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**North American
Economic Integration:
Opportunities and
Challenges for Canada**

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North American Economic Integration: Opportunities and Challenges for Canada

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Globalization has increased economic interdependence among countries but the greatest impact has been felt regionally, especially in the countries of the EU, NAFTA and Asia. Increased North American integration has benefited all three countries without forcing unwanted policy harmonization in many areas. Deeper economic integration would benefit all three NAFTA countries, especially, for example, if rules-of-origin could be eliminated by a common external tariff. To capture a greater share of economic benefits from North American economic integration, Canada must invest more in physical and human capital, R&D, improve the competitiveness of its tax and regulatory frameworks and narrow productivity and real income gaps.

Introduction

Economic interdependence among countries around the world has increased considerably in the past quarter century. It is reflected in the greater mobility of goods and services, capital, people and innovation activity across national boundaries. Transnational corporations played a key role in the globalization of economic activity. International trade, foreign direct investment and sales of foreign affiliates in many countries increased at a considerably faster pace than GDP. Much of the international trade by transnationals is conducted between divisions of the same multinational firm (intra-company trade) rather than between arm's length companies. Increasingly the location of economic activities of both foreign and domestic transnationals is becoming highly sensitive to differences in economic and political conditions, and tax and investment incentives. In other words, transnationals are becoming increasingly footloose.

Dramatic reductions in transportation, information and communication costs, rapid advancements in production technologies, fierce international competition for markets, capital, people, and high value added

* The views expressed in this paper are author's only and cannot be attributed to either Industry Canada or the Government of Canada

economic activities among firms and countries and bilateral, regional and multilateral trade agreements have all contributed to the internationalisation of economic activity.

Nevertheless, much of the increase in global trade, foreign direct investment and migration of skilled people has occurred within the major regional trading blocks such as the EU, NAFTA and the Asia Pacific. For instance, intra-regional trade accounts for almost three-quarters of the total trade of the EU countries. Similarly, about 50 percent of total NAFTA trade is with in the three member countries and is growing (see chart 1). EU and NAFTA represent just under 13 percent of world population but account for over 60 percent of world GDP and almost 50 percent of global trade. Regional trade agreements, geographic proximity, and the long standing economic and social ties have all played a key role in the growing importance of regional trading blocks that characterize the current pattern of globalization. .

Recent Trends

Canada has actively participated in the globalisation process. The share of exports in GDP is over 40 percent today, compared to only 25 percent just 10 years ago. Similarly, the import propensity too increased considerably since 1990 (see chart 2). In addition, the ratio of international trade to inter-provincial trade more than doubled during this period. Similarly, Canada has become a major exporter and importer of capital. The shares of inward and outward foreign direct investment (FDI) stocks in Canadian economic output (GDP) also increased dramatically in the 1990s (see chart 3). It is important to note that Canada is a net exporter of capital, a major reversal of the situation in less than 10 years.

Much of the increase in Canada's outward orientation is the result of increased economic linkages with the U.S., and to a small extent with Mexico. The U.S. share of Canadian exports of goods and services is over 80 percent, a 10 percentage point increase since 1990. Similarly, the U.S. share of Canada's imports of goods and services also increased, but not to the same extent as exports. Like wise, the investment linkages between the two countries have strengthened since 1990. Acharya, Rao and Sawchuk (2003b) developed an index of economic integration between Canada and the U.S., using data on trade flows, portfolio capital flows and foreign direct investment stocks. The index increased at an annual rate of 1.1 percent per year between 1990 and 2002, compared to a **negative** growth of 0.9 percent per year in the 1980s (see chart 4).

Canada is also an important trading partner to the U.S. Canada accounts for between 17 to 20 percent of total U.S. exports and imports. Canada is the largest trading partner of 39 U.S. states. It is the largest supplier of U.S. energy imports. Canada's share of U.S. imports of wood and paper and allied products averaged over 70 percent during 1995-2000. The increased economic linkages between Canada and the U.S are pervasive across Canadian provinces and industries.

