENT REVENUE AND EXPENDITURE IN CANADA AND THE UNITED STATES, 1972-92
PERCENTAGE OF GDP

	1972	1976	1980	1984	1988	1992
United States						
Central Government						
Revenue	17.7	17.6	20.2	19.0	19.6	19.1
Expenditure	19.2	21.2	22.0	22.8	22.8	24.0
State Governments						
Revenue	6.7	6.8	7.0	7.5	8.1	8.7
Expenditure	8.5	8.8	8.9	8.7	9.4	10.9
Canada						
Central Government						
Revenue	18.6	19.1	18.6	19.2	19.7	20.9
Expenditure	17.8	20.1	21.2	25.0	22.0	25.2
Provincial Governments						
Revenue	12.8	14.8	16.0	16.6	16.5	17.1
Expenditure	17.8	19.7	20.3	22.1	21.5	25.1

Source: Government Finance Statistics and International Financial Statistics, IMF.

TABLE 11

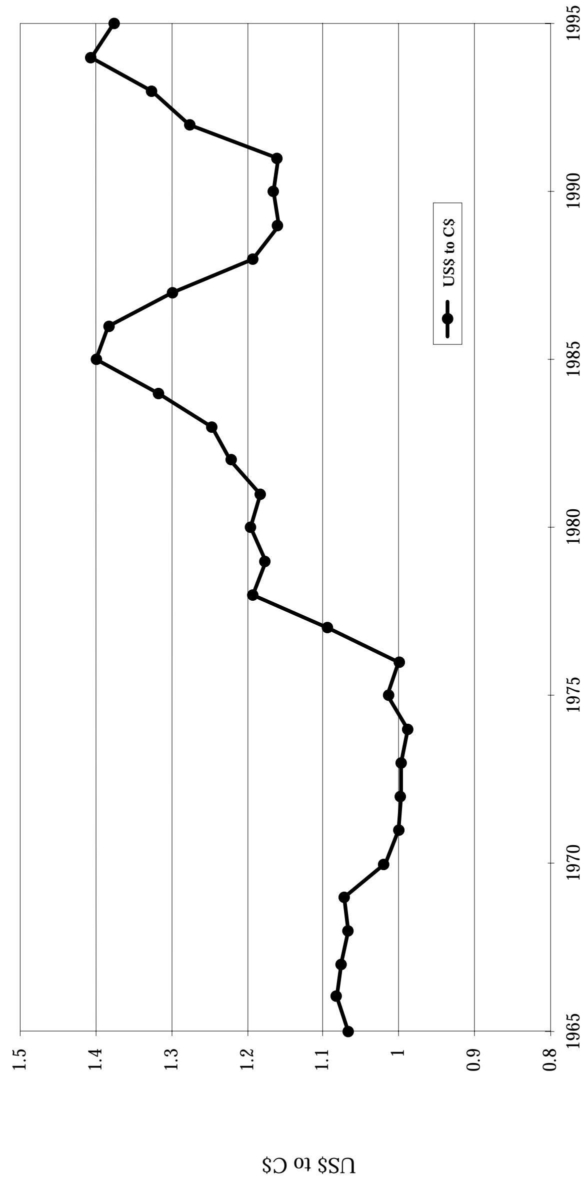
TAX REVENUE IN THE UNITED STATES AND CANADA, 1965-93
PERCENTAGE OF GDP

	1965	1970	1975	1980	1985	1990	1993
Canada							
Income and Profit	10.0	14.0	15.3	14.7	14.6	17.7	15.7
Social Security and Payroll	0.5	1.3	1.2	1.2	1.5	1.2	1.3
Property	3.7	4.0	3.1	2.9	3.1	3.6	4.0
Goods and Services	10.5	9.9	10.4	10.3	10.5	9.4	9.5
Total	25.9	31.3	32.4	31.6	33.1	36.5	35.6
United States							
Income and Profit	11.9	14.0	12.6	13.8	12.3	12.7	12.6
Social Security and Payroll	1.7	2.4	1.9	2.9	3.2	3.4	3.4
Property	3.9	4.0	3.8	2.9	2.9	3.2	3.4
Goods and Services	5.7	5.6	5.4	4.9	5.1	4.8	5.1
Total	25.8	29.2	29.0	29.3	28.7	29.4	29.7

Source: Revenue Statistics of OECD Member Countries, OECD, 1995.

FIGURE 4

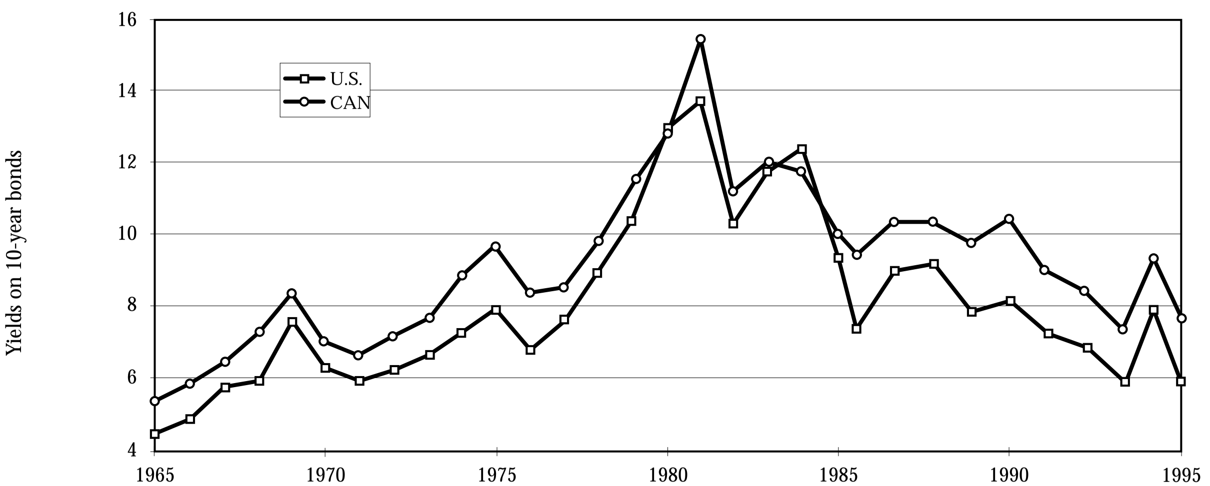
FOREIGN EXCHANGE RATES BETWEEN CANADA AND THE UNITED-STATES, 1965-95



Source: International Financial Statistics, IMF.

FIGURE 5

MEDIUM-TERM INTEREST RATES IN CANADA AND THE UNITED STATES, 1965-95



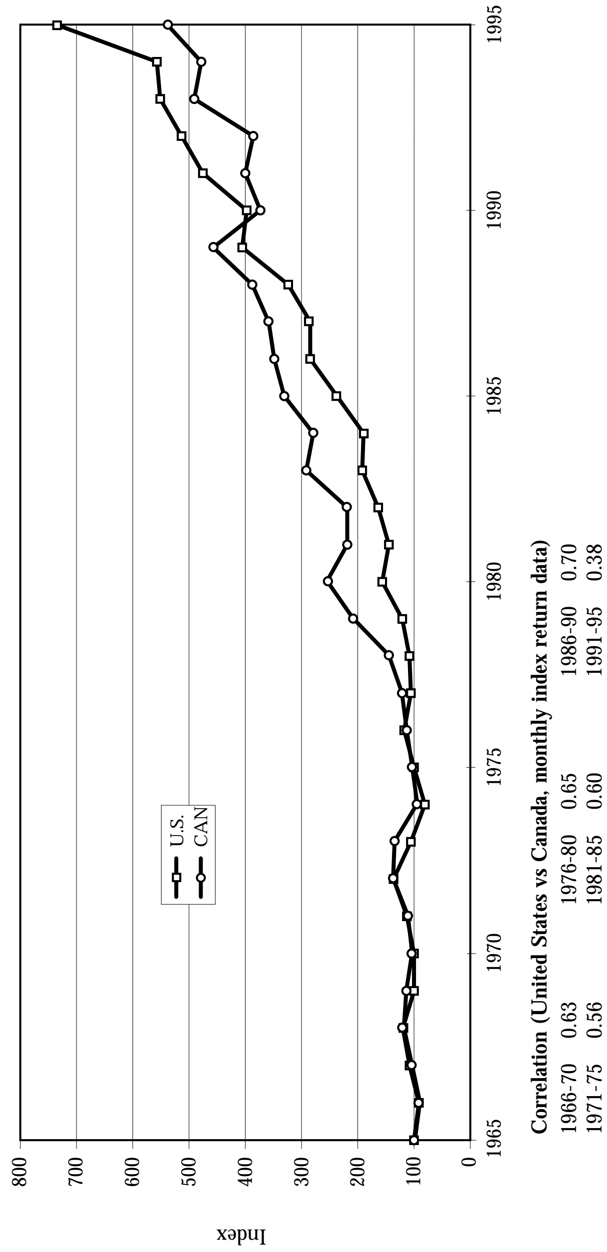
Correlation (United States vs Canada, monthly data)

1966-70	0.98	1976-80	0.97	1986-90	0.77
1971-75	0.95	1981-85	0.94	1991-95	0.93

Source: International Financial Statistics, IMF, June 1996.

FIGURE 6

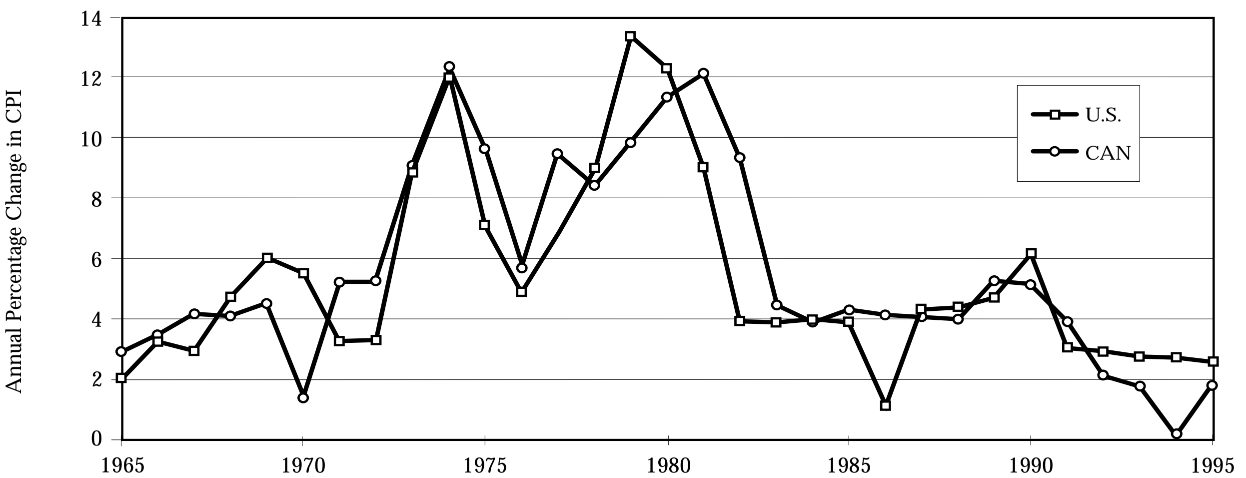
SHARE PRICE INDEX IN CANADA AND THE UNITED STATES, 1965-95



Source: International Financial Statistics, IMF, June 1996.

