

**Remarks to the Senate Committee on Foreign Affairs
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Canada-United States of America Trade Relationship

Mr. Chairman,
Honourable Senators,

On behalf of the Centre for Trade Policy and Law, I am pleased to contribute to the Committee's study of the trade relationship between Canada and the United States on which my remarks will principally concentrate.

Canadians have been debating the relationship with the United States for more than two centuries and for good reason. It is only with the United States that Canada has a comprehensive foreign policy relationship. Canadians, moreover, measure themselves and their country against American benchmarks. This is as true for issues such as health care and gun control as it for economic performance and job creation.

The Centre has submitted a study for the Committee's consideration entitled *Common Borders, Shared Destinies: Canada, the United States and Deepening Integration*. My remarks will draw upon this study.

In a few short years, the Canadian economy has undergone a profound transformation. The agent of this transformation has been the Canada-U.S. Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA). The result is a Canadian economy increasingly integrated on a North American basis.

It is worth recalling that although the NAFTA predates the World Trade Organization, it is a deeper and broader agreement encompassing an exchange of

commitments and which in most areas goes far beyond the current WTO agreements or those contemplated in the new round of multilateral trade negotiations launched in 2001.

We should also note that the major difference between the NAFTA and the European Union is the absence of common institutions and common policies for managing the relationship and governing its evolution. However, as a matter of practice and especially between Canada and the United States, the degree of commonality, in many cases, harmonization of policy and practice, matches or exceeds that of the EU. As much it may be claimed that the EU is a single market, the same claim applies to Canada and the United States.

The FTA and the NAFTA, for Canada, were products of the failure of a one hundred-year effort to develop an economy that defied economic geography.

In North America, economic geography is structured on a north-south axis. Canada tried to develop an economy on an east-west basis by protecting a small and fragmented manufacturing sector and paying the economic costs through the export of unprocessed resources.

In the 1970s, Canada threw up barriers to foreign investment and paid out large industrial and regional development subsidies in the misguided belief that the east-west economy could be strengthened by a massive dose of government intervention.

In the mid-1980s, this Canadian dreamland was shattered by a severe recession. Protection had not worked. Canadian manufacturers were too weak to exploit export markets and to prevent significant incursions of imports into the domestic market.

New competitors in global resource markets, combined with the exhaustion of easily exploitable resources in Canada meant that Canada's abundant resource endowment could no longer bear the cost of supporting an inefficient manufacturing economy.

Barriers to foreign investment meant Canadian economic development had become increasingly dependent upon inadequate pools of domestic savings. Massive state intervention created large bureaucracies, unsustainable budgetary deficits and little economic development.

The decision to enter into the FTA meant that rather than resisting the ineluctable forces of economic geography, Canada would henceforth try to harness those forces.

The results have surpassed the expectations of governments and business, and confounded the critics.

During the first decade, trade grew by 140 percent in nominal terms, reaching \$1 million of two-way trade every minute.

Trade between Canada and the U.S. is almost as great as trade between the U.S. and the fifteen countries of the EU.

In some sectors — automobiles, for example — cross border trade exceeds total trade between Canada and the rest of the world.

Of even greater significance than the volume of trade is its characteristic. By some measures, as much as two-thirds of cross border trade is intra-firm trade. Whole industrial sectors in Canada have been restructured on a north-south basis.

The old model of international trade and investment — autonomous firms engaged in arms length transactions across national borders — has been largely replaced by integrated networks crossing and recrossing the border as if it did not exist.

We hear little now of the strident criticism of the NAFTA which dominated the debates of ten years ago. It is worth recalling its main points because we will hear them again.

How can a small country like Canada have free trade with the United States and not lose its identity or independence? Ten years of public opinion polling is convincing proof that Canadians dismiss that argument as pure bunk. They do not equate poor economic prospects with stronger Canadian identity or prosperity with diminished identity.

How can industrialized countries like Canada have free trade with a developing country like Mexico and not lose all its jobs to low paid workers? Steady economic growth, and in recent years an astonishing record of job creation, give the lie to that criticism.

How can Canada with its strong environmental and employment laws avoid a race to the bottom in order to remain competitive? It has not happened.

Just as the NAFTA was the product of failure, we face a new set of problems that are the product of success. Parts of those problems originate in the unfinished NAFTA agenda. Parts, — the more important parts — originate in the need to move beyond the NAFTA, which was a product of its time, and capture the dynamics of an integrated North American economy.

The unfinished agenda is a collection of relics of old fashioned trade and investment policy:

- There are well-fortified redoubts of protection in agriculture in both countries even though trade in agricultural products is largely free of restriction.

- There are cumbersome rules of origin requiring some industrial sectors to use raw materials and parts procured in North America in order to benefit from free trade.
- Investment restrictions in some areas prevent the achievement of full efficiencies.
- Old economy industries remain attached to anti-dumping, countervailing duty and safeguard measures to hold more agile competitors at bay. These issues have largely been reduced to those of resource pricing.
- Government procurement remains encased in a myriad of trade restricting rules.

