

CANADA-US ECONOMIC RELATIONS: A WINDOW OF OPPORTUNITY



Canada and the United States have forged the largest bilateral trading relationship in the world, with some C\$2 billion worth of goods and services crossing the border each and every day. This trade linkage, however, is only one small manifestation of the degree of interdependence which currently exists between the two countries. Fry, a longtime Canada-watcher and former US trade official, examines the various dimensions of Canada-US economic interdependence, discusses the special challenges facing the relationship in a period of unprecedented globalization and technology change, and ponders some of the policy choices which will be available to Canada over the next decade.

Earl Fry

Le Canada et les États-Unis entretiennent la plus importante relation commerciale bilatérale du monde : chaque jour, des biens et services totalisant 2 milliards de dollars canadiens traversent la frontière. Aussi impressionnants qu'ils soient, ces échanges n'offrent pourtant qu'un mince aperçu du niveau d'interdépendance de nos deux pays. Ancien représentant commercial américain et grand connaisseur du Canada, Earl Fry examine ici les nombreuses facettes de cette interdépendance économique, les enjeux qui en découlent à l'heure d'une mondialisation galopante et de changements technologiques sans précédent, ainsi que les choix politiques sur lesquelles le Canada pourra miser dans les dix prochaines années.

In the extensive 2002 Chicago Council on Foreign Relations survey of US attitudes toward foreign policy, Americans consider Canada to be their best friend in the world, ranking just ahead of Great Britain and then with a big gap down to third-ranked Italy. However, the average American's knowledge about Canada and Canadians is abysmal. Many consider that China or Japan is the leading trading partner of the United States. In reality, the United States exports almost 3 times more to Canada than to Japan and 12 times more to Canada than to China. The US also exported more in 2001 to Canada than to the 15 European Union countries with a combined population of 375 million people. In 2001, over 22 percent of America's total exports went to Canada and about 19 percent of its total imports came from north of the border. Canada has also moved up to be the leading foreign provider of critical petroleum products to the United States, with US\$14.5 billion in shipments in 2001 alone.

Canadian direct investment in US-based companies has also increased dramatically, topping \$US109 billion in 2001. These Canadian-controlled companies in the United

States now provide over 640,000 jobs for US workers. Moreover, Canadians constitute almost 30 percent of all foreign visitors to the United States, with slightly fewer than 15 million visits made in 2000. Trade, direct investment, and tourism linkages between the US and Canada roughly account for over 3 million US jobs.

Canada's dependency on linkages to the United States is even more pronounced. Exports were responsible for over 43 percent of Canada's gross domestic product in 2001, appreciably higher than for any other major Western nation. About 87 percent of merchandise exports are destined for only one market, the United States. US foreign direct investment in Canada also exceeds US\$139 billion, with US-owned companies on Canadian soil providing more than 1 million jobs and responsible for 10 percent of Canada's GDP. Americans also make about 90 percent of total foreign visits to Canada every year. Trade, direct investment and tourism ties to the United States account for about 4 million of the 15.4 million jobs in Canada and perhaps 40 percent of the nation's GDP. In an era of globalization, Canada ranks as the most "globalized" nation among the major Western countries and is thus the most vulnera-

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ble to what transpires outside its borders, especially in terms of what transpires in the United States.

There are a variety of dimensions to globalization, which may be defined in basic terms as a growing interdependence and interconnectedness among nations and people in general.

Economic globalization is manifested in the record levels of the cross-border movement of goods, services, capital, technology and people. Annual world trade in goods is about US\$6 trillion, with trade in services adding another US\$1.5 trillion. The volume of world trade increased from an index of 2 in 1950 to 175 in 2001 (computed in current dollars) and, in recent years, cross-border trade has been growing at a rate almost three times faster than the aggregate growth in national economies. The year 2001 was an exception to this rule, with the volume of trade actually declining modestly for the first time since 1982.

Foreign direct investment (FDI) is defined as an investor or company in one country either installing a new facility or buying control of a company in another country. Most FDI is in the form of mergers and acquisitions (M&A) rather than "greenfield" investments such as building a new car assembly plant abroad. Transborder M&A activity surpassed a record US\$1 trillion in 2000, and both short-term and long-term investment flows more than doubled between 1995 and 2000. This M&A activity fell back to US\$ 594 billion in 2001, but was still very robust by historical standards.

