TRADE POLICIES IN CANADA

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The author discusses Canada's post-war commercial policies and the reason which motivated the country to enter into a free trade agreement whith the United States. He then reviews the agreement's principle points and analyzes Canadian commercial policies (policy) since its conclusion, in light of the GATT, the Pacific Rim and Mexico.

L'auteur expose les politiques commerciales canadiennes de l'après-guerre ainsi que les raisons qui ont motivé le pays à conclure un accord de libre-échange avec les États-Unis. Il résume ensuite les principaux points de cet accord, et analyse la politique commerciale canadienne postérieure à sa conclusion, notamment face au GATT, aux pays du Pacifique et au Mexique.

INTRODUCTION

Canadian commercial policy was reoriented during the 1980s. Having engaged for decades in cautious multilateral trade liberalization through the General Agreement on Tariffs and Trade (GATT), Canada shifted gears and negotiated a bilateral free trade agreement with the United States. Canada remains very committed to the multilateral trading system, however, and is participating actively in the Uruguay Round off GATT negotiations.

This chapter first reviews the main developments in Canada's post-war trade policies, discusses why Canada launched the Free Trade iniciative, and summarises the key features of the Canada-US Free Trade Agreement. The chapter then examines the structure of Canadian trade barriers after the Free Trade Agreement, analyzes Canadian participation in the Uruguay Round of the GATT, and explores Canadian responses to proposals for Pacific economic cooperation and to Mexico's Free Trade initiative.

OVERVIEW OF CANADIAN TRADE POLICIES FORM 1930 TO 1985

The roots of Canada's postwar trade policy can be traced to the 1930s. To start the decade, the United States enacted the Tariff Act of 1930, the Smoot-Hawley tariff, which established record heights for US tariffs. Various European economies imposed quotas on trade citing balance-of-payments problems. Faced with foreign trade barrierrs, Canada's Prime Minister, R.B. Bennett, increased Canadian tariffs in an effort "to bust into foreign markets", a cry that echoes today in the US Congress. The international spread of protectionism and massive debt defaults, precipitated the Great Depression of the 1930s. Canada then, as now, was vulnerable to protectionism in world trade and suffered severely. Canadian exports plunged by 50 percent from 1929 to 1932. Neither Smoot nor Hawley in the United States, nor R.B. Bennett in Canada, were re-elected.

Yet if the 1930s represented the nadir of Canadian trade policies, the decade also laid the foundations for a remarkable period of growth and prosperity. Canadian efforts to negotiate improved access to offshore markets met with some success in the British Imperial conferences convened in Ottawa in the early 1930s which resulted in the British Preferential Tariff System involving the United Kingdom and the British Empire. Canada negotiated a bilateral trade agreement with the United States under the aegis of US Secretary of State Cordell Hull's far-sighted Reciprocal Trade Agreements Act of 1934. The 1935 Canada-US trade agreement, which was subsequently broadened in 1938, began the process of reducing tariffs between the two countries, and helped build the underpinnings of the postwar General Agreement on Tariffs and Trade (GATT) and create the framework for the multilateral system that has fostered expanded trade and global prosperity over the last four decades.

Immediately after the Second World War, Canada and the United States again explored the possibility of a free trade zone. This time a draft protocol was developed secretly by officials from both sides, but the Canadian government demurred and adopted the more cautious tack of pursuing gradual reduction of trade barriers through the GATT negotiations.

During the 1950s and 1960s, Canada focused its trade policies on multilateral GATT negotiations.[1] As a result, Canadian tariffs declined slowly throughout the post-war period —see chart 1— . The

1 Some of the obstacles to consideration of free trade in the 1950s and 1960s are discussed in Lea (1987, 11-29). Canada's participation in the GATT is reviewed by Stone (1984)

average Canadian import duty-measured as the ratio of total customs duties collected to total imports —was 11.1 percent on all imports and 21.1 percent on dutiable imports in 1945— . By 1970, the averege duty on all imports had declined to 6.4 percent and 15.2 percent on dutiable imports.

There was, however, a notable exception to this reliance on multilateral negotiations. In 1965, Canada and the United States concluded the Automotive Products Trade Agreement, otherwise known as the Auto Pact. The specific impetus for negotiating the Auto Pac was a countervailing duty suit filed in the United States against Canada's export-based duty remission program for automobiles. [2] Faced with the probable aplication of countervailing duties, which would have had a disruptive impact on bilateral automotive trade and damaged the interests of the US automotive companies and the United Auto Workers' members on both sides of the border, the two federal governments negotiated a complicated set of automotive trade arrangements. Although both sides were aware that benefits were to be derived from rationalizing bilateral automotive trade and production, the motivation came from the attempt to resolve a specific bilateral problem, the countervailing duty suit on automotive trade.

