

CANADA'S ECONOMIC RELATIONSHIP WITH THE UNITED STATES

Earl H. Fry

The Canada-US economic relationship is in a period of upheaval. The United States is mired in its longest and most disruptive recession since the Great Depression. Because of its deep and expansive economic ties to the United States, Canada is now experiencing the full force of the US downturn. In this time of turmoil, President Barack Obama envisions the greatest restructuring of American society since the New Deal. In order to win key allies on Capitol Hill for his ambitious agenda, Obama may be tempted to enact some protectionist measures that would be injurious to Canadian businesses and workers.

Les relations économiques canado-américaines sont actuellement mises à rude épreuve. Les États-Unis sont ébranlés par une récession d'une ampleur et d'une durée sans précédent depuis la Grande Dépression, qui touche maintenant le Canada de plein fouet, vu la profondeur et l'étendue de nos liens avec notre voisin du Sud. Pour affronter la tourmente, le président Obama vise à restructurer la société américaine comme elle ne l'a jamais été depuis le New Deal. Et pour assembler autour de cet ambitieux programme les alliés décisifs dont il a besoin au Capitole, il pourrait être tenté d'édicter des mesures protectionnistes qui nuiraient aux entreprises et aux travailleurs canadiens.



The current recession of 2008-09 will be the longest since the Great Depression and may ultimately be deeper than the recession of 1981-82. During that previous recession, Marie-Josée Drouin and Harald B. Malmgren warned in *Foreign Affairs* that "relations between Canada and the United States have become more strained than at any time in recent memory," and that the "two governments seem to be on a collision course, in a context that political leaders cannot fully control."

Are these warnings applicable to today's bilateral economic relationship? Stephen Harper is the most conservative Canadian prime minister in recent memory, even though his policy aspirations are hampered by his minority government status and a contracting economy. Barack Obama, in contrast, is the most liberal US president since John F. Kennedy and perhaps even Franklin D. Roosevelt. Nevertheless, the personal relationship between the two men appears quite cordial, and even warm, as manifested during Obama's February visit to Ottawa. This stands in stark contrast to the cool personal relationship between Pierre Trudeau and Ronald Reagan in the early 1980s. The Reagan administration also had serious doubts about Trudeau's commitment to liberalized trade and investment

after the introduction of the National Energy Program in 1980 and the strengthening of restrictions in the *Foreign Investment Review Act*.

As we near the end of a very turbulent first decade of the 21st century, Canadians can take some comfort in North American Free Trade Agreement (NAFTA) provisions that will shield them from some potential protectionist actions on the part of Washington. However, dire economic conditions in the United States are going to reverberate in Canada to an extent not seen since the early 1980s, and the bilateral economic relationship will face some precarious moments because of the severity of the US recession and Obama's quest to restructure American society.

Many Canadians would love to turn the clock back to a couple of years ago. Canada was leading the G7 group of nations in economic growth and Ottawa was enjoying a long series of government surpluses. Housing prices were up dramatically, unemployment rates had plummeted to 30-year lows, and labour participation rates in many provinces were at record-high levels. Commodity prices were robust and the Toronto Stock Exchange index was rocketing upward. For most Canadians, life had never been better in

terms of their overall wealth and future economic prospects.

Many of these same conditions were also to be found in the United States. Housing prices finally peaked in mid-2006 but the Dow Jones Industrial Average went on to register an all-time closing high of 14,164 on October 9, 2007. Then, all of a sudden, the sub-prime house of cards collapsed.

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Titans of America's industrial and financial world have also collapsed. General Motors was the world's largest corporation through most of the 20th century but is now on the verge of bankruptcy even after an infusion of billions of dollars of taxpayers' money. Citigroup used to be the world's largest financial institution but has essentially been nationalized and has traded

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Washington is also on a spending spree never witnessed since the end of the Second World War. Ottawa was able to achieve 11 consecutive years of budget surpluses up to 2009, whereas Washington has been able to balance a budget only five times since 1961. The gross federal government debt has almost doubled since 2000 to US\$11

trillion, and the deficit for the current fiscal year will approach a staggering US\$2 trillion.

