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FREE TRADE BETWEEN CANADA AND THE U.S.A.- HOW THE LUMBER INDUSTRY WILL BE AFFECTED

By

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B.B.A., St. Francis Xavier University, 1985

Presented in partial fulfillment of the requirements
for the degree of
Master of Business Administration
1986

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CHAPTER 1

INTRODUCTION

The issue of free trade is presently very important, both in Canada and the United States. As a Canadian attending school in the U.S., I have taken an interest in the outcome of the free trade negotiations, and in particular, the controversy over Canadian lumber exports to the United States. Having lived in an area of Canada where the lumber industry is an important part of the economy, I can understand the Canadian views on the lumber issue. Having also lived in Montana where the lumber industry plays the same important role in the economy, I can understand the American views on the lumber issue as well.

Although the lumber issue is a primary concern, the overall issue between Canada and the United States is free trade. Free trade occurs when two countries agree, by binding treaty, not to use tariff or nontariff devices to protect their respective domestic industries. At the present time, the governments of Canada and the United States are preparing for discussions on free trade between the two nations. Several preliminary meetings have been held and both sides hope to reach an agreement by the fall of 1987. The reason for the time limitation is that the U.S. Congress has only given President Reagan until the first of 1988 to reach a free trade agreement with Canada, and Congress requires six weeks to decide on any agreement reached between the two sides. Thus the fall 1986 deadline.



free trade ?

Purpose of the Paper

The purpose of this paper is twofold. First, the paper will examine the politics behind setting up a free trade agreement and the difficulties that the Canadian and U.S. governments face in doing so. Second, the paper will examine the economic effects of a free trade agreement on North America's lumber industry and the political implications on Canada and the United States.

In examining these two issues, the paper will address questions regarding the guarantees required by each country before each agrees to negotiate a free trade package, the effects of free trade on the lumber industry (both large and small firms) in both countries, and the impact that a free trade agreement between Canada and the United States could have on America's other trading partners.

Definition of Terms

Countervailing Duties

A countervailing duty is a monetary penalty placed on an import product that has been determined to be unfairly subsidized and therefore injuring similar domestic products.

GATT (General Agreements on Tariffs and Trade)

The principal global arrangement for trade liberalization. Although generally designed as a temporary agreement, GATT evolved into a permanent and important institution. It became effective in 1948 with 19 countries as members. Its membership has since expanded to include almost all of the important noncommunist nations and several socialist countries of Eastern Europe (Robock and Simmonds, 1983).

The primary reason for GATT's existence is to provide a framework for multinational trade negotiations. GATT also has a number of principles that help further trade expansion. One of the principles is nondiscrimination. A tariff that is granted must be granted to all GATT members under the most-favored-nation clause of the agreement. Therefore, no country can give trade preference to another without giving it to all members of GATT.

Another GATT principle is the concept of consultation. When trade disagreements occur, GATT provides a forum for consultation. Here the two sides in the dispute are more likely to reach a compromise than to resort to arbitrary trade-restricting actions. World trade cooperation since World War Two has led to a more open-door trading policy. GATT has played a major role in this effort (Terpstra, 1972, 1978, 1983).

Stumpage

Stumpage is the monetary value of standing timber, or more narrowly, the cost to remove the timber. The residual value method of calculating stumpage arrives at prices by subtracting from the end product value all relevant costs of production and transportation, as well as an allowance for profit and risk.

In Canada, private firms are awarded 15-25 year tenure agreements and cutting licenses on a first come, first served basis. Firms pay the appraised price but are also responsible for planning, managing and replanting the forest and other associated costs, including road building and fire protection. As well, stumpage prices change every month in accordance with the market. The provincial governments net most of their gain or loss from these fluctuations.

In the United States, the appraisal constitutes a base from which to launch competitive bidding for forest cutting rights, sometimes up to five years in advance. The management cost is added to the appraisal before bids are let, and the U.S. Forest Service carries out the work. Prices are set on the day of sale and do not change over the life of the contract, usually three to five years (Maly, DalSaglio, and McKinsey, 1986).

Justification of the Paper

Free trade between Canada and the United States is not only important to the two nations, but to the rest of the world as well. Most countries follow a practice of subsidizing or protecting major industries which are of vital importance, be it in terms of national security, economy or pride. What Canada and the United States are discussing is eliminating subsidies and protectionism. Such an agreement will have a profound effect on businesses in both countries which is the primary reason why it has become so difficult for the two sides to sit down and to come to an agreement on a free trade package.

Free trade between the two nations is also significant on other grounds. Some Canadians are fearful that their country may be annexed by the United States. They feel that free trade will open up the border between the two countries to such an extent that only one country will emerge. As well, other countries are taking an interest in the Canada-US talks. If free trade is achieved between Canada and the United States, such countries as Japan, Britain and West Germany may also seek to negotiate similar trade agreements with the United States. These issues must be considered when discussing the Canada-US free trade issue.

The US lumber industry has stated that it is being hurt by Canadian lumber imports. It accuses the Canadian government (both Federal and Provincial) of subsidizing its lumber industry. Canadian producers, on the other hand, assert that they are simply more efficient than U.S. producers and that the high value of the U.S. dollar makes Canadian lumber cheaper. Obviously, the Reagan Administration believes Canadian lumber is being subsidized, as it recently moved to impose a 15 percent import duty on Canadian softwood products entering the United States. The possibility of Canada subsidizing its lumber industry versus the possibility that the Canadian industry is more efficient, needs to be examined further as no free trade agreement could be signed if Canada were protecting its lumber industry.

Research Methods

This paper is based on a content analysis of secondary sources from the Federal and Provincial governments of Canada and the Federal and State governments of the United States. In addition, editorials and articles on the issue of free trade and how it will affect the lumber industry will be examined in this research paper.

Contributions of the Paper

This paper will be of benefit to individuals interested in the free trade talks between Canada and the United States, especially those involved in the lumber industry. The paper will also provide insight regarding the free trade issue using the views of government officials on both sides of the border. As well, the views of leading critics and

proponents of the talks from both countries are presented. This paper will also provide an understanding of what the two nations are hoping to achieve from a free trade agreement and what types of pressure are being placed on the governments in each country.

CHAPTER 2

HISTORY AND DEVELOPMENT OF THE CANADA-US LUMBER TRADE RELATIONSHIP

Background

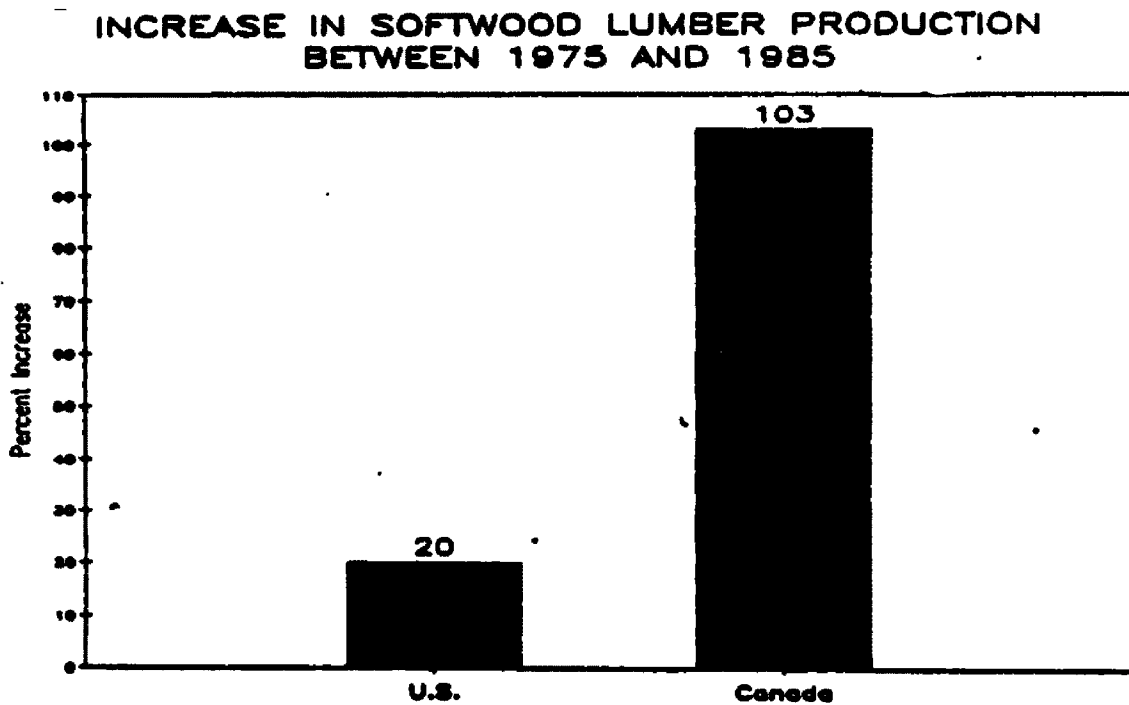
The recent proposal to place import tariffs on Canadian lumber is not the first time restrictions have been placed on cross-border trade of lumber products. Tariffs were in effect until 1913 when the U.S. realized the need for Canadian wood in order to increase the pace of urbanization of American cities (Maly, DalSaglio, and McKinsey, 1986). During the depression, the United States refused to allow lumber imports, but in 1935 the restrictions were removed as domestic lumber prices rose significantly.

In the 1960's and early 1970's, Presidents Johnson and Nixon appealed to Canada to increase their export production to meet U.S. demand and to keep prices low in the U.S. housing market. Figure 1 shows the increase in softwood lumber production in Canada and the U.S. between 1975 and 1985.

American leaders acknowledged that the U.S. could not be self-sufficient in lumber production during periods of stable growth and looked to Canada as a secure source of supply (Maly, DalSaglio, and McKinsey, 1986). By the 1980's, economic conditions in the United States worsened and actions in favor of restricting Canadian imports began.

In the late 1970's, Canada increased its market share of lumber consumption in the United States. A primary cause for the increase was the use of new technology in Canadian mills. The Canadian industry also began harvesting smaller trees which gave them an

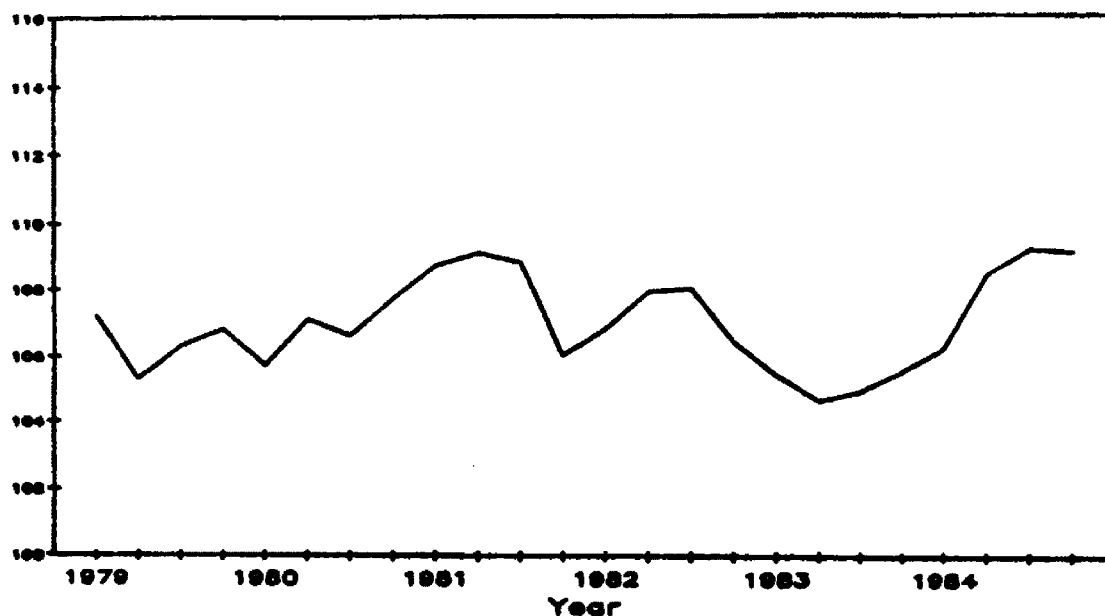
FIGURE 1



increased supply of lumber. Another important factor in Canada's increased U.S. market share was the decreased value of the Canadian dollar. In 1976, exchange rates reversed and the value of the U.S. dollar moved above parity with the Canadian dollar, where it still remains today even in terms of real exchange rates. Figure 2 presents exchange rates for 1979-1984.

FIGURE 2

QUARTERLY INDEX OF REAL EXCHANGE RATES
CANADIAN DOLLAR PER U.S. DOLLAR
(1977 ANNUAL AVERAGE = 100)



Source: U.S. International Trade Commission

How A Countervailing Suit Is Processed

At this time, it is relevant to discuss how a countervailing suit is processed. Both Canada and the United States are members of GATT, General Agreement on Tariffs and Trade, and therefore have similar trade laws in regard to imposing countervailing duties. In the United States, any concerned party (individual, group, or business firm) may file a petition requesting countervailing duties to be placed on subsidized imported goods. It should be noted, however, that such duties are illegal under the GATT agreement. The petition is then moved to the U.S. International Trade Commission (ITC) who determine whether there is a material injury caused by imports on domestic products. If no material injury is found, then the case is dropped. If, however, the Commission finds that the import product is causing material injury, the case is turned over to the International Trade

Administration (ITA), part of the U.S. Department of Commerce, who determine if foreign subsidies exist. If ITA finds that subsidies do exist, it moves to establish the amount of the countervailing duty to be imposed on the foreign goods.