FIGURE 7

INFLATION IN CANADA AND THE UNITED STATES, 1965-95



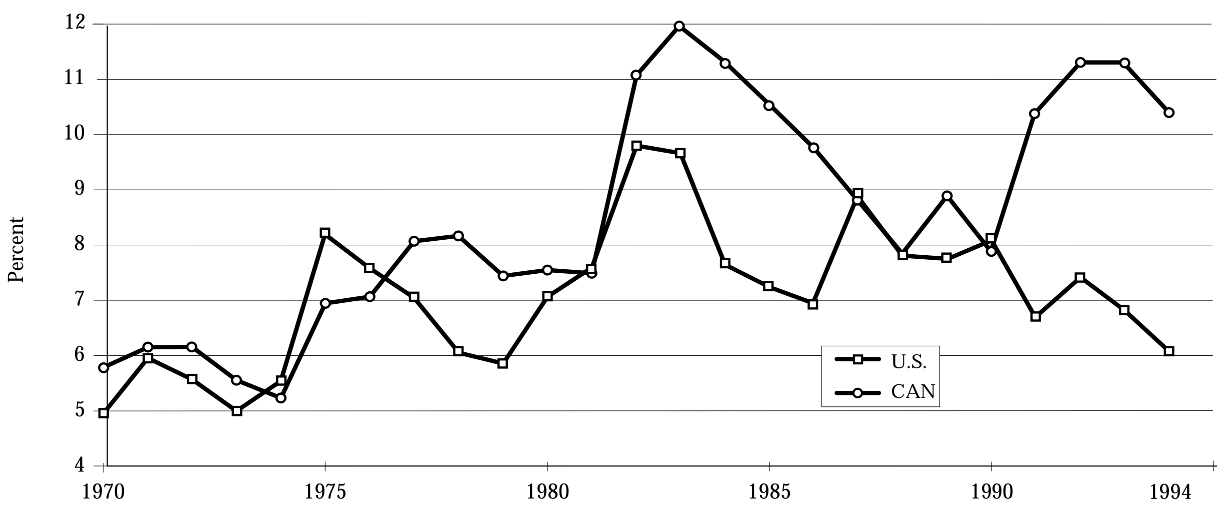
Correlation (United States vs Canada, monthly data)

1966-70	0.22	1976-80	0.69	1986-90	0.51
1971-75	0.90	1981-85	0.87	1991-95	0.85

Source: International Financial Statistics, IMF, June 1996.

FIGURE 8

UNEMPLOYMENT IN CANADA AND THE UNITED STATES, 1970-94

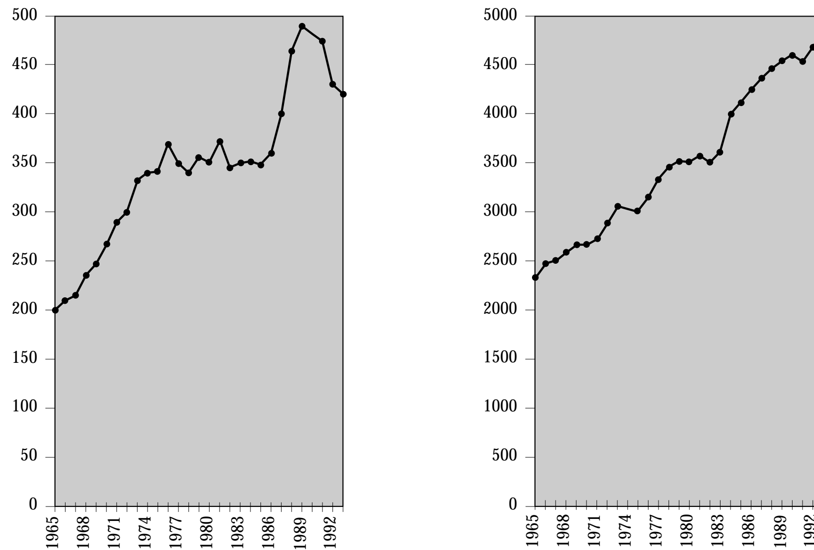


Correlation (United States vs Canada, annual data)
1970-94 0.51

Source: International Financial Statistics, IMF, June 1996.

FIGURE 9

GDP IN CANADA AND THE UNITED STATES, 1965-93
MARKET PRICES, BILLIONS OF US$



Source: *International Financial Statistics*, IMF.

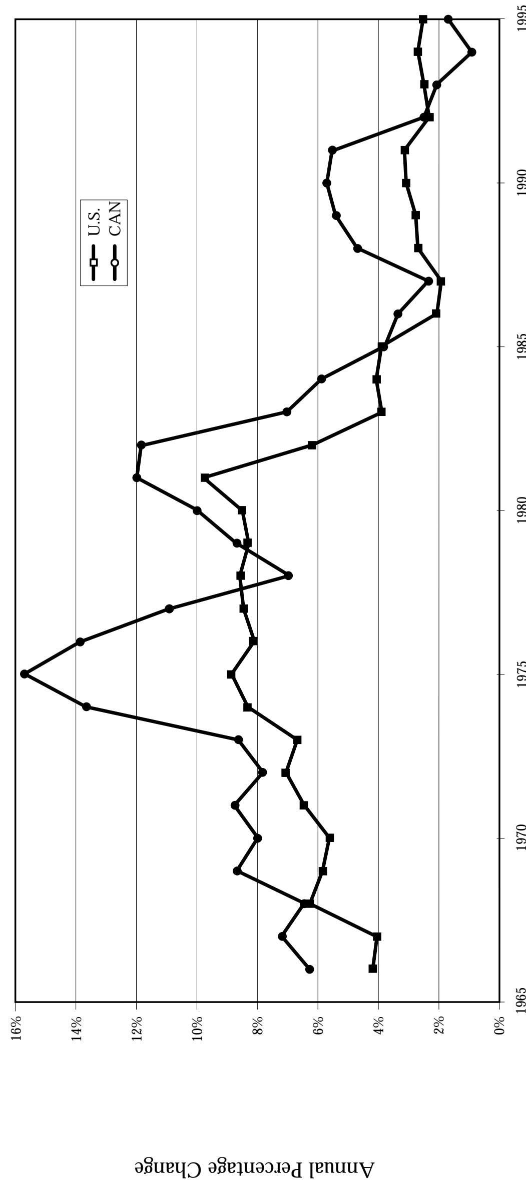
Trade and Investment Frictions: Recent Issues of Contention in the U.S.–Canadian Relationship

Even the best of friends have moments of tension, and trade and investment frictions almost always accompany wide-ranging economic ties; so it is not surprising that commercial disputes frequently arise between Canada and the United States. As the two economies increasingly integrate into the world economy, and as they move closer together, trade disputes will surely continue to be an important feature of commercial diplomacy.

Among the impediments to integration of the North American economies are unilateral trade actions that can distort trade and investment flows and undercut business strategies seeking to rationalize production across the region. Three types of measures deserve brief mention in this regard: antidumping and countervailing duties, U.S. Section 301 actions and economic sanctions.

FIGURE 10

WAGES IN CANADA AND THE UNITED STATES, 1965-95



Correlation (United States vs Canada, annual data)
1965-1995 0.86

Source: International Financial Statistics, IMF, June 1996.

Anti-dumping and countervailing duties (AD/CVD) have been the source of fractious trade disputes in the past. They have been imposed relatively rarely given the overall volume of bilateral trade, but their imposition has drawn considerable attention in Canada because a few of the U.S. cases covered big ticket sectors, such as softwood lumber. The fact that these measures are a declining U.S. trade policy tool offers little solace to Canadian exporters, whose access to their main market is subject to the vagaries of petitions filed with the U.S. Commerce Department.

The United States has hit Canada with anti-dumping or countervailing duties 70 times in the past three decades. The level of activity was particularly high during the 1980s, when AD/CVD actions were imposed in an average of 3.8 cases per year. In the 1990s the average has dropped to 2.5 per year, and the figure may be artificially high since 13 of the 15 cases occurred in 1991–92, half of them being targeted at the steel sector. Lumber has been another main target for countervailing duty cases, with actions taken in 1982, 1986 and again in 1991 against imports of Canadian softwood lumber.

Recent trade disputes between the United States and Canada have involved softwood lumber, uranium, poultry and dairy products, wheat, sugar, and cultural industries. A U.S. complaint regarding wool suits from Canada looms in the near future. Several of these disputes involve U.S. challenges to Canadian import and export management practices. The poultry supply management system was rendered obsolete by the Uruguay Round, and the United States claimed that Canada's subsequent tariffication of former quotas (with tariffs of up to 350 percent) was not permitted under the NAFTA. The U.S. claim was unanimously rejected by a five-member dispute settlement panel; still, the sky-high Canadian poultry tariff is very much alive as a political issue. Similarly, there have been suggestions from critics such as Senator Richard Lugar that Canada eliminate its Wheat Board. This view is shared by many farmers from Alberta and Saskatchewan, who prefer to drive their trucks across the border and sell their wheat directly in the United States.

While the Canada–United States Free Trade Agreement (FTA) did not pretend to eliminate all trade disputes, it helped lower tensions by creating new procedures. Under the agreement, the United States and Canada could continue to use their national remedies to address trade frictions, but a new mechanism was created for reviewing the decisions of national trade authorities. This was extended and made permanent under the NAFTA.

Both the United States and Canada have made good use of the FTA-NAFTA dispute settlement mechanism (DSM). As of November 1, 1995, the total number of disputes under the NAFTA and the FTA numbered 75. Of these, 17 were brought under Chapter 19 of the NAFTA, 52 under Chapter 19 of the FTA, 1 under Chapter 20 of the NAFTA and 5 under Chapter 18 of the FTA.[4] Thirty months after the NAFTA came into force, Chapter 19 panels have completed seven appeals: two concerning U.S. determinations, one concerning a Mexican determination and four concerning Canadian determinations.