The lion's share of FDI is made by transnational corporations (TNCs). Roughly 65,000 TNCs worldwide currently operate 850,000 foreign affiliates around the globe. These affiliates employ 54 million workers worldwide and account for US\$19 trillion in annual sales, far more than total global trade in goods and services. Without any doubt, one of the distinguishing features of globalization in the 21st century, especially in comparison to the earlier period of "internationalization" between 1870 and 1914, is the key role played by TNCs. Not only do these TNCs make most direct investments, but they also account for one-tenth of the world's GDP and one-third of world exports. Furthermore, one of the heaviest concentrations of intrafirm trade (defined as trade between units of the same TNC) occurs in North America, with 67 percent of Canada-US

merchandise trade and 63 percent of Mexico-US trade intrafirm.

The international movement of people for business, tourism, and immigration purposes has never been higher, with almost three million people crossing national borders daily, triple the level of 1980.

Revolutionary advances in communications and transportation are increasingly negating the importance of distance, space and national boundaries. One of the chief accomplishments of the Information Technology (IT) revolution is the creation of cyberspace which allows a person anywhere in the world to communicate with a potential audience of hundreds of millions of people in other parts of the world within less than one second. It also means that the nearest competitor to a business, which local governments depend on to create jobs and pay taxes, is less than a second away, at least via cyberspace. The dominance of market systems around the globe, when combined with extensive deregulation and privatization, has also diminished the capacity of governments to protect and enhance the interests of their constituents. As an illustration, with the growth in the internationalization of production, roughly divided into eight-hour segments beginning in Asia and the Pacific, then moving on to Europe and Africa, and winding up in the Americas, TNCs have the ability to shift jobs to low-wage countries or other nations which provide special advantages. However, workers who previously held these jobs are rarely themselves transferred, meaning they may wind up looking for new employment. For example, more than 100 US firms now outsource their software code cutting to sites in India, where the work is completed and then returned overnight through electronic networks.

In his treatise on globalization, Richard Longworth calls it "a revolution that enables any entrepreneur to raise money anywhere in the world and, with that money, to use technology, communications, management, and labor located anywhere the entrepreneur finds them to make things anywhere he or she wants and sell them anywhere there are customers." The IT revolution is accelerating this globalization thrust.

The combination of globalization and the IT revolution is also accelerating the battle between "place and space" and intensifying the impact of what Joseph Shumpeter called "cre-

Provincial Dependency of the US Market, 2001
Exportations provinciales vers les États-Unis, 2001

| Province | Exports of Goods & Services as % GDP | % of Merchandise Exports to the US |
|---------------|--------------------------------------|------------------------------------|
| Newfoundland | 37.1 | 65.6 |
| PEI | 31.8 | 88.8 |
| Nova Scotia | 29.0 | 82.6 |
| New Brunswick | 45.7 | 89.0 |
| Quebec | 39.6 | 84.7 |
| Ontario | 51.5 | 93.2 |
| Manitoba | 30.7 | 79.8 |
| Saskatchewan | 44.2 | 58.4 |
| Alberta | 41.3 | 88.7 |
| BC | 31.3 | 70.3 |

active destruction.” Creative destruction is dramatically affecting businesses, workers, localities and households. In the United States, about 600,000 businesses are created every year, but another 550,000 to 600,000 fail during the same period.

Many residents of Canada and the United States are apprehensive about globalization, perceiving it as facilitating the loss of local jobs to low-wage developing countries. They also have second thoughts about the IT revolution, where the information base may be doubling every half dozen years and workers may have to be retrained several times during their careers (echoing the words of Jeremy Rifkin that a major challenge in the 21st century will be the ability to learn, unlearn and then relearn).

Many household residents are concerned that either they, their children or grandchildren will not be able to keep pace with the rapid changes occurring in the Information Age and may eventually be counted among the digital have-nots instead of the digital haves. When one takes into account these general apprehensions, and adds in the specific concerns that many Canadians have about becoming too closely integrated with the huge nation to the south, the issue of future bilateral relations between the two North American neighbours becomes much more convoluted and has repercussions for national governments, provinces, cities, neighbourhoods and households alike.