Canada's economic linkages with Mexico also increased considerably in the 1990s, although from a very small base. Mexico's share of Canadian imports almost doubled between 1990 and 2002, reaching 3.9 percent. While only 0.6 percent of Canadian exports in 2002 were destined to Mexico, compared to 0.5 percent in 1992, Canada's share of Mexico's total imports more than doubled during this period. Canada's investment linkages with Mexico also improved, but they are still quite small.

The two free trade agreements (FTA and NAFTA), the booming North American economies, especially the U.S. economy, and the real depreciation of the Canadian dollar all seem to have contributed to the increased economic interdependence among the three NAFTA member countries (see Acharya, Sharma and Rao (2003a)). Intra-industry and intra-company trade played a key role in the increased economic integration. For instance, intra-company trade accounts for about 40 percent of Canada-U.S. trade.

The large and growing two-way trade and investment linkages between the two countries indicates increased product specialisation in both countries.

Economic Benefits to Canada

The increased economic linkages with the U.S. and Mexico stimulated economic growth and productive efficiency in Canada. Increased exports to the U.S. and Mexico were responsible for close to 80 percent of the growth manufacturing shipments and employment in Canada. According to Treffer (1999) and Acharya, Sharma and Rao (2003), the two free trade agreements induced product specialisation and rationalisation, and raised productivity in Canadian manufacturing industries. The industries where tariff reductions were larger, the improvements in productivity and wages were higher, and vice versa. Of course, there were considerable adjustment difficulties, leading to a significant net exit of firms, job loss and dislocation during the transition period.

Similarly, the increased inward and outward foreign direct investment orientation provided large benefits to Canada. Research done for Industry Canada and research by others show that both Canadian and foreign transnationals contribute to improvements in living standards in Canada in a number of ways. On average, they are more productive, pay higher wages, stimulate, trade, investment and innovation, and exert positive productivity spillovers on other firms in Canada (see Rao and Tang (2004)).

Research done for Industry Canada also show that the increased North American integration did not lead to harmonisation of Canadian policies, or weaken social programs and environmental standards in Canada (see Harris (2003), and Harris and Lemieux (2004)).

In short, the increased economic integration provided significant economic benefits to Canada without undermining Canada's policy autonomy and social programs. There is still large scope for further economic integration between Canada and Mexico and to narrow the Canada-U.S. productivity and living standard gaps. Research by Helliwell MaCallum and others show that the border effects on Canada-U.S. trade, investment and labour migration, though declining significantly since 1990, are still substantial (see Harris and Lemieux (2004)). The causes of large border effects are not yet very well understood. But, removal of remaining impediments to trade, investment and labour mobility might further reduce the border effects and deepen North American economic integration.

Challenges

To fully benefit from increased economic integration, Canada needs to overcome a number of formidable challenges and become a highly competitive location for investment, skilled people and high value-added activities.

Despite a huge increase in Canada's exports to the U.S. in the 1990s, Canada's share of U.S. imports in 2002 was 1 percentage point lower than in 1990. Furthermore, the export expansion in the 1990s was mainly due to the booming U.S. economy and the large real depreciation of the Canadian dollar vis-à-vis the U.S. dollar. Improvements in Canada's cost competitiveness were entirely due to the depreciation of the Canadian dollar. It more than offset Canada's relatively poor productivity performance. In the manufacturing sector, the battle ground of cut throat international competition, labour productivity in Canada increased at less than half the pace in the U.S. in the 1990s. As a result, the Canada-U.S. labour productivity level gap

increased from about 19 percent in 1990 to almost 35 percent in 2002 (see chart 5). The deterioration in the manufacturing productivity gap was largely responsible for the widening of the aggregate productivity and income gaps in Canada. Furthermore, Canada's share in North American FDI has steadily declined in the past 20 years.

