



Canada-United States Law Journal

Volume 12 | Issue

Article 11

January 1987

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Recommended Citation

Carl Beigie, *The Anticipated Economic Effect of a North American Free Trade Area on Business in the North American Context*, 12 Can.-U.S. L.J. 83 (1987)

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The Anticipated Economic Effect of a North American Free Trade Area on Business in the North American Context

by Carl Beigie*

We are looking at the case for freer trade, and I underline freer, not free. Lawyers have their jargon, economists have theirs, and what we are talking about is movement toward less restricted trade. That's freer trade, more liberalized trade. The case for bilateral freer trade is usually argued at a very broad macroeconomic level, quite broad. There will be, according to this broad prospective, winners in business and there will be losers in business; but on an aggregated basis, it is reasonable to anticipate that the theory of gains from trade among participating nations in trade liberalization will produce a positive sum situation in which the net result is that there are winners.

All participants are going to end up as net winners. From an economic perspective, there are two issues. First, whether the winners realize that they are going to be winners sufficiently early and, second, whether those winners can get together and convince—in economics it is called bribe—the losers not to blockade the arrangement. That's really why governments are necessary. Governments effectively have to go out, in the absence of a clear set of numbers that is going to lead to what the theoreticians tell us is theoretically possible, and make the political commitment to go ahead and do it.

At the present time, both the United States and Canada, particularly the latter, have political leaders who, at least in this area, are demonstrating support for highly contentious political issues. The macro effect, overall, is a net of winners, because of the positive gains from trade.

Now, in economics you have on the one hand macroeconomics. You also have, on the other hand, microeconomics. On the microeconomic side, the issue of trade liberalization has been most effectively analyzed in the context of actual or proposed sectorial trade pacts. In the bilateral context of Canada and the United States, that particular microeconomic prospective can draw heavily on the experience of the 1965 Automotive Products Agreement, which was essentially negotiated on Canada's side.

The Automotive Agreement does have some important lessons for business firms in North America. Though not perfectly parallel to a macroeconomic approach, there are some fairly significant lessons. To the extent that the Automotive Agreement is representative of what can

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be anticipated at a firm level or industry level in a bilateral trade agreement, the Autopact demonstrates that there are clear gains in efficiency from economies of scale and economies of specialization.

Economists traditionally have argued from a theoretical framework, but with the Autopact as practical illustration, the increased opportunity to exploit economies of scale and economies of specialization result in significant productivity benefits. This is fundamentally the main reason for going into, from both a macro and a micro standpoint, freer trade agreements between not only two countries, but all countries.

The productivity gains in the kind of an agreement that we are negotiating, or seeking to negotiate, between Canada and the United States is most significant to the smaller partner. There is very little doubt that Canada stands to gain a much higher proportion of the productivity gains than would be estimated on the basis of the relative sizes of the Canadian and U.S. economics.

In Canada, the smaller of the two partners by a long measure, the higher productivity that was achieved quite demonstratively in the Automotive Agreement resulted in very clearly improved wages as one of the precise benefits of a freer trade agreement. Lower prices are another benefit. A Canadian public policy paper that will be coming out soon demonstrates quite conclusively that a number of North American produced cars actually now sell, adjusting for the exchange rate and for taxation differences, at a lower price in Canada than they sell in the United States.

This was not the case for at least the first ten years of the Automotive Agreement, but it is fairly clearly demonstrated that it is so at the present time. Furthermore, there is, and has been, an opportunity for increased profit potential as a result of the freer trade opportunity.

The problem with the microeconomic approach is that there are few balanced treatments that result in advocacy of sectorial agreements which anticipate, in advance, that one side or the other be a loser. There are going to be some, especially at a broad macroeconomic level of the sort in the bilateral trade agreement, which are much more comprehensive in terms of picking both those sectors that will do well and those sectors that won't do so well, in Canada particularly, in comparison to the Autopact.

The Autopact, in terms of a concrete experience in bilateral freer trade, contained certain special features. They are rather complicated, and are not going to be discussed at length unless requested during the question period following this speech. Generally, the Automotive Agreement contains certain special features that make it less than totally appropriate as an expandable model for a more comprehensive evaluation of a bilateral trade pact of the sort that is now being discussed.

Nevertheless, the Autopact's efficiency gains are illustrative of what is feasible for industries in which scale and/or specialization economies are significant. To an economist, that is obvious. That will be discussed

later because the question is how universally relevant it is in the kind of economy that the industrial world is moving into at the present time. There must, on the basis of the numbers, be a fair number of such industries or firms in Canada that are in a position where scale economies and specialization, or the absence thereof, matters quite a bit. Why? Because the aggregate productivity of Canadian manufacturing remains and so, very fundamentally, affects the results of the comparison between the two countries' manufacturing industries. There are still massive differences in the aggregate productivity performance of Canadian manufacturing vis-a-vis the United States manufacturing.

There are a lot of reasons for the differences, but one of them must be that the Canadian firms suffer from inadequate scale, and more importantly, inadequate specialization in terms of production. The benefits are not confined just to Canadian firms. That's one of the mistakes that is often made in terms of generalized discussion.

A manufacturing firm in the northern tier states of the United States which produces relatively bulky, high transportation cost intensive goods would benefit from a freer trade opportunity by having access to the Canadian market. With fairly low labor cost goods, there can be a fairly substantial market in the United States, but being on the northern tier, the manufacturing firm will be relatively close to the vast majority of all Canadians. Canadians, on the average, live within 50 miles or so of the Canadian-U.S. border.