Currently, Chapter 19 panels are considering twelve appeals. All FTA Chapter 19 appeals have been completed.

Could future regional and/or multilateral negotiations curb the abuses of the anti-dumping regimes that have evolved since the passage of the Canadian anti-dumping law almost 75 years ago? Past attempts do not offer optimism; indeed, Tokyo and Uruguay Round accords on anti-dumping added to the dense regulatory guidelines for administrative agencies and thus opened the door to more subjective injury and dumping findings. We are wary of new efforts in this area; it may be better to let anti-dumping practices wither on the vine rather than try to prune them back. Past pruning has led to new grafts that have strengthened anti-dumping rules.

The one exception could be an approach suggested by Messerlin.[5] His proposal would leave anti-dumping rules intact but require the application of a competition policy test before petitions could be accepted. This would ensure that anti-dumping actions do not accentuate anti-competitive conditions in the marketplace.

In other words, a competition policy test would overlay the use of the anti-dumping statute. Such an approach would not follow Canadian proposals to substitute one regime for the other, but it would promote competition policy objectives sought by Canada in the FTA and the NAFTA.

CVDs would not be a problem if governments were not so fixated on subsidizing sectors of their economy to redistribute income and promote employment. Both countries have tried unsuccessfully to rein in subsidy practices at the sub-federal level, where states and provinces compete with each other to attract new investments to their jurisdiction. There is a particularly long history of such conflicts in the auto sector, which was the focus of subsidized competition as long ago as the early 1960s, precipitating the Auto Pact. Most recently, subsidized competition manifested itself in bidding wars between U.S. states for the right to host Mercedes Benz and BMW.

Despite three decades of negotiations to limit such investment incentives, neither the FTA, the NAFTA, or the World Trade Organization contains rules that significantly impede the use of sub-federal subsidies. Moreover, the new investment negotiations in the OECD are likely to avoid the issue altogether. Canadian efforts to supplement regional disciplines on subsidies pursuant to NAFTA Article 1907 suffer from the same lack of political will in both countries. For now, the only effective policy to curb sub-federal subsidies is budget constraint or taxpayer revolt.

U.S. Section 301 cases, in contrast, have not been a major concern in bilateral relations and are unlikely to become a problem, with the notable exception of cases concerning cultural industries. Section 301 of the Trade Act of 1974 authorizes the President to retaliate against "unfair" foreign trade practices. Only eight of the ninety Section 301 cases filed through 1994 were against Canada. Four of these cases dealt with manufactured goods, two were

against Canadian softwood lumber, one was agriculture-related and one was targeted at services.[6]

A recurrent subject of U.S.–Canadian disputes has surfaced in the Section 301 arena: Canada's measures aimed at protecting its culture industry. The dispute over Country Music Television shows the exacerbation of cultural issues and the essentially political nature of dispute resolution. For two years, U.S. firms battled in Canadian courts. In 1995, the United States Trade Representative (USTR) initiated a Section 301 investigation, and in 1996 the USTR determined that certain Canadian broadcasting policies denied national treatment and market access to U.S. companies. In 1996 a commercial agreement was reached, and in the fall of 1996 a U.S.–Canadian joint venture, CMT (Canada), was launched.

Under the new WTO dispute settlement procedures, countries are required to avoid retaliatory action until a panel finding authorizes it. Unilateral actions before such a ruling would violate WTO obligations, unless the measures affect areas not covered by the WTO. This is one reason why, on labour and environmental issues, it may be useful to develop core WTO obligations that meet a trade relevance test.

In brief, WTO rules legitimize the use of Section 301 retaliation after a panel finding if the offending country does not agree to bring its actions into compliance with WTO obligations; but the rules constrain the use of such measures, or the types of sanctions that can be deployed, to the dwindling arena of global commerce not covered by WTO agreements. With Canadian insistence on exempting cultural industries from regional and multilateral obligations, it is thus easier for the United States to apply Section 301 to contested trade practices in this area.

Economic sanctions: Until the recent enactment of the U.S. Helms–Burton Act, which allowed for extraterritorial application of U.S. sanctions designed to restrict trade and investment in Cuba, the United States and Canada differed infrequently on the use of sanctions in support of foreign policy objectives. Indeed, both countries participated in UN sanctions against Iraq, Iran, Libya, Serbia and South Africa.

Most unilateral U.S. sanctions have targeted countries where Canada has only minor economic interests, with the notable exceptions of China and Cuba. The measures against China opened the door for new Canadian export opportunities and thus elicited little commercial opposition. Quite different was the response to the Helms–Burton Act, which restricts activities by violating Canadian firms and their officers in the U.S. market.

Overall, U.S. sanctions have not impeded regional trade and investment plans to a significant degree. However, the trend toward invoking sanctions through legislation rather than executive order is worrisome. Such measures are deployed when there is sharp disagreement between the Congress and the Administration, with the Congress objecting to Presidential discretion in applying sanctions. As a result, sanctions can be fixed in stone until subsequent

legislation overrides the provisions of the existing law. If this trend gathers strength, as it has done over the past decade, the United States could find itself increasingly embroiled in rancorous disputes with Canada and other trading partners over the imposition of U.S. sanctions.

Bilateral Economic Initiatives

U.S.–Canadian bilateral initiatives reflect an emerging understanding that negotiated approaches to dispute resolution are more constructive than unilateral actions. The political payoff from inflammatory rhetoric is gradually diminishing, even on matters as charged as softwood lumber, culture or Cuba.

The first landmark in postwar U.S.–Canadian bilateral relations was the Automotive Products Trade Agreement, better known as the Auto Pact, signed in 1965. Before the 1960s, the automobile industries in the two countries had been fairly isolated and nationalistic. During the late 1950s, the Canadian market was sheltered by tariff barriers and strict local content requirements. Canadian policy makers devised a duty remission program to stimulate this sector, with effects similar to an export subsidy. This prompted a countervailing duty suit initiated by a U.S. auto parts supplier. The Auto Pact addressed the immediate problem and created the legal framework for an integrated industry.

The Auto Pact allowed duty-free exchange of most automotive products between Canada and the United States, while providing production and investment safeguards for the Canadian industry. The safeguards generally required auto makers to assemble approximately as many cars in Canada as they sold there in order to qualify for duty-free importation rights. Auto firms were also required to achieve a Canadian value-added in excess of 60 percent of the value of the cars sold in Canada.[7] The Auto Pact spawned a huge network of cross-border trade in automobiles and spurred investment in the Canadian auto sector. As it turned out, Canada did not need to rely on the safeguard provisions for its industry to thrive. Table 12 shows the robust U.S.–Canadian trade in automobiles from 1980 to 1995.

In a conceptual sense, the bilateral Auto Pact was the forerunner of the Canada–United States Free Trade Agreement. The Pact was the first significant departure by the United States from its postwar strategy of pursuing trade liberalization on a multilateral basis. Autos continued to be a major debating issue in both the FTA and the NAFTA negotiations, but in the end neither agreement fundamentally changed the provisions of the 1965 Auto Pact. The main result was that Mexico joined the North American auto market.

No ground-breaking steps were taken in the 1970s to advance the bilateral Canada–United States relationship, but in the 1980s the idea of new free trade talks gathered strength in Canada. Oil price shocks and worldwide inflation had made the international economy volatile in the 1970s, and the Tokyo Round of multilateral trade negotiations had consumed most of the decade. Canada had experienced a fair amount of economic turbulence, followed by

TABLE 12

US–CANADIAN TRADE IN PASSENGER MOTOR CARS, 1980-94
BILLIONS OF US$

	1980	**1981**	**1982**	**1983**	**1984**	**5-Year Annual Growth Rate**
U.S. Exports to Canada	3.0	3.1	2.4	4.1	4.8	17.1%
Canada Exports to the U.S.	4.0	4.4	6.2	8.2	11.3	30.7%
	1985	**1986**	**1987**	**1988**	**1989**	
U.S. Exports to Canada	6.3	6.5	6.6	6.7	7.3	3.8%
Canada Exports to the U.S.	12.9	14.3	11.5	14.9	14.4	4.2%
	1990	**1991**	**1992**	**1993**	**1994**	
U.S. Exports to Canada	6.2	6.7	5.8	6.2	7.6	5.9%
Canada Exports to the U.S.	14.8	15.1	15.8	19.5	24.1	13.5%

Source: U.S. Department of Commerce.

recession in the early 1980s. In 1983, the Canadian Department of External Affairs published a trade policy review paper advocating free trade talks with the United States in specified sectors. This sectoral initiative was inspired by the huge success of the Auto Pact, but the circumstances of that industry could not be replicated elsewhere. In fact, the sectoral approach ultimately failed: each side offered to negotiate in sectors where it had strong export interests but refused to give way in sectors where its firms were relatively weak. Still, the breakdown in sectoral talks did not eliminate the idea of liberalizing trade between the United States and Canada; rather, it pointed the way toward a broader framework.

In 1985, the Macdonald Commission published its evaluation of the Canadian economy, with a recommendation that Canada undertake wide-ranging bilateral negotiations with the United States. This paved the way, politically and intellectually, for the "Shamrock Summit," which that same year produced the Declaration of Trade in Goods and Services. In the autumn, Prime Minister Mulroney announced that Canada would seek free trade negotiations with the United States.

On January 1, 1989, the Canada–United States Free Trade Agreement entered into effect. The FTA covered tariffs, non-tariff barriers and institutional arrangements. Negotiated pursuant to GATT Article XXIV, the FTA incorporated issues traditionally covered in GATT negotiations, such as market access and quotas; but it went further in many areas, with provisions on services, investment, financial services and energy. The implementation schedules called for complete free trade and investment in 10 years, although significant exceptions were made for agriculture, energy and cultural industries.

A major contribution of the FTA is the innovative and comprehensive dispute settlement mechanism noted above. Disputes fall into either of two chapters of the FTA: Chapter 18 disputes (except those dealing with financial services or anti-dumping/countervailing duties) are subject to a notification process followed by consultation, then are referred to a binational commission, and finally may be subject to binding arbitration. Chapter 19 establishes binational panels to address contested countervailing duty and anti-dumping actions on the part of national authorities.

During the negotiations, Canada proposed a comprehensive code on government procurement to give it access to the vast U.S. government procurement market. This initiative failed, although the FTA chapter on government procurement ensured more transparent bidding procedures. Subsequently, the Uruguay Round accord negotiated in this area removed some additional restrictions to cross-border procurement.