Given the mobility of capital and skilled people, Canada needs to narrow the productivity and income gaps for attracting and retaining high value added activities to Canada, and generating a virtuous cycle of capital accumulation, brain gain and strong economic growth. Such prudent policies will avoid a vicious circle of slow economic growth, brain drain, capital flight, and widening of productivity and real income gaps.

The imperative of a relatively strong productivity performance is more pressing in view of a 20 percent real appreciation of the Canadian dollar in 2003, a dramatic reversal of the situation in the 1990s. Canadian companies need to invest more in machinery and equipment (M&E), human capital and R&D, improve productivity and cost competitiveness and overcome the challenges of dollar appreciation.

Competition from the emerging economies such as China, Mexico and India has intensified at home and abroad. The rapid expansion of these economies will provide considerable trade and investment opportunities to Canadian companies, and increase the choice of imports at highly competitive prices. At the same time, that expansion will also increase competition in our export markets as well as at home. For instance, Mexico's share in the U.S. market has almost doubled since 1990. Similarly, China almost tripled its market share during this period. India is becoming a major exporter of services to the U.S. and Canada. These countries are rapidly moving up the value chain. It means that to take advantage of the opportunities in these emerging markets and effectively face their competitive challenge, Canada needs to improve its innovation and productivity performance by shifting resources to high value-added activities and by investing in R&D, M&E and human capital, and by reforming regulations.

Another challenge is to secure and improve access to the U.S. market. The tragic events of September 11, 2001 and the continued terrorist threats have increased the risk of not having a secure and open access to the large and dynamic U.S. market. The Canadian and US governments have taken steps to address the issues related to border security so that commerce between the two countries can continue to expand.

In addition, protectionist trends in the U.S. are on the rise, largely because of the large and growing U.S. trade deficit and increasing concerns about offshore outsourcing. The recent depreciation of the U.S. dollar might be of some help in addressing these difficulties. However, unless the U.S. addresses in a major way its huge and growing budget deficit problem, the trade deficit problem and protectionism will persist.

Looking Forward

There has been a great deal of public discussion and debate about future Canada-U.S. economic relations in Canada in the last five years. A number of researchers and policy analysts have put forward various proposals to broaden and deepen NAFTA (see Harris (2001), Dobson (2002), Dymond and Hart (2003)). These include: harmonisation of border measures and procedures with regard to customs, refugees, drugs and immigration; increased co-operation in countering terrorist threats; mutual recognition by Canada and the U.S. of each other's regulatory procedures and practices; freer movement of labour between the two countries; replacement of anti-dumping and countervailing in both countries by competition laws; a monetary union or common currency; and a Customs Union --- common external tariffs and the elimination of the rules-of-origin provisions of the NAFTA.

Ghosh and Rao (2004) simulated the economic impact of a customs union between Canada and the U.S. on Canadian industries, using a multi-country and multi-industry dynamic CGE model. Their results suggest that a customs union could increase Canada-U.S. trade by close to 20 percent and raise real GDP by as much as 1 percent. The high-tech industries will be the big gainers. Mexico and the U.S. will also benefit from the elimination of the rules-of-origin. A recent paper by Koch, Rafiqzaman and Rao (2004) concluded that about one-third of the Canada-U.S. innovation gap could be attributed to the differences in regulatory policies and procedures between the two countries.

In summary, the economic link ages between the three NAFTA member countries increased considerably in the 1990s and thereafter. Deeper North American economic integration has benefited all three countries. Contrary to fears by some opponents of the two trade agreements, increased economic integration did not result in the harmonisation of policies in a wide range of areas. Common external tariffs and the elimination of the rules-of-origin would deepen the economic linkages and benefit all three countries. To benefit fully from the North American economic integration, however, Canada needs to invest more in physical and

human capital and R&D, and maintain highly competitive tax and regulatory frameworks, and narrow the productivity and real income gaps.

