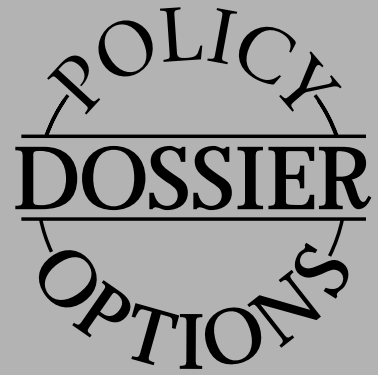


# CANADA AND FREE TRADE — 15 YEARS ON

Daniel Schwanen



Fifteen years ago, in January 1989, the Canada-US Free Trade Agreement was implemented. Ten years ago, in January 1994, free trade was expanded to bring Mexico into the North American Free Trade Agreement. On the 15th anniversary of the FTA, and the 10th anniversary of NAFTA, IRPP Senior Economist Daniel Schwanen checks in with an update and analysis on trade flows in goods and services, productivity and the degree of economic integration resulting from free trade. Canada's exports to its NAFTA partners, as a percentage of output, have risen from 20 percent to 30 percent in the last decade. Exports to the US and Mexico as a percentage of global exports have risen from 73 percent to 84 percent since 1988, the year before the FTA came into effect. Moreover, writes Schwanen, "the structure of Canada's goods exports under the FTA has shifted markedly away from the traditional resource base and toward non-resource exports, now accounting for some 55 percent of all exports." Still, he warns there are "serious clouds on the horizon."

En janvier 1989 entré en vigueur l'Accord de libre-échange Canada-États-Unis. Cinq ans plus tard, en janvier 1994, la libéralisation des échanges commerciaux s'étendait au Mexique dans le cadre de l'Accord de libre-échange nord-américain. À l'occasion du 15<sup>e</sup> anniversaire de l'ALE et du 10<sup>e</sup> anniversaire de l'ALENA, Daniel Schwanen, économiste principal à l'IRPP, fait le point sur les flux commerciaux, la productivité et le niveau d'intégration économique résultant du libre-échange. Son analyse démontre qu'en vertu de l'ALENA, le taux de rendement des exportations canadiennes est passé de 20 à 30 p. 100 au cours des 10 dernières années. Et par rapport aux exportations mondiales, nos exportations vers le Mexique et les États-Unis ont augmenté de 73 à 88 p. 100 depuis 1988, année précédant l'entrée en vigueur de l'ALE. Qui plus est, soutient l'auteur, la structure de nos exportations a sensiblement évolué d'une base de ressources traditionnellement issues du secteur primaire vers les produits et services, lesquels comptent désormais pour environ 55 p. 100 de toutes nos exportations. Pour autant, l'avenir n'est pas totalement souriant; de sombres nuages se profilent à l'horizon prévient-il.

**J**anuary 1, 2004, marked the 15th anniversary of the implementation of the Canada-US Free Trade Agreement (FTA), which largely formed the basis of the North American Free Trade Agreement (NAFTA), including Mexico as a partner, that came into effect exactly five years later at the beginning of 1994.

Both agreements were seen as epochal and were the subject of intense scrutiny and debates in Canada (at least with respect to the FTA) and the United States and Mexico (at least with respect to NAFTA). In retrospect, they also must be put in context of the broader trend toward the increased liberalization of global merchandise trade, investment, and flows of services and peoples after the Second

World War, as well as technological changes affecting transportation and communications. These trends toward more deeply interconnected world economies called for new rules, beyond simply those affecting trade in goods at the border that had been the mainstay of the rounds of negotiations on the multilateral General Agreement on Tariffs and Trade until the 1970s. In some ways the FTA and NAFTA served as role models for the subsequent agreement on the Uruguay Round of multilateral trade negotiations.

