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NAFTA's Economic Effects: Plus or Minus--A Canadian Perspective

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NAFTA'S ECONOMIC EFFECTS: PLUS OR MINUS? - A CANADIAN PERSPECTIVE

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I started working in the financial services sector, and I was trained as a monetary economist. One day after meeting some Japanese clients, I told my boss that I was really interested in this international stuff, and that got me started on this very slippery slope of dealing with international economic issues.

The more I deal with issues such as dispute settlement, intellectual property rights, and, of course, cultural issues, as I have to do in my job, the more I realize that it is not necessarily economics that drives the world, but often legal issues and strange transient politics that I think I am really only beginning to understand. So whenever I can, I retreat to the safety of numbers and charts, and that is what I have done in this Article. I am going to be referring to a number of charts and tables in this Article.

The paper upon which I am basing this Article was published about a month ago, and I am going to read some suitable amendments for final publication for this particular conference. It was published as a follow-up to similar work that I did three years ago regarding what the impact was, at the time, of the Canada/U.S. Free Trade Agreement on Canada/U.S. trade flows.

In fact, most of what I am going to talk about here really refers to the period since the implementation of the Canada/U.S. Free Trade Agreement, which for all intents and purposes in Canada, because our trade with Mexico was and is still very, very small, the NAFTA is really a continuation and, in many cases, an improvement upon that earlier Free Trade Agreement. So for us, the impacts are basically measured from the year, 1988, if you like, which was the last year before the implementation of the Free Trade Agreement on January 1, 1989.

I published this update on the earlier study because, of course, the earlier study showed that trade is up between Canada and the United

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States, markedly so since the implementation of the Free Trade Agreement. And then the questions started flowing. Yes, trade is up, but does that mean that we are replacing good manufacturing jobs with poorly paid services jobs because imports are up as well as exports? Does this mean that we are facing downward pressure on wages and investment because now our firms have more opportunities to go and invest in the United States or Mexico? The United States and Mexico had, in fact, lower labor costs, lower labor standards, and less onerous environmental regulations than applied in Canada. And, of course, that was the case with the United States, that was perceived to be even more the case with respect to Mexico. There were concerns about downward pressures on wages and on investments.

Earlier on, we had concerns about the trade deficit, but I think that those concerns have rather disappeared. We now have a huge trade surplus, so I can at least point to that. This update to my earlier work is really an attempt to look further into how much of this increase in trade between Canada and the United States since the Free Trade Agreement can be reasonably attributed to the Free Trade Agreement and how much to other factors.

The fact is that much can reasonably be attributed to other factors, so do not expect me to say that our trade has doubled or so in the past eight years, all because of the Free Trade Agreement. Far from it. But, I have been able to isolate certain factors that show that free trade has, indeed, had a very positive impact certainly on trade flows. I am going to also look at the effects on investment and on the labor market in Canada.

If you look at Figure 1, it shows that, if Canada was a trading nation before, it certainly is even more so now after free trade.[1] The growth in trade, both exports and imports relative to GDP, is pursuing an almost vertical rise here in this chart. The increase started in the 1960s with, of course, the implementation of the auto package. I think, twenty-five to thirty percent of the trade between the two countries is still automobile trade. Then, of course, the Uruguay Round and, generally, the GATT exercises in the 1970s and 1980s possibly propelled growth in trade during that period.

But since the Free Trade Agreement, we have had, in fact, even more rapid growth in bilateral trade. That is Canadian trade relative to GDP for all countries. But, as you probably know, eighty percent of our trade is with the United States, and, in fact, as I am going to show,

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[1] *See* Figure 1, Appendix, *infra* p. 54.

most of that increase was in trade with the United States.

Here are some more basic facts just to give you some context. In Table 1 what you see is that in the first column our exports, that is, Canada's exports to the United States doubled over the first seven years of the Free Trade Agreement to the end of 1995. That does not include 1996. But, they doubled over the period. Mind you, that is in Canadian dollars. If you look at the volume impact, it is quite considerable as well, in fact, just as big because some of these export deflators have gone down, for example, for computers. Canadian imports from the United States have also grown very rapidly.

The only other major Canadian trading partner that has experienced a trade increase as quickly is Asia, excluding Japan. But, as you can see, that particular region experiences much faster growth than the United States to begin with, so our relative performance in the U.S. market looks all the better in that context. Of course, trade growth with Europe and Japan or between Europe and Japan on the one hand, Canada, on the other really has not kept up to the same degree over that period.