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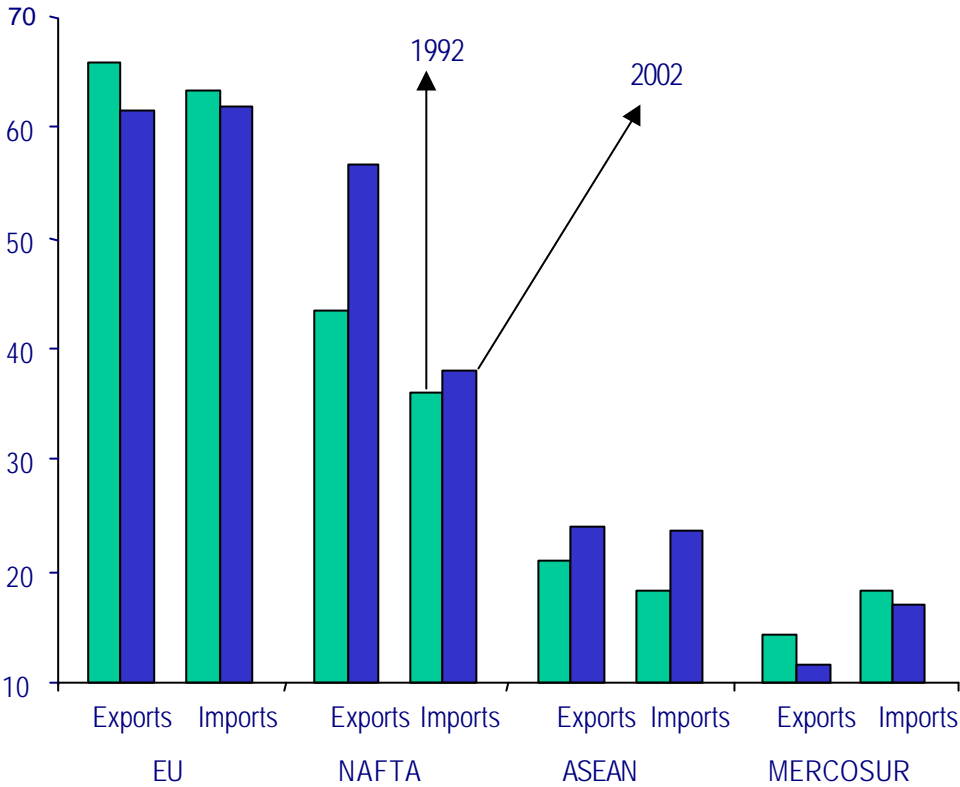
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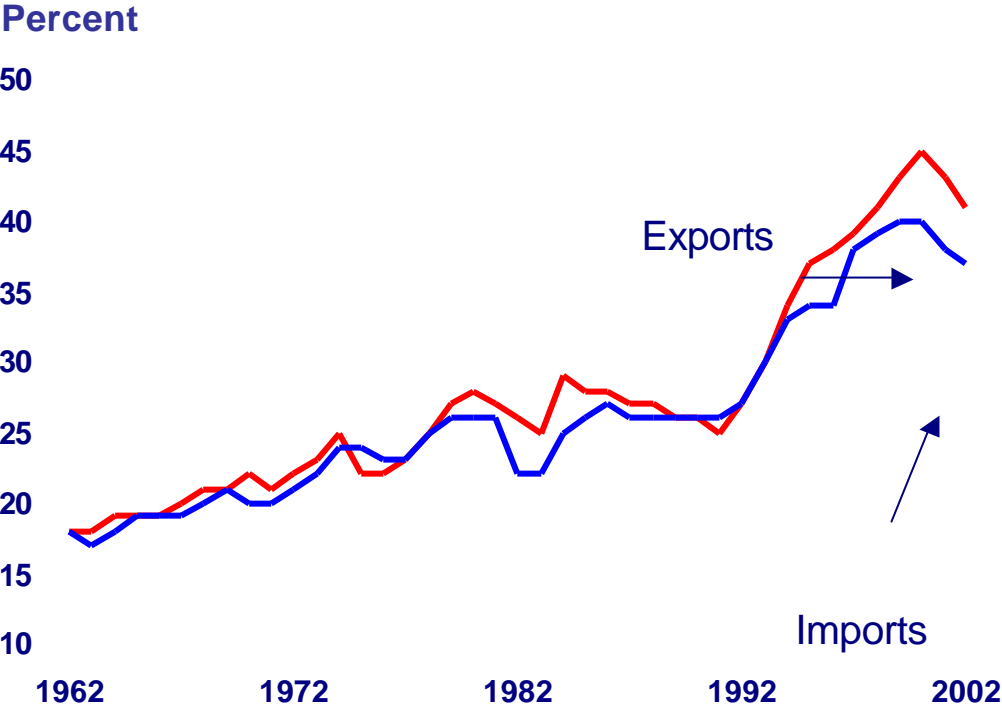
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Chart 1: Share of Intra-Regional Trade in Major Regional Trading Areas (Percent)