Not much liberalization of agricultural trade was achieved under the FTA. While it eliminated agricultural tariffs, the United States and Canada were both able to retain quotas that supported supply management regimes and price support mechanisms. However, the agreement advanced the producer subsidy equivalent (PSE) concept, an approach for calculating the extent of

public support. Later this concept provided the basis for agricultural talks in the Uruguay Round.

A significant step was the inclusion of services in the Canada–United States agreement. The FTA services agreement provided for contractual obligations on services for both countries, creating a framework of rights and obligations regarding national treatment, licensing and certification procedures. The FTA services agreement proved to be a forerunner of the General Agreement on Trade in Services (GATS), negotiated in the Uruguay Round. The big difference is that actual liberalization commitments were made in the FTA for most services (except transportation and telecommunications), but GATS provided only a framework for future liberalization.

The FTA investment provisions were designed to allow companies to take advantage of the enlarged North American market. A commitment was made to national treatment in most instances, and the agreement barred the introduction of new trade-related performance requirements. The United States has traditionally advocated an open investment policy (except, of course, in the areas of defence and communications), while Canada has often flirted with restrictions on foreign investment; an example that still makes U.S. investors shudder is the Trudeau-era National Energy Program.

Financial services are covered in the FTA. Both countries had been moving toward deregulating their financial markets, and the FTA provisions reflected the substantial progress in preceding decades toward integration of the Canadian and U.S. financial markets. As noted earlier, since 1970 the financial sector has been an area of growing importance in the overall U.S.–Canadian investment relationship (Figure 3).

The FTA financial agreement opened the Canadian financial market to U.S. investors. In turn, it allowed Canadian banks and securities firms to underwrite and sell Canadian government securities in the United States. In addition, in a development that currently is proving very significant, the United States accepted a provision allowing Canada to take advantage of any future changes in U.S. banking laws or regulations (i.e., the Glass–Steagall Act). Trade in financial services has grown at an annual rate of 21 percent in the years since the FTA was implemented, while trade in closely related computer and information services has grown by almost 30 percent.

The North American Free Trade Agreement represented a further step in the integration of the North American market. Before the NAFTA, Canada and the United States both had in place bilateral framework agreements on trade and investment with Mexico. The FTA largely provided the institutional underpinning for further liberalization achieved in the NAFTA.

Canada has benefited from the NAFTA. Trade with the United States continues to grow as barriers are lowered further. In addition, the NAFTA provides Canada with increased access to the Mexican market. In 1992, Canada exported only $600 million and imported less than $1 billion worth of goods

TABLE 13

NAFTA – GROWTH OF EXPORTS, 1988-95
PERCENTAGE

	Growth 1988-95	Growth 1990-95	Average Annual Growth 1988-95	Average Annual Growth 1993-95
United States to				
World	83	49	9	12
Canada	81	52	9	12
Mexico	122	60	12	4
NAFTA	90	54	10	10
Canada to				
World	63	50	7	16
United States	87	60	9	16
Mexico	95	61	10	15
NAFTA	87	60	9	6
Mexico to				
World	291	194	22	30
United States	396	254	26	34
Canada	625	776	33	13
NAFTA	401	261	26	33

Source : *Direction of Trade Statistics*, IMF.

from Mexico. By 1995, these figures had climbed to almost $800 million in exports and close to $2 billion in imports from Mexico.

Table 13 shows the increased trade between NAFTA countries from 1988 to 1995. Intra-NAFTA trade has increased from 40 to about 47 percent of total exports by NAFTA members during this period. Canada's exports to the United States have grown at an average annual rate of almost 16 percent, and its exports to Mexico have grown at almost 15 percent per year since NAFTA was ratified in 1993.

In mercantilistic terms, Canada paid a low price for the NAFTA. It was able to maintain the exemption of its cultural industries, protection of agriculture, and the basic framework first set out under the Auto Pact.

Although a comprehensive arrangement, the NAFTA does not cover all economic issues. One that is outside its scope is civil aviation; another is taxation. In 1995, the United States and Canada negotiated an income tax protocol to update the 1980 tax agreement. Withholding tax rates on cross-border payments were reduced from 10 to 6 percent on corporate dividends (if the

holder owns at least 10 percent of the company) and from 15 to 10 percent on interest. The 10-per-cent withholding tax on royalties for software, patent and technological information was abolished. The system of taxing capital gains on residential real estate for Canadians living in the United States or Americans in Canada has been modified to minimize double taxation. And an important change is that Canadians visiting American casinos are now able to deduct their gambling losses from their winnings for U.S. tax purposes (Canada does not charge tax on gambling income)!

TWENTY-FIVE YEARS FORWARD

ECONOMIC INTEGRATION – THE EXAMPLE OF GERMANY AND THE BENELUX COUNTRIES

ECONOMIC INTEGRATION HAS PREOCCUPIED EUROPE since the Second World War. The 1951 Treaty of Paris created the European Coal and Steel Community; this was soon followed by the 1957 Treaty of Rome, which launched the European Common Market (EC) and called for the free movement of goods, services, capital and labour (the "four freedoms"). To carry out this ambitious agenda, institutions were established, countless subsidiary agreements were negotiated, and numerous directives and decisions were handed down by the European Commission and the European Court of Justice.

Integration in Northern Europe was particularly far-reaching because of shared borders and close linguistic ties (French and English are common second languages). By 1960, the Benelux states and West Germany had reached a degree of formal integration that Canada and the United States did not achieve until 1990. In population and GDP, Germany (now including the former East Germany) is about three times the size of the Benelux countries. This background suggests that an examination of Benelux–German economic convergence over the past three decades can give insights into future convergence between the Canada and the United States (Table 14).

On the basis of the European experience, in North America the importance of trade is likely to grow relative to GDP. In the case of Germany, imports plus exports of goods and business services rose from about 35 percent of GDP in 1965 to about 55 percent in 1990. In the case of the Benelux states, the rise was from 85 percent to about 115 percent of GDP. The growing relative importance of goods and services trade is not, of course, confined to common markets. Rising trade ratios have been a worldwide phenomenon, attributable to sharp postwar reductions in transportation and communication costs as well as decisively lower tariffs and the elimination of most quotas. Rising trade ratios are the essence of globalization. In the 1960s and 1970s, however, trade-to-GDP ratios rose faster in Europe than elsewhere, and it is fair to attribute the extra growth to the Common Market.

By the same token, it seems probable that trade-to-GDP ratios for Canada and the United States will also rise perhaps by 15 to 20 percentage points between now and 2010, spurred partly by the FTA and NAFTA liberalization. In 1993, the ratio of trade (in goods and business services) to GDP was 60 percent for Canada and 22 percent for the United States. We could envisage a rise in these numbers to 80 and 35 percent respectively.

The development may be expressed in another way: the rising ratio of trade to GDP means that the U.S. and Canadian import markets should grow at least one percentage point faster per year than real GDP. Overall import market growth could be 3 to 4 percent annually, even though real GDP growth will be only 2 to 3 percent.

TABLE 14

BASE ECONOMY COMPARISON, GERMANY AND BENELUX, 1965-93

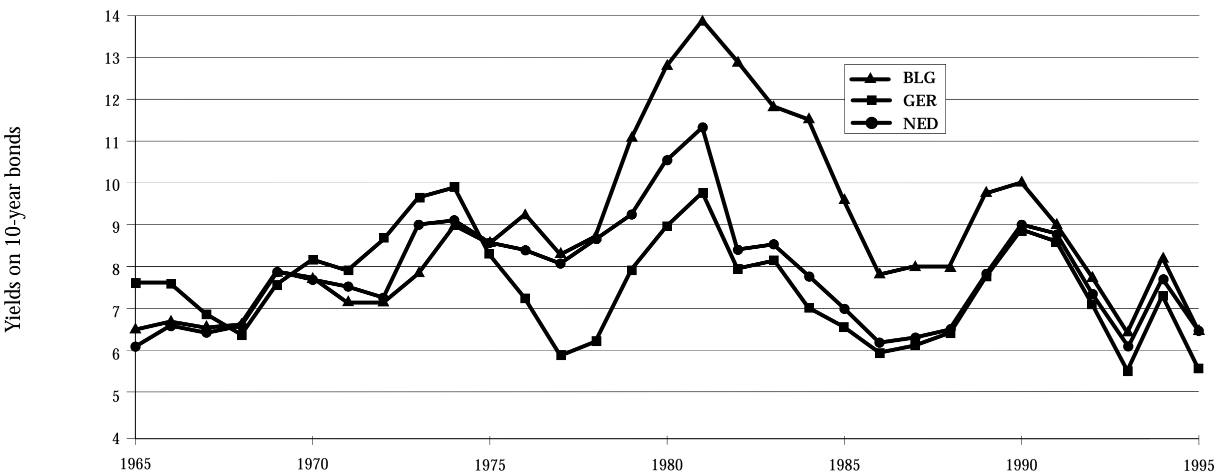
Germany[a]		**1965**	**1970**	**1975**	**1980**	**1985** [b]	**1990**	**1993**
Population	M	59.0	60.7	61.8	61.5	61.0	63.2	80.7
GDP (real, 1987)	US$ M	631,590	770,368	857,928	1,007,388	1,066,294	1,258,187	1,439,494
GDP (real, 1987) per capita	US$	10,703	12,689	13,876	16,370	17,489	19,899	17,839
Export and import of goods and business services as a percentage of GDP	%	35.8	40.3	46.5	53.3	61.5	58.4	42.9
Benelux								
Population	M	22.1	23.0	23.8	24.4	24.7	25.3	25.7
GDP (real, 1987)	US$ M	193,383	247,878	291,527	334,300	350,509	407,520	421,367
Import (goods and non financial services)	US$ M	16,121	28,492	74,43	168,760	134,952	286,452	285,005
Export and import of goods and business services as a percentage of GDP	%	85.4	94.6	99.6	113.1	131.4	121.7	112.2

a Datas refer to the Federal Republic of Germany through 1990 (before unification).
b The trade-as-percentage of GDP figures for 1985 are distorted by a superstrong U.S. dollar that year, which depressed nominal GDP expressed in U.S. dollars.

Source: World Data 1995, World Bank, 1995, International Financial Statistics, IMF, June 1996.

FIGURE 11

MEDIUM-TERM INTEREST RATES IN GERMANY, BELGIUM AND THE NETHERLANDS, 1965-95



Correlation (Germany vs Belgium and the Netherlands, monthly data)

	1966-70	1971-75	1976-80	1981-85	1986-90	1991-95
Belgium	0.55	0.61	0.77	0.87	0.92	0.98
Netherlands	0.50	0.81	0.91	0.98	0.94	0.97

Source: International Financial Statistics, IMF, 1996.