Subsequent to the 1965 Auto Pact, there has been significant rationalization of automotive trade and

2 Under the duty remission program, one dollar in export sales of vehicles or automotive parts resulted in the rebate of the tariff of 25 percent on one dollar of imports.

production within North America, and considerable benefits have accrued to both countries as well as to the North American automotive producers and their employees. Although the Auto Pact was not conceived as a strategic response to offshore competition, the production rationalization under the Auto Pact has yielded significant benefits in this regard.

In addition to the Auto Pact, Canada and the United States concluded a series of bilateral agreements on defense procurement during the 1950s and 1960s. Known as the Defense Production Sharing Arrangements, these agreements date back to the Second World War.

Canadian trade policies oscillated during the 1970s and Canada began to pursue more nationalistic investment policies. In the early 1970s, the Canadian government became concerned about Canada's growing trade dependence on the United States as trade with the United Kingdom declined and proposed the Third Option to diversify Canada's trade. Canada also became concerned about the high level of foreign investment in the Canadian economy (Gray Report, 1972). In 1973, Canada established the Foreign Investment Review Agency (FIRA). Yet at the same time in the early 1970s that Canada was pursuing closer links with the European Community, Canada reduced MFN tariffs unilaterally as an anti-inflation policy.

Subsequently, however, protectionist pressures became intense in a number of sectors. In the mid-1970s Canada pursued expansionary fiscal policies to offset the global recession which led to an overvalued Canadian dollar. In response to pressure from domestic producers, a series of antidumping actions were launched on imports of steel and capital goods and Canada imposed global quotas on textiles, apparel and footwear in December 1977.

By the late 1970s, Canada once again focused its trade initiatives on the multilateral front. Canada participated fully in the Tokyo Round of multilateral GATT negotiations. While Canada agreed to tariff reductions of about 40 percent, comparable to the other industrial countries, many textile and apparel tariffs were excluded. The global quotas on textiles and apparel were replaced by bilateral restraints negotiated under the Multifibre Arrangement (MFA) in 1980.

Immediately after completion of the Tokyo Round, however, bilateral trade and investment issues reemerged on the agenda. During 1980-82, the Canadian government was concerned that oil prices would continue to escalate and moved aggressively under the National Energy Program to control foreign investment, to favor the activities of Canadian oil companies, and to increase procurement from Canadian sources for megaprojects. At the same time, the Foreign Investment Review Agency became more aggressive in seekin to control the activities of foreign corporations operating in Canada.

Although Canada had pursued a multilateral trade policy, there was an element of discrimination in Canadian bilateral non-tariff barriers. Canada imposed quota restraints on exports of clothing from developing countries under the MFA and exports of automobiles from Japan, but did not apply these restrictions to exports form the United States or Europe.

In the aftermath of the 1982 recession and in light of the collapse of oil prices, the Canadian government pursued a more conciliatory policy toward foreign investment and began to focus on trade initiatives. In August 1983, the Trudeau government tabled its Trade Policy Review, which provided the basis for exploring sectoral negotiations with the United States aimed at achieving free trade in selected sectors (External Affairs, 1983).

Chief among the sectors proposed by Canada for bilateral talks were items of unfinished business from the Tokyo Round. Canada had failed to obtain some of its principal objetives, including access to the US petrochemical market and to public procurement for urban transit vehicles. Although Canada's sectoral initiative raised issues with respect to the compatibility of sectoral agreements with the GATT, the US administration responded favorably and began consultations with domestic industries to identify sectors where the United States might wish to consider negotiations.[3]

Quite apart from problems in reconciling sectoral arrangements with the GATT, the sectoral initiative soon foundered because there was not much overlap in the Canadian and US lists of sectors that were candidates for sectoral agreements. If the bilateral initia-

3 The misture of encouragement and concern of the US administration about GATT rules in responding to the Canadian sectoral proposal is reflected in Brock (1984, 65-68).

tive was to succeed, it had to be conducted on a wider basis.

WHY THE FREE TRADE INITIATIVE?