There are a number of ways to stop the countervailing duties from being imposed. The U.S. President has the power to decide not to impose the duties. Also, the decisions of the ITC and ITA may be contested in the U.S. Court of International Trade. Rarely is this step taken but a reversal of a decision could have an immense impact on the future interpretation of U.S. trade law by the ITC and ITA. The Court of International Trade's rulings are subject to review and possible reversal in a Court of Appeals; otherwise the administrative agencies are obliged to abide by court decisions (Maly, DaSaglio, and McKinsey, 1986).

RULINGS ON CANADIAN LUMBER IMPORTS TO THE U.S.

In December 1981, the U.S. Senate Finance Committee and the U.S. House Ways and Means Committee petitioned the U.S. ITC to conduct a study comparing the Canadian and American lumber industries and the effect of Canadian softwood lumber imports on the U.S. industry. In April 1982, the ITC issued its report. The report found that Canadian softwood lumber imports caused a material injury to U.S. lumber producers. In October of the same year, the United States Coalition for Fair Canadian Lumber Imports submitted a petition to the ITA calling for countervailing duties on Canadian lumber (Maly, DaSaglio, and McKinsey, 1986). The petition accused the Canadian governments of directly and indirectly subsidizing their lumber products industry. It stated that the subsidies enjoyed by Canadian lumber firms was causing U.S. competitors to be injured. Canadian stumpage prices was the main issue of the allegations made by the Coalition.

In November of 1982, the Canadian Softwood Lumber Committee was formed to represent the Canadian lumber industry at the ITA hearings. The first move of the Committee was to prepare a brief denouncing the charges and stipulating that the decline of the U.S. softwood industry was caused by a combination of economic factors affecting both countries, and that speculative overbidding and declining value of the Canadian dollar were more correct causes of increased market share than alleged subsidies (Maly, DalSaglio, and McKinsey, 1986).

By March 1983, the ITA had returned with its preliminary findings. It stated that the subsidies being provided to Canadian producers and exporters of softwood lumber were below the minimum level, 0.5 percent of the value of the product, needed to class the subsidies as significant. The ITA also stated that Canadian stumpage fees should not be considered a subsidy, as they were not being used to assist a specific industry or company and were not export oriented. The U.S. Coalition for Fair Canadian Lumber Imports challenged the ITA's findings in the U.S. Court of International Trade. The appeal was denied and the ITA's final decisions were handed down in May 1983.

In March 1985, U.S. President Ronald Reagan and his Special Trade Representative requested the ITC to do an updated investigation of the U.S. and Canadian lumber industries. This action was undoubtedly triggered by members of Congress, especially those from the Northwest of the U.S., who continued to make allegations of unfair trade practices by the Canadian government. Domestic complaints centered around the disparity between record consumption levels in 1984 and only marginal improvements in employment and profitability among U.S. firms (Maly, DalSaglio, and McKinsey, 1986). Senator Bob Packwood, committee chairman of the special Senate session on Canadian lumber said, It is time for the Canadian government to recognize the consequences of its softwood lumber pricing practices. Canada must come to terms with the severe dislocations experienced by the American industry and the reaction which that has produced.

The ITC released the findings of the updated report in October 1985. It found that Canadian lumber firms pay only one-tenth of what U.S. firms must pay for timber. Senator Bob Packwood then requested Ambassador Clayton Yeutter to enter into high-level negotiations with the Canadian government on the timber pricing problem (Senator Max Baucus' Office). The negotiations failed to come up with a solution and in May 1986, the U.S. government imposed a 35 percent tariff on Canadian cedar shingles.

The Canadian government tried to avoid a similar ruling on Canadian softwood imports to the United States. Canadian Trade Minister Pat Carney offered to raise stumpage prices of Canadian Crown lumber by 12 percent. Carney hoped this would change the minds of U.S. lumber producers and end the cross-border dispute over softwood lumber. Carney said that Canada had made a 'once only' offer to voluntarily raise the price of lumber exported to the United States. The U.S. producers refused the offer.

On October 16, 1986, the U.S. Commerce Department reversed their 1983 finding that Canadian lumber pricing practices did not constitute a subsidy (AP, October 17, 1986). The Reagan Administration then moved to impose a 15 percent duty on Canadian softwood lumber imports to offset what it claimed were illegal subsidies by Canadian provincial governments. This was only the preliminary ruling. The final decision will be presented on December 30, 1986 and the Canadian government can then decide whether to appeal the decision.

The Prevalent Economic Conditions of the Canada-U.S. Lumber Industries, 1970 to the Present

In a sense, North America could be considered one large forest. Combined, Canada and the United States have almost a billion acres of productive forestland. Canada has 490 million acres of productive

forestland while the United States has 483 million acres of productive forestland. Figures 3 and 4 show productive forestland in Canada and the U.S.

FIGURE 3

**OWNERSHIP OF PRODUCTIVE FOREST
LAND IN CANADA
1976**

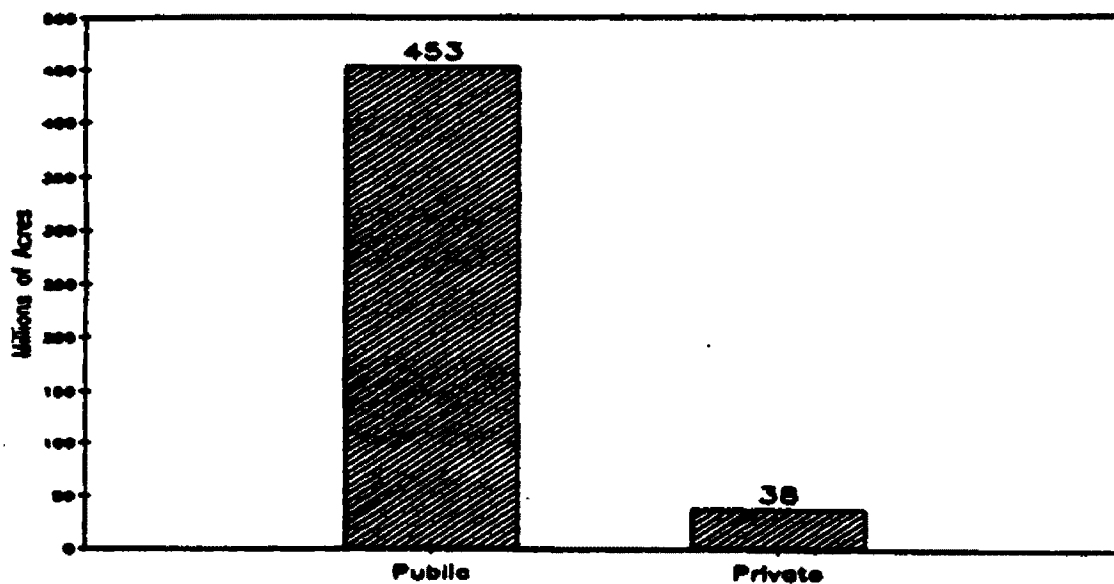
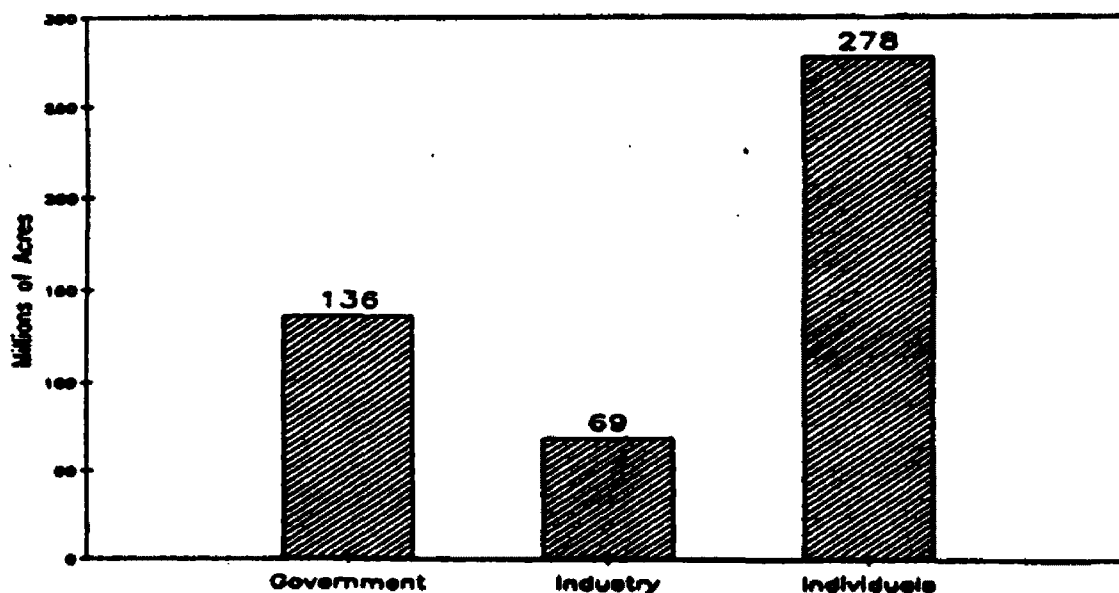


FIGURE 4

**OWNERSHIP OF COMMERCIAL TIMBERLAND
IN THE UNITED STATES
1977**

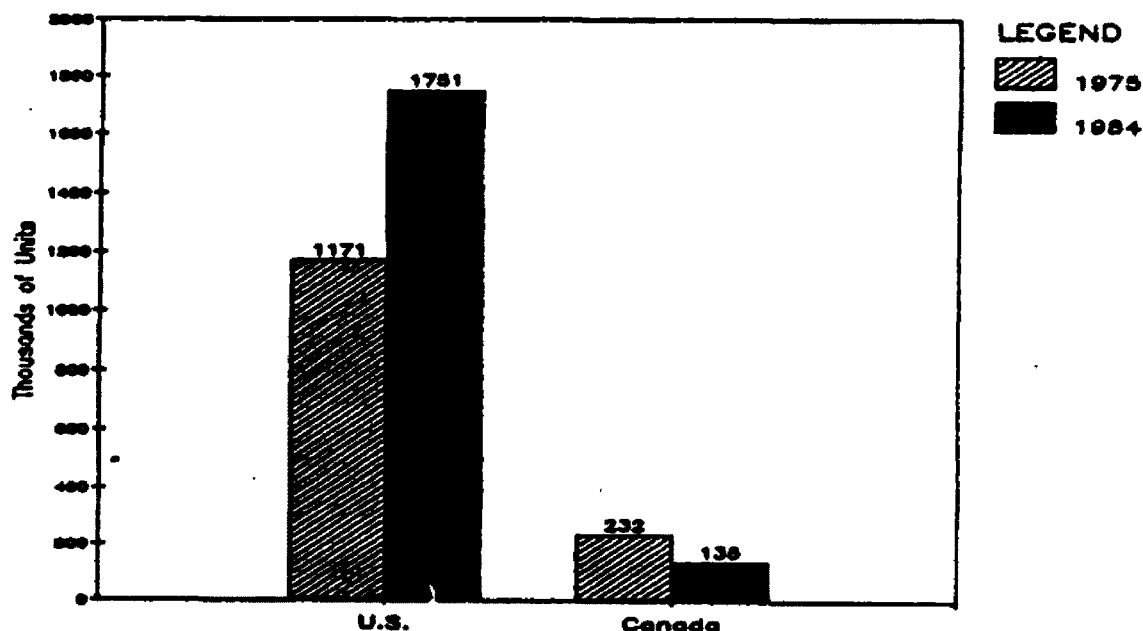


Canada and the United States have the second and third largest productive forest resources, while the U.S.S.R. has the largest available resources. Future estimates have shown that the big three—the U.S.A., Canada and the U.S.S.R.—will produce approximately two-thirds of the world's supply of forest products in 1990 while at the same time consuming 64 percent of the world's total demand. (Maly, DalSaglio, and McKinsey, 1986).

During the mid to late 1970's, the lumber industries of Canada and the United States attained high levels of activity. Then activity dropped during the world recession of 1981-82. However, by 1986 the two nations lumber industries had recovered. U.S. production levels rose from the 1982 low of 25.1 billion board feet to 32.8 billion board feet, while Canadian production increased nearly one-third over 1982 levels to 20.1 billion board feet in 1983 and 20.6 billion board feet in 1984. (Maly, DalSaglio, and McKinsey, 1986). Housing starts are also another indicator of how well the lumber industry is doing. Figure 5 shows a comparison of 1975 and 1984 housing starts in Canada and the U.S.

FIGURE 5

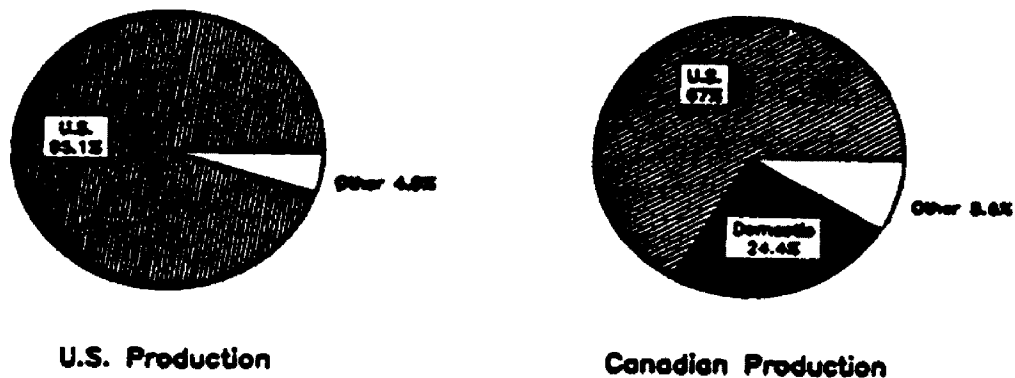
U.S. AND CANADIAN HOUSING STARTS 1975 TO 1984



The U.S. lumber industry basically exists to serve a domestic market. Only a very small portion of U.S. production is exported. The Canadian lumber industry is much different. It sells only about one-quarter of its production for domestic use and exports the remainder. About 67 percent of all Canadian lumber exports goes to the United States, as shown in Figure 6.