But rising overall trade ratios will not necessarily translate into higher trade shares between partners with common borders and a common language. From the extensive econometric work of Frankel and others[8], we know that the Common Market increased EC internal trade by about 50 percent above levels that would otherwise have been achieved in 1985. However, the experience of Germany vis-à-vis Belgium and the Netherlands suggests that there will be no lasting lift in the trade shares of these countries.

These patterns may be repeated in North America. Frankel's econometric analysis of trade between Canada and the United States could detect no FTA effect as of 1992. But implementation had barely started then and the NAFTA was still on the drawing board. It is conceivable that, by 2005 or 2010, trade within North America will be 20 to 30 percent higher than it would have been without the two agreements. The preferential trade area effect is not likely to be as great as in Europe because external barriers around the North American market are substantially lower than they were for the European Common Market in the 1960s. Still, the effect should be substantial and measurable.

But it is less certain that there will be a prolonged rise in bilateral Canada–U.S. trade shares as a result of the FTA. Bilateral trade shares have already gained several percentage points since 1990 and the blip could be over. After 1970, Germany's trade with its southern neighbors grew as fast as with the Benelux states or faster; in the same way, from now onward, U.S. bilateral trade with Mexico seems likely to rise in share terms.

Another aspect of integration is correlation in interest rates. As Figure 11 shows, the monthly correlation of medium-term interest rates between Germany and Belgium, and between Germany and the Netherlands, has gradually strengthened over the past 30 years. Whereas the correlation coefficients were about 0.60 in the late 1960s, they now exceed 0.95. What does this say for Canadian–U.S. financial integration? Probably not much, because U.S. and Canadian financial markets are already tightly linked. The correlation between 10-year bond yields has exceeded 0.90 for much of the past 30 years (Figure 5). Similarly, share price correlations between Germany and its two neighbours are not much higher than they are between the United States and Canada (Figures 6 and 12).

Since the early 1980s, there has been very little exchange rate fluctuation between the Belgian franc, the Dutch guilder and the German mark. The planned Economic and Monetary Union (EMU) will put a *de jure* facade on what is already a system of virtually fixed parities (Figure 13).

In contrast, over the past 15 years the Canadian dollar has fluctuated significantly against the U.S. dollar. European experience might suggest a narrower range of fluctuation in the future. However, neither Canadian nor U.S. authorities place great emphasis on narrow bilateral exchange rate bands as a symbol of integration. If greater stability occurs in the future, it will probably reflect fundamental forces (particularly synchronized inflation rates) rather than a policy decision by the Bank of Canada.

The monthly inflation rates of Germany, Belgium and the Netherlands are no more synchronized than U.S. and Canadian rates (Figures 14 and 7). Nor is there a closer correspondence of annual wage movements (Figures 15 and 10). But unemployment rates move much more closely in Northern Europe than in North America (Figures 16 and 8). The creation of open markets for goods and services will probably lead to more flexible labour practices throughout Canada and a closer match with U.S. unemployment levels.

In broad terms, for several key macro-economic variables North America has already converged as much as Northern Europe. The two areas where greater convergence might occur in the future are the exchange and unemployment rates.

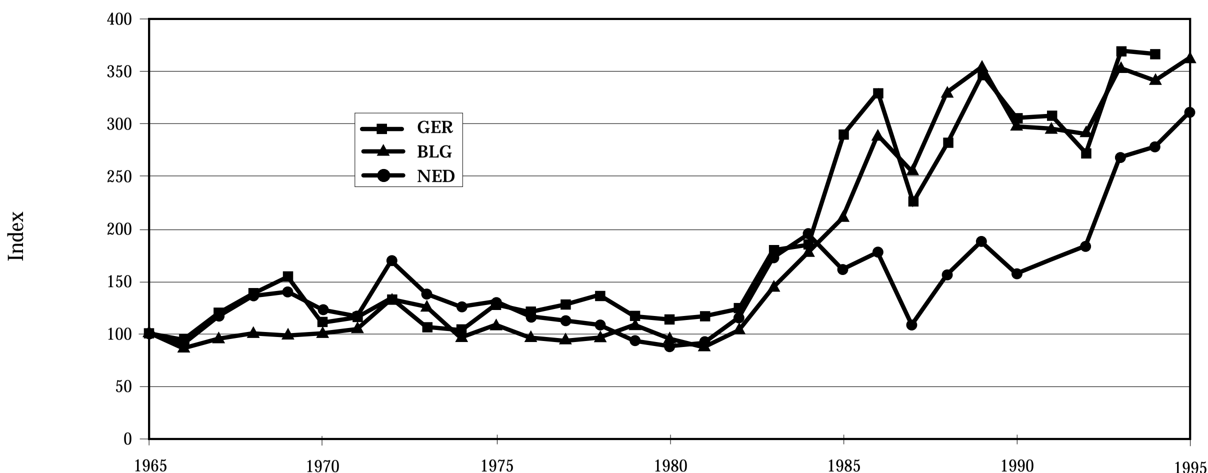
Even with substantial macro-economic convergence and the likelihood that additional markets will move in tandem in the future, a high degree of institutional convergence does not necessarily follow. In the early 1970s, for example, when Denmark was on the verge of joining the European Community, many Danes feared an end to their social safety net. This did not happen nor, in recent years, has Denmark been forced to accept lower Spanish or Greek environmental standards. Denmark has maintained its environmental standards on such items as disposable packaging, and it is even pushing for higher European-wide standards on industrial processes.

An institutional feature that lends itself to easy quantification is taxation. In 1965, before integration had reached an advanced stage, there were remarkable similarities between Germany, Belgium and the Netherlands in the overall tax burden as well as in the structure by types of tax. All three countries had total tax burdens of between 31 and 33 percent of GDP. In all three, income and profit taxes were between 9 and 12 percent of GDP, social security and payroll taxes between 9 and 10 percent, and goods and services taxes between 9 and 12 percent. Some 30 years later, after intensive integration of all markets, the tax structures were not nearly as similar. The Dutch tax burden was 48 percent of GDP, whereas the German burden was 39 percent. There were wider spreads in some of the major tax headings as well. In other words, the smaller partners were able to carry on with a more extensive social agenda than the largest partner (Table 15).

This experience suggests that the current disparities between U.S. and Canadian tax structures at the federal, provincial and state levels will endure for some decades. Not only will revenues collected as a percentage of GDP differ, but tax rates may diverge sharply. At the federal level, the top marginal corporate rate in the United States is 35 percent, while state corporate taxes range between 1 and 12 percent. In Canada, the federal rate on manufacturing profits is about 35 percent, and about 44 percent on other types of corporations. Provincial rates range between 9 and 17 percent. These differences in rate structure are well within the bounds of the European experience. The corporate tax rate is 35 percent in the Netherlands, 40 percent in Belgium and 51 percent in Germany.

FIGURE 12

SHARE PRICE INDEX (INDUSTRIAL) IN GERMANY, BELGIUM AND THE NETHERLANDS, 1965-95



Correlation (Germany vs Belgium and the Netherlands, monthly index return data)

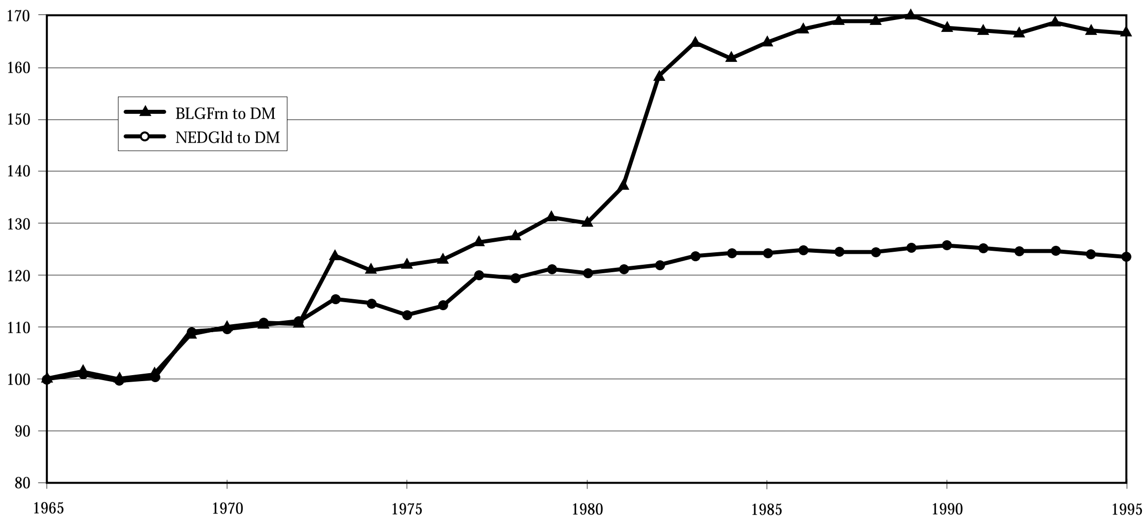
	1966-70	1971-75	1976-80	1981-85	1986-90	1991-95*
Belgium	0.42	0.46	0.43	0.28	0.55	0.70
Netherlands	0.51	0.74	0.52	0.22	0.79	0.75

Source: International Financial Statistics, IMF, 1996.

* Calculation based on January 1991 to June 1995 data.

Figure 13

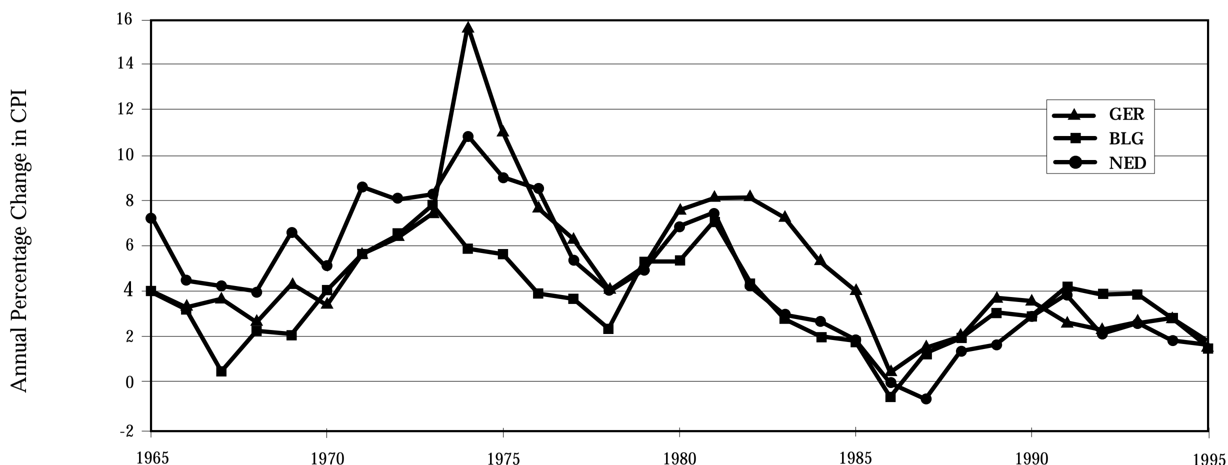
Foreign Exchange Rates in Germany, Belgium and the Netherlands, 1965-95



Source: International Financial Statistics, IMF, 1996.