In light of the tortuous history and political perils involved in the pursuit of free trade between Canada and the United States, why did Canada launch the Free Trade initiative in 1985? [4] And what factors shaped the US response? For both sides, there was a mixture of positive and negative factors that served to motivate them in this bilateral undertaking in the mid-1980s.[5]

For the United States, the disappointing results of the GATT Ministerial in 1982 illustrated the obstacles to progress on trade liberalization on a multilateral basis. It was proving difficult to solve old problems, such as distortions to agricultural trade, or to deal with new issues, such as developing rules for trade in services and investment issues. A bilateral approach to trade negotiations offered the prospect of making greater progress on some of these difficult issues, which could stimulate multilateral progress.[6]

4 Free trade has often been contentious in Canada-US economic relations. Twice in the 19th century the United States rebuffed Canadian efforts to negotiate reciprocity agreements and in 1911 Canada failed to ratify the Reciprocity Treaty which had been ratified by the US Senate. (See Young (1957) and Riggs and Velk (1987).)

5 Several studies recommended that Canada pursue the negotiation of a free trade area with the United States. The most prominent was the Report of the *Royal Commission on Canada's Economic Union and Development Prospects* (1985) chaired by Donald S. Macdonald. See also Lipsey and Smith (1985), and Canadian-American Committee (1985).

6 For a fuller discussion of the interaction between bilateralism and multilateralism, see Diebold (1988). On the significance of a demonstration effect for US trade policy, see Aho and Levinson (1987, 143-155). Also see Jeffrey J. Schott's "US Assessment" and "Implications for the Uruguay Round" in Schott and Smith (1989).

Of course, macroeconomic developments in the 1980s have had a dramatic impact on the evolution of trade policy, particularly in the United States. The global trade imbalances of the 1980s and the resulting rise of US protectionism created severe stresses in bilateral economic relations and stretched the fabric of the world trading system. There was greater pressure for the application of US unfair trade laws, as well as increasing resort to escape clause actions and voluntary export restraints, which were used to institute maneged trade regimes in mayaor industrial sectors.

On the Canadian side, the rise of US protectionism was an important motivating force in undertaking the Free Trade negotiations. The strong US dollar in the mid-1980s created stresses in resource sectors in the United States that became a source of conflict between Canada and the United States, and potential disputes over automotive trade loomed. Since US protectionism has been channelled into complaints about unfair foreign trading practices, the threat to impose penalty duties adversely affected the investment climate in Canada and unleashed political pressures on Canadian governments. Thus, countervailing duties and other remedies against unfair trade became a central Canadian concern during these negotiations.

Macroeconomic developments in the 1980s also served to shift Canadian attitudes toward trade liberalization. During the 1970s the Canadian government had pursued stimulative fiscal policies resulting in an overvalued exchange rate and a persistent current account deficit. As a consequence of

Canada's growing international liabilities, external debt service obligations mushroomed with the high interest rates of the early 1980s. The need to generate a trade surplus to service these mounting international liabilities placed downward pressure on the Canadian dollar. Many US industries competing with Canadian products felt that Canada was deliberately devaluing its currency in order to gain a competitive advantage. In fact, from 1982-85, Canada pursued fiscal policies that were as expansionary as US policy on a proportional basis. Although Canadian fiscal policy in the 1980s tended to make the Canadian economy less competitive, the legacy of accumulated international debt dominated current policy developments, compelling exchange rate adjustments that made the Canadian economy more competitive.[7]

The impulse for Canadian unilateralism often takes the form of nationalist investment policies. Particularly during 1980-82, Canada pursued interventionist investment policies under the National Energy Program as well as more activist policies by the Foreign Investment Review Agency. Thus, obtaining more open and predictable regimes for investment and for trade in services became important objetives for the United States, just as Canada sought to obtain greater security of access to markets. Indeed, some of the difficulties with Canada during 1980-82 over services and investment issues may have helped stimulate US interest in dealing with these issues on a multilateral, as well as a bilateral, basis.

7 For a fuller discussion, see Lipsey and Smith (1987, 18-19).

On both sides, the desire to avoid disputes that threaten to disrupt bilateral commerce has been an important motivating factor in pursuing the negotiations. To be sure avoiding disputes is in the mutual economic and political interests of both nations, but such negative arguments have tended to dominate in the public debate. However, the positive case for bilateral trade liberalization receives less attention than is warranted.[8]

Despite the progress achieved in the GATT in reducing tariffs on trade between Canada and the United States, significant tariff and nontariff barriers to trade between the two countries remain. Removal of these remaining barriers offers significant economic benefits to both countries. First, both countries stood to gain from greater interindustry specialization when trade barriers are removed, although these gains are relatively small. Second, the United States stood to gain improvements in its terms of trade, while Canada is likely to lose in this regard, because Canadian tariffs are significantly higher than US tariffs. In 1987, the average Canadian tariff on dutiable imports was 9.9 percent compared with 3.3 percent on dutiable US iimports from Canada. Third, both countries could gain substantialy in terms of increases productivity and rationalization within the manufacturing sector.