Given that various proposals have recently surfaced to facilitate even further the exchanges between the US and Canadian economies, it may be useful to look back on what we know about how the FTA and NAFTA did or did not work

and about economic integration in North America more generally, and to ask what questions remain or what lessons can be drawn as we look to the future. To that end, this article reviews some of the recent analysis and data relevant to the evaluation of how the FTA and NAFTA have affected Canada, and attempts to draw some conclusions relevant to the future of Canada's economic position in North America.

**E**conomic integration is typically analyzed by looking at four broad types of cross-border flows: trade in goods, trade in services, investments and people. These distinctions are useful in terms of examining the breadth of North American integration across a range of activities. I summarize the evolution of these four variables between Canada and the other two NAFTA countries in table 1. The table

compares data for the years 1988 (the year before the FTA came into effect), 1993 (the year before NAFTA came into effect), and 2002. For investment, I show the accumulated stock of foreign direct investment (FDI, as distinct from portfolio investments) in Canada by NAFTA nationals, and by Canadians in other NAFTA countries. A sub-category of services transactions called "commercial" services, which excludes travel, transportation (which often reflects trends in goods trade) and government-provided services, is also shown. Commercial services include, for example, cross-border flows of royalties and licence fees, financial services, management services, and architectural, engineering and other professional services.

These data are, in a first block of rows in the table, expressed as a share of Canada's GDP, except the data on temporary worker movement (only shown for 1993 and 2002), expressed as a share of Canada's total employment. The picture that emerges from these lines is unambiguous: all the key trade and investment cross-border flows with NAFTA countries, as well as the temporary presence of Canadians working in other NAFTA countries, have assumed a much bigger importance relative to Canada's economy since 1988.

These flows overwhelmingly represent transactions with the United States. Canada's merchandise imports from Mexico, Canadian direct investment to Mexico, and two-way flow of temporary workers between Canada and Mexico have grown markedly faster than the corresponding transactions between Canada and the United States since 1988, but they did so from a very small base, and hence they have slightly reduced but not challenged the dominance of US flows for Canada as far as intra-NAFTA relations are concerned.

These intra-NAFTA data can also be expressed relative to similar transactions between Canada and all countries, and I have done this for trade and FDI flows in a second set of rows in the table. Of note here is how much

TABLE 1: SOME BASIC STATISTICS

Yearly average	1988	1993	2002
As % GDP			
Goods exports to NAFTA	17.3	20.6	30.6
Goods imports from NAFTA	15.3	18.4	23.5
Services exports to NAFTA	1.9	2.3	3.1
(excl. travel, transport., govt.)	0.9	1.2	1.7
Services imports from NAFTA	2.6	3.6	3.7
(excl. travel, transport., govt.)	1.3	1.7	2.1
Direct investment stock to NAFTA	8.4	9.4	18.0
Direct investment stock from NAFTA	12.4	12.5	19.7
As % of transactions with all countries			
Goods exports to NAFTA	73.7	78.8	84.3
Goods imports from NAFTA	70.7	75.6	75.1
Services exports to NAFTA	60.8	58.1	61.0
(excl. travel, transport., govt.)	69.3	64.0	64.8
Services imports from NAFTA	62.7	63.2	62.6
(excl. travel, transport., govt.)	75.2	71.8	73.1
Direct investment stock to NAFTA	64.2	55.7	47.5
Direct investment stock from NAFTA	66.6	64.1	64.2
As % employment			
Temp. migrants to NAFTA		0.4	1.1
Temp. migrants from NAFTA		0.2	0.2
% US imports from Canada	18.5	19.2	18.0
(excl. imports from China, Mex.)	19.9	21.8	23.2
Labour statistics			
Unemployment rate	7.8	11.4	7.5
Employed: manufacturing as % total	16.6	13.9	15.1
Mfg. weekly earnings (all Ind. = 100)	116.0	118.1	121.9
<b>Average for period</b>	<b>1984-88</b>	<b>1989-93</b>	<b>1994-2002</b>
Unemployment rate	9.6	9.7	8.4
Bus. fixed capital spending as % GDP	12.0	11.2	12.0
Labour income as % nat'l income	53.0	54.5	51.7
Corp. profits as % nat'l income	10.1	6.1	10.6
% return on Canadian FDI in US	6.2	2.93	3.4
% return on US FDI in Canada	9.6	5.7	8.7