So now I asked myself again, what are the results that we would obtain if we did the simple exercise since actually, happily, a great deal of our trade, not exactly half, but a great chunk was already free of tariffs before the Free Trade Agreement, for example, in aerospace and defense products and news print due to various historical agricultural machinery, fertilizers and, more or less, automobiles, which were certainly free of duty and which were flowing fairly freely between Canada and the United States?

We had a control group of products for which the Free Trade Agreement then changed directly, if you like, some of the border measures, certainly the tariff measures between the two countries. And then we had this other group for which the tariffs came down as a result of the Free Trade Agreement. I did this comparison in Table 2.[2] I will just point out to you the two numbers or four numbers that I want to focus on from this table. Over the seven-year period, Canada's exports to the United States went up by 100%, but exports in the categories that were liberalized by the Free Trade Agreement went up by 139%. And those in the categories for which, if you like, the trade regime did not change much, exports went up by sixty-five percent. So, clearly, there is faster growth in those categories liberalized by free trade.

The same thing goes for U.S. imports. They went up in those categories that were liberalized and in which Canada lowered its tariffs now

[2] *See* Table 2, Appendix, *infra* p. 55.

practically to zero in all categories. In those categories, U.S. imports to Canada grew by 102% over the period; whereas in the categories that were already mostly free of tariff barriers before free trade, U.S. exports to Canada went up only thirty-eight percent. Quite a differential, if you like, in the growth rate between those sectors that were liberalized by free trade and those sectors that were not.

There are some appendix tables that describe what these categories are, but, in fact, I based this analysis on a much greater number of products. The tables that you have here are basically summary tables. I looked at a breakdown of approximately 200 import categories and 160 export categories to come up with this accurate statistic and classified them as liberalized by the Free Trade Agreement. There has not been much change. I would probably have come up with the same conclusion two years ago. Those kind of differential effects really tapered off a couple of years ago, and that is not surprising since most of the liberalization occurred in the first five years of the agreement.

People have responded that, maybe we already had liberalized trade and goods that were growing really fast between the two countries. That is a fair comment. Sometimes you find that it is trade that drives the trade liberalization. You know, we want to do more trade; it looks like there is more opportunity; so let us liberalize this particular sector. That is a fair comment. I looked a little bit at the historical trends in liberalized versus non-liberalized categories. And in Figures 2 and 3, what you find is that trade with the United States in the liberalized categories, both in terms of exports in Figure 2 and imports in terms of Figure 3, accelerated the increase in growth rate between the seven years before free trade and seven years after free trade was most markedly, again, in the sectors liberalized by free trade.[3] In other words, our growth in these sectors not only was faster than the other sectors, but accelerated more in the period under free trade compared to the period prior to free trade than other categories or, for that matter, than most exports or trade with other countries.

I have excluded from these charts the fastest-growing category because of criticism that the tariff was too low. In any event, I was really careful in excluding the major outliers, anyway. So it seems that, again, this points to the conclusion that free trade has had a positive impact on trade flows.

I also looked at another statistic, which is that of revealed comparative advantages that U.S. producers hold in the Canadian market and

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[3] *See* Figure 2 & Figure 3, Appendix, *infra* p. 56.

vice versa. These statistics revealed comparative advantages of Canadians in the U.S. market. I wanted to eliminate the use of that particular statistic. Maybe the United States has just gone on a buying binge for products that we happen to import from all sources, not just from Canada. I wanted to eliminate that. I also wanted to eliminate the specific impact of the declining Canadian dollar boosting Canadian exports to the United States and people saying, it is due to the dollar.

Tables 3 and 4 show that, in fifteen out of the eighteen categories that I used, U.S. imports into Canada registered an increase in their measured comparative advantage in the Canadian market relative to other goods.[4] Obviously, it is a relative measure. And the same thing went for twelve out of sixteen Canadian exports, categories that were liberalized by free trade, increasing their measured comparative advantage in the U.S. market.

All totaled, I am fairly satisfied that trade has gone up. We know that to be a fact. But why? Not only because of the macroeconomic factors, which was strong U.S. trade growth with all countries during the period as well, but factoring that out, factoring out the low Canadian dollar, I think we can conclude that free trade has had a positive impact on trade flows between the two countries and I would argue a major positive impact.