Although the gains are small relative to the size of

8 The classic work is Wonnacott and Wonnacott (1967). Their analysis was revisited extensively in the 1980s. (See Harris (1987), Department of Finance (1988), and Economic Council (1988) as well as the background studies for the Macdonald Commission.)

its economy, all quantitative estimates indicate that the United States gains from bilateral trade liberalization. Estimates of the potential impact on Canada range from small losses under a pessimistic productivity and trade expansion scenario to substantial gains of almost nine percent of Canadian GNP under a more optimistic productivity scenario. The quantitative models do not always capture well, however, the expansion of intraindustry trade, which has been the main effect of tariff elimination among industrial countries. Furthermore, the models do not incorporate measures of the gains from liberalization of trade in services or investment flows.

Clearly the most significant gains from freer trade between Canada and the United States accrue from the potential for greater productivity and specialization within particular industries in the more integrated Canadian and US markets. Historically, the potential for rationalization within industries and within multinational corporations has been a matter of indifference to the United States and a matter of great anxiety in Canada because of concerns that US-based branch plants will retrench.

Global competition appearss to have altered perceptions on both sides. Offshore competitive challenges facing both economies have increased greatly, reflecting more intense competition among the developed countries in high technology industries, rapid expansion of exports by newly industrializing countries in heavy industries such as steel and shipbuilding, and ever increasing competition from developing countries in labor intensive products such as apparel and footwear. The liberalization of trade between Canada and the United States is a strategic response that will increase the competitiveness of both economies and is particularly important to multinational firms with operations on both sides of the border.

Large segments of the Canadian economy, particularly manufacturing industries in Ontario and Quebec that had long resisted trade liberalization, changed their positions dramatically during the 1980s. As Canada's tariffs were reduced in accordance with the Tokyo Round agreements, many Canadian manufacturing firms and subsidiaries of foreign multinational enterprises found that they could adjust and compete successfully.

For both the United States and Canada, global developments tended to make bilateral negotiations of a comprehensive free trade agreement more attractive than in previous decades. The exchange rate misalignments and resurgent US protectionism helped prod Canada into the negotiations, but the resulting hostile environment in the Congress made it difficult to negotiate the unfair trade issues of particular interest to Canada. In addition to these powerful currents in the global economy, which generated political pressures on trade policy in each country, there were a range of bilateral issues and irritants, some of longstanding duration, that required attention.

THE ARCHITECTURE OF THE CANADA-US TRADE AGREEMENT

Although the agreement was shaped by the many pressures and interests impinging on the world's largest bilateral commercial linkage, it is compatible with the multilateral system. Not only are the two nations implementing a classic free trade area, consistent with article XXIV of the GATT, but the agreement is interwoven with their respective multilateral trade obligations and interlinked with the Uruguay Round negotiations.

The Canada-US Free Trade Agreement also compares favorably with past precedents for the formation of free trade areas, such as the European Free Trade Association (EFTA), the bilateral free trade agreements between EFTA countries and the European Community (EC), the Australia-New Zealand Closer Economic Relations agreement of 1983, and the US-Israel Free Trade Agreement of 1985. In particular the Canada-US Free Trade Agreement provides for the elimination over ten years of all tariffs, not only in the industrial sector but also in the food and agricultural sectors, for products which qualify under the rules of origin of the Canada-US Free Trade Agreement.

Thus, the agreement goes further in liberalizing agricultural trade and in avoiding sectoral exclusions than do many other free trade areas that have been reviewed under Article XXIV of the GATT. True, the United States and Canada retain quotas that serve to buttress supply management regimes and price support mechanisms for agricultural products. However, such selective exceptions are permitted under article XXIV, if the measures conform with GATT article XI or article XX. Similarly only limited progress was made in resolving agricultural subsidy issues-both sides will cease export subsidies on bilateral trade-because the real problems in world agricultural trade result from the interaction of European and Japanese agricultural policies with US and Canadian policies and can be only addressed in the Uruguay Round.

It must be stressed that the Canada-US Free Trade Agreement creates a free trade area, not a customs union. Thus, each countries retains separate commercial policies for trade and economic relations with third countries. Maintaining this commercial policy independence while at the same time preventing undesired pass-trough trade or deflections of trade and production, requires the negotiation of clear and predictable rules of origin. On a technical level, the rules of origin in this agreement are much clearer and involve less uncertainty than do the rules used by EFTA-EC bilateral agreements and the internal EFTA arrangements. Of course, some of the most difficult issues in balancing conflicting sectoral interests required special rules of origin for textiles, apparel, and automotive trade.