No one knows how much public funding will eventually be needed to rebuild the financial system and restore confidence in private-sector lending. Almost US\$200 billion has already been pumped into just one corporation, American International Group (AIG), which lost over US\$60 billion during the fourth quarter of 2008, the highest short-term loss of any company in history. While public attention is riveted on Wall Street's woes, another colossal challenge is on the horizon as the first of the 76 million baby boomers begin to retire and collect their Social Security and Medicare benefits. Roughly one-fourth of the US population will retire between 2012 and 2029, and the worker-to-retiree ratio will fall from an already low three-to-one to almost two-to-one.

Some of the economic problems facing the United States are cyclical and the economy will indeed begin to grow again within the next year or so. Unfortunately, some of the challenges are much more structural in nature and will adversely impact economic performance for several years. For example, how will

the massive buildup in government debt be repaid, and what will be the implications for interest rates, inflation rates and the future value of the US dollar? Washington is already dependent on foreign investors, mainly Chinese and Japanese, to buy half of its Treasury debt obligations. With much more government debt to be auctioned off over the next few years, will foreign investors be as willing to purchase these instruments of debt, and will they expect higher rates of return for their investments? More ominously, with Washington printing unprecedented amounts of money in an effort to stimulate economic growth, will international investors begin to turn away from the US dollar as the principal currency for both international trade and the foreign reserves held by central banks?

The "decoupling" theory was in vogue not too long ago, meaning that various parts of the world would continue to expand economically even if the planet's largest economy, the United States, suffered through a recession. This theory has now been thoroughly debunked, in part because of globalization patterns, the major role that the US continues to play in the international economy and the toxic effects of transnational trade in credit derivatives.

Realistically, Canada should have never been included in this decoupling scenario, even though some felt that historically high commodity prices and the signing of new trade accords with non-North-American nations would permit Canada to pull away gradually from the US orbit.

In fact, no major country in the world is as dependent for its economic well-being on another nation as Canada is dependent on the United States. Among the G7 nations, only Germany has a higher export-to-GDP ratio than Canada, and Canada ships almost four-fifths of its exports to only one market, the United States. Furthermore, all of Canada's recent sur-

pluses in its current account (the broadest measure of trade) are attributable to the United States. For example, in 2008 Canada had a C\$11.2 billion surplus in the current account, but a closer reading indicates that its current account surplus with the US was C\$38.3 billion while its transactions with the rest of

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the world were a negative C\$27.1 billion. Since the implementation of the Canada-US Free Trade Agreement in 1989 and NAFTA in 1994, north-south commercial linkages between Canada and the United States have grown dramatically and at a much higher rate than east-west linkages within Canada itself. Consequently, almost all provinces now ship more goods to the United States than they do to the rest of Canada. As Americans cut back on their consumption habits and begin to save more, businesses in Canada are feeling the pinch as their export shipments to the US rapidly decline.

Investors from the United States also account for about 58 percent of the foreign direct investment stock in Canada, and these investments have provided over one million jobs for Canadian workers. As an illustration, America's leading automakers, GM, Ford and Chrysler, have been producing more cars and light trucks in Ontario than in Michigan, in part because of the huge health care savings available in Ontario. With all three US auto companies now suffering deep financial setbacks, Ontario's manufacturing sector has been devastated almost to the same extent as Michigan's.

Americans also account for about 80 percent of all foreign visitors to Canada. Hundreds of thousands of Canadian jobs are linked to tourism and conference-related activities.

During the third quarter of 2008, visitors from the US to Canada registered 5.2 million overnight trips, the lowest third-quarter level since records were first kept by Statistics Canada in 1972. Once again, economic pain in the US has been carried across the border to afflict

Canadian workers in the tourism and hospitality sectors.

Canadians are fully aware that the current global economic crisis was not their fault and that the origins of the crisis were immediately to their south in the United States. The fiscal policies of the Canadian government were per-

haps the most exemplary in the Western world and the Canadian banking system was a paragon of virtue in comparison to its counterparts in the US and Europe. Nonetheless, just as growing interdependence and interconnectedness in an era of globalization can bring substantial benefits to an export-dominated country such as Canada during times of prosperity, just the opposite can occur during times of economic contraction. Consequently, Canada is now in the midst of a major economic downturn mostly attributable to its neighbour to the south.