The aggregate benefits to Canada in being a part of NAFTA clearly outweigh the costs, but aggregate gains distort some of the pain being suffered by various communities, groups and households across the vast Canadian landscape. Targeted policies implemented by all levels of

government within Canada’s federal system will be needed to mitigate some of these localized losses.

Although not everything can be attributed to Canada’s close economic ties with the United States through the Canada-US Free Trade Agreement (FTA), which went into effect in 1989, and the North American Free Trade Agreement (NAFTA), which superceded the FTA in 1994 and will be fully implemented by the end of 2008, measurable benefits have certainly accrued to Canada because of its FTA and NAFTA affiliations.

A good yardstick for comparing Canada’s economic performance over the past several years would be the performance of the 20 other major Western nations. This list includes the United States, the members of the European Union (with the exception of tiny Luxembourg), Norway, Switzerland, Japan, Australia and New Zealand. In most economic categories, Canada has outperformed almost all of these countries over the past decade. What follows constitutes a laundry list of some of the potential benefits of close economic ties with the United States.

- (1) Canada has been ranked no worse than third, and often number one, in the annual UN Human Development Report for each and every year since the early 1990s.
- (2) Canada ranked in the top tier of major Western nations in annual GDP growth in the period 1993-2001, and has been far ahead of Japan and the EU. It has been able to accomplish this while leading the Western world, proportionally, in welcoming new immigrants from around the planet. Indeed, Canada stands above almost all other Western nations with a population base which is over 17 percent foreign-born.
- (3) Canada was ranked by the World Bank as having the world’s eighth largest economy in 2001. It has been able to achieve this success with a much smaller population base than any other member of the Top 10.
- (4) Canada has been able to create 1.8 million net new jobs since the beginning of 1998, of which 1.7 million are full-time. During the first 10 months of 2002, Canada created 450,000 jobs while the United States actually lost 50,000 jobs.
- (5) The Canadian job participation rate in September 2002 was at the highest level in 12 years.
- (6) At the end of 2002, Canada completed its 11th consecutive year of economic growth, the longest stretch in over three decades.

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(7) Canada is the only G7 nation and among the very few major Western nations with an annual government budget surplus. Its annual interest payments on the national debt have decreased from 36 cents of every revenue dollar to 22 cents, the lowest since 1981.

(8) Canada has enjoyed huge merchandise trading surpluses with the United States of C\$92 billion in 2000 and C\$96 billion in 2001.

(9) Canada's inflation rates have been among the lowest in the Western world over the past decade and real interest rates are at levels not seen for decades.

On the other hand, what are the actual or potential economic costs of being too closely integrated with the United States, other than the localized losses discussed earlier?

(1) Canada continues to run a significant current account deficit with the rest of the world, in part because of such easy access to the large market south of its border. Its export mix to nations other than the United States is also far more dependent on the shipment of raw materials and low valued-added products.

(2) Canada still badly trails the United States in overall productivity, in part because of its reliance on a relatively low-valued Canadian dollar, its small allocation of R&D to the production process, and perhaps economy-of-scale disadvantages and a relative lack of skilled labour in the manufacturing sector.

(3) Even though it ranks as the world's eighth largest economy, its population is only one-ninth the size of the United States' and its economy one-fourteenth the size.

(4) As the events of September 11, 2001 poignantly illustrated, Canada must have virtually open access to the US marketplace in order to maintain its economic prosperity. By value, most trade with the United States is carried by truck, with 5 out of about 150 established border crossings accounting for roughly 70 percent of total shipments, and 11 for about 90 percent. These crossings represent potential choke points which could dry up trade activity in times of emergency, wreak havoc with just-in-time manufacturers, and cause investors to rethink whether they should place parts-manufacturing facilities in Canada instead of the United States.

Both globalization and the IT revolution will continue to intensify, although in a fits-and-

Exports of Goods and Services as % of GDP
Exportation de biens et services en % du PIB

| Country | 1989 | 2001 |
|------------|------|------|
| Canada | 25.6 | 43.1 |
| France | 24.0 | 28.5 |
| Germany | 29.6 | 35.4 |
| Italy | 19.8 | 27.7 |
| Japan | 10.7 | 10.8 |
| UK | 23.7 | 27.1 |
| USA | 9.3 | 9.9 |
| G7 average | 15.2 | 15.0 |

starts pattern rather than a straight-line progression (as illustrated by September 11 and periodic economic downturns in regions and the global economy in general). One-fifth of annual world output is currently open to global competition in products, services and ownership, and this could increase to about four-fifths within three decades, meaning that much of the planet is only in the beginning stages of globalization. A failure to globalize further would probably be much worse than a pattern of gradual globalization, reminiscent of the loss of decades of commercial trade growth built up between 1870 and 1914 as a result of World War I and the subsequent Great Depression.