FIGURE 6

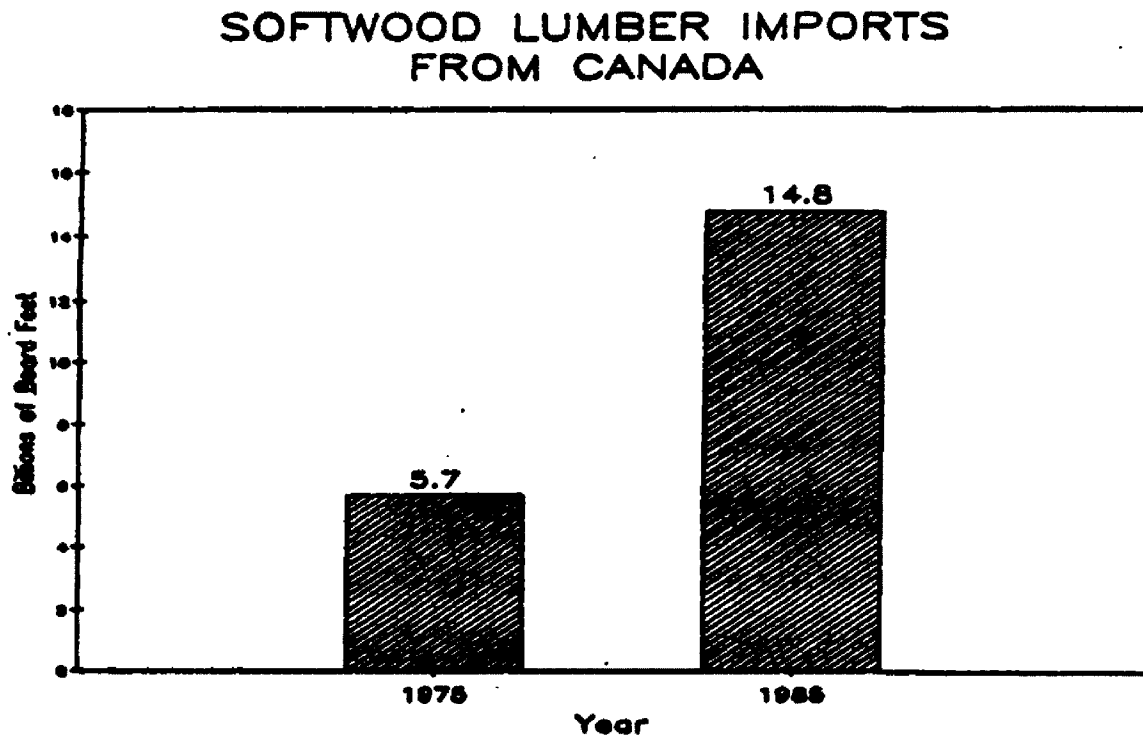
**MARKETS FOR U.S. AND CANADIAN
LUMBER PRODUCTION
1985 (9 MONTHS)**



The ten year period between 1976 and 1985 saw the amount of U.S. lumber exports decrease while imports into the U.S. increased. Total U.S. softwood exports declined from a high of 1.9 billion board feet in 1980 to 1.6 billion board feet in 1984 while total imports have steadily risen from 22 percent of the U.S. market share in 1976 to 31 percent of the market share in 1984. (Maly, DalSaglio, and McKinsey, 1986). By 1985, Canadian softwood imports into the United States

reached 14.8 billion board feet, up almost threefold from 1975. Figure 7 shows softwood lumber imports from Canada for 1975 and 1985.

FIGURE 7



For over 50 years Canada has been a dependable supplier of softwood lumber to the United States. Softwood lumber is one of the most important single items of trade between Canada and the United States. In 1985 Canadian lumber exports to the U.S. were in excess of Canadian \$3.5 billion. Over 60 000 Canadian jobs are directly dependent on those exports (Department of External Affairs, Canada, July 4, 1986). By placing a tariff on Canadian softwood lumber imports, it is obvious that the Canadian lumber industry will suffer economically. On the other hand, the United States may be able to save some of the economic downfall of its lumber industry by imposing this action. Potlatch Corporation, which already had been forced to close three lumber mills in Idaho, announced the closure of a fourth in 1985.

That mill employed just over 200 workers (Coalition for Fair Lumber Imports, January 20, 1986). Between 1977 and 1984, the U.S. government calculated that 30 000 jobs were lost in the lumber industry. This statistic does not begin to show the real job loss in the U.S. because of Canadian imports due to the ripple effect of such losses in the economy.

Future of the Canada-US Lumber Industries

The Canadian forest industry is worried about reforestation. Part of the money received for a harvested tree must be used for reforestation. Since stumpage fees are uncommonly low in Canada, they find themselves unable to generate the funding to reforest harvested woodlands at a rate that would generate a future timber supply. A spokesman for the Canadian Pulp and Paper Association recently stated: Continuation of present levels of regeneration, stand improvement, and resource protection will precipitate a decline from current levels of wood production. Consequently, members of the Canadian lumber industry are concerned that the lack of expenditures on regeneration and resource protection may have long-term implications on the industry's competitiveness in the export market.

In the United States, the U.S. Forest Service predicts that long-term demand for lumber products will increase during the next half century. Imports are expected to rise, especially from Canada, filling part of the domestic need. The balance of domestic need will be filled by U.S. lumber. Total projected softwood roundwood harvest rises from 9.6 billion cubic feet in 1980 to 11.9 billion cubic feet in 2030. Projected annual softwood timber harvests in the West remain close to the 1980 level of 2.3 billion cubic feet until 1990 and then decline slightly to about 2.0 billion cubic feet. The Southern subregions of softwood timber harvests are projected to increase steadily from about 4.1 billion cubic feet in 1980 to 7.3 billion in 2030 (Maly, DaSaglio, and

McKinsey, 1986). As well, prices are expected to change with variances in supply and demand.

Chapter Summary

The history of lumber trade between Canada and the United States has been long and sometimes rocky. In the 1960's and 70's the American government was almost begging for Canada to increase its lumber exports to the U.S. to help meet domestic demand. By the 1980's, the U.S. had had enough of Canadian lumber imports. The U.S. economy was sagging and Canadian imports were causing U.S. lumbermills to shut down and lumbermen to lose their jobs. A countervail action was brought against the Canadian lumber industry in 1981, but by 1983, the U.S. ITA had ruled against the petition. In 1985, the suit was reopened and the recent preliminary findings (October 1986) have reversed the earlier decision.

As far as competition goes, the U.S. lumber producers are not trying to drive their Canadian competitors out of the U.S. market. What U.S. lumber producers are seeking is an equal competitive position in order to retain a fair market share at prices that result in an adequate return on investment (Coalition for Fair Lumber Imports, January 20, 1986).

Concerns have been raised over Canadian reforestation practices. Canadians have been cutting younger trees and failing to reforest the lands. Experts predict that a continuation of this policy could cause a decline in future levels of wood production. This could hurt the Canadian lumber industry as U.S. officials predict an increase in demand for lumber over the next 50 years and imports are expected to increase. If Canada's production declines due to lack of reforestation, they will be unable to capitalize on the projected increase of demand in the U.S. market.

CHAPTER 3

THE NORTH AMERICAN LUMBER INDUSTRY
IN TERMS OF THE BROADER FREE TRADE QUESTIONBackground

The Canadian lumber import controversy has interrupted the Canada-US discussions on a full scale free trade agreement. On December 10, 1985, President Ronald Reagan formally requested authority from the Senate Finance Committee and the House Ways and Means Committee to begin negotiations. These Committees agreed to Mr. Reagan's request and he may negotiate with Canada until the beginning of 1988. However, some members of Congress and the Special Trade Representative have said that broader discussions could not begin until the lumber issue is cleared up (Maly, DaSaglio, and McKinsey, 1986). On the other side of the border, Prime Minister Brian Mulroney of Canada addressed the House of Commons and told them of his plans to proceed with free trade negotiations between Canada and the United States. Because of the different political system in Canada (the Parliamentary system), Mr. Mulroney was able to prepare for free trade talks with only minimal discussion and delay.

Canada and the United States are currently preparing for talks on free trade between the two nations. Over the past year, a number of studies have been completed by the respective Federal governments to ascertain the advisability of more liberal trade relations. From these studies, two basic recommendations have been set forth: (1) to proceed with negotiations to establish a comprehensive Canada-United States Free Trade Area; or (2) to take more liberal steps toward trade enhancement, such as selective tariff reductions and removal of certain nontariff barriers to increase trade flows and improve market

accessibility on both sides of the shared border (Maly, DalSaglio, and McKinsey, 1986). The two governments are still in the process of discussing the trade issues.

Causes of the Delay in Free Trade Negotiations Between Canada and the United States

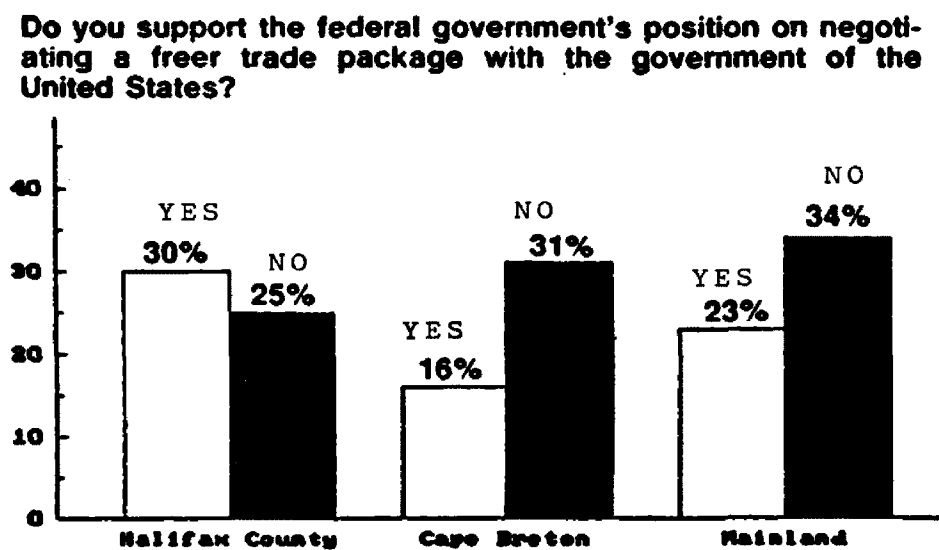
Most Americans feel that Canada is unfairly subsidizing its lumber industry. Representative Bonker stated that throughout the Administration and the Congress there is now a widespread agreement that the Canadian stumpage pricing system constitutes an unfair subsidy, and that this practice must be terminated (NFPA, May, 1986).

Since the lumber issue appeared to be the stumbling block in the negotiations, Canadian and U.S. trade officials held a number of meetings to address the problem. As of yet, no consensus has been reached. The focal point of the dispute stems around a report issued by the U.S. ITC in October 1985 and a decision by the U.S. Commerce Department in October 1986. Basically, the report was a re-evaluation of an earlier report presented by the ITC in 1983. The subject of the report was whether or not the Canadian government was subsidizing its lumber industry. The 1983 report found that Canada was not subsidizing its lumber industry, but the 1985 report and the 1986 U.S. Commerce Department decision overturned this ruling and imposed a 15 percent import duty on Canadian softwood imports.

The Canadian government feels that their stumpage pricing practices should not be an issue since in 1983 the International Trade Commission set down a decision that exonerated Canadian lumber exporters from U.S. industry charges that they were being subsidized (Lewington, April 10, 1986). Some Canadians believe that the new tough stance taken by the U.S. government will hurt trade talk relations. Opinion polls show public support has been slipping rapidly in Canada and the U.S. lumber duty may make it all that much harder

for Ottawa to continue with the talks, government sources said (Blinch, October 21, 1986). Figure 8 shows the results of the poll.

FIGURE 8 SUPPORT FOR CANADA-US TRADE TALKS



However, a different view is held by American officials. The U.S. decision to slap duties on Canadian lumber has worsened ties between the two big trading partners, but in the end may prod them toward an early agreement on bilateral free trade, U.S. officials say (Trautman, October 18, 1986).

Wheat subsidies are another controversial issue which has been deterring the trade talks from beginning. The U.S. Congress has proposed legislation that would allow U.S. subsidized wheat to be sold to the Soviet Union and China, two of Canadian wheat producer's best customers. George Schultz, U.S. Secretary of State has called the legislation ridiculous and harmful to relations with grain-exporting allies such as Canada, although the U.S. Congress continues to pressure the Reagan Administration to ignore foreign protests (Shepherd, 1986).

Since wheat is one of Canada's major export products, this move by the U.S. Congress has enraged a majority of Canadian wheat farmers and, in turn, a majority of Canadian politicians who are putting pressure on Prime Minister Mulroney to take retaliatory actions.