Notes: Most data are from Statistics Canada CANSIM data base, and author's calculations. Data on temporary migrants are from Papademetriou (2003); his data on entry into the US reflect admissions, and the same individual may thus be counted several times. In calculating NAFTA trade in commercial services for 1988 and 2002, the author used Mexican data from 1989 and 2001, the only ones publicly available currently. Both these figures are from Canada Department of Foreign Affairs and International Trade (2003).

more subdued, when not in fact submerged, the just-noted increased importance of intra-NAFTA transactions becomes, when compared to the increasing flows that Canada has also experienced with the rest of the world. Note however, that 2001 and 2002 were years of exceedingly slow growth for the United States economy, and also ushered in noticeable increases in the costs of transacting business across the US border due to the fallout from the September 11, 2001 terrorist attacks. (Total Canadian goods and services trade as a share of GDP are shown in figure 1.)

In other words, while our interdependence with NAFTA increased across all key indicators, Canada's relationships with the rest of the world in

some cases grew even faster, notably with respect to flows of Canadian direct investment abroad. Furthermore, even though Canada's goods trade with its NAFTA partners rose much faster than that with the rest of the world, Canada has not actu-

Even though Canada's goods trade with its NAFTA partners rose much faster than that with the rest of the world, Canada has not actually increased its share of the total US import market during the period.

ally increased its share of the total US import market during the period.

It could be tempting to conclude on that basis that North American free trade has had little overall impact, and that most of the explosion in trade is due entirely to the booming American economy for much of the period and attendant rise in US imports (figure 2). But this would not likely be the correct conclusion. We cannot expect North American integration to proceed in isolation from other rapidly evolving global trends and events, and the broad numbers may hide significant shifts on the ground. For example, while Canada has not gained share in total United States imports, it has in fact done quite well, relative to many traditional competitors, since the FTA. If one excludes the emergence of Mexico on the US market since NAFTA (and the 1994 peso devaluation), and the huge progress that a rapidly modernizing China is making in the world's major markets (including Canada, where China has displaced Japan as the number two importer), Canadian producers have done well relative to the rest of the field (see table 1). Indeed, early signs clearly had shown that by 1995 Canada-US trade was booming specifically in those sectors that were liberalized by the FTA, and relative to trade with other countries, suggesting a positive impact on trade flows from the trade agreement.

This is not to say that subsequent competition from Mexico or China is to be taken lightly. On the contrary, it is important both to understand who the competition is and to adjust our

strategies accordingly, a point to which I will return below.

A similar observation applies with respect to FDI. China and other large and promising markets have opened themselves up to foreign investors since the FTA came into

effect. It is not surprising that these new and fast growing markets exert a profound attraction on global firms, including Canadian ones, leading to a neglect (but only a relative one) of markets that in any event are already well "mined" by foreign investors, such as Canada's.

Another factor might be at play in the Canada-NAFTA investment relationship. Foreign direct investment used to be, in part, the means by which foreign firms could "jump" over a country's tariffs and access its market. With tariffs between Canada and the United States falling to zero for the vast majority of products, some of the increased cross-border trade could have substituted for products that might have otherwise had to be made locally by a subsidiary. In other words, trade reduced the need for FDI as a means of accessing markets, which would be consistent with the increasingly standard finding that investment is now in large part a complement to trade, not a substitute for it.