A draft report leaked from the House of Commons Committee on Foreign Affairs suggests that Canada should strongly consider entering into a customs union with the United States and Mexico. Prime Minister Jean Chrétien, Deputy Prime Minister and Finance Minister John Manley, and the Governor of the Bank of Canada, David Dodge, have also suggested recently that Canada should explore the expansion of NAFTA ties with its two trading partners. Recent opinion surveys indicate that a majority of Canadians are willing to explore further economic integration with the United States, as long as Canada's political sovereignty and distinctive values are not jeopardized.

Canada will have to take the lead in initiating any further economic integration in North America, although some efforts may be done in tandem with Mexico. In spite of post-September 11 fears, Washington would probably be amenable to broadening the classification of Canadian workers who can cross the border and work for extended periods in the United States, with the stipulation that Ottawa provides reciprocity to the same category of US workers. Both countries are forecasting a severe shortage of skilled workers within the next decade, and this

concern might hasten cross-border exchanges. Washington may also be willing to extend the same invitation to Mexico, as long as the classifications are clearly delineated. This might also include a significant number of agricultural workers for specified periods of the year. Whatever is worked out will most likely fall short of a customs-union arrangement for the free movement of people within the NAFTA countries.

In addition, Congress would probably balk at putting in place another feature of a customs union, namely common external tariffs. Capitol Hill jealously guards its authority to impose tariff and nontariff barriers. In a system where "all politics is local," members of Congress want to retain the flexibility of protecting local companies, even though these companies are usually not globally competitive, and other nations stung by US protectionism tend to retaliate against US enterprises which do produce globally competitive goods and services.

Discussions on the creation of a pegged currency or a common currency would also be very premature. NAFTA is a long way from being transformed into the EU, and it took decades for the EU to introduce the euro. Even now, three EU member-states refuse to use the currency. If there is ever a common currency in North America, it will not be the "amero" as suggested by Robert Pastor, but rather it will be the US dollar, with most monetary decisions rendered by the US Federal Reserve. In the distant future, Canada might be tempted to adopt the US dollar if more and more nations around the world either use the dollar (including Mexico), euro or some form of Asian currency agreed to by Japan and China, thus crowding out the currencies of most other countries. The adoption of the US currency would also become easier if a growing percentage of bank deposits in Canada and intra Canada business transactions were made in US dollars. A pegged-currency system or a de facto floating range have also had their share of problems in other parts of the world and do not seem to represent a viable option for Ottawa. For the moment, Ottawa does not want to surrender its made-in-Canada monetary policy and the flexibility it provides to use interest rates and money supply as tools for combating market perturbations. As for the United States, there is no interest whatsoever in adopting a North American currency, and even if Ottawa announced it would like to adopt the US dollar as its official currency, Washington would offer little in the form of rep-

resentation in the Federal Reserve System. Perhaps Canada could become the eighth member of the Fed's Board of Governors, the 13th Federal Reserve District, or the 13th member of the Federal Open Market Committee (FOMC). In any of these scenarios, the Canadian representative would possess a tiny fraction of the influence accorded to US colleagues.

Nonetheless, Canada does possess a few trump cards in any future negotiations with the United States, with the most important being its abundant energy base. The Bush administration would like to create some form of North American energy accord and may be willing to wheel and deal with Ottawa in other sectors as well.

The second trump card is President Bush's own flexibility in making a deal in the near future, if his personal preoccupation with Iraq and homeland security could be diverted for a moment. Bush is the most popular mid-term president in recent memory, he singlehandedly helped to secure a Republican majority in the Senate and a larger majority in the House of Representatives last November 5, and he has been vested with the trade-promotion (fast-track) authority which was denied to Bill Clinton during most of his presidency.