Besides the grain dispute, relations between Canada and the United States have been strained over President Ronald Reagan's decision to slap a 35 percent tariff on Canadian cedar shakes and shingles and Canada's decision to retaliate with new and increased duties on items such as Christmas trees, books and computer parts(*ibid*). Canada imposed a 10 percent tariff on American books and periodicals published less than four times per year, a 3.9 percent tariff on computer parts and a 5.4 percent tariff on certain semiconductor devices. As well, other tariffs will be applied against a variety of U.S. imports into Canada, from oatmeal to diesel cars. The two nations keep saying they want a free trade arrangement with each other, yet they do everything in their power to place strains on the talks by issuing new tariffs or duties. As Canada's Prime Minister, Brian Mulroney recently said, If you were a betting man right now, you'd have to say there's going to be no deal—the Americans are going to shoot it down.

Another major issue delaying the trade talks—at least on the Canadian side of the border—is the issue of sovereignty. The feeling is growing in Canada that these talks pose a grave danger to our sovereignty. Canadians are worried about becoming merely a trust territory of the United States, said prominent nationalist Mel Hurtig, chairman of the Council of Canadians. Some Canadians fear that the increased trade caused by a free trade agreement will allow Americans to infiltrate their very way of life. They fear that their cultural history and ties with the Commonwealth will be destroyed. They fear annexation.

However, Prime Minister Mulroney has pledged to protect the vague concept of 'cultural sovereignty' in the trade negotiations. Mulroney said the Canada Council, the CBC and the National Ballet are examples of institutions not up for negotiation (Blinch, 1986). Until this group of Canadians is satisfied that Canada will not give up her sovereignty in a free trade deal, they will continue to pressure the Canadian government to stop trade negotiations with the United States.

Many of the difficulties that have arisen in preparing for free trade talks stem from the fact that Canada and the United States have different political systems. The United States places an emphasis on the private sector taking a prominent role in the country's economy, whereas in Canada the public sector (government) plays a prominent role in the economy.

Presently, there is pressure in the U.S. Congress to formulate more rather than less restrictive trade measures. At the present time, there are over 300 pieces of legislation before Congress that would in some way restrict imports to the United States. Of these 300 bills, there are at least a dozen that could affect Canada-US trade. The primary reason for this pressure is the U.S. trade deficit. The United States trade deficit with Canada soared last year to \$22.2 billion U.S., second only to the nearly \$50 billion with Japan. Of the total, the Canadian forestry products accounted for \$4 billion (AP, August 4, 1986). By singling countries or industries out, the U.S. Congress can make an easier argument that imports are hurting U.S. workers. The Congress tends to focus on trade deficits with specific countries and certain import categories because job losses and the transfer of ownership of domestic industries to foreign creditors are more tangible problems (Maly, DalSaglio, and McKinsey, 1986). That is why the Canadian lumber industry has been singled out as causing unemployment in the U.S. lumber industry.

Trade negotiations between Canada and the United States cannot begin until the problems stated here have been solved. As it stands now, it seems unlikely that trade talks will be able to begin in time enough to reach an agreement by the fall 1987 deadline.

Guarantees Required by Canada and the United States Before
Free Trade Talks Can Begin

Since January 1986, there have been a number of government to government discussion sessions held between Canada and the United States. The first was in San Diego on January 20, a second in Prince George B.C. February 12-14 and a third in Washington D.C. on March 12. These meetings were held to see how far apart the two sides actually were from reaching an agreement. The lumber issue was the primary concern of the meetings. Since that time, several more sessions have been held, and in late August 1986, the Canadian bargaining team set down a list of guarantees that would have to be agreed to before they would be willing to sit down and discuss a free trade package with the United States.

Specifically Canada wants four concessions from the U.S.:

- (1) Relief from protectionist measures, including quotas, that limit foreign imports into the United States, plus new rules limiting the use of American trade remedies or penalties like countervailing duties now being considered against softwood lumber, anti-dumping and other special tariffs like those imposed on cedar shakes and shingles.
- (2) A reduction in remaining American tariffs on Canadian goods.
- (3) Access to buy American programs and other federal and state government procurement policies that encourage American agencies to

prefer American goods and services even when they are more expensive than similar foreign goods and services. And, (4) A mechanism for settling future trade disputes that would head off the use of harsh and sometimes arbitrary trade remedy laws (Blinch 1986).

The United States' bargaining group has not as yet set down a formal list of guarantees that it will require before it agrees to hammer out a free trade package with Canada. But you can be sure that an end to Canadian lumber subsidies is at the top of the list. As well, Congress will never relinquish its power to levy countervailing duties on imports deemed to be unfairly subsidized (Tower, September 1986).

The free trade talks between Canada and the United States seem to be on hold now, waiting for December 30, 1986 when the final judgment will be passed on whether or not a 15 percent import tariff should be placed on Canadian softwood lumber imports. Canadian officials previously had warned that punitive measures against Canadian lumber could jeopardize delicate negotiations on a free trade pact intended to eliminate most trading barriers between the two nations (AP, October 17, 1986). Whether Canada and the United States continue their free trade talks will not be decided until January of 1987. If the trade talks are continued, they will have to be done quickly as Congressional authority for the negotiations expires at the beginning of 1988. Any deal would have to be presented to Congress by the fall of 1987 because the law gives U.S. legislators 60 working days to examine it (Shepherd, 1986).

Canadian Versus U.S. Arguments on the Need for Trade
Restrictions on Canadian Softwood Lumber Imports

This section will provide the arguments of U.S. Congressional supporters of trade restrictions with Canada and the opposing arguments of Canadian officials defending their country's trade practices. Each set of arguments will be followed by a comments section which will try to clarify the different issues.

The Level of Canadian Imports to the United States

Point: Canada has substantially increased its export level of softwood lumber to the United States

According to the Coalition for Fair Lumber Imports, softwood lumber production in Canada has increased by 10 billion board feet between 1975 and 1984, an increase of 103 percent. During the same period, U.S. production of softwood lumber increased by 20 percent. The Canadian lumber industry has also increased its share of the U.S. lumber market. From 1975 to 1984, Canadian softwood lumber exports to the United States rose by more than 7 billion board feet. In 1975, Canada held a 19 percent share of the U.S. softwood lumber market while in 1984, Canada's market share was 33 percent.

Counterpoint: Canada has only modestly increased its export level of softwood lumber to the United States

The Canadian government stresses that production of softwood lumber in Canada has not increased substantially between 1978 and 1984. In 1978 Canadian lumber exports were 11.4 billion board feet while in 1984 they were 13.2 billion board feet, an increase of only 16 percent.

Canadian officials feel that the United States is distorting the analysis of the increasing market share enjoyed by Canada. They argue that using 1975 statistics is misleading as it was a year of low Canadian production due to a long strike in the lumber industry in Western Canada. By using 1978 statistics, Canada's increase in market share in the U.S. is not substantial. Between 1978 and 1984, Canada's share of the U.S. market increased from 28 percent to 31 percent, a grand total of 3 percent.

Comment:

Both Canada and the United States agree that the information used to analyze the increase in Canadian softwood lumber is for the most part correct. However, the discrepancy arises over which information is pertinent and what time period should be used to observe trends. In their 1985 report on Canadian softwood lumber imports, the ITC used 1977-1984 to calculate statistics and observe trends, and still found that Canadian softwood lumber imports injured U.S. producers.

The Effects of Canadian Softwood Lumber Imports on the U.S. Lumber Industry

Point: Canadian lumber imports have hurt the U.S. lumber industry

Over the past five years, demand for lumber in the United States has increased yet prices and profitability have declined. Over 600 mills have been closed in the United States in the last eight years, meaning the loss of thousands of jobs. The injury is also apparent in the growing trade imbalance (imports outweigh exports) between the United States and Canada. Senator Max Baucus (D., Montana) made the following points in a Senate committee testimony:

- (1) Since 1980, the industry has gone from a \$400 million trade surplus to a \$2 billion trade deficit.

- (2) Although softwood lumber consumption reached an all-time high level of 43 billion board feet in 1984, U.S. sawmills are operating at only 83 percent of capacity.
- (3) Since 1978, 250 sawmills have closed and 30 000 U.S. lumber industry workers have lost their jobs (Maly, DalSaglio, and McKinsey, 1986).

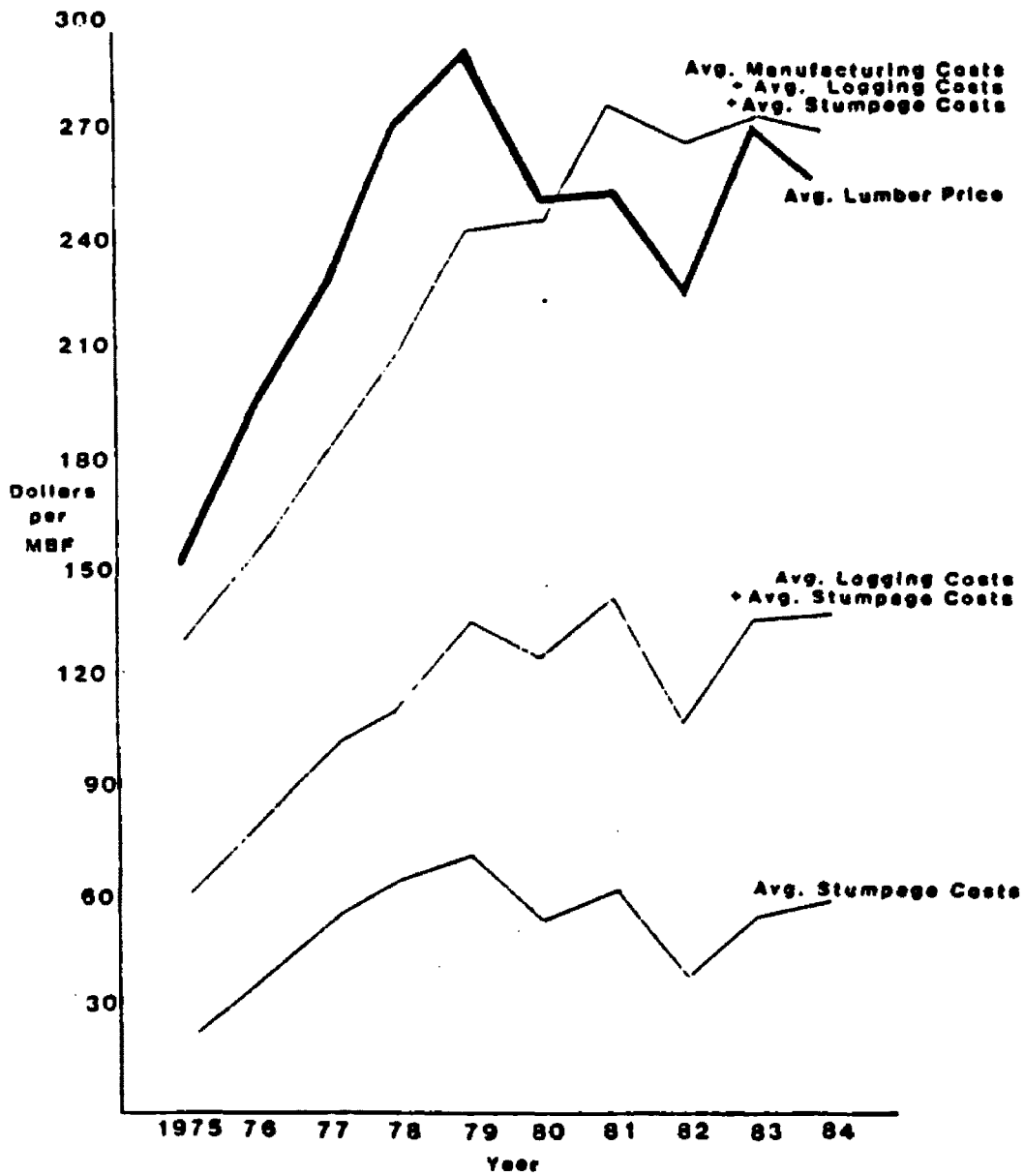
In July 1985, the Chairman of the U.S. Coalition for Fair Lumber Import reported to the ITC that if Canadian lumber imports continue to flood into the United States, the resulting decline of the return on capital will prevent continued investments in the U.S. softwood lumber industry. The U.S. Department of Agriculture requested the Idaho Forest Industry Council to compile information on the cost of manufacturing softwood lumber. The Council provided a graph entitled Lumber Cost-Price Squeeze, shown in Figure 9. Since 1980, the average selling value of lumber in the United States has dipped and remains below the average costs for manufacturing, logging and stumpage. The Council concludes that the reason for the decline can be based partially on increasing manufacturing costs and the current depressed price for lumber due to the greater supply of inexpensive Canadian lumber (Maly, DalSaglio and McKinsey, 1986).

Counterpoint: The lumber industry is suffering in both Canada and the United States

The Canadian lumber industry is suffering from the same problems as the U.S. industry. Mill closures, job losses and low profit margins are all visible in Canada's lumber industry. Nationwide, the lumber industry accounts for one in every ten jobs in Canada, therefore having a great impact on the country's economy. During the recession of the early 1980's, employment in the Canadian lumber industry dropped between 30 and 40 percent below the normal level. High levels of debt at high interest rates have combined to ravage corporate balance

FIGURE 9

Lumber Cost-Price Squeeze



Source: U.S. Dept. of Agriculture Forest Service Region I Data
All Species

sheets. Capital expenditures for 1983 were estimated at \$1.4 billion for the forest industry, about half the annual level of the 1980-82 period. In short, what started out as a severe cyclical downturn has had longer-term effects with severe structural implications for the Canadian industry (Maly, DalSaglio, and McKinsey, 1986).