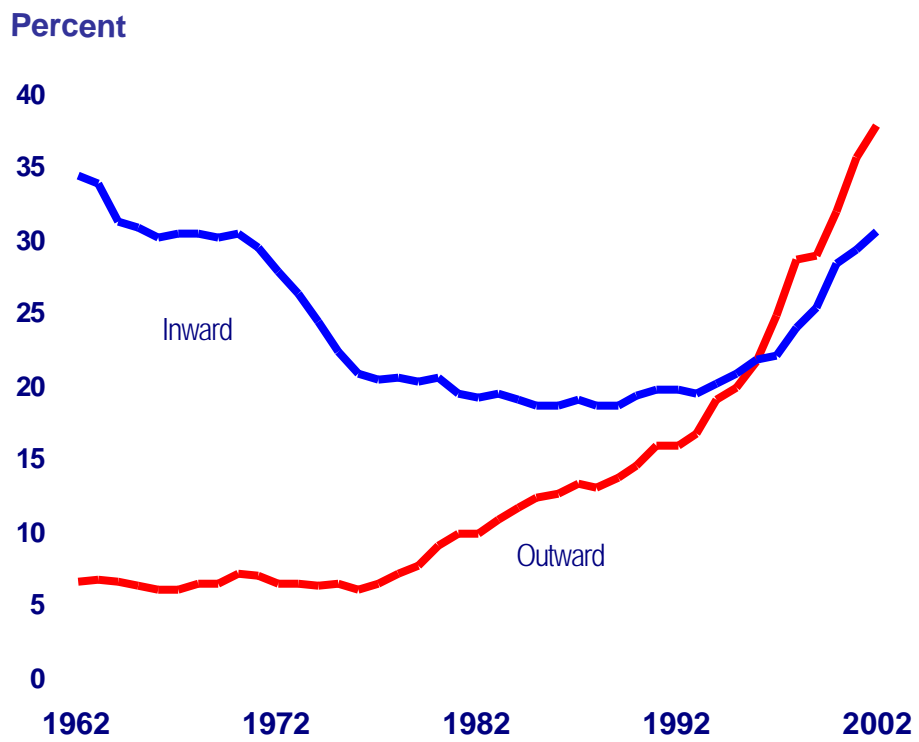
Source: World Trade Organization

Chart 2: Ratio of Exports and Imports to GDP, Canada (Percent)



Source: Industry Canada compilations based on Statistics Canada Data

Chart 3: Ratio of inward and outward Foreign Direct Investment* to GDP, Canada (Percent)