FIGURE 14

INFLATION IN GERMANY, BELGIUM AND THE NETHERLANDS, 1965-95



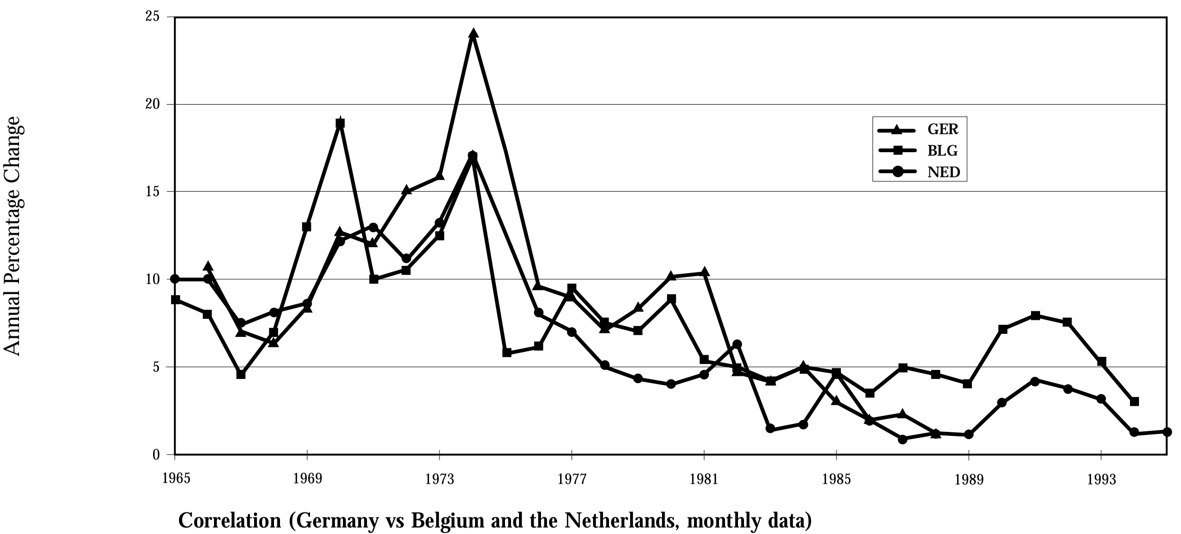
Correlation (Germany vs Belgium and the Netherlands, monthly data)

	1966-70	1971-75	1976-80	1981-85	1986-90	1991-95
Belgium	0.63	0.40	0.45	0.71	0.87	0.63
Netherlands	0.15	0.34	0.41	0.94	0.82	0.72

Source: International Financial Statistics, IMF, June 1996.

FIGURE 15

WAGES IN GERMANY, BELGIUM AND THE NETHERLANDS, 1965-95



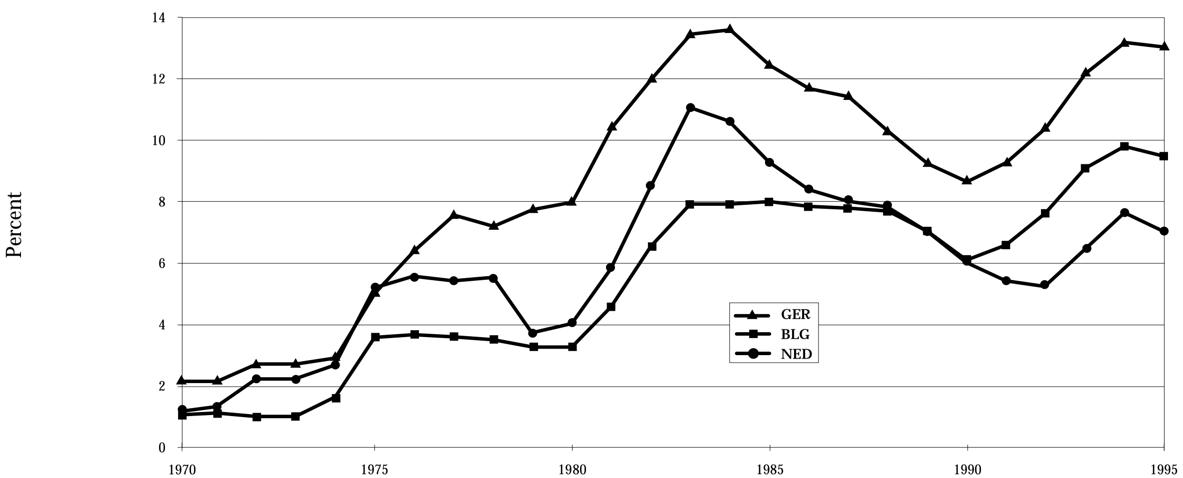
Correlation (Germany vs Belgium and the Netherlands, monthly data)

	1966-88
Belgium	0.72
Netherlands	0.89

Source: International Financial Statistics, IMF, June 1996.

FIGURE 16

UNEMPLOYMENT RATE IN GERMANY, BELGIUM AND THE NETHERLANDS, 1970-95



Correlation (Germany vs Belgium and the Netherlands, monthly data)

	1970-95
Belgium	0.95
Netherlands	0.86

Source: OECD Economic Outlook, Nos. 39, 59.

TABLE 15

TAX REVENUE IN GERMANY, BELGIUM AND THE NETHERLANDS, 1965-93
AS A PERCENTAGE OF GDP

	1965	1970	1975	1980	1985	1990	1993
Germany							
Income and Profit	10.7	10.6	12.4	13.4	13.3	11.9	12.0
Social Security and Payroll	8.7	10.2	12.5	13.2	13.9	13.7	15.1
Social Security	8.5	10.0	12.2	13.1	13.9	13.7	15.1
Goods and Services	10.4	10.5	9.7	10.3	9.8	9.8	10.9
Total	31.6	32.9	36.0	38.2	38.1	36.7	39.0
Belgium							
Income and Profit	8.6	11.2	16.4	18.2	19.4	16.8	16.2
Social Security and Payroll	9.8	10.9	13.3	13.5	15.7	15.4	16.3
Property	1.2	1.1	1.0	1.0	0.9	1.2	1.2
Goods and Services	11.6	12.5	11.0	11.6	12.0	11.7	12.0
Total	31.2	35.7	41.8	44.4	48.1	45.1	45.7
Netherlands							
Income and Profit	11.7	12.4	14.9	14.8	11.6	14.4	15.5
Payroll and Workforce	—	—	—	—	—	—	—
Goods and Services	9.4	10.3	10.4	11.4	11.3	11.8	12.1
Total	32.7	37.0	42.9	45.0	44.1	44.6	48.0

Source: Revenue Statistics of OECD Member Countries, OECD, 1995.

In other words, the European experience suggests that, as a matter of political economy, countries can maintain very different tax structures even with completely open markets for goods and services.

However, according to the findings of recent econometric work (summarized by Hufbauer and DeRosa, 1997[9]), countries that impose high business taxes suffer severe investment penalties. Econometric studies of foreign direct investment suggest that an increase of one percentage point in the corporate tax rate (e.g., from 34 to 35 percent) may diminish the FDI stock by as much as 3 percent. In fact, between U.S. states the impact may be as high as 10 percent. As this econometric work becomes more widely known and is borne out by practical experience, it seems likely that there will be considerable pressure on high-tax states, provinces and countries to cut their business tax rates.

IMPLICATIONS FOR COMPETITIVENESS

THE EVIDENCE SHOWS THAT A HIGH DEGREE OF CONVERGENCE has already been achieved in important fields: a wide range of products and services, interest rates, share prices, and broad movements in wage rates. In the future, unemployment rates may move more closely together. Moreover, the high response of investment to differing business tax regimes will probably cause high-tax jurisdictions to cut their corporate income tax rates. At the same time, European experience suggests that there is considerable scope for institutional divergence between Canada and the United States.

What does convergence in markets and divergence in institutions mean for Canadian competitiveness over the long haul? As Paul Krugman rightly argued, if competitiveness between nations means anything, it means how they compare in per capita living standards. In the long run, the trade performance of particular industries and the trade balance of the nation are less important than per capita income performance. If per capita income is rising in Ontario relative to Michigan and New York, it doesn't much matter whether net Canadian auto exports are declining; and the reverse is equally true.

In answering the appropriate but difficult question about competitiveness, it is instructive to start by examining the per capita income performance of the 50 U.S. states and the District of Columbia between 1960 and 1990. From Table 16, three points stand out. First, the per capita income ratio between the top three and bottom three states narrowed somewhat over this 30-year period, but at the slow rate of about 0.5 percent per year, from 2.18 in 1960 to 1.84 in 1990. In other words, convergence in per capita incomes occurred, but at a slow pace. Second, the correlation in rank ordering between 1960 and 1990 was a quite high 0.85, measured by the Spearman rank correlation coefficient. History matters: leaders generally remain leaders and laggards generally remain laggards. Finally, there are some significant ups and downs. The rising economic escalator did not guarantee the same relative place for every state. Among those gaining more than 10 places in rank order were New

Hampshire, Georgia and Oregon. Among those losing more than 10 places were Delaware, Michigan and New Mexico. Through a combination of luck and policy, some states made big gains and others suffered heavy losses.

The per capita income ratio between the United States and Canada is also narrowing slowly at a rate of about 0.4 percent per year, from 1.43 in 1965 to 1.28 in 1990. With greater convergence, the ratio should narrow further and, in time, Canada could catch up in per capita income. The narrowing could be accelerated with a dose of good policy or a good dose of luck.