The obligations in the Canada-US Free Trade Agreement regarding technical barriers to trade and government procurement, build on the GATT codes negotiated in the Tokyo Round. The procurement and technical barriers provisions of the agreement are not sweeping and revolutionary changes, but they are further steps to liberalize trade and to make more transparent the impediments that remain. The limited scope of the procurement provisions is one area where the negotiations fell short. It is ironic that Canada did not obtain the improved access to US procurement of urban transit equipment that was sought in the earlier sectoral initiative.

Other bilateral free trade areas, such as between Switzerland, Austria or Sweden and the European Community, or the US-Israel Agreement, do not have such formal dispute settlement processes. The principal mechanism for resolving disputes in these other bilateral agreements is a joint committee of the two governments. The Canada-US Trade Commission under the FTA is a simular type of joint committee, but there are some important and unique innovations in the dispute settlement process in the Canada-US Agreement.

The most innovative element of the Canada-US Free Trade Agreement institutes an expeditious binding binational appeal process for antidumping and countervailing duty cases and a binational review process governing changes in the trade laws. As a number of authors have observed, the potential recourse to judicial review should have a sobering effect on the administrative processes. Thus, the agreement seeks to stop the protectionist drift in each country's trade laws and to buffer the administration of those laws from political influences. In addition, the general dispute settlement mechanism incorporates some of the reforms proposed for GATT dispute settlement.

POSSIBLE EVOLUTION OF THE CANADA-US FREE TRADE AGREEMENT

Subsidies and allegations of "unfair" trade Practices are often contentious international issues. Developing rules regarding subsidies and countervailing and antidumping laws was a goal in the

Canada-US free trade negotiations, but it was not achieved because Canada sought greater security of access to the American market al the same time as the US Congress was seeking to strengthen US trade laws. This goal remains on the bilateral agenda since the Free Trade Agreement mandates future negotiations on rules for subsidies and for the antidumping and countervailing duty laws, but the two countries are focusing their efforts on developing better multilateral trade rules.

A study by Bence and Smith (1989) reviews, on as comparable a base as possible, the available evidence related to federal subsidy and assistance programs in place for the non-agricultural sectors of the economies of Canada and the United States. The assistance measures covered include grants, direct loans, loan guarantees and duty remission programs. Data are also incorporated on tax expenditures and other indirect assitance measures, but on a less comprehensive basis. Some of the subsidy and assistance measures dealt with would not be regarded as countervailable subsidies at present under either US or Canadian countervailing duty laws.

Excluding agriculture, in 1984 only a few industries in both countries had, at the federal level, a subsidy rate which was large enough to have a significant effect on trade. Explicit federal subsidies in the industrial and services sectors taken together averaged in 1984 about 1 percent in Canada and 0.5 percent in the United States. Out of 83 industries, 5 in Canada and 3 in the United States had subsidy rates greater than 5 percent, while an additional 6 industries in Canada and 10 in the United States had subsidy rates less than 5 percent but greater than 1 percent. Moreover, the industries with the highest measured subsidy rate in each country –forestry in the United States and fisheries in Canada– share some of the attributes of the agricultural sector.

Although comparable data are not available after 1984, both federal governments have acted to reducė non-agricultural subsidies in a number of major industries. In Canada, the complicated web of energy-sector price controls and subsidies under the National Energy Program has been completely dismantled and in the United States industrial development bonds have been curtailed through tax reform. Furthermore, among the remaining heavily subsidized industries, some had no output internationally traded and for others, the resul of the subsidies was more to lower imports than to increase exports.

Thus, in both countries, explicit federal subsidies have only modest impact on non-agricultural trade between Canada and the United States. However, further work is required on the subsidy programs of provincial and state governments as well as on certain indirec subsidies (e.g., stumpage or defense procurement) that are often contentious between Canada and the United States. For example, if defence procurement were included as a subsidy measure, then the average US federal non-agricultural subsidy rate would amount to roughly 2 percent and would be greater than the equivalent Canadian average subsidy rate including defense procurement.

The subsidy and countervailing duty issues that arise in agricultural trade are quite different form those that arise in Canada-US bilateral trade in the industrial sector. Data compiled by the Organization for Economic Cooperation and Development indicate significant subsidies in a number of agricultural commodity sectors in both countries. In the Canada-US free trade negotiations, it was agreed that export subsidies would be eliminated from bilateral trade in agricultural products. However, because of the subsidies, and export subsidies into thir markets for agricultural products, could only be negotiated multilaterally in the Uruguay Round of GATT negotiations. Since over half of US countervailing duty cases against Canadian exports, and the only Canadian countervailing case against US exports, involved agricultural products, the outcome of the Uruguay Round multilateral negotiations on agriculture will also have important implications for Canada-US bilateral trade relations.