With respect to Canada's trade with Mexico, I think in Canada the fact of the matter is that we were fretting a lot about the NAFTA and this idea, I think, was largely imported from the debate in the United States. Maybe I am exaggerating when I see this, but we went through this debate first with the United States. So I think we were fretting a little bit less about investments just disappearing when we were just about to lower our tariffs with Mexico. In fact, I believe that the investment flows into Mexico have really not been that markedly higher after NAFTA as opposed to before NAFTA and perhaps that has to do with Mexico's domestic economic situation.

In any event, when I look at the rather minuscule trade flows, relatively speaking, between Canada and Mexico, which is really less than one percent of our trade, there is really no difference in the trends before and after the implementation of NAFTA in terms of the overall growth rate. I take that as a positive in terms of our exports to Mexico because, given the domestic economic situation there, one would have expected our exports with other countries' exports to be really hit. In fact, they were not. They continued growing, more or less, at the same

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[4] *See* Table 3 & Table 4, Appendix, *infra* pp. 57-58.

pace than they were before.

In terms of Canada's imports from Mexico, the fact that there has not been much difference since NAFTA illustrates the point that we were trying to make in Canada during the NAFTA debate. When concerns were raised about Mexico being so much more competitive on the labor cost side, for example, we were saying, really our trade with Mexico is already relatively free. In fact, it was very free. The tariffs were quite low. A lot of the trade was imported auto parts that were imported tariff-free under the auto pact by U.S. manufacturers operating in Canada. It is not that there are not interesting underlying changes in the categories, but basically we can be fairly satisfied that our trade with Mexico is continuing to grow. But it has not done much more so since NAFTA came into effect three years ago.

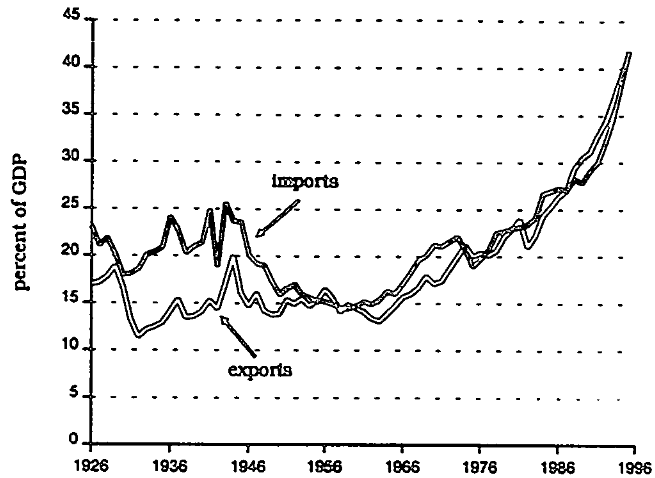
I have also looked at investment trends since the Free Trade Agreement. Rapidly, I think that the story of investments in Canada since the implementation of free trade has been a story of stability. Figure 4 shows that, contrary to the fears, again, of people who were thinking that investment would disappear following the disappearance of the relatively high tariffs that existed and protected the Canadian market before free trade, contrary to those fears, in fact, investment in Canada, if you look at Figure 4, relative to total North American investments, that is, fixed capital spending on machinery and on structures in the United States, Mexico, and Canada, Canada's share of all these investments or the actual physical investments that are made in the country remains higher than the historical average. In fact, it rose immediately after the implementation of the Canada/U.S. Free Trade Agreement, despite the fact that there was a much more severe recession in Canada than in the United States, which would normally have dragged down investment. Investment was dragged down a little bit in absolute terms, but relative to Canadian GDP, especially machinery and equipment, investment held up very, very well during that recession.

I attribute that partly to free trade, not simply because suddenly our exporters saw all these increased market opportunities, but also because of something else that usually drives investment, and that is the cost of fixed capital. With the Canadian dollar being very high and tariffs coming down very quickly, what you had was that the cost of fixed capital for Canadian businesses really fell very rapidly, not just on computers, but on all kinds of other machinery. And I think between eighty and ninety percent of our machinery requirements, of our investment requirements in terms of fixed capital, are still imported from the United States. So you can imagine, or I can imagine, anyway, that free trade actually did contribute quite a bit to the relative stability of the investment given our domestic recession during that period.