Barack Obama is attempting to restructure the US economic and social systems to a greater extent than any president since FDR. He is determined to bring wholesale changes to the vast US health care system, which is responsible for one-sixth of the nation's

CANADA-US RELATIONS BY THE NUMBERS	
90	Percent of Americans who consider Canada to be America's best friend
80	Percent of Canadian exports destined for the American market
80	Percent of foreign visitors to Canada accounted for by Americans
1M	Number of Canadian jobs provided by US foreign direct investment
10	Number of Canadian federal budget surpluses in past 10 years
2	Number of American federal surpluses over the same period
11T	Dollars of gross federal debt in US, up nearly 100 percent since 2000
20	Percent of American homeowners who owe more on their mortgage than their house is worth

GDP. Without a doubt, these drastic changes are needed. Americans spend almost twice as much per capita on health care as any other Western nation, but the US is alone among these nations in not providing coverage for all of its citizens. In spite of the nation's total spending of 16 percent of GDP on health care, 45 million Americans have

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Obama also intends to expand federal control over education, lamenting that one million young people are dropping out of school every year and that American students do so poorly in cross-national tests measuring aptitude in reading, science and mathematics. Moreover, he wants to end the new Gilded Age in American society. Although the US economy has grown steadily over the past few decades, most of the benefits have accrued to a small percentage of the population. For example, in 2004 the top one percent of US households controlled 34 percent of all private wealth, more than the bottom 90 percent combined. Annual income is not as skewed, but the top one percent in 2004 still accounted for almost 22 percent of total income and the top 10 percent for about half of all income. With the Bush administration "suspending" the inheritance tax, wealth has become even more concentrated in the hands of relatively few individuals and families. Obama has pledged to restore the inheritance tax and impose heavier taxes on those households making over US\$250,000 per year.

With these and other ambitious goals, Obama will be taking on the most powerful and best organized

special interests in the United States. He must also convince Congress to pass his initiatives. Even though Democrats control both chambers on Capitol Hill, many members will align with the special interests that provide the lion's share of campaign contributions. An added stumbling block is the necessity of piecing together 60 votes in the Senate in

order to cut off the dreaded filibusters used to block proposed legislation. If the current economic crisis carries over into 2010, all Democrats in the House of Representatives and the 17 Democrats up for re-election in the Senate will be running scared. Ronald Reagan was able to achieve a smashing victory in his 1984 re-election campaign, but many forget that the Republicans lost 27 seats to the Democrats in the House and stayed even in the Senate in the 1982 midterm election dominated by recession-related issues.

In order to consolidate support for his key restructuring issues, Obama might heed some of the protectionist demands of his most ardent supporters, particularly organized labour, environmental groups and the most liberal wing of his congressional party. This has already been manifested in the "Buy America provisions added to the recent stimulus legislation. Canada may be able to dodge this particular bullet because of NAFTA commitments, but how about new US legislation or regulations that might impact trade in steel, lumber and various natural resources, or country-of-origin-labelling rules affecting beef and processed meats, or new restrictions on the import of "dirty" energy from the oil sands in Alberta? Hopefully, such concessions to the protectionists will be minor

and Canada might also avoid being sideswiped by new restrictions aimed primarily at China. Nonetheless, this is a period of extraordinary stress for policy-makers in Washington, and leaders in Ottawa must remain vigilant about the threat of creeping protectionism in the United States.

In their 1982 *Foreign Affairs* article, Drouin and Malmgren warned of strained Canada-US relations, but by December 1983 officials from Ottawa and Washington were meeting together to discuss freer trade arrangements, an event that years later would culminate in the bilateral Free Trade Agreement and eventually NAFTA.

The United States is now floundering in a very deep economic and financial abyss that was created almost entirely from its own missteps and ineptitude. However, the US has been in even deeper craters linked to the destructive Civil War, the "Long Depression" period of 1873-97, the Great Depression and the Second World War. In every case, the United States has been able to recover and then experience long periods of prosperity.

Canada has garnered many benefits from being situated right next to the world's largest national economy. Americans also rank Canada as their nation's best friend, with a recent favourable rating of 90 percent compared with Mexico's falling favourable rating of 51 percent, according to a recent Gallup Poll. The bilateral economic relationship during the early Obama years will be turbulent, but eventually commercial ties will begin to grow again. In a gesture of good will and pragmatism, Obama may even be tempted to dismantle some of the onerous "thick border" provisions of the Bush administration, which have hampered the cross-border movement of goods and people.

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