CANADIAN TRADE POLICY AFTER THE CANADA-US FREE TRADE AGREEMENT

The crucial difference between a free trade area and a customs union is that in a free trade area each member maintains control over commercial policy for, and trade negotiations with, third countries. Canada (and also the United States) recognizes that the members of a free trade area have a continuing interest in the international trade rules which provide the framework for manacing trade relations and trade disputes. Each member continues to have separate trade relations with third countries, and important elements of the multilateral rules continue to govern bilateral trade.

It is important to note that Canada has not increased any trade barriers against third countries. As the Canada-US Free Trade Agreement is implemented, tariff preferences will increase for US suppliers as compared with third country exporters. Of course, many developing countries have preferred access under Canada's General Preferential Tariff.

At the same time, Canada has maintained quota restraints on agricultural products permitted under article XI of GATT on an MFN basis. In addition, Canada has high tariffs on the imports of textiles and apparel and retains bilateral restraints with more than 20 developing countries under the Multifibre Arrangement.

In contrast, a common market with elaborate supranational institutions such as the European Community is less likely to be outward looking in its orientation. Indeed, the drive to complete the internal market of the European Community by 1992 will have an important influence on the Uruguay Round. It is too soon, however, to judge the precise nature of this interaction.

In the Uruguay Round, Canada will need to address the services, investment and intellectual property issues which proved controversial in the Canada-US negotiations, since these issues are high priorities for the United States, the European Community and Japan. Canadian sensitivities on cultural industries and intellectual prosperty issues may make Canadian participation difficult. Yet, multilateral agreements on these new issues, and related problems pertaining to subsidies and unfair trade, could help protectec Canada against unilateral actions under the trade laws of the United States or the European Community. In this regard, Canada has proposed a World Trade Organization which would provide an integrated dispute settlement process and a permanent institutional framework for the GATT system.

Even with the Free Trade Agreement implemented, Canada has a vital interest in the Uruguay Round and the strengthening of the GATT system. The Uruguay Round negotiations are not an alternative to the Canada-US Free Trade Agreement; the two approaches are complementary. If Canada is going to have some success in resolving agricultural trade problems and in achieving access objetives in offshore markets for upgraded resource products and high technology manufactured goods, Canada will need to continue to build coalitions such as the Cairns Group. Canada can play a helpful role in brigding the differences between developed and developing countries in the GATT negotiations.

Canada and the other middle-sized and small economies have the greatest stake in an open and more effective multilateral trading system, and thus, should be prepared to play an active and constructive role in the Uruguay Round. The real test of whether the members are prepared to negotiate subsequent multilateral liberalization.

THE PACIFIC IN THE GLOBAL TRADING SYSTEM

Canada is participating in a new process for Asia

Pacific Economic Cooperation (APEC), which is working to promote a successful conclusion to the Uruguay Round off GATT negotiations. The APEC grouping includes Japan, Korea, the six ASEAN countries, Australia, New Zealand, the United States and Canada. The Uruguay Round is the most complex and protracted set of multilateral negotiations ever held under GATT auspices. Old problems, such as agricultural trade problems, textiles trade, and safeguards, present serious challenges to resolution. New issues, such as trade in services, investment and intellectual property, are also likely to present serious difficulties for the negotiations.

Much rides on the outcome of the Uruguay Round and many difficult issues will need to be resolved in the negotiations culminating in the ministerial meeting in Brussels in late 1990. The deadline is a firm one because of US legislative provisions.

Few argue for a Pacific trading bloc even if the Uruguay Round goes badly. Indeed, if the global trading system starts to fracture along hemispheric fault lines involving the Asia-Pacific economies, the North American economies, and the European Community along with an emerging Eastern Europe and the Lomé countries, then there are risks of mounting trade frictions among the trading blocs.

The clear immediate priority for the Pacific countries is to develop collaborative strategies to promote liberalization of trade and revitalization of the multilateral trading system in the critical final stage of the Uruguay Round negotiations. Whatever the specific outcomes of the Uruguay Round and however Delphic the texts which emerge from the

Brussels Ministerial meeting, the Pacific countries are recognizing their common interests in an open multilateral trading system that constrains unilateral actions by the major economic powers and sustains the expansion of global commerce. The Pacific countries can take an active role in shaping the evolution of the global trading system into the 21st century.