Comment:

The United States government and the U.S. lumber industry are blaming Canadian lumber imports for the decline in prices, profitability and jobs prevalent in the U.S. industry. Canada's argument is that their industry is suffering too and that other possible reasons for the decline, such as structural changes in the industry and domestic economic conditions, should be investigated (Maly, DalSaglio and McKinsey, 1986).

Exchange Rates

Point: Exchange rate increases do not account for the total increase in Canadian lumber imports into the United States

Since 1976, the value of the U.S. dollar in comparison to the value of the Canadian dollar has risen from below par (\$1.00) to approximately \$1.40 Canadian (1986). American government officials do agree that the strong U.S. dollar is partially responsible for the increase in Canadian lumber exports to the United States. Senator Max baucus said The overvalued dollar contributes significantly to the problem by making imports cheap and exports expensive. But U.S. officials want to make sure that subsidies by the Canadian government are not overlooked. They feel that these subsidies have as much effect on the lumber trade imbalance as exchange rates do.

Counterpoint: There is a direct correlation between the increase in Canadian lumber exports to the United States and the value of the U.S. dollar.

Canadian officials state that the strong value of the U.S. dollar which stands at approximately \$1.40 Canadian is the major cause of the price advantage Canadian lumber producers are currently enjoying. To prove this point, one only has to look at the relationship over the last several years between the Canadian share of the U.S. market and the value of the U.S. dollar, shown in Figure 10. Even some American officials agree that there is a direct correlation between increases in Canadian lumber exports to the U.S. and the value of the U.S. dollar. Congressman James Weaver stated, currently the most significant influence on Canadian lumber imports to the U.S. is the exchange rate. Morris Udall in a 1984 report to the House Committee on Interior and Insular Affairs said, The single most important factor affecting lumber imports into the United States at the present time is the exchange rate.

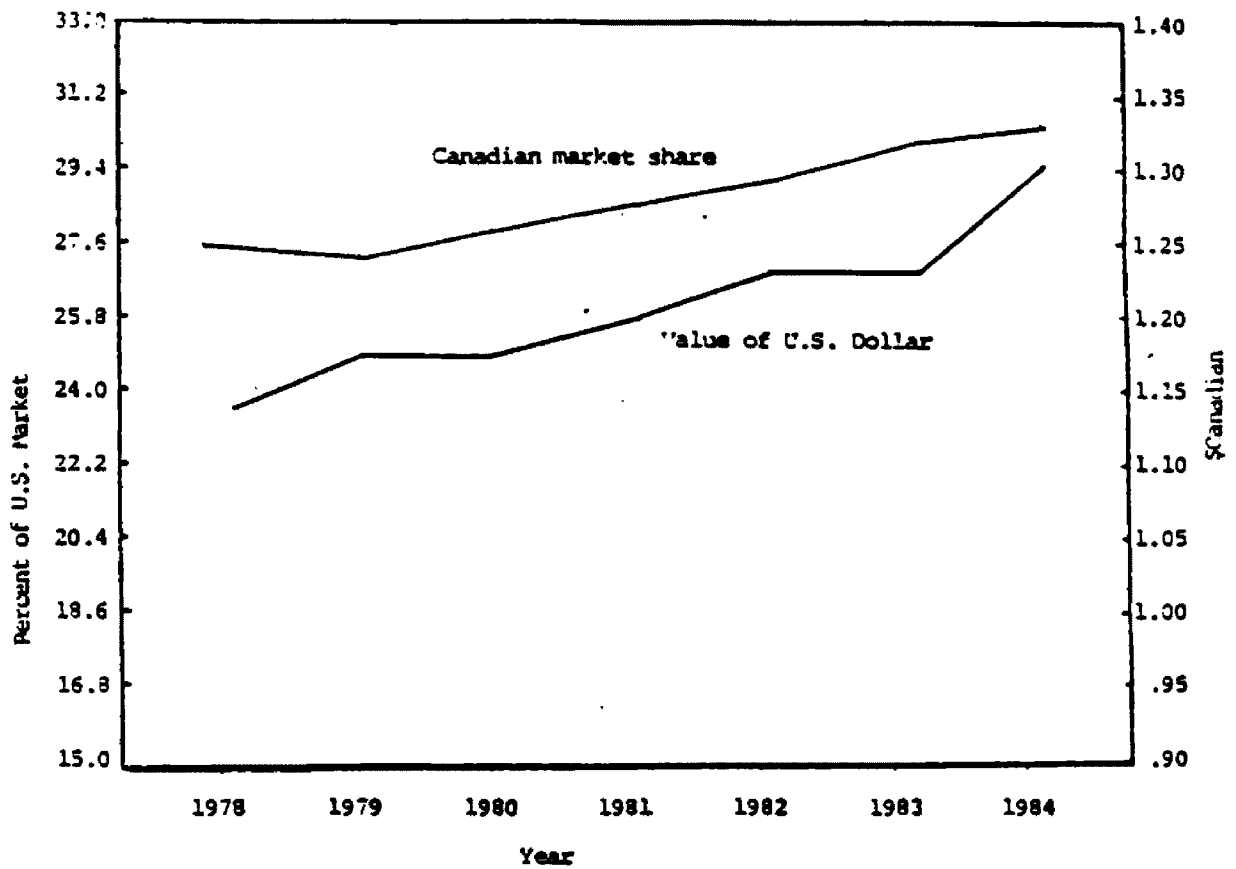
Comment:

While the two governments disagree on the perspective of this point, evidence has been given to substantiate Canada's claim that exchange rates have a substantial effect on the lumber trade between Canada and the United States. The value of the Canadian dollar cannot, however, fully explain Canada's cost advantages. It is the opportunity to sell in the American market that gives the Canadian lumber industry its advantage over the U.S. industry—as a direct result of the dollar disparity (Maly, DaSaglio and McKinsey, 1986).

In the ITC's 1985 report, it was estimated that the difference in real (versus inflated) dollars between Canada and the United States gave Canada an 11 percent exchange rate advantage. Thus any Canadian firm

FIGURE 10

CANADIAN MARKET SHARE VS. STRENGTH OF THE U.S. DOLLAR
FIGURE 10



that can pay for raw materials and other production costs in Canadian dollars and turn around and sell the finished product in American dollars, is going to have an advantage over a U.S. competitor.

Contrary to uniformed opinion, the exchange rate differential is largely the result of high public deficits and interest rates rather than a consequence of deliberate Canadian policy to keep their dollar value low. The two national currencies are closely tied and Canadian producers have suffered the same impacts of overvaluation as their U.S. competitors (Maly, DalSaglio, and McKinsey, 1986).

The Effect of Different Approaches to Stumpage

Point: Canadian stumpage prices constitute a subsidy to the Canadian lumber industry

A large number of U.S. government officials feel that the price the Canadian government charges for stumpage constitutes a subsidy to the Canadian lumber industry. U.S. officials argue that Canadian stumpage fees do not represent fair market value of the standing timber and that these undervalued stumpage fees are causing unfair competition. According to Senator Max Baucus, the U.S. industry has been inundated by Canadian imports that benefit from massive government subsidies. In the past, the U.S. Coalition for Fair Lumber Imports has used the issue of low Canadian stumpage prices to petition the ITC to rule if countervailing duties should be placed on Canadian lumber imports.

Counterpoint: Stumpage by itself does not account for all the costs of harvesting timber

Canadian officials feel that the emphasis placed on stumpage fees, and the cost difference between Canada and the United States, is exag-

generated. When all the costs of timber management are considered (stumpage, reforestation, road building, cutting, hauling and taxes) the Canadian softwood lumber industry does not have a notable cost advantage over the U.S. softwood lumber industry. The main reason for this is that in Canada the company that buys the rights to cut Crown Land also endures the cost for road building and reforestation. In the United States these jobs are done by the U.S. Forest Service.

Comment:

Canadian firms can sell lumber cheaper than American firms. Everyone agrees with this fact, but there is disagreement when it comes to the reason why. U.S. officials stress that stumpage prices constitute a subsidy. But neither country can agree on the importance of such things as efficiency, productivity, transportation costs and forest management policies. A recent study by the International Woodworkers of America (IWA), a union representing about 100 000 workers on both sides of the border, shows that Canadian mill workers on an average produce about 65 percent more lumber than their U.S. counterparts (Maly, DaSaglio, and McKinsey, 1986). The IWA report shows that the difference in productivity is due to state of the art technology and equipment and economies of scale at the larger Canadian mills.

In the 1982 report by the ITC, it concluded that Canadian stumpage fees did not give the Canadian lumber industry an advantage over the U.S. lumber industry because the delivered price of logs to the mill were comparable. The 1985 ITC report changed that decision. It reversed the estimates of the logs delivered to the mill and found the average U.S. price to be \$205 while the average Canadian price was \$166. This means that despite more difficult terrain, longer hauls and sparser timber stands, Canadian mills delivered prices of logs is cheaper. Therefore, it can be assumed that lower stumpage prices allow the Canadian lumber industry to undersell the U.S. lumber industry.

Canadian Market Penetration

Point: The Canadian governments change the market price of lumber to maintain production and jobs

The Canadian government has a practice of offering low stumpage fees to Canadian lumber firms to help keep mills open and stop unemployment in the lumber industry. Because of this, Canadian production has been able to increase over the period 1977-84 and penetrate the U.S. lumber market to a greater extent. U.S. officials have referred to this practice as a "welfare system" and a major reason for revised trade legislation.

Counterpoint: Canadian government policy remains the same between 1977 and 1984

Canada has not changed any of its policies dealing with the lumber industry between 1977 and 1984, therefore, the increased U.S. market penetration of Canadian lumber must be attributed to some other cause. In the past, the Canadian share of the U.S. market has correlated with housing starts in the United States. The increase in market share of Canadian lumber reflects an increase in U.S. housing starts. When in 1981-82 U.S. housing starts fell off, so did the Canadian market share of the U.S. lumber market. Other factors to consider are exchange rates, efficiency of Canadian mills and increased demand for Canadian lumber products in areas other than the new home construction market (Maly, DalSaglio and McKinsey, 1986).

Comment:

Low stumpage fees in Canada and an overall low price for lumber have caused an increased demand for Canadian lumber in the United States. While Canadian stumpage remains at a consistently low level, American producers are forced to pay fair market value for timber

rights. This difference allows Canadian producers to sell lumber cheaper than American producers can, thus causing increased purchases of Canadian lumber in the United States. It is true that Canada has not changed its policy on stumpage between 1977 and 1984 but Canadian stumpage prices may have been too low to begin with.

Forest Management Policies

Point: Canadian forest management policies are inconsistent with a policy of sustainable yield

U.S. officials are upset because the Canadian stumpage system does not follow the same rules as the U.S. stumpage system. The U.S. feels that Canada's policy does not guarantee reforestation. By doing so, Canada is essentially "mining" its timber resources to the ultimate detriment of its forest products industry (Maly, DalSaglio and McKinsey, 1986).

Canadian stumpage fees are lower than U.S. fees because the Canadian system sees trees for harvest only whereas the U.S. system puts timber in competition with other uses, therefore causing a higher stumpage fee in the U.S. There are feelings on both sides of the border that continuation of Canada's present stumpage system will lead to the ruin of its forest products industry. Continuation of present levels of regeneration, stand improvement and resource protection will precipitate a decline from current levels of wood production (Canadian Pulp and Paper Association, 1985).

Counterpoint: Canadian forest management policies are consistent with a policy of sustainable yield

The Canadian viewpoint is that its forest management policies do constitute a reasonable harvest/reforestation rate to guarantee a

sustained yield. Their view is that lower stumpage fees are reasonable on land containing sparse, low quality timber or on land in remote areas (Maly, DalSaglio and McKinsey, 1986). Since much of Canada's forestland falls into this category, stumpage fees are reasonable.

Canada follows a forest management policy consistent with its resource base and should not be governed by conditions in the United States. In fact, Canada has more productive forestland (544 million acres) than the U.S. has commercial forestland (482 million acres). Along with this, Canada has 550 billion cubic feet of softwood inventory while the U.S. maintains only 456 billion cubic feet (Maly, DalSaglio and McKinsey, 1986). This means that Canada can afford to have a higher rate of harvest than the United States, yet presently, it only harvests about 68 percent as much timber as the United States (21 billion board feet as compared to 31 billion board feet).

Comment:

Although Canada harvests more timber stands than the U.S. does, it must be remembered that Canada can afford to do so as its domestic requirements are only 10 percent the size of domestic needs in the United States. If sustained yield is a policy meant to insure adequate timber supplies indefinitely, then Canada is in a far better position than the United States to risk overharvest. The United States, in the long run, has a far greater problem of guaranteeing a sustainable yield for domestic purposes (Maly, DalSaglio, and McKinsey, 1986). Canada has less reason to adopt the U.S. philosophy on forest management because of its large size and small population. Canada is concerned about forest management but it should not be bound by U.S. standards reflecting greater population density and less remote resources (Maly, DalSaglio, and McKinsey, 1986).

Loophole in U.S. Trade Laws

Point: A loophole in the U.S. trade laws allows subsidized Canadian lumber to enter the United States

The 1982 ITC report found that Canadian stumpage practices gave Canadian producers an advantage over their U.S. counterparts. However, the U.S. Commerce Department rejected the petition for a countervail action because the advantage enjoyed by the Canadian softwood lumber industry was available throughout the Canadian economy to a broad array of wood products firms. Because of this, S.1292, Natural Resource Subsidies was proposed. S.1292 would amend U.S. countervailing duty law to clearly establish that a subsidy exists when a government, acting through a controlled or regulated entity, sells an input product or sells or grants the right to remove or extract an input product to domestic industries at a price that is below market value for such inputs or removal rights (Senator Baucus' Office, 1986).