I am not going to say much more about that, except to say that, in terms of cross-border investment flows, Canada and the United States seem to be, in my view, getting a bit bored with each other. In absolute terms, the flows of the stocks are still growing, but they are not growing as fast, despite the fact that we have created this free trade area. Our businesses, both on the U.S. side and on the Canadian side, have really shown, since the implementation of NAFTA, increased interest in Latin America, in Asia, in other parts of the world far more than we have shown in each other. I want to emphasize that it is not the absolute flows of stocks that are falling. It is just that the importance of the U.S. and the Canadian investment portfolio or the importance of Canada in the U.S. investment portfolio that has gone down a little bit over that entire free trade period.

APPENDIX

Figure 1: ***Canadian Trade Relative to GDP, 1926–95***



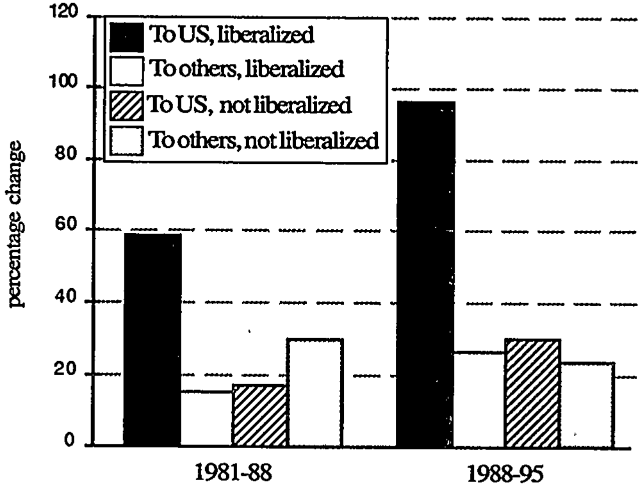
Source: Statistics Canada, CANSIM database on CD-ROM, September 1996.

Table 2: ***Canadian Exports and Imports by FTA Status, 1988–95***

	Value (in Canadian dollars)				Estimated Volume			
	To United States	To Other Countries	From United States	From Other Countries	To United States	To Other Countries	From United States	From Other Countries
	(percentage change)							
All exports	99.4	42.9			77.3	22.0		
All imports			74.9	66.6			67.5	62.0
Autos and parts	75.5	116.1	50.4	35.5	39.7	81.8	21.6	13.7
Crude oil	127.0	-70.9	-91.5	109.3	66.2	-78.7	-93.0	73.1
Other								
Liberalized by FTA	139.1	34.7	101.5	74.2	132.9	19.5	97.2	76.6
Excluding wheat, computers	133.5	47.0	103.0	67.2	97.9	27.6	64.4	37.0
Not liberalized by FTA	64.5	53.6	38.1	37.4	48.2	24.2	7.9	37.0
Excluding natural gas	60.6	53.6			31.9	24.2		

Sources: Statistics Canada, *Exports, Merchandise Trade*, cat. 65-202 (various issues); idem, *Imports, Merchandise Trade*, cat. 65-203 (various issues); and author's calculations.

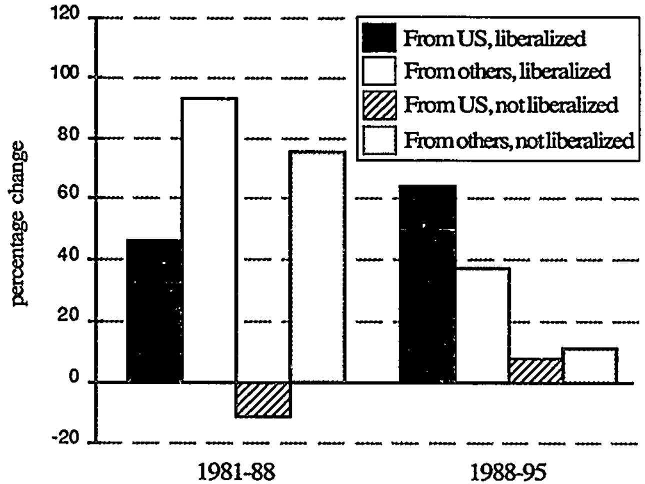
Figure 2: *Change in Canadian Export Volumes, Pre- and Post-FTA*



Note: Data exclude exports of wheat, natural gas, and computers.

Sources: Statistics Canada, *Exports, Merchandise Trade*, cat. 65-202 (various issues); idem, *Imports, Merchandise Trade*, cat. 65-203 (various issues); and author's calculations.