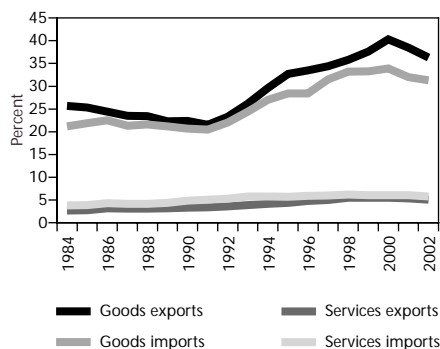
Having said this, there appears to have been a structural shift in Canadian investments in the United States toward services industries rather than goods production. During the first year of the FTA, in 1989, 33 percent of Canadian FDI in the United States was in services. Today, that ratio is close to 65 percent. This shift, which seems to be continuing with recent announcements of substantial Canadian acquisitions of US firms in the insurance and retail sectors, including Manulife's purchase of John Hancock, may be a sign that many

FIGURE 1: US EXPORTS AND IMPORTS AS PERCENTAGE OF GDP



Source: US Department of Commerce, Bureau of Economic Analysis, "National Economic Accounts."

FIGURE 2: TRADE AS PERCENTAGE OF GDP IN CANADA



Source: Statistics Canada, CANSIM Database.

Canadian services companies are pursuing, through investments, the vertical integration achieved through trade by their colleagues in manufacturing. Indeed, Statistics Canada has shown

ple for economic reasons has also experienced a significant leap during the period. Here again, one may speculate that these temporary exchanges of talent may well be the sign of more

Greater integration has had a positive effect on Canada's productivity performance. The importance of productivity (producing more or better goods and services with a given amount of resources) is hard to overstate as a key underpinning of well-being, regardless of whether one thinks that standards of living are sufficiently approximated by GDP (economic output) or not.

that, relative to manufacturers, Canadian service providers tend to serve their foreign clients more through majority-owned affiliates in foreign countries (Marth 2003). In part, this is because the nature of certain services makes it difficult to provide them without having a significant physical presence in the market. Having said this, the US services market remains more open to Canadian services exports than most others around the world.

Clearly, vertical integration (countries specializing in various stages of production in a wide range of products, as opposed to each country specializing in different industries) has been more intensively pursued than specialization by industry between the NAFTA partners. Indeed, a key trend there has been the increased use of imports from each other as inputs into our exports to each other. Thus, the typical Canadian export was made up of 33 percent imported goods and services in 1999, up from 26 percent in 1988, according to Statscan in 2002. This increased ratio — evident across resources, manufactured goods and commercial services exports — underlines the greater sensitivity of North American production to potential border disruptions, as well as the increasingly self-defeating nature of protectionist measures between countries. A similar phenomenon has sprung up from more open trade between Mexico and the United States.

The temporary movement of peo-

vertically integrated economies and are often supportive of Canadian exports or Canadian investments.

Greater integration has had a positive effect on Canada's productivity performance. The importance of productivity (producing more or better goods and services with a given amount of resources) is hard to overstate as a key underpinning of well-being, regardless of whether one thinks that standards of living are sufficiently approximated by GDP (economic output) or not.

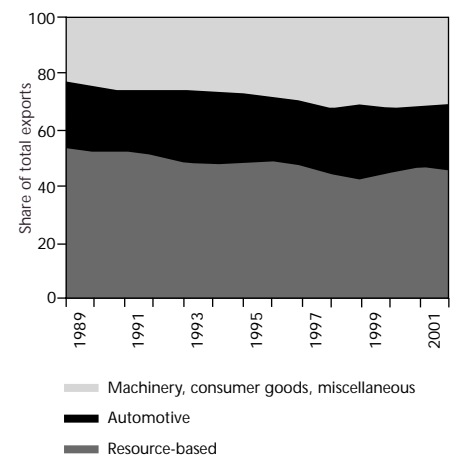
A number of micro-economic studies show that greater trade integration with the United States has been positive for Canada's productivity performance. They suggest, simply, that free trade fulfilled its mission by raising the productivity of Canada's manufacturing industry beyond what it would have been otherwise. A by-now classic reference is Dan Trefler's 2001 paper "The Long and Short, of the Canada-US Free Trade Agreement." In the same vein, a more recent 2003 Statistics Canada study by John Baldwin and Wulong Gu concludes Canadian manufacturing plants that have increased their exposure to export markets accounted for three-quarters of manufacturing productivity growth in the 1990's, even though they accounted for less than 50 percent of manufacturing employment.