Counterpoint: Canadian stumpage rates are the same for both foreign and Canadian producers and for both foreign and Canadian markets

Even though provincial stumpage rates are low in comparison to those in the United States they cannot be regarded as a subsidy under U.S. law because they are 'generally available' in Canada to domestic producers and exporters alike; there is no 'two-tier' pricing structure that leads to export 'dumping' and U.S. companies avail themselves of the same stumpage rates as Canadian companies. Official studies in the United States have confirmed that stumpage practices do not confer a subsidy on the export of softwood lumber (Maly, DalSaglio, and McKinsey, 1986).

Canada's official reaction to S.1292 is that since the U.S. critics could not find an unlawful subsidy in the Canadian softwood lumber industry, they would change the law so that any difference that makes a foreign product more competitive is unlawful. The effect of the bill is to put everything in terms of U.S. standards. This is unrealistic when you consider that not every country has the same standard of living, resource base and environmental goals as the United States. Canada believes that S.1292 would place at risk all international trade, including that of the U.S., and that it is a substantial departure from international rule and practice and sets up a fair market value benchmark for input products which is impossible to measure with any objectivity (Diplomatic note 320).

Comment:

A 1985 study by the Congressional Budget Office shows the possible effects of amending the U.S. countervailing duty law. S.1292 would broaden the list of foreign government policies that are subject to countervailing duties to include the use of natural resources inputs at less than free market prices. The study also agrees with Canada's position that S.1292 could hurt international trade. Using U.S. prices to determine the fair market value of natural resources would present several problems. Generally the U.S. enjoys different productive capabilities than other countries and has different patterns of supply and demand. Using U.S. prices would negate these very substantial differences and could lead to misallocation of resources to the detriment of both U.S. consumers and foreign nations.

Fair Lumber Markets

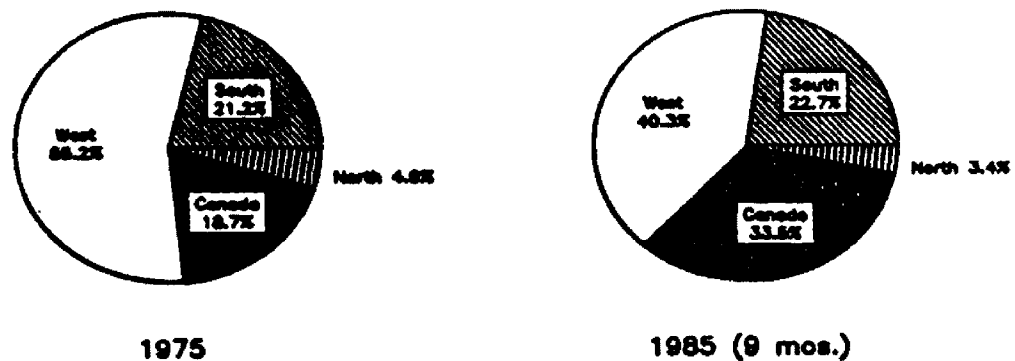
Point: U.S. lumber producers are being driven out of their own market by cheap Canadian imports

Between 1975 and 1985, Canada's share of the U.S. lumber market grew from approximately 19 percent to over 33 percent, as seen in

Figure 11. Because of this increase, domestic production has decreased in the U.S. Thus U.S. producers are being driven out of their own market.

FIGURE 11

REGIONAL MARKET SHARE OF U.S. LUMBER CONSUMPTION



Counterpoint: Canadian lumber imports complement the U.S. market

Canada should not be compared with countries who "dump" products into U.S. markets. In the past, Canada has been a willing supplier of lumber products to the United States, responding to formal government requests to maintain or increase lumber exports to help maintain the growth in the U.S. housing market. It is not appropriate for the United States to undermine Canada's lumber industry which is specially scaled to respond to U.S. needs (Maly, DalSaglio and McKinsey, 1986).

Comment:

Canada's lumber industry is geared for large levels of exports to the United States, mainly because in the past the U.S. has formally

requested that Canada increase its lumber exports to the U.S. It is difficult to ask a country to decrease its exports when it has been constantly asked to increase its exports in the past.

Implications of Free Trade Decisions on the Canadian and U.S. Lumber Industries

This section will discuss the possible effects on the Canadian and U.S. lumber industries if a free trade agreement is signed between Canada and the United States. It will also discuss the possible outcomes should free trade talks fail and trade restrictions be imposed.

If free trade is achieved between Canada and the United States, it will mean an end to duties and tariffs and nontariff barriers that are now in place to protect domestic industries in both countries. Free trade will mean that any product made in North America (Canada or the United States) could be sold anywhere within North America at the price the selling firm deems competitive. For example, a lumber firm in Alberta could sell its lumber to a housing contractor in Miami at the price it would sell it to a housing contractor in Calgary. No duties or tariffs would be placed on the lumber.

Assuming free trade negotiations are successful, there will be an increase in the variety of products available. The types of trees grown in Canada and the United States differ in species and, due to the colder climate in Canada, they also differ in strength (Northern trees tend to have tighter rings which tend to make them stronger). In other words, Canadian lumber products are different than those found in the United States. Free trade would allow products not normally found in a

region to become available in that market. This would help the lumber industries in both countries as they could supply the needs of both Canada and the U.S., and it would benefit consumers as it would increase the variety of products to choose from.

With increased trade comes increased efficiency in manufacturing. In order to remain competitive, firms on both sides of the border will have to increase their efficiency and in turn lower their prices to meet competition. Because new equipment would be required to meet new efficiency standards, the Canadian lumber industry would probably be in a more advantageous position than the U.S. lumber industry because over the past ten years Canadian firms have replaced old equipment with modern, more efficient, equipment while U.S. firms have continued to use the same equipment. The increased competition would lower lumber prices to both Canadian and U.S. consumers.

Because of the competitive nature that a free trade agreement between Canada and the United States would produce, more efficient means of lumber production would have to be used. To make the lumber industry more efficient, new machinery would have to be used and lumber companies would have to reduce their costs to remain price competitive. Increased efficiency tends to coincide with decreased employment. As machines take over the jobs of many unskilled laborers, companies will have to let workers go. A recent report by MTN News stated that the loss of jobs in Montana alone could reach into the thousands and that unemployed workers would probably seek jobs in the secondary lumber market. Both the Canadian and U.S. lumber industries see a decrease in employment if a free trade agreement is signed between the two nations.

Under the present system, the United States exports almost no lumber products to Canada. Some Maine logs head for eastern Canada but the wood products generally return to the United States (Maly, DalSaglio, and McKinsey, 1986). Free trade would allow U.S. lumber firms to sell their products in Canada without restrictions and allow Canadian consumers to take advantage of the different types of lumber available. The U.S. lumber industry could increase its non-domestic sales. There is also the possibility of the two industries joining forces to penetrate markets in other countries, thus opening third country market opportunities.

Free trade tends to lower prices because industries become more efficient. In Canada and the United States, the largest consumer of lumber products is the housing industry. As prices decrease, due to free trade, savings can be passed on to homeowners. The decreased cost of house building will encourage more people to build homes. While this fact will help the housing industries in both countries, it will also help the lumber industries in both countries as there is a direct correlation between housing starts and the amount of lumber sold. Costs to other users of wood products such as furniture makers will also go down. The benefits will be felt throughout the economy.

Maintaining long term supply is a concern in the United States where lumber demand is high and resources are slowly depleting. By allowing another country (in this case Canada) to provide cheap lumber resources, the United States would be able to conserve its lumber resources for higher value uses such as recreation or future consumption. Canada has large areas of productive resources (larger than those in the United States) yet its domestic demand is only one-tenth the size of U.S. domestic demand.

Free trade would reduce regulatory costs as no agencies would be required to stop or place tariffs on imports from Canada into the United States or vice versa. Presently some states and provinces do impose bans on certain types of lumber. This process would be eliminated under a free trade agreement between the two nations.

Assuming free trade talks fail and trade restrictions are imposed, costs to manufacturers are bound to increase. U.S. lumber is more expensive than Canadian lumber. If the United States were to impose a tariff on Canadian lumber to make it price competitive with U.S. lumber, the increased cost would be passed on to manufacturers who presently use Canadian softwood lumber (mainly in the housing industry). This would mean increased housing costs in the United States which in turn would mean fewer housing starts. As mentioned earlier, housing starts are directly correlated to the amount of lumber sold. If housing starts decrease, so does the lumber market. By placing restrictions on Canadian softwood lumber imports, the United States could be cutting its own lumber industry's throat.

By restricting Canadian softwood lumber imports, the United States will be forced to use domestic supplies of lumber to meet demand. Today, Canadian lumber meets 33 percent of total U.S. needs or about 15 billion board feet of lumber per year. There is some doubt as to whether the U.S. lumber industry can maintain a sustained yield under present conditions. Taking 15 billion board feet of lumber a year out of the reserves could destroy the future of the lumber industry.

As domestic supplies of lumber are decreased, the remaining timber stands will become more valuable. Since timber stands are owned predominantly by private firms in the United States, stumpage prices are bound to rise. The effect of this will be that market prices of lumber will rise. As market prices increase, cheaper products such as plastics will be considered as alternatives for lumber, thus reducing the demand for lumber and hurting the U.S. lumber industry.

As more restrictions are placed on Canadian softwood lumber imports to the United States, more agencies will have to be put in place to assure that the restrictions are enforced. Additional customs enforcement costs of \$100 000-\$150 000 per year have been estimated by the Congressional Budget Office (Maly, DalSaglio and McKinsey, 1986). That figure is for enforcement of the restrictions alone, not for discussing or studying the restrictions which is paid out of taxpayers money as well. Regulatory costs in the millions of dollars could be endured by the United States, if trade restrictions were placed on Canadian softwood lumber.

The major concern of placing trade restrictions on Canada's softwood lumber imports is retaliation by the Canadian government. Some U.S. officials feel that Canada will not retaliate. Senator John Melcher (D., Montana) said that Canada is taking advantage of Uncle Sam" and that lumber restrictions like the recent 15 percent duty placed on Canadian softwood lumber "will not spoil our relationship with them (Canada). However, Canada has responded to the recent lumber tariffs. Although saying it was not a retaliatory measure, the Canadian government imposed a duty on U.S. corn exports to Canada in November 1986. Placing trade restrictions on Canadian softwood lumber imports would have a devastating effect on Canada's vitally important lumber industry, and retaliation should be expected. If the United States were to continue to place restrictions on Canadian lumber, more retaliatory

restrictions would be inevitable on Canada's part. The bad feelings built up over a situation like this could have enormous effects on diplomatic ties between the two nations as well. The cooperation, communication and friendship that Canada and the United States have enjoyed in the past would be damaged.

While there are no obvious answers to the problem of burgeoning Canadian exports and corresponding market share reductions for some domestic producers, a mutually beneficial alternative to protection and retaliation is clearly what the two countries should pursue. Government officials in both countries have suggested working more closely together to expand and secure overseas markets for North American forest products in general. This approach seems sensible in light of the fact that both U.S. and Canada exporters suffer from the penalty of overvalued currencies. Following through with this approach would, however, require a much more cooperative attitude than is presently visible and arrangements to preclude the issue of 'unfair' competition from spreading into new market areas (Maly, DalSaglio, and McKinsey, 1986).

Implications of a Canada-U.S. Accord For U.S. Trade With Other Trading Partners

Before the turn of the twentieth century, over 80 percent of U.S. exports went to European nations, with Great Britain as one of the largest consumers of U.S. goods. Today only about 30 percent of U.S. exports are sent to Europe. While European export markets have decreased, Asian markets have increased. Between 1900 and 1985, exports to Japan have increased from less than one percent to more than 30 percent.

Import percentages have changed as well. In the early twentieth century, Europe accounted for over 50 percent of the imports to the United States. Asia on the other hand, has increased its imports to the United States from 15 percent in the early 1900's to almost 35 percent today, making Japan the second largest exporter to the United States next to Canada. 1980 statistics show Japan exporting \$30.8 billion of products to the United States and importing \$20.8 billion from the United States. Great Britain exported \$9.8 billion to the United States in 1980 and imported \$12.8 billion from the United States. Figure 12 shows the leading trade partners of the U.S. in 1980.

FIGURE 12

Leading Trading Partners of the United States 1980			
Major Customers	\$ Billions	Major Suppliers	\$ Billions
1. Canada	35.5	1. Canada	41.5
2. Japan	20.8	2. Japan	30.8
3. Mexico	15.2	3. Mexico	12.6
4. United Kingdom	12.8	4. Germany	11.7
5. Germany	11.1	5. United Kingdom	9.8
6. France	7.6	6. Venezuela	5.3
7. Italy	5.7	7. France	5.3
8. Venezuela	4.7	8. Italy	4.4
9. Brazil	4.4	9. Brazil	3.8
10. Australia	4.2	10. South Africa	3.4

Source: *Survey of Current Business* (November 1981), 18-20.

A free trade agreement between Canada and the United States could have definite effects on U.S. trade policies with other nations. Free trade will cause increased trade activity between Canada and the United States. Canadian products that had previously been restricted from entering the United States or that had duties placed on them will now be available to American consumers. This could allow Canadian firms to steal market share away from other import countries like Japan and Great Britain. Instead of buying technology from Japan, it may now be cheaper to buy it from Canada. Britain could lose some of the U.S. export market share if Canada were able to sell petroleum at lower prices. With Canada already the U.S.'s largest trade partner, a free trade deal between the two countries could open the door to Canadian firms to a much greater extent. If this were to happen, export nations like Japan and Great Britain could be severely hurt by the decreased U.S. export market share.