Furthermore, the US had gone for a long period of time without negotiating bilateral trade accords, but is currently engaged in a flurry of new negotiations. The first ever free trade accord was with Israel in the early 1980s, and it was done more for political than economic reasons. The most important bilateral economic treaty in US history was ratified with Canada in 1988, to be followed by Mexico's inclusion beginning in 1994. Various efforts were also made to bring Chile into the NAFTA fold, but Clinton's failure to secure fast-track authority doomed that effort. Now, however, the White House has moved rapidly to begin free trade discussions, energized by the renewal of the trade-promotion authority. A free trade agreement is already in place with Jordan, and US Trade Representative Robert Zoellick was working to complete bilateral free trade accords with Chile and Singapore at the end of 2002. He has also formally announced to Congress his intentions to negotiate agreements with five Central American countries, with Morocco, and with sub-Saharan nations. Zoellick has also expressed an interest in pursuing similar discussions with Australia.

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Canada's third trump card is that its negotiating team has always been much better prepared than the US team in discussions regarding bilateral free trade. This trend will certainly continue if Canada requests new negotiations with the United States and Washington responds affirmatively to the request. The big question then becomes what agenda Ottawa will put forward for new discussions, and will Mexico be an active player as a partner in NAFTA. In a new set of negotiations, Ottawa would be looking foremost at securing assured access to the US market, even in the face of new terrorist incidents. Other issues on the agenda might include mitigating US antidumping, antisubsidy, and escape-clause provisions, experimenting with harmonized competition rules in steel and other selected industries, and reaching a new dispute-settlement framework in softwood lumber, wheat and other sensitive agricultural and natural-resource sectors. The liberalized flow of workers across national borders could also be a part of these initial discussions.

A window of opportunity may now be open for "beyond NAFTA" discussions with the United States dealing with the freer movement of goods, services, capital, technology, and workers, and the harmonization of certain competition policies. Canada will have to be the initiator of any discussions and be prepared to enter into negotiations in the near future, a scenario cloud-

ed somewhat by the imminent change in the Liberal Party's leadership and the lame-duck status of Prime Minister Chrétien. Any announcement of new negotiations will certainly foment heated debate across Canada about the wisdom of even closer ties with the United States, a concern reinforced by the public's ambivalent attitudes toward globalization in general and the repercussions of the ongoing IT revolution.

Nevertheless, a complacent attitude about maintaining the status quo may be just as dangerous as pursuing a far too ambitious economic integration strategy with Canada's neighbour to the south. Canada's federal, provincial and municipal governments must deal with all aspects of creative destruction in rapidly changing global, regional, national, and local settings, and governance will become much more complicated in the years ahead. Canada's economic relationship with the United States will certainly be one of the greatest challenges to governance in the foreseeable future.

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The Art of the State Canadians have witnessed the end of certainty. Indeed, it has now become trite to write that the pace of change in society has accelerated dramatically in recent years. It is apparent, even to the most casual observer, that traditional public policy solutions no longer work. In Canada, the national economy is withering away at the edges as regional economies begin the process of disengaging from each other and forging new relations with their neighbours to the south.

Not surprisingly, therefore, the Canadian federation is undergoing important changes, albeit by stealth rather than by constitutional reform. Canadians are far more pragmatic today than they were 40 years ago, but public opinion surveys suggest that they have less confidence in government as a problem-solving mechanism for society. Protecting jurisdiction and turf only makes sense to the current generation of politicians who came of age when federal-provincial conflicts over constitutional reform and when Ottawa's spending power dominated the national media. The next generation of politicians will have come of age in the new economy, seeing endless potential for both government and the private sector in the cybernetic revolution. They will likely have very little interest in old federal-provincial conflicts preferring to focus on how to make things work, and how to strike new collaborative mechanisms between regions.

Indeed, the issues today are even different from those associated with the not-so-distant Charlottetown Accord, the last major rethink of our institutions. They include the rise of multi-level governance because the dominant issues now require it; the search for new public policy instruments because existing ones are being discarded (e.g., tariffs); dealing with the mobility of capital and the impact of international markets on fiscal and monetary policies because trade barriers continue to fall, and so on. Quite apart from the above, we now need to explore how to make representative democracy work better and how to gain a better understanding of the growing trend toward decentralization and its implications.

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