While the list is impressively long, the cumulative impact has been diminishing over time.

The new North American agenda is more complex, more challenging and more promising than it has ever been, and fresh thinking is needed based upon some fundamental realities.

First, Canada and Canadians are engaged in a process of silent integration with the United States, which is deepening across virtually every area where the two societies connect. The question for governments, especially the Canadian government, is whether to help or hinder that integration.

Second, Canadians are comfortable with deepening integration. Secure in their identity and confident in their values and preferences, Canadians are perfectly capable of distinguishing between the relationship with the U.S. and their own identity. In other words, they like the existence of the border but they do not want it to get in their way.

Third, the debate whether Canada should have a defence or any other kind of a perimeter with the United States is detached from reality. Canada already has a perimeter with the United States, defined by geography, economics, demographics, largely shared political and societal values, and common security arrangements and challenges. The issue is whether the perimeter is strong or weak, not whether it exists.

Fourth, broad convergence between Canada and the United States exists across a wide range of public policy areas including security and immigration. The differences lie in administration, not in fundamental concept.

Fifth, current cross-border arrangements for the management of common trade, security, and immigration issues are inadequate to the demands being placed upon them. Canada and the United States now require a new design for new circumstances.

Some of that fresh thinking is apparent in efforts by the Canadian and U.S. governments in the Smart Border Accord.

There is evidence that very bolder steps are under quiet consideration

Beyond these small incremental steps, there is a larger debate about the kind of relationship we should have with the United States, and some interesting questions are being asked.

Do we need a customs union like the EU, providing for total free trade in goods and services, complete capital and labour mobility, a host of common policies in competition, regulation, transportation and the like, all governed by complex networks of institutions? For all practical purposes, there is a customs union between Canada and the United States that is managed by the rules and institutions of a free trade agreement. If a customs union is the answer, then we may borrow freely from the outstanding success of the European Union.

Perhaps a NAFTA-plus arrangement could suffice. We might package the old agenda items with some bold steps in competition policies, and harmonized regulation, for example, for energy, and product standard equivalence and attach it to the current agreement. This approach has the advantage of familiarity.

All of these approaches miss the point because they are means to an end when we have yet to decide what that end should be. Before we embrace solutions and certainly before we propose a course of action to the United States, we need to ask ourselves some hard questions.

What role should the border play in cross-border flows of trade and investment? How many of the functions fulfilled by customs, immigration, and other services can be met behind the border? Which tasks currently being performed at the border can be eliminated or managed elsewhere?

What is the impact of regulatory differences upon the Canadian economy and are the costs worth these differences? Both intergovernmental agreements and the pressures of silent integration have accelerated regulatory convergence and narrowed differences, but they have neither eliminated existing differences nor discouraged new differences from emerging in regulatory design, objectives, implementation, and compliance.

Do we need new institutions with the United States? Traditionally, we have avoided elaborate institutional arrangements to manage the relationship in large part from the fear that the U.S., by its sheer weight, would dominate them. Instead, we have relied upon the negotiation of fixed rules backed by dispute settlement procedures, both of which are time-consuming and politically charged. Does the International Joint Commission, which for almost a hundred years has had an enviable record of managing cross-border environmental problems, provide a model that could be adapted to serve the larger relationship?

Does our religious aversion to linkage make sense? Canada and the United States have traditionally managed their relationship pragmatically, dividing the issues where cooperation is required into neat compartments where they can be treated without one set of issues intruding upon others. This compartmentalization of the relationship has served us well. But it may no longer work and a new approach may be necessary.

To date this is a Canadian debate and for reason.

In the history of Canada-U.S. relations, the ideas originate north of the border, not because our American cousins have no ideas but because Americans have big ideas and Canadians, or at least their politicians prefer small ideas. The art of Canadian-American negotiations is to package a proposal in a small enough way to reassure Canadians and at the same time in a big enough way to capture American imagination.

Some analysts conclude that Americans will never be sufficiently interested in pursuing innovative, visionary approaches, and draw the conclusion that time spent on the problem is time wasted. That would be a mistake that would cost Canadians dearly. Canadians and Americans working together have succeeded in meeting this large challenge in the past and can do so again, but not if they start by accepting the conventional wisdom that the tough issues of the moment limit the agenda.

The issues are also largely bilateral rather than trilateral in nature. The successful conclusion of a trilateral North American Free Trade Agreement created expectations about the evolution of a North American community. This has not happened. Trying to address Canada-U.S. issues on a trilateral basis is likely to prove counter-productive. The Mexican factor is important but not critical. The challenge for Canada is to decide upon the architecture of the relationship with the U.S. that it wishes to have in the 21st century and, on this basis, to seek a new accommodation with the U.S., whatever the Mexicans do. If Mexico reaches compatible conclusions, a parallel initiative would become possible. If Mexico is not disposed, Canada needs to press forward nevertheless. The

relationship with the United States is too important to be left hostage to policies and preferences of another country.

To this discussion, the Committee can make a valuable contribution.