There will not be merely gains, however. The Canada/U.S. discussions seem to be focused principally on the pluses. Anybody who is fairly serious about studying the Canadian industry and the U.S. industry realizes that some firms in both countries are simply not going to be able to meet the expanded competition. There is very little doubt about that.

One of the questions that eventually must be addressed is what will be done to help those companies that are going to be losers in the process. Now, there is a fairly easy manner in which to evaluate who are the most likely to be the losers. Nobody can say anything for sure in economics these days, but it seems that the more protected of industries in the past, most of which are in Canada, but not all, will be the most probable losers. There are a number of U.S. firms that have been protected over the years, but the less competitive industries in either country are the ones with the greatest likelihood of being losers.

The exchange rate between the two countries, especially during the transition arrangement, is going to be a critical issue in determining who the winners are and who the losers are over the transitional period. Now, GATT plays a role; it has nicely bordered edges and economists muck up the works with things like exchange rates. The exchange rate is fundamentally important and nobody wants to talk about what the exchange rate relationship is going to be between the two countries. They just want to keep it higher than what it ought to be at the present time.

What about the miniature replica subsidiaries that have dominated much of Canadian manufacturing development over the years? Are they going to close as a result of freer trade with the United States? In Canada the vast majority of the critics of freer trade between the two countries argue that that is a fundamental loss that Canada is going to experience. I don't think much of that particular argument. Yes, some of the subsidiaries are going to close down.

My own view has been, and continues to be, that even more of those subsidiaries would be closing over the next ten years without an agreement than are going to close with an agreement. I am personally convinced that with a well planned mutually advantageous agreement, and I don't think either side would sign something other than that, we will demand provisions which are mutually beneficial for us and the United States.

If you get that kind of mutually beneficial agreement, and that is the only agreement to which the legislatures in both countries will agree, I think there is a very strong chance of product specialization agreements being worked out between the parent companies and the subsidiaries.

Indeed, as I teach at McGill University to my Canada/U.S. business class, in all probability what will happen is that you will have miniature replica subsidiaries which are very inefficient operations in Canada being converted into true branch plants, where they will finally be integrated into the broad production plans of the parent company instead of being treated as a separate severable unit.

I'm prepared to believe, and I would strongly argue in favor of the notion, that Canada is very likely to end up in a business context with a substantial share of total North American production of those goods in which it gets a production specialization agreement. I have avoided the term 'world product mandates.' I don't think that is what we are going to be seeing.

We are going to be seeing specialization agreements that will be much less rigid than 'world product mandates.' Still I think we are going to do quite well, again depending on the exchange rate. The exchange rate will be especially critical during the transition period.

One of the people that I have read with the greatest interest is Robert Reich, whose book, *The Next American Frontier*, lays out a set of very informative evaluations of the nature of the prospects of manufacturing industries in not just North America, but the industrial world, for the years ahead. I have talked a number of times to Bob Reich about some of these issues and the fact is that initially he was a strong supporter of a bilateral freer trade agreement between the two countries, but the last I have heard is that he has backed away from that approach. The essential reason for his shift as far as I can tell is—what most economists and I argue about—that is, economies of scale and economies of

specialization which really relate to industries of the past rather than the future.

The business of the industrial era, in which very large scale activity has been dominant, is increasingly being shifted away from North America to parts of the world which have lower labor costs. This is a well-known phenomenon and, quite frankly, I find the argument to be totally persuasive. If we want to stay in the Henry Ford-type assembly line operations, we are going to find that there are many more competitive production locations around the world, locations where you get disciplined workers who will work for relatively lower wages than what they will work for in North America. When the production process is standardized, then production will be shifted to those countries.

Reich argues that the force of industrial evolution around the world is giving rise to a realization of two things. First, because of high-speed communications and the increase of the internationalization process, we are seeing that capital management and technology are extremely mobile and will quickly go to that part of the world where the transportation and adjusted wage costs are attractive for production. At the moment, that happens to be many of the Asian countries, not merely Japan, but increasingly Taiwan, South Korea and who knows what country next.

Second, we are in the process of experiencing a shift from an industrial-type of dominant technological change into an informational-type of technological change, which essentially alters the nature of the production process. As we move away from the traditional industrial era types of activities and as companies and countries mature, within the time of a new era which focuses more on information, the emphasis will shift away from jobs in manufacturing to jobs in services and jobs in the specialized niche-type production activities.

This suggests that the traditional argument on behalf of freer trade that is organized largely on the simplistic arguments of economies of scale and specialization will come under increasing challenge. Not that you have to totally throw away the conclusions, but they will have to be based on a much more sophisticated diagnosis than is currently in play in terms of the discussions that go on about Canada/U.S. trading relations from a business prospective.

I would conclude that it strikes me that we have focused our analytical attention on what are called static efficiency gains. Economies of scale and economies of specialization, to the economists, take you toward the production possibility frontier. That's old hat, frankly. It strikes me that what we are going to have to seriously consider in terms of the bilateral, the global liberalization of trade, are the implications in the context of dynamic efficiency gains.

In effect, will Canada be able to move to an earlier stage in the product life cycle development era? Canada, in my judgment, throughout its history has stayed in the relatively inefficient late end, due to our high

wage scales which we are paid on the basis of our resource abundance. We have stayed at the relatively late end when we have wanted wages that can only be sustained by being at the earlier, more innovative end on a long-term basis. I think that is the nature of the Canadian dilemma.

The problem I have is that I evaluate the thing from that perspective of the bilateral accord possibilities, and what is in it for the United States on the static efficiency gains argument. You are pushing goodwill awfully hard when you make the case on the dynamic efficiency gains element. I don't think Canada is going to push the United States into greater dynamic efficiency, but maybe I am wrong. The chances are much greater that it would go the other way.