THE IMPLICATIONS OF MEXICO'S FREE TRADE INITIATIVE

Mexico has made a bold move with the launch of its free trade initiative with the United States which will influence future Canadian trade policies. The outcome of the Uruguay Round will also be significant for the potential trade diversion consequences of Mexico's recent Free Trade initiative. It is evident that the potential for trade diversion in a Free Trade Agreement involving Mexico and the United States, or the United States and Canada is significant because Mexico is a low wage complementary economy. Of course, the potential for trade diversion derives from Canadian and US trade barriers. For example, Mexico is not a major supplier of textiles and apparel products to Canada, but because Canada imposes high tariffs and bilateral restraints on low-cost suppliers under the Multifibre Arrangement, Mexico might expand substantially exports of these products if it was exempted from these Canadian trade barriers. If, however, significant liberalization of tariff and non-tariff barrierss to textiles and apparel trade con be achieved in the Uruguay Round, then the potential for trade diversion will be reduced.

The future evolution of the US-Mexico or Canada-US-Mexico trade talks will also have implications for the multilateral trading system.[9] Wonnacott has argued that a hub-and-spoke approach of bilateral FTAs is more trade diverting than a trilateral arrangement.[10] Certainly, the trilateral approach of a core FTA lends itself more easily to plurilateral regionalism and would result in a much tidier set of arrangements than a series of parallel bilateral FTAs.

CONCLUSION

The general problem that economists have in trying to measure the impacts of these trade policy changes, whether they relate to the existing Canada-US Free Trade Agreement or to some new arrangement, is that it is very difficult to separate the impact of changes in the trade policy factors, such as reduction in trade barriers, from other factors, such as interest rates, exchange rates, cyclical factors, and various shocks such as the ware in the Middle East, all of which have very substantial impact on economic activity.

The way in which economists deal with this issues is through the development of various kinds of econometric models. I have reviewed a number of the

9 Hart (1990).
10 Wonnacott (1990).

studies done over the years on the impact of the Tokyo round of multilateral negotiations in Canada and the Unites States and those on the impact of the Canada-US Free Trade Agreement.

The advantage of these models is that you can isolate the impact of the policy changes within the model. The disadvantages, however, are that there are significant differences in structure and assumptions among the different models and it is frequently difficult for a lay audience to interpret them.

However, what I conclude, having reviewed several of the models, whether they were the large-scale macroeconomic models, the various input/output models, or the general equilibrium models, some results are robust and remain valid across different assumptions about either the structure of the economy or the responses to trade liberalization.

One result I find quite robust, across the different types of models, is the fact that the macro-economic factors have a much more immediate and dramatic impact on short-term economic perfomance and employment than do changes in the trade policy variables.

The other factor that is interesting and sometimes surprising is that the reductions in trade barriers, if they are phased-in, have only modest impacts on employment and trade, even for very disaggregated models. The reasons is that most of the models show an expansion of intra-industry trade, *i.e.*, trade within industries, rather than of one industry expanding very rapidly and another industry contracting very rapidly, and a major shift of employment from one industry to another within, say, the Canadian or US economy.

I would be happy to pursue at some length the issue of the models and of how they might provide some useful evidence but I think I would soon exhaust the patience of the audience on that issue. I will, however, illustrate the results that the models do suggest. Recent experience in Canada with multilateral liberalization under GATT is quite consistent with the results predicted by the models.

In 1979 the typical Canadian tariff in much of the manufacturing sector was 15%. In January 1988 we started reducing those typical Canadian tariffs by about 85 basis point per year, and there were steady reductions until January 1987 when we lad fully implemented the Tokyo Round tariff reductions which were implemented on a multilateral MFN basis. Then there was a one-year pause and, one year later, we started implementing tariff reductions with the United States at exactly the same rate over the 10-year phase-in of the Canada-US Free Trade Agreement.

Now what do we observe about the Canadian economy through that period? From 1980 to 1982 there was a severe recession and a major shake-out throughout the whole economy, particulary in the manufacturing sector. From 1983 to 1989 the economy as a whole boomed and the manufacturing sector boomed as well. There was strong growth in employment productivity, and investment in manufacturing sector. Moreover, if you look at individual manufacturing industries, you would find, say, in trade whith the United States that were not big shifts in the trade balances within particular manufacturing industries. There tended to be much more expansion of two-way trade-increases in imports and exports within each individual manufacturing industriy.

To the extent that there were intra-industry shifts in trade during that period, it was primarily through trade with developing countries that where imports of labour-intensive products increased particularly from the Asia-Pacific economies. Through 1989 and 1990 we have experienced a dramatic slowdown in the economy as a whole, and there has been a particularly severe shake-out in the manufacturing sector.