Figure 3: *Change in Canadian Import Volumes, Pre- and Post-FTA*



Note: Data exclude imports of computers.

Sources: Statistics Canada, *Exports, Merchandise Trade*, cat. 65-202 (various issues); idem, *Imports, Merchandise Trade*, cat. 65-203 (various issues); and author's calculations.

Table 3: ***The United States' "Revealed Comparative Advantage" in the Canadian Import Market, by Commodity Group, 1981, 1988, and 1995***

Commodity Group	1981	1988	1995
	(1.00 = US share of Canadian import market for all commodities)		
Not liberalized by the FTA/NAFTA[a]	1.20	1.09	1.11
Crude food and feed	0.96	0.87	0.83
Other crude materials	1.11	1.15	1.15
Fabricated products	1.21	1.20	1.16
Industrial machinery	1.18	0.95	0.98
Agricultural machinery	1.31	1.09	1.13
Aircraft	1.33	1.01	1.11
Medical and safety equipment	1.22	1.19	1.13
Printed materials	1.27	1.30	1.28
Other transactions	1.29	1.21	1.24
Liberalized by the FTA/NAFTA[a]	0.97	0.90	0.95
Meat and dairy products	0.59	0.69	0.88
Fresh fruits and vegetables	0.93	1.11	1.04
Processed food, beverages	0.64	0.58	0.84
Crude materials	1.03	1.20	1.15
Textile materials	0.83	0.71	0.86
Chemicals	1.15	1.09	1.15
Petroleum products	0.84	0.79	0.83
Steel	0.66	0.56	0.86
Basic fabricated metal	1.15	1.13	1.14
Other fabricated materials	1.12	1.02	1.14
Industrial machinery	1.12	0.98	1.06
Transport equipment, excluding autos	0.75	1.02	1.09
Office and telecommunications equipment	1.11	0.94	0.81
Other equipment	1.19	1.12	1.13
Clothing	0.18	0.10	0.23
Furniture and furnishings	0.89	0.77	1.03
Other household goods	0.56	0.53	0.67
Other end products	1.01	0.88	0.94
Crude oil	0.21	0.05	0.01
Automobiles and parts	1.29	1.25	1.20

[a] Constant 1988 commodity weight.

Sources: Statistics Canada, *Imports, Merchandise Trade*, cat. 65-203 (various issues); and author's calculations.

Table 4: *Canada's "Revealed Comparative Advantage" in the US Import Market, by Commodity Group, 1981, 1988, and 1995*

Commodity Group	1981	1988	1995
	(1.00 = Canadian share of US import market for all commodities)		
Not liberalized by the FTA/NAFTA[a]	1.83	1.59	1.67
Natural gas	4.69	5.29	4.92
Other energy, excluding crude oil	1.03	0.91	1.74
Other crude products	0.28	0.28	0.38
Lumber	5.32	5.11	4.68
Pulp and newsprint	5.53	5.05	4.71
Fertilizer	3.39	2.45	1.79
Agricultural machinery	2.27	1.33	1.07
Ships, aircraft, and parts	1.71	1.24	1.37
Other end products	0.62	0.48	0.31
Liberalized by the FTA/NAFTA[a]	0.71	0.62	0.74
Meat and dairy products	0.89	1.34	2.10
Fish	1.45	1.19	0.68
Other foods and feeds	0.29	0.58	1.10
Beverages	0.88	0.84	0.82
Other crude materials	1.92	2.29	2.24
Wood-fabricated materials	2.36	2.49	2.63
Paper, excluding newsprint	3.15	2.23	2.84
Textile materials	0.18	0.36	0.69
Chemicals	1.07	0.98	0.77
Chemical products	0.90	1.08	1.54
Iron and steel	1.39	0.93	1.01
Other basic products	1.01	0.96	1.12
Industrial machinery	0.68	0.44	0.61
Office and telecommunications equipment, precision instruments	0.51	0.34	0.33
Other equipment and tools	0.20	0.31	0.93
Other finished goods	0.40	0.33	0.44
Crude oil	0.18	0.63	0.74
Automobiles and parts	1.95	1.81	1.86

[a] Constant 1988 commodity weight.

Source: United States, Department of Commerce, Bureau of the Census, Foreign Trade Division, *US Imports from Canada by End-Use Commodity Classification*, special compilation on CD-ROM, January 1997.