While Canada's manufacturing employment continued on its secular downward trend relative to total

employment, its decline since the FTA was nothing like the decline in manufacturing employment that characterized the US economy during the same period. The establishment survey conducted by the US Bureau of Labor Statistics shows that US manufacturing employment now stands at less than 12 percent of total US employment, compared to 17 percent in 1988. Canada appears, relatively, like a manufacturing powerhouse, with average weekly earnings in manufacturing (including overtime) rising by five percent in Canada since the free trade agreement, relative to earnings in other sectors of the economy. Furthermore, the structure of Canada's goods exports under the FTA has shifted markedly away from the traditional resource base, and toward non-resource exports, now accounting for some 55 percent of all exports, and no longer absolutely dominated by automobiles (see figure 3).

To be sure, there are serious clouds on the horizon. As useful as free trade has been in helping Canada shed its image of hewer of wood and drawer of water, there are dangers in the position that Canada finds itself in. It is clear that the low Canadian dollar during much of the period has also

FIGURE 3: CANADIAN EXPORTS: RESOURCES VERSUS NONRESOURCES



Source: Department of Foreign Affairs and International Trade, "Fourth Annual Report on Canada's State of Trade," May 2003, Annex Table 4D.



The Woodrow Wilson Center

Former prime minister Brian Mulroney speaks to a NAFTA 10th anniversary conference in Washington, while (from right) former US president George Bush, former Mexican president Carlos Salinas, and Lee Hamilton, director of the Woodrow Wilson Center, look on.

been a very significant factor in sustaining the Canadian manufacturing success. The recent rise in the Canadian dollar is now testing the basis of this success. And in a way this will be a good thing, for as Mexico is finding out, low costs are not a sustainable basis for competitiveness in the face of emerging economies. If Canada is to sustain its penetration of the US market, it will have to be on the basis of innovative products and superior quality.

Having said this, as is widely known, and in spite of the boost provided by free trade, Canada's overall productivity performance did not keep pace with that of the United States. OECD statistics show that labour productivity in the business sector increased by 26.5 percent in the United States since 1988, or 1.7 percent per year, compared with 20.3 percent or 1.3 percent per year in Canada. This result runs explicitly against the hope that, thanks to free trade,

Canada's productivity could catch up to that of the United States.

What went amiss on that score, then? Recent studies point to two possible explanations: a rise in self-employment, and a lack of innovation. Rather than reaping huge economies of scale from free trade as some had predicted, Canada's productivity initially increased through the shedding of workers in non-competitive firms, according to a 2003 Statscan analysis. To be sure, workers remaining in industries that modernized in the face of foreign competition, and the myriad consumers benefiting from lower prices and greater choice, were "winners" from free trade. But, as the table shows, this was also a period of high unemployment due not only to those initial losses to liberalized imports, but to other factors that made it hard for employment to gain traction at the time, such as the punishingly high level of the Canadian dollar at the beginning of the 1990s, under-

mining export efforts in the short run, and the beginning of serious fiscal retrenchment in the public sector.

This period coincided with an extraordinary mushrooming of self-employment, with the self-employed not having the level of productivity as those remaining in the incorporated business sector. This factor alone can account for most of the productivity differential between Canada and the United States, according to a Statscan analysis.

Another, possibly complementary, explanation focuses on innovation. Kais Dachraoui and Terek Harchaoui in another 2003 Statscan analysis found that while there was a revival of Canadian productivity after 1992 relative to US levels, this revival was due to the progressive adoption of best-practice existing technology in Canada, presumably in the face of greater international competition. However, while Canada was copying best practices, the United States was able to keep its lead by pushing the innovative frontiers in new industries.