Looking back on those 10 years one might conclude that the first two years of trade liberalization are painful and then you get five or six years of benefits. I do not think that conclusion could be supported. Instead, I would conclude there were cyclical macroeconomic factors operating that dominated the short-term effects of the trade flows. Looking back on the last decade, I think the results predicated by the economic models were confirmed by recent experience in the Canadian economy.

Whey should the impact of a free trade agreement involving Mexico-and suppose for a moment that we are talking about a Mexico-U.S.-Canada free trade agreement —be somewhat larger than recent experience or the economic models might suggest?— . One reason is that Mexico is a low-wage economy and thus there may be more import competition coming from Mexico in particular labour-intensive sectors than there is from the United States.

There is also the question of the height of trade barriers in particular sectors. It is true that Canada liberalized trade significantly through the Tokyo Round tariff reductions, but those reductions in trade barriers were somewhat less in the labour-intensive textile and apparel sectors. There were fewer reductions in our tariffs and we retained quota restraints under the Multi-Fibre Arrangement.

Those are two reasons why the impact of a full free trade agreement with Mexico might be somewhat greater than what we have experienced either as a resul of the Tokyo Round reductions in trade barriers, or as the result of the Canada-US Free Trade Agreement, which have been analyzed in considerable detail.

My observations on those questions are as follows. Yes, Mexico is a low-wage economy. Certainly it is a low-wage economy as compared to Canada and the United States. Depending on how you measure it, Mexican wages are approximately 10 per cent to 15 per cent of the level in Canada. But if we look at the economies that are expanding exports to Canada in labour-intensive areas such as textiles, apparel, consumer electronics and related areas, you find that those economies have much lower wage levels than does Mexico.

The economies of the People's Republic of China and India have wage levels that are 10 per cent of the wage levels in Mexico. When we look closely we find that Mexico is not a major exporter to Canada of textiles and apparel products. Moreover, we do not restrict exports of textile and apparel products from Mexico to Canada under the Multi-Fibre Arrangement. We have imposed quota restraints on more than 20 countries on a wide range of apparel products, but Mexico is not included. This suggests that the import competition pressures from Mexico are not particularly intense in that sector.

I would then pose the question: why would the impact of a trilateral free trade agreement be relatively small? There are two factors to consider. First, presumably the United States and Canada would be reducing their trade barriers simultaneously. If Mexico were to suddenly expand its exports in a particular industry, those increased exports then would be absorbed by the combined US and Canadian markets. Undoubtedly the US market would absorb a substantial proportion of the increased Mexican exports.

Secondly, Mexico now accounts for about 1/50th of Candad's trade –if you look at imports and exports together. One of the consequences of trade liberalization on a trilateral basis among the three economies would very likely be some degree of trade diversion. We might import more textiles and apparel from Mexico if we were to eliminate our tariffs on their exports, but the main consequence might be a shifting of import suppliers. Instead of the Philippines and Thailand and the People's Republic being the suppliers, those products would come from Mexico.

That is an issue we ought to consider in terms of our overall trade policy and our trade relationship with the Asia-Pacific economies. It is an issue that will be very much influenced by the outcome of te Uruguay Round of multilateral negotiations. In particular, it will be influenced by the outcome of the Uruguay Round negotiations with respect to the Multi-Fibre Arrangement, which restricts textile and apparel imports.

The final pint I would make with respect to the possible impact of a trilateral trade agreement would be that if one reviews the various studies on the impact of the Canada-US Free Trade Agreement, one clear observation is that the studies tended to assume that all barriers were eliminated.

In fact, the negotiating process invariably responds to real or perceived concerns about import competition. As a result, when the trade agreements actually come to fruition one find there are exlusions, long phase-in periods, or rules of origin that reduce the competitive pressures one might have anticipated if all the barriers were rapidly elimanted.

My overall conclusion is that there may be individual industries that could be subjet to increased import competition as a result of a trialteral free trade agreement, but it is very hard to support the conclusion that there would be a massive increase in import competition in Canada if we were to reduce trade barriers simultaneously among the three economies.

I also make the observation that if we look at the sectors where Mexico is increasing its exports most rapidly —auto parts, machinery, and equipment— the existing Canadian barriers in those sectors now are very low. Many of those products come in duty-free, either under Canada's implementation of the Auto Pact, or they come in at zero duties or 6 per cent duties under the General Preferntial Tariff.

In much of the manufacturing sector the incremental reduction in Canadian trade barriers through a trilateral free trade agreement would be quite small in most instances. This would further tend to moderate the impact of any trilateral free trade agreement.

I would be most interested if any of the other witnesses could identify for me a particular industry where we would have some reason to believe that the impact might be somewhat greater than the average.