*Stock

Source: Industry Canada compilations based on Statistics Canada Data

Chart 4: Canada-U.S. Trade and Economic Integration Index 1989 = 100

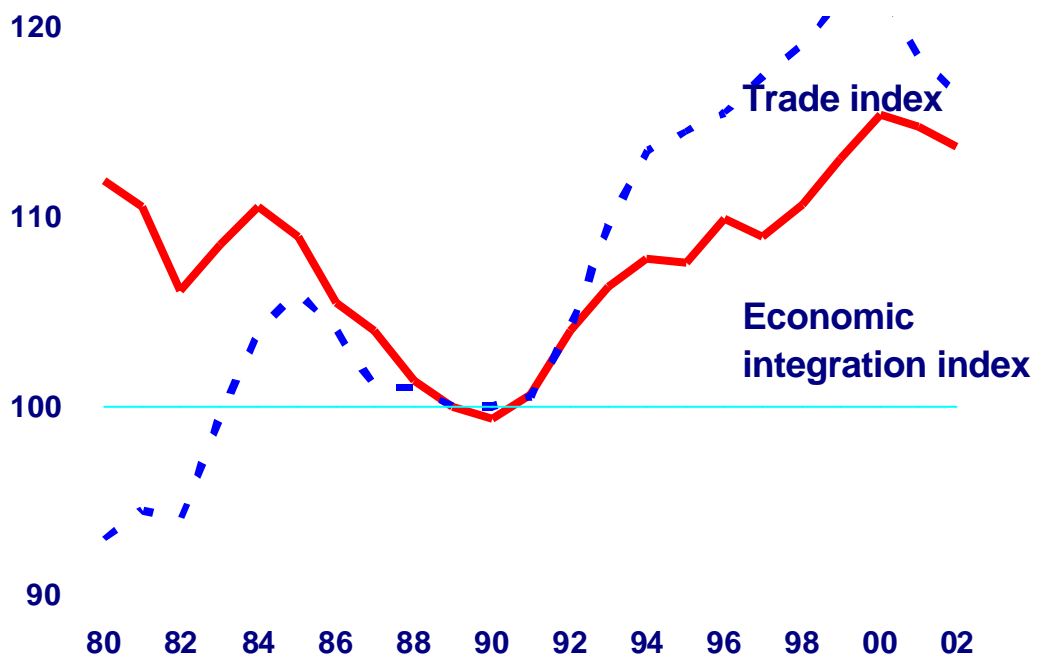
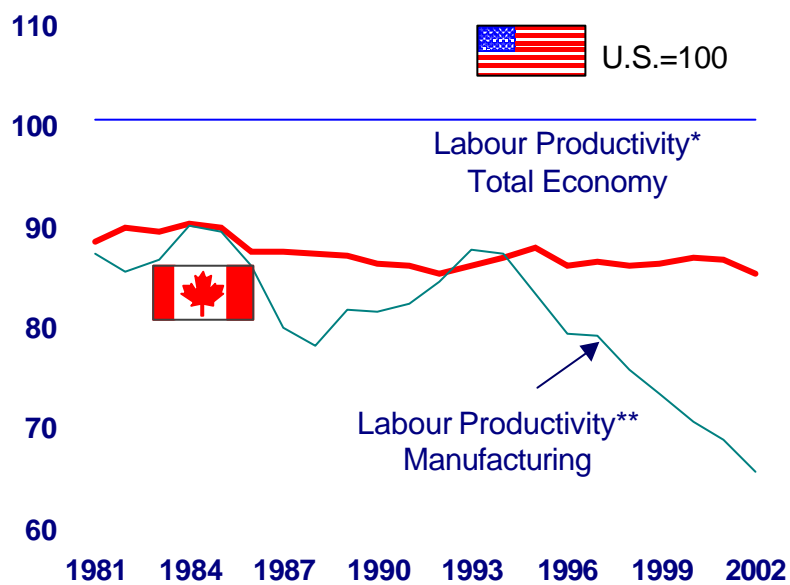


Chart 5: Canada-U.S. Labour Productivity Gaps



*Real GDP per hour worked, PPP based

**Real GDP per hour worked, derived by extending a benchmark estimate (79.4) in 1987 using real GDP per hour worked indexes from U.S. Bureau of Labor Statistics.

Source: Statistics Canada, U.S. Bureau of Labor Statistics and U.S. Bureau of