Economists have nothing useful to say about luck. However, they can make relevant observations about policy. The scenario of market convergence and institutional divergence suggests four lessons:

- Corporations must follow the high-quality, low-cost leader or go out of business. Government barriers that protect key markets are going to fade away (e.g., restricted access to the Toronto–Montreal air corridor, or "buy America" steel specifications for bridge construction in U.S. states). Equally important, past ties will command little loyalty on the part of corporate customers and big retailers. GM and Ford have demonstrated this with respect to their suppliers; Walmart and Du Pont will be just as ruthless; and so will state, provincial and federal agencies. Accordingly, firms must have lean staffs and keep health and pension costs to the minimum. It's one thing if government requires all firms to pay a given level of health or pension benefits; area-wide requirements will be offset by area-wide declines in wage rates and/or property values. But it's another thing for a particular firm, such as the old IBM, to provide wages or benefits above the prevailing level to its workforce. At the same time, management must move rapidly in adapting to new process technology, bringing out new products and devising new distribution systems. Management that lags will be bought out or thrown out.

- In making new decisions on location, firms will be very sensitive to workforce availability and habits. Unions that limit workforce flexibility (in terms of job assignments, layoffs and seniority rules) will be a major negative force. Post-secondary training programs designed to suit particular corporate needs will be a major positive force. Similarly, good transportation links, high-quality primary and secondary schools, and a clean living and recreational environment will attract firms because they enhance workforce availability.

TABLE 16

PER CAPITA INCOME OF U.S. STATES, 1960 AND 1990

State	Population (,000)	1990 Income Per Capita $	Rank	Population (,000)	1960 Income Per Capita $	Rank
Mississippi	2,575	12,583	51	2,178	1,240	51
Arkansas	2,351	13,824	50	1,786	1,400	49
West Virginia	1,793	13,943	49	1,860	1,613	44
Utah	1,723	14,103	48	891	2,010	30
New Mexico	1,515	14,257	47	951	1,893	34
Louisiana	4,220	14,265	46	3,257	1,658	42
Montana	799	14,768	45	675	2,074	28
Kentucky	3,687	14,782	44	3,038	1,580	46
Alabama	4,040	14,926	43	3,267	1,530	48
Oklahoma	3,146	15,130	42	2,328	1,890	35
South Carolina	3,486	15,175	41	2,383	1,385	50
North Dakota	639	15,336	40	632	1,741	41
Idaho	1,007	15,392	39	667	1,799	38
South Dakota	696	15,661	38	681	1,762	40
Tennessee	4,877	15,952	37	3,567	1,570	47
Arizona	3,665	16,317	36	1,302	2,074	29
North Carolina	6,632	16,330	35	4,556	1,602	45
Iowa	2,777	16,709	34	2,758	1,994	31
Texas	16,986	16,808	33	9,580	1,942	33
Indiana	5,544	16,847	32	4,662	2,188	21
Wyoming	454	16,960	31	330	2,121	25
Maine	1,228	17,101	30	969	1,858	37
Georgia	6,478	17,197	29	3,943	1,648	43
Oregon	2,842	17,312	28	1,769	2,205	19
Vermont	563	17,407	27	390	1,795	39
Nebraska	1,578	17,427	26	1,411	2,126	14
Missouri	5,117	17,432	25	4,320	2,106	26
Wisconsin	4,892	17,437	24	3,952	2,201	20
Ohio	10,847	17,572	23	9,706	2,349	14
Kansas	2,478	17,676	22	2,179	2,157	22
Michigan	9,295	18,268	21	7,823	2,365	12
Minnesota	4,376	18,830	22	3,414	2,080	27
Colorado	3,294	18,883	19	1,754	2,281	16
Florida	12,938	18,906	18	4,952	1,959	32
Pennsylvania	11,833	18,981	17	11,319	2,271	17
Rhode Island	1,003	19,043	16	859	2,212	18
Washington	4,867	19,396	15	2,853	2,348	15
Virginia	6,189	19,615	14	3,967	1,865	36
Delaware	666	19,820	13	446	2,915	2
Illinois	11,431	20,191	12	10,081	2,649	9

TABLE 16 (CONT'D)

New Hampshire	1,109	20,289	11	607	2,142	23
Nevada	1,202	20,549	10	285	2,807	4
California	29,758	20,757	9	15,717	2,730	7
Alaska	550	20,909	8	226	2,655	8
Hawaii	1,108	21,029	7	633	2,370	11
Massachusetts	6,016	22,257	6	5,149	2,466	10
New York	17,991	22,333	5	16,782	2,747	5
Maryland	4,718	22,467	4	3,101	2,354	13
New Jersey	7,730	24,217	3	6,067	2,736	6
District of Columbia	607	24,547	2	764	3,010	1
Connecticut	3,287	25,434	1	2,535	2,840	3

Spearman's rank correlation between personal income per capita in 1960 and 1990: 0.853

- With the expected market environment of the next 30 years, low corporate income tax rates and targeted subsidies may well be effective in attracting individual firms. National and international codes leave plenty of room for permitted subsidies, particularly by municipal, provincial and state governments. Moreover, states, provinces and national governments are entirely free to alter their corporate tax systems. European experience suggests that top-down discipline is likely only in egregious cases. In designing their subsidies and shaping their tax systems, few sub-federal governments will be able to afford the full range of permitted practices. Instead, they will need to ask whether money is more effectively spent on general programs (such as better schools and parks) or targeted programs (such as a new road link to a specific industrial site, or a tax holiday for new investment).

- The prospective economic environment does not compel governments to adopt the same expenditure policies in order to remain competitive. Some jurisdictions may emphasize education in their social agendas; others may emphasize retirement benefits. The prospective environment does, however, suggest a greater emphasis on goods and services taxes that can be adjusted at the border, and on income tax systems that are fairly uniform so as to avoid driving away highly skilled people or especially profitable but mobile industries. In particular, the new environment will penalize states and provinces that levy high corporate income taxes on business firms.

THE TRADE POLICY OUTLOOK AND ITS IMPLICATIONS FOR THE NORTH AMERICAN ECONOMIC INTEGRATION

ANY VISION OF REGIONAL INTEGRATION IN NORTH AMERICA must reflect the dominant influence of U.S. policy on the trading system. The United States account for 71 percent of total NAFTA exports (including intra-regional trade), 54 percent of Western Hemisphere exports, 30 percent of APEC exports and 12 percent of global exports. When the United States sneezes, its trading partners get a cold. When U.S. policy makers get cold feet, new trade initiatives freeze up.

The 1996 U.S. presidential campaign saw only limited trade policy debate. At first glance, the lack of attention raises concern that the United States may not be able to sustain its legacy of free trade initiatives in the face of protectionist sentiments festering in both major political parties. Anxiety over stagnant wage growth and job insecurity (despite near-full employment in the United States) threatens to undercut support for new trade talks. Politicians in both parties have seized on these concerns; some have revived the pauper labour arguments, which were discredited during the NAFTA debate but have resurfaced since the Mexican crisis.

To be sure, the United States will have to go through a wrenching national debate on these issues over the next few years, just as Canada did before ratifying the FTA in 1988 (but without recourse to a national referendum). At the end of the day, we believe the free traders are likely to prevail, for two reasons:

First, new trade pacts support the export-oriented U.S. trade strategy advocated by both parties. The U.S. economy is not as dependent on exports as Canada's, but many more U.S. companies and workers rely on exports to underpin growth and employment than was the case even a decade ago. Second, prospective trade deals entail asymmetric obligations regarding trade liberalization. Because U.S. barriers are generally very low, little change is required in U.S. practices compared to the significant reductions undertaken by U.S. trading partners. The NAFTA was a prime example of such a pact: the negotiations essentially involved agreeing on commitments that Mexico would undertake in order to join the Canada–U.S. club, and few changes were required in return by the United States and Canada. This mercantilist calculus resonates well with U.S. political leaders, who object to giving up something for nothing but not the reverse!

For those reasons, we expect that the U.S. Congress will re-authorize fast-track negotiating authority by mid-1998, allowing the United States to gear up for regional and multilateral trade initiatives that have been stuck in neutral since early 1996. Accordingly, U.S. policy is likely to follow the script of the past two decades and continue to be based on a mixture of domestic legislative actions, regional trade initiatives and multilateral negotiations in the WTO.

The following sub-sections briefly speculate on the main trends that might emerge in each area. To be sure, forecasting trends in U.S. trade policy

is as hazardous as predicting the weather. We will undoubtedly miss the sudden squalls that rain on bilateral trade and investment for short periods, but the long-term forecast is for a Bermuda high to dominate North American trade relations.

Within the next 25 years, the United States and Canada have committed to eliminating barriers to trade with the major trading nations in the Asia Pacific and Latin America. If barriers really are removed, free trade and investment in both regions will yield a rich harvest of reforms in the dynamic economies of East Asia and South America, but only modest changes will be required in North American policies affecting most manufacturing sectors (with the important exception of apparel). Agricultural reform will be a sticking point in both regions, as it has been in the U.S.–Canadian context. These commitments hold three main implications for the North American economies:

- increased adjustment pressure on the apparel sector;
- additional competition in meat and dairy products from Argentina, Australia and New Zealand, and in sugar from Brazil and potentially Cuba; and
- increased export opportunities in the markets of regional partners, as a result of trade-spurred growth.

Seen in this light, the free trade commitments do not seem so daunting. Indeed, the main problem in terms of employment is probably in the apparel sector, where politicians fear massive inflows of goods from China. However, by the time China is ready to assume all the obligations of APEC free trade and thus receives the full benefits, our 25-year horizon will have mostly expired. Moreover, we can assume that apparel will be among the last sectors liberalized by the United States and Canada in 2010, and reciprocity conditions may be attached; these could open the Chinese import market for textiles while maintaining some safeguards against Chinese apparel exports.

Prospects for Free Trade in the Americas

In December 1994, at the Summit of the Americas in Miami, the Western Hemisphere's 34 democracies declared their intention to negotiate a Free Trade Area of the Americas by 2005. The objective is a bold one, especially for the region's smaller countries with one-dimensional and relatively underdeveloped economies. To be sure, these countries are pursuing integration initiatives within their own sub-regional trade pacts, albeit on a lesser scale, so the process of economic integration is already under way. The successful and sustained implementation of these initiatives is a prerequisite for hemispheric integration.

But can hemisphere-wide integration be achieved given the economic and political challenges confronting most governments?

Three factors fuel doubts about the durability of the FTAA process. In our view, all of them reflect transitional problems that should be resolved within the next few years:

- The first concern is the U.S. difficulty in extending fast-track negotiating authority, thereby stalling progress on Chile's accession to the NAFTA and on NAFTA parity for Caribbean Basin Initiative (CBI) countries. As explained above, however, fast track is likely to be revived in 1998 and U.S. protectionist pressures are likely to be manageable.