American firms will become more efficient under a free trade agreement because they will be openly competing with Canadian firms. This new efficiency level will cause prices to drop and possibly make products, normally imported from other countries, cheaper to produce in the U.S. Consumers may choose to buy cheaper American goods rather than import more expensive products. Therefore, U.S. trade partners face a possible reduction in their U.S. export market because of domestic U.S. domestic producers as well.

Finally, countries like Japan and Great Britain may be forced to negotiate a free trade agreement of their own with the United States. If Canada begins to take away their export markets, they will have to do something to try to stop the decay. A free trade agreement similar to one that would be signed between Canada and the United States could return the U.S.'s other trading partners to their former level of importance. However, there is a negative side to countries like Japan agreeing to free trade with the United States. Presently, Japan places a large number of restrictions on trade with foreign countries. If

Japan were to come to an agreement similar to that being discussed between Canada and the United States, it would have to remove most of these barriers. Japan is an extremely protectionist nation and it is possible that it would not want to remove the tariffs it now has in place. While Great Britain is not as protectionist in nature as Japan, it too would have to agree to remove a number of trade restrictions in a free trade agreement with the U.S. It is unknown whether Japan or Great Britain would be willing to remove their present trade restrictions on U.S. imports. If not, then a free trade arrangement between the U.S. and Japan or the U.S. and Great Britain would be unlikely.

If free trade fails between Canada and the United States, the door may open for other U.S. trading partners to capture some of Canada's export market to the United States. If free trade is not achieved it is likely that trade restrictions will be put in place by the United States government. These restrictions could cause hard feelings between the two countries and cause retaliatory actions to be taken by Canada. Once retaliation began, it could turn into a vicious cycle of tariffs and counter tariffs to the detriment of both nations.

America's other trade partners will be anxiously awaiting the decision on free trade between Canada and the United States. No matter what the outcome, it is likely they will be affected.

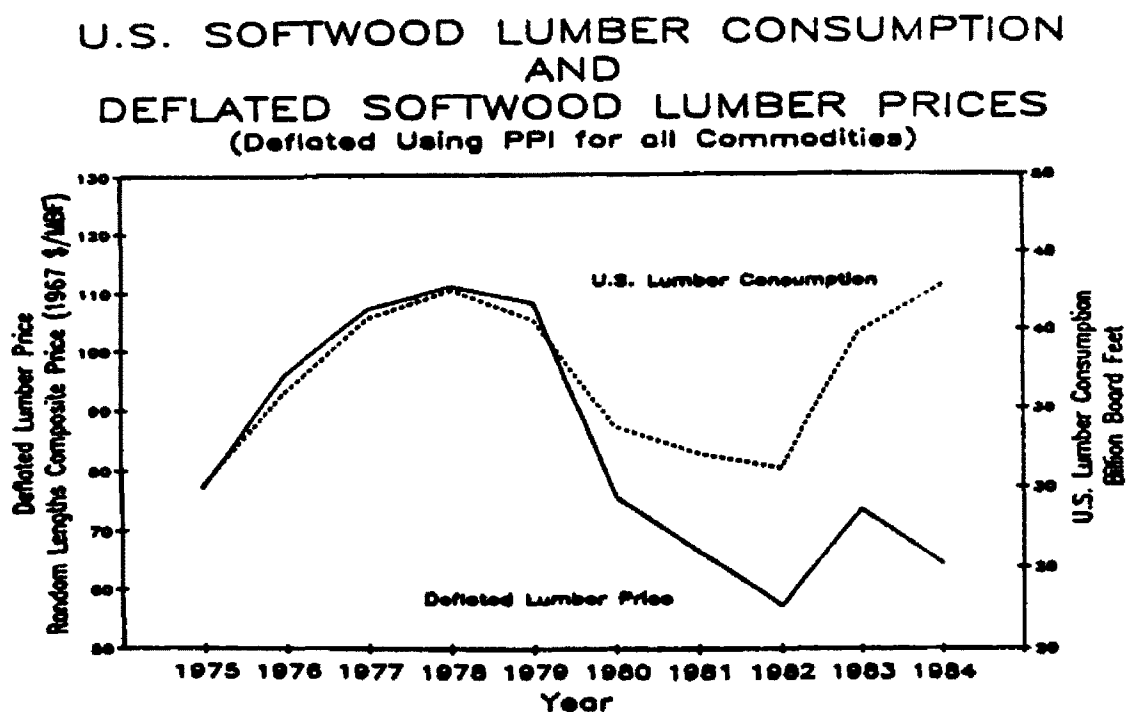
Chapter Summary

The demand for lumber in the United States is increasing. 1986 will set a consumption record, for the third year in a row. The long term demand projections of the 1970's are beginning to pan out. Yet, with the increased consumption of wood products, producers' profits are not at the level indicative of frantic economic activity (NFPA, May, 1986).

U.S. companies are operating with margins that are nowhere near the levels enjoyed during the 1970's housing boom. Figure 13 compares U.S. lumber consumption and lumber prices.

The cause of low prices and mill closures is an abundance of domestic supply coupled with increased imports from Canada and continued high production levels in U.S. mills. Figure 14 shows Canadian market share in the U.S., and Figure 15 compares Canadian lumber production to the Canadian share of the U.S. market. Added to this is the fact that stumpage charges in Canada (the price paid to the Canadian government for use of Crown Land) are much lower than in the United States, as shown in Figure 16, and therefore Canadian firms have an advantage over U.S. firms. Exchange rates are another factor in discovering the reason for the low price of lumber in a boom period. If a Canadian

FIGURE 13



firm sells lumber in the United States for \$1 Canadian, the U.S. consumer only pays \$.70 U.S. because of the exchange rate. With the low price of Canadian lumber along with a high value of the U.S. dollar, Canadian lumber becomes cheaper than domestic lumber in the U.S., thus driving the overall price of lumber down and decreasing the profit margins of U.S. firms. In turn, some mills have been forced out of business in the United States. Between 1977 and 1984, the U.S. International Trade Commission has reported a net loss of 629 U.S. softwood sawmill and planing plants, an 18 percent drop. By contrast, during the same period, Canadian sawmills increased by 85, a 9 percent increase (Coalition for Fair Lumber Imports, January 20, 1986). Figure 17 shows the lumber producing establishments in Canada and the U.S. from 1977 to 1984.