While many of the studies of the impact of free trade just mentioned have focused on manufacturing wages and employment, there is no doubt that services were also profoundly affected. This was not necessarily due to any liberalization that was contained in the FTA or NAFTA, since many trade and investment restrictions remained in the service industries under these two agreements. Rather, the need to serve customers who were themselves coming under greater competitive pressure provided the backdrop for changes in the Canadian

and that have sadly come true with respect to Mexico's newly liberalized agricultural sector, with attendant social and migration and environmental problems, the Mexican economy faces formidable emerging competitors. Yet Mexico has not fully taken advantage of the opportunities afforded by NAFTA to transform itself into a dynamic economy that could, among other things, provide better employment for displaced agricultural workers. The main lesson there is the role that domestic policies do or do not play in ensuring that economies can properly compete

al policies to the subsidies being sought by the automobile industry, should be reviewed to ensure that it does not stifle or discourage innovation. Similarly, the case is strong that some elements of Canada's tax mix are out of synch with building a more innovative and productive economy in the context of open trade, notably our relatively strong reliance on income-based rather than consumption-based taxes (note that this is not necessarily a question of the overall tax levels needed to fund public services).

While Canada's manufacturing employment continued on its secular downward trend relative to total employment, its decline since the FTA was nothing like the decline in manufacturing employment that characterized the US economy during the same period.

services sectors. CN is the prime example of this, having reoriented its entire rail and service infrastructure from being geared to east-west trade to being able to serve north-south trade. While CN did shed workers in the process, there is evidence that free trade favoured employment and earnings of workers in trade-related services industries —those services most linked to both export and import activities.

**T**his exploration of the impacts of the FTA on the nature of North American integration and on Canada's economy, while short and inherently incomplete, raises a number of questions moving forward.

Thanks to more open trade, Canada has improved and in many cases realized its potential to become a more productive economy overall than would otherwise have been the case. Thanks in part to the low Canadian dollar relative to its US counterpart, it has certainly been competitive in NAFTA. But, as I have sketched out, the world is moving rapidly, and simply holding the line on competitiveness is not sufficient.

Mexico provides a sobering object lesson in this respect. Quite apart from the difficulties that had been predicted

under conditions of more open transactions with the rest of the world. In the Mexican case, an energy sector struggling for capital under state ownership, and a poor tax structure and tax collection that in turn starve the public sector of much needed funds for infrastructure and education, seem to be key culprits.

**T**he point made above concerning the productivity travails of the Canadian economy under free trade also suggest some lack of flexibility and innovation domestically, preventing the capture of potential benefits from the larger market. It is remarkable that innovation has been such a buzzword of public policy for so long, and that governments at all levels have produced countless studies and strategies aimed at improving Canada's innovation performance, and that we still find ourselves with a major shortcoming on that score. Yet there are strong reasons to think that the larger and richer the markets in which we operate, the greater the returns to innovation and, conversely, the lower the relative incomes of those who do not have the skill or talent to innovate. In that light, every policy area and major public investment, from health care to cultur-

The emphasis I have just put on bringing domestic policies more in synch with the more open economy does not mean that we should not address the many flaws and unfinished business of existing trade agreements. But it is important to take the time to

do this right, because the experience of the FTA and NAFTA also shows that partial liberalization has a cost, and indeed can corner participants into clearly sub-optimal situations. For example, the incomplete liberalization of transportation services is a major element preventing the full realization of the benefits of trade in goods, as noted by Mary Brooks in her 2003 paper, "Mapping the New North America." This is just one illustration of the fact that it makes less and less sense to discuss strictly goods trade liberalization (for example, under a customs union), without also considering how we can improve the cross-border relationship more generally (for example, concerning dispute avoidance and settlement) or address complementary flows of services, investments and peoples.

Thus, while NAFTA remains a major asset in Canada's economic arsenal, the lessons from our own experience and elsewhere is that the world keeps moving, and that continued adaptability, as well as taking greater account of the complementarity of policies in various areas, is the name of the game.

*Daniel Schwanen is Senior Economist at the IRPP. dschwanen@irpp.org*