- The Mexican financial crisis, erupting just 10 days after the Miami Summit, re-opened concerns about the sustainability of economic reforms in Latin America. Although the tequila effect was felt in only a few Latin countries, it exposed the vulnerability of many countries to future crises because of their weak banking sectors. Fortunately, the World Bank and the Inter-American Development Bank have devoted substantial resources to help central banks shore up and monitor the banking sector. The Mexican crisis could thus turn out to have been a timely, if expensive, wake-up call.

- Finally, political developments have cast doubts on whether the hemispheric partners have the requisite harmony to work together toward a FTAA. Large income disparities exist not just between but within countries; these have been increasingly divisive and weakened support for political leaders in the forefront of the battle for economic reform. Colombia's drug connection continues to burden U.S. relations with that country and others (including Mexico) that serve as conduits for drug shipments. At the same time, border conflicts have beset relations between Ecuador and Peru, and between Colombia and Venezuela. These are the most intractable problems; but the FTAA process, which addresses sustainable development, narcotics and other issues, should be a constructive part of national responses.

On balance, the concerns noted above are more than offset by the positive signals that continue to be projected by Latin American countries. Three developments, if sustained, give cause for optimism:

- First, economic reforms continue to advance throughout the hemisphere, strengthening the foundations for economic growth over the medium and long term. For the hemispheric integration process to culminate in a FTAA, the major countries of Latin

America and the Caribbean will have to strengthen their own economic reform programs.

- Second, the Summit of the Americas process is working. Ministerial meetings have been held in Denver (June 1995) and Cartagena, Colombia (March 1996); the next sessions are scheduled for May 1997 in Belo Horizonte, Brazil, and 1998 in Costa Rica. Trade ministers have established 11 working groups to examine areas of existing and potential co-operation between hemispheric partners; work on dispute settlement is to be launched at the next ministerial meeting in Brazil. Most important, hemispheric leaders have agreed to attend a second Summit of the Americas in March 1998 in Santiago, Chile; at that time they could well announce the launch date for the FTAA negotiations.

- Finally, the process of integration has continued to advance in various sub-regional pacts. The MERCOSUR countries continue to deepen their customs union, despite sectoral problems in autos and agriculture. At the same time, the four members are linking up with Chile, Bolivia and the Andean Group countries in what they refer to as "association arrangements"; in fact these are merely free trade pacts that cover primarily border measures on merchandise trade. In addition, the Central American countries have revived their common market, and the Caribbean countries are beginning to implement the regional commitments they undertook years ago.

Building the FTAA

What is the most likely course for developing the FTAA? Some, including former Canadian Trade Minister Roy MacLaren, favour the "big bang" approach: they call for all countries to sit down together and develop a new trade accord, as was done in the GATT/WTO. Others argue that the FTAA need not reinvent the wheel but should rather evolve from the continuing process of subregional integration throughout the hemisphere, culminating in the link-up of those groups into an integrated free trade area.

We suggest a more pragmatic, ad hoc approach that combines both the continuation of sub-regional integration efforts (including the expansion of the NAFTA region) with hemisphere-wide efforts to harmonize national and/or subregional trading rules that could potentially erect obstacles to the FTAA. Given the different circumstances of each country and each sub-regional group, we believe the process must reflect variable geometry rather than linear progression.

NAFTA expansion will play an important role in future hemispheric integration since the NAFTA region accounts for more than 85 percent of hemispheric output. Companies that want to do business in the dominant market will tailor their policies to comply with NAFTA norms.[10]

Negotiations on Chile's accession to the NAFTA should proceed quickly in 1997-98 once the prospects for U.S. fast track authority are clear and positive. NAFTA membership could then expand to several other countries in Central America and the Caribbean; and Colombia could join as well if it successfully mitigates the severe political frictions generated by the drug issue (something it probably cannot do until after President Samper leaves office in 1998). In addition, legislation was introduced in the U.S. Congress to grant NAFTA-like preferences to the 24 members of the Caribbean Basin Initiative on the understanding that they will seek NAFTA membership within a decade. Some of the CBI countries will be able to accede much sooner if their domestic economic reforms remain on track. When Fidel Castro disappears from the scene, Cuba will be a prime candidate for NAFTA membership. Simple arithmetic shows that 29 countries could well be associated with the NAFTA by the year 2005.[11]

Can these countries commit to the rigorous NAFTA obligations? In many respects, they already have done so through their participation in the Uruguay Round accords, which incorporate several reforms modeled after specific NAFTA provisions. The main challenge will be to devise pathways to solutions for the WTO-plus features of the NAFTA (e.g., investment, intellectual property, services and labour/environment side agreements).

The main question mark for FTAA development will be the relationship between the expanding NAFTA and MERCOSUR. This relationship will depend on how the NAFTA adjusts to its wider membership, and on how the MERCOSUR evolves over the next five years as it moves to complete its customs union and also negotiate free trade accords with its neighbours in South America.

With the expansion of the NAFTA and MERCOSUR, some countries (including Chile and possibly Colombia) will have overlapping accords with both North and South American powers. Some will be members of several free trade areas involving different partners, and there could be conflicts in trade rules and regulations as well as liberalization schedules.[12] These types of problems could best be addressed by hemisphere-wide negotiations to complement the sub-regional integration process and the negotiations between sub-regional groups.

In this connection, we see the FTAA working groups serving several discrete purposes:

- They can remove obstacles in the path of integration between countries and sub-regional groups (and forestall the emergence of new problems), primarily by spotlighting inconsistencies and monitoring developments in the sub-regions.

- They can promote consultations on specific issues not covered by sub-regional or multilateral (i.e., WTO-plus) rules and obligations.
- They can provide a forum for hemispheric negotiations on standards and customs procedures that may be amenable to harmonization or mutual recognition arrangements.

Prospects for Free Trade in APEC

At Bogor, Indonesia, in November 1994, the 18 members of the Asia Pacific Economic Co-operation forum committed themselves to achieving free trade and investment in the Asia Pacific region by 2010 for developed countries and 2020 for developing countries. APEC members took cautious first steps toward that goal at their Osaka meeting in November 1995. At the Subic Bay Summit in November 1996, APEC leaders gave a concerted push to the Information Technology Agreement (ITA), which was embraced at the Singapore Ministerial meeting in December 1996.

The APEC process is different from that of the FTAA. APEC members have committed to the goal of free trade by a fixed date but have left open the modalities for implementing national reforms. They have opted for a flexible, ad hoc approach under the banner of "concerted unilateralism." Each country decides where, when and how to liberalize, subject to two constraints: the fixed target dates and the requirement that countries undertake comparable reforms given their relative development status. APEC negotiations will effectively occur in "consultations" to ensure comparability of unilateral reforms. In addition, APEC may inspire multilateral liberalization in other sectors, such as financial services, civil aviation and chemicals.

Nonetheless, it is difficult to imagine APEC reforms going beyond or being implemented sooner than the comprehensive free trade obligations covered by the NAFTA. U.S.–Canadian norms will be the high water mark for APEC efforts; and as the initial talks on APEC investment principles demonstrated, the rule-making results are likely to fall short of the NAFTA model.

In simple terms, we do not expect APEC's government-to-government negotiations to function as a catalyst for North American integration. Instead, the lure of expanding Asian markets and the challenge of competing in those markets will provide a more powerful impetus for North American industry to restructure. Trade with East Asian countries will expand sharply, promoting the rapid development of the West Coast regions in each North American country.

Prospects for Global Free Trade

If regional free trade initiatives are sustained, they are likely to become linked in new WTO negotiations under the banner of global free trade.[13] The motive behind such a scenario is straightforward: fear.

In our view, the fear of being left out of major markets is leading the European Union to rethink its policy of giving priority to expanding regionalism in Europe. That policy inevitably increases pressure to maintain or surreptitiously strengthen protection against other countries, particularly those that compete with East European and Mediterranean countries in agriculture and low-tech manufactures. If the European Union maintains its Euro-focus, it will be left out of the integration initiatives that now involve the world's most dynamic economies of East Asia and Latin America. To avert this danger, the EU has attempted to link its regional efforts with those of Asia (in the Asia–Europe Meeting) and MERCOSUR, and some foreign policy officials have promoted a U.S.–EU link in a Trans-Atlantic Free Trade Area (TAFTA). All these initiatives are long on political dialogue and short on economic content; all will founder on the unwillingness of the European Union to include agriculture in any free trade negotiations.[14]

Since the new WTO provides a forum for continuing negotiations, we expect that multilateral negotiations will start shortly on the built-in agenda mandated by the Uruguay Round accords, supplemented by new issues added at the Singapore and subsequent ministerial meetings. The Singapore ministerial meeting was extremely important in setting the near-term agenda. We do not foresee the organization of one-shot, big bang rounds as in the past under the GATT; instead, the process of biennial ministerial meetings and continuing negotiations accommodates a modified approach, which we call "round-ups."[15] In brief, every two years or so, WTO members would round up issues on the WTO agenda that are ripe for resolution. Each round-up would include a large enough package of agreements to afford the opportunity for cross-issue and cross-sector trade-offs. Negotiations would continue on other issues and new areas could be brought into the talks at any time. Round-ups would essentially be consecutive rounds rolled together.

The main question for these prospective WTO talks is whether WTO negotiations will be able to achieve the same degree of integration that is the hallmark of EU integration and that is evolving in North America as well. The difference is that the WTO talks will balance EU norms with those of other regions. In some areas the U.S.–Canadian norm may not be the most far-reaching and North American policies could be strengthened to meet EU norms. Three areas where this might occur are adoption of area-wide competition policy norms; adoption of rule-of-origin treatment for indirect taxes when goods are shipped across national borders; and mutual recognition of standards, test data and certification marks.

CONCLUSIONS

OVER THE NEXT 25 YEARS, the economic integration of North America will advance markedly:

- The border between Canada and the United States will be no more intrusive than the German–Dutch border today. Border trade measures will be a relic of the past; declining resort to anti-dumping duties and other border measures will be replaced by regulatory competition and investment subsidies.
- Trade will play an even larger role in both economies, and two-way trade flows will continue to expand sharply.
- Trade with Asia will take a much larger share of U.S. and Canadian exports and imports, spurring further expansion of west coast ports.
- Regardless of developments in Quebec, we will continue to see the devolution of power from federal governments to states and provinces. In both countries, provinces and states will play a larger role in shaping the direction of future integration. This trend will constrain growth of the federal tax base and thus will continue to squeeze social services budgets.

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10 Indeed, the European Free Trade Association countries adopted EC standards long before they negotiated EC membership.
11 Barbados recently announced that it would not seek NAFTA membership and would await the FTAA. However, at the same time it reiterated interest in NAFTA parity, which is dependent on gradual NAFTA accession.
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