FIGURE 14

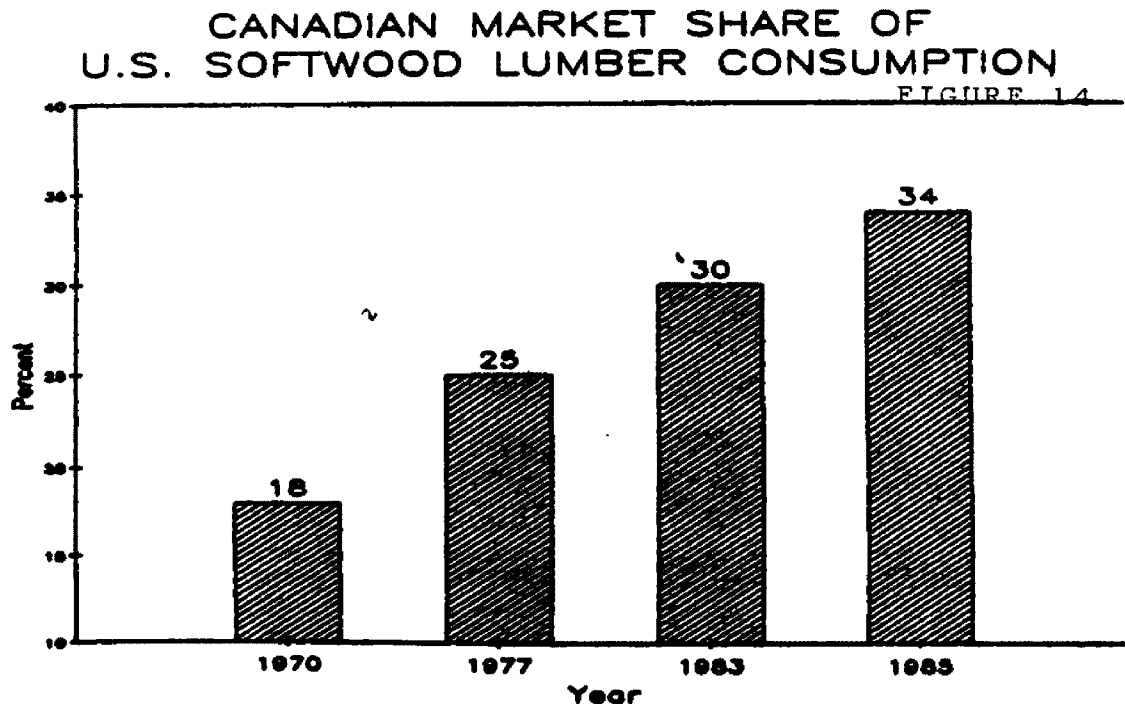


FIGURE 15

CANADIAN SOFTWOOD LUMBER PRODUCTION AND SHARE OF U.S. MARKET

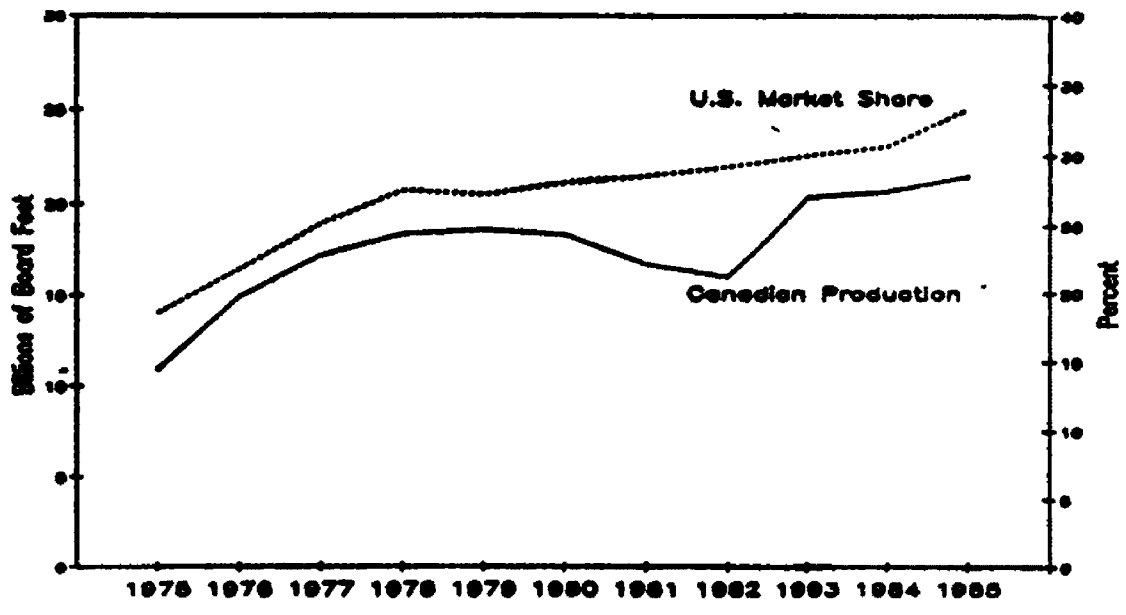


FIGURE 16

PRICE OF STUMPAGE U.S. AND CANADA 1984

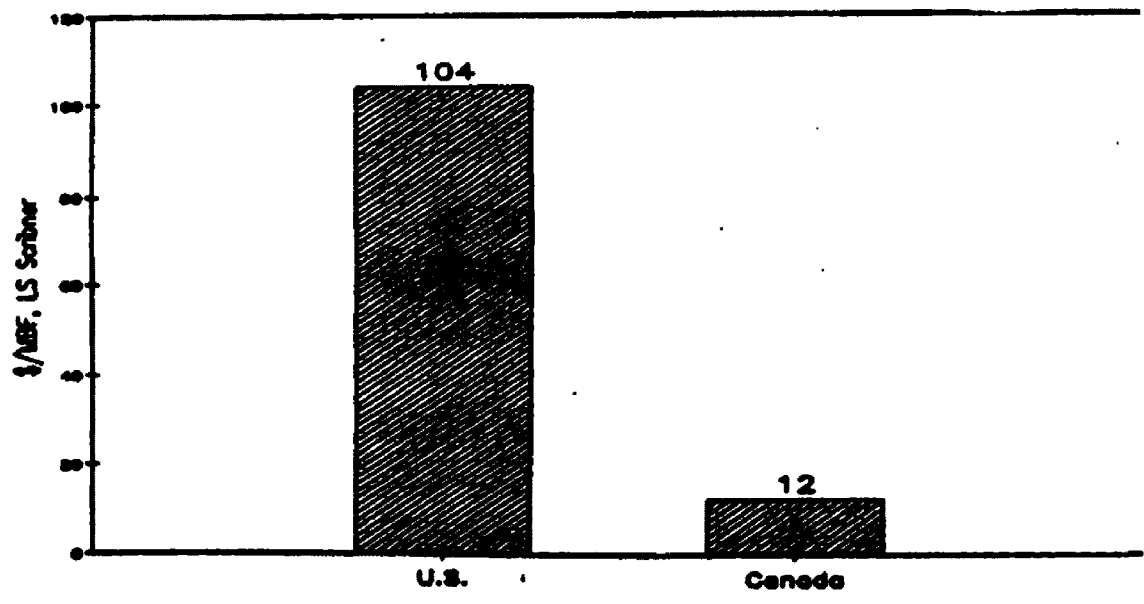
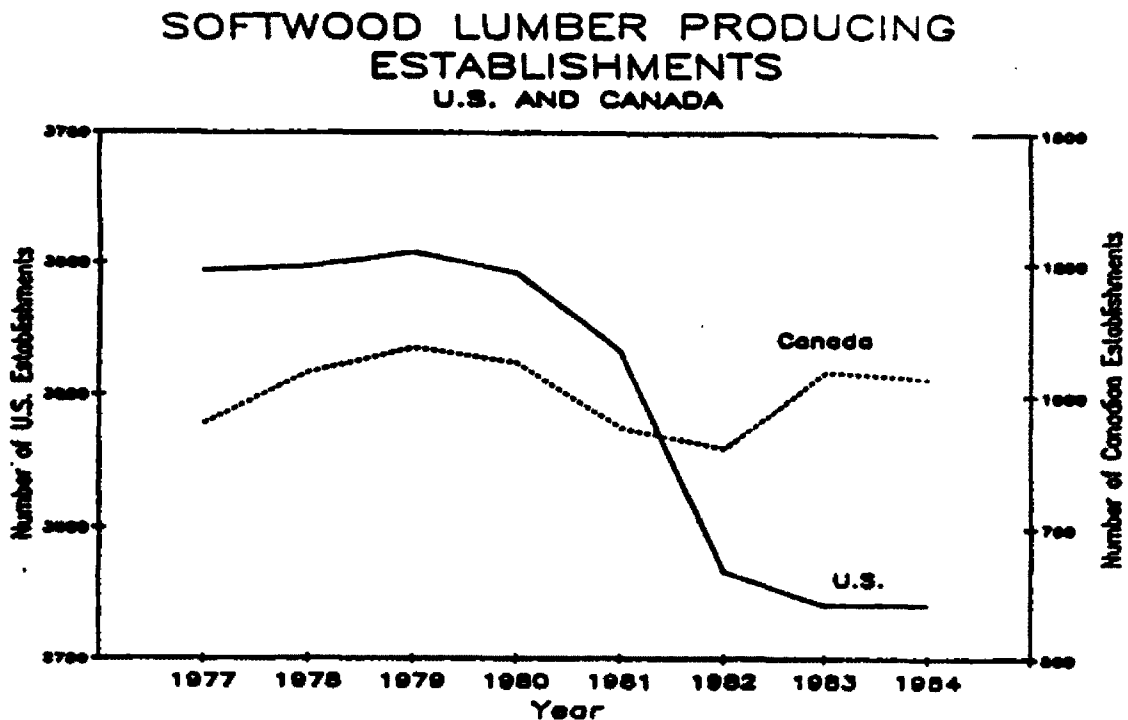


FIGURE 17



Because Canadian lumber imports are so visibly damaging the U.S. lumber industry, it is no wonder that the Canadian lumber imports are at the forefront of the free trade discussions between Canada and the United States.

If free trade is achieved between the two nations, a number of advantages and disadvantages will be realized by both lumber industries. New markets will be opened up, more efficient plants will be built, workforce requirements will be reduced and domestic resources (especially in the United States) can be conserved. If free trade is not achieved, the U.S. is likely to continue its policy of trade restrictions. This could harm the U.S. lumber industry by causing a

decrease in domestic supplies of lumber, increased stumpage fees and the possible use of cheaper substitute products.

There are also implications for other trading partners of the United States. They face the possibility of Canada capturing a portion of their export market in the U.S.. Free trade will mean increased trade activity between Canada and the United States and products normally imported to the U.S. from other nations may now be imported from Canada.

CHAPTER 4

SUMMARY AND CONCLUSIONS

Summary

Free trade has become the center of attention in both Canada and the United States over the past year. The two nations have expressed their desires to reach a joint agreement on free trade. Several preliminary sessions have been held between the two negotiating teams, but no date has been set for formal talks to begin. The two nations have until the fall of 1987 to reach an agreement (the deadline was placed on U.S. President Ronald Reagan by the U.S. Congress). If no agreement is reached by that time, the U.S. side will have to resubmit its request to Congress to allow negotiations between Canada and the United States to continue.

The main issue which is presently holding up the trade talks is lumber. The U.S. accuses Canada of subsidizing its softwood lumber industry by charging stumpage fees that are well below fair market value. This action causes Canadian lumber to be less expensive and because of this, exports from Canada to the U.S. have dramatically increased over the last ten years.

In 1982, a U.S. ITC report stated that Canadian lumber exports to the United States were causing an injury to the U.S. lumber industry. But the U.S. Commerce Department decided that Canadian stumpage prices did not constitute a subsidy to the Canadian lumber industry. Therefore no tariffs could be placed on Canadian softwood lumber imports. In 1985, the U.S. ITC reviewed their 1982 report and again found that Canadian lumber exports were causing injury to the U.S. lumber industry. This time, the U.S. Commerce Department found that

stumpage prices did constitute a subsidy and reversed its earlier decision.

The recent preliminary decision of October 16, 1986 by the U.S. Department of Commerce levied a 15 percent tariff on Canadian softwood lumber. The Department's final decision will be made on December 30, 1986. The Canadian government and softwood lumber industry deny that Canadian stumpage fees amount to a subsidy. They argue that since these fees are offered to a variety of producers, both Canadian and export, and that the price is the same whether the lumber is for domestic or export use, that Canadian producers are not being subsidized. Canadians also point out that exchange rates favoring the U.S. and the efficiency of Canadian mills also cause Canadian softwood lumber prices to be lower than U.S. softwood lumber prices.

There are serious implications to consider if Canada and the United States go ahead with free trade plans as well as serious implications if the trade talks fail. Free trade will bring an increased variety of products and lower prices while decreasing the lumber industries workforce. However, by buying cheap Canadian lumber, the United States could conserve its own lumber supply and guarantee a sustainable yield for the future. If trade talks between the two countries fail, it is likely that the United States will impose trade restrictions on Canadian softwood lumber imports to the U.S. . Presently, Canada fills about one-third of the U.S. domestic need. Having to supply domestic lumber requirements could cause the U.S. to fall below a level of sustainable yield needed to guarantee future lumber supplies. Restrictions could also increase the price of lumber which in the U.S. is directly correlated to stumpage fees. Therefore, stumpage fees are likely to increase if restrictions are imposed. By placing trade restrictions on Canadian lumber, the U.S. also leaves itself open for retaliation. Canada's lumber industry is vitally important to that country's economy and it is reasonable to believe that Canada would retaliate in some form.

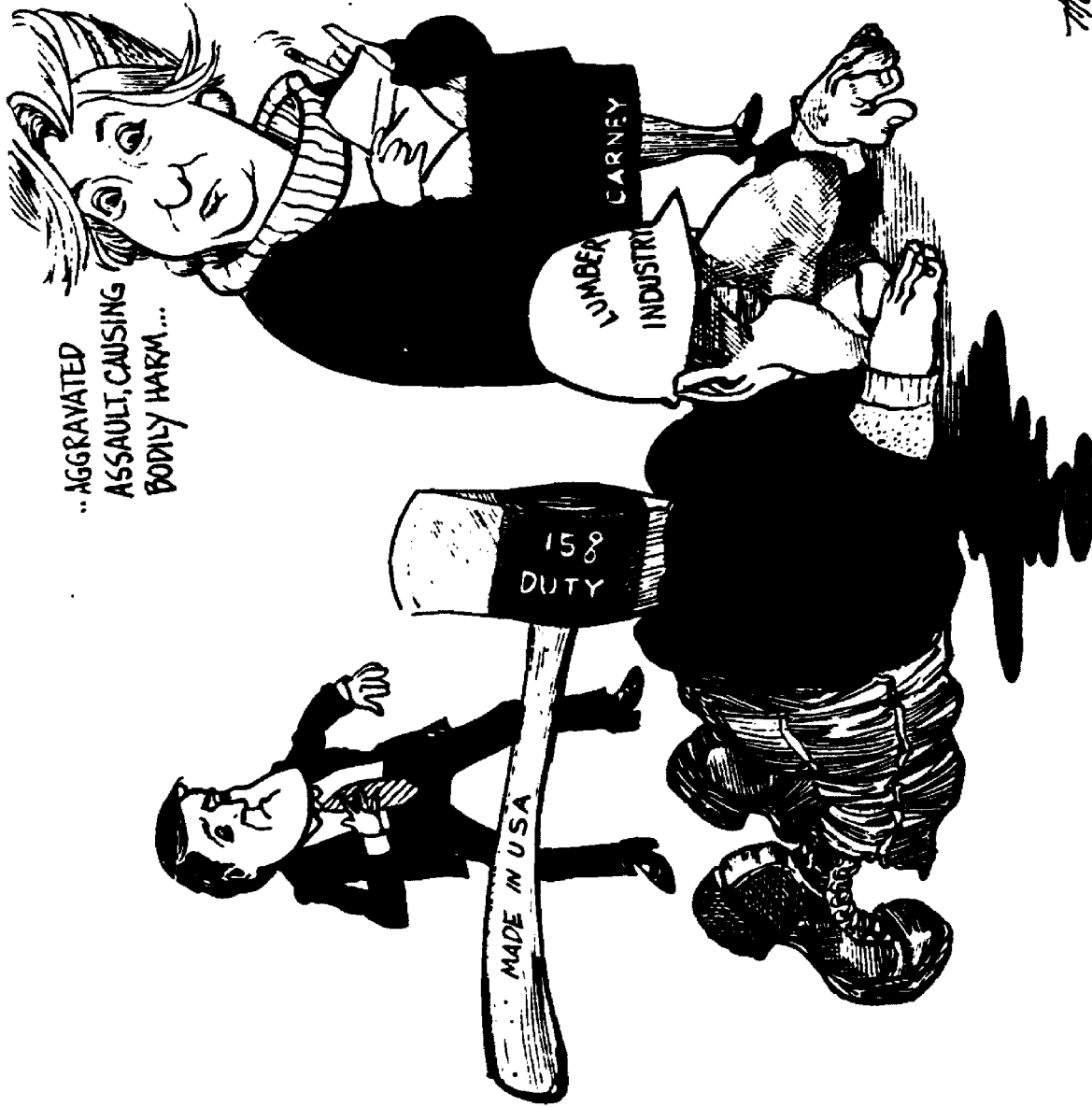
Free trade appears to be the most beneficial path for both countries. But unless an agreement can be reached on the lumber dispute, it is likely that trade restrictions will be put in place by U.S. officials.

The free trade issue has also implications for America's other trading partners to consider. A free trade agreement with Canada could lessen the amounts of exports the U.S. buys from countries other than Canada. It could also force countries like Japan and Great Britain to negotiate a free trade agreement with the U.S. themselves. Whether or not Japan or Great Britain would be willing to remove their present protectionist tariffs is unknown, but it is certain that neither country would be able to reach a free trade agreement with the U.S. (similar to the one Canada and the U.S. are discussing) unless they did remove the majority of their tariffs on foreign imports. If free trade is not achieved and trade restrictions are imposed by the U.S. on Canada, retaliation could occur. Potentially, the U.S.'s other trade partners could gain any lost export market share in the U.S. that Canada might experience.

Conclusions

In terms of the free trade talks between Canada and the United States, several conclusions can be drawn from this paper. This section will examine such conclusions.

Differences over the lumber dispute have caused the delay in free trade negotiations. Both sides feel that lumber is an issue that must be settled before any trade talks can begin. The United States has accused Canada of subsidizing its lumber industry by charging low stumpage fees on Crown Land. Canada argues that stumpage prices do not cause a subsidy and that when all of the costs to harvest timber in



..AGGRAVATED
ASSAULT, CAUSING
BODILY HARM...

LUMBER
INDUSTRY

158
DUTY

MADE IN USA

JONES
THE HERALD 11/10/36

'Murder' she wrote.

Canada are considered (transportation costs, sparse timber areas) the Canadian lumber industry does not have an advantageous position over their U.S. counterparts. The recent findings of the U.S. Department of Commerce disagree with Canada's position. The Commerce Department found that Canadian stumpage prices did constitute a subsidy to Canadian lumber firms and it imposed a 15 percent duty on Canadian softwood lumber imports to the U.S. The final decision on the duty will be made on December 30, 1986. The outcome will have a great impact on the future of free trade talks between Canada and the United States.

When the U.S. accuses Canada of setting stumpage prices too low, Canada is being judged by U.S. standards. Unfortunately, things are not the same in Canada as they are in the United States. Canada is a much more remote land with a colder climate, shorter growing season and sparser timber stands. Therefore, the timber harvested by Canadian producers is generally smaller than the timber harvested in the U.S. Also, because timber stands are so sparse in Canada, fewer trees are harvested from each timber stand in Canada than in the U.S.. Canadian stumpage fees should be based on Canadian standards, not American. This is the only way that an accurate assessment of Canada's stumpage fees could be made.

Stumpage fees are not the only area where Canada is judged by American standards. When U.S. officials talk about free trade with Canada, they speak in terms of the U.S. way of thinking. They do not seem to realize that other countries do not do things in the same manner as the U.S. Senator Russell Long was quoted as saying I have hope of getting the government of Canada to agree to trade rules that are consistent with those we have learned to live with in the United States.

A free trade agreement will be beneficial to both Canada and the United States. With free trade, the potential markets for industries in both nations increase. Canadian firms have been waiting for the day when they could compete for U.S. government contracts.

Free trade will allow these Canadian firms to compete against U.S. firms for these contracts. The U.S. can benefit from a free trade agreement with Canada because Canada has an abundance of natural resources which the United States could use. Domestic requirements for natural resources in the U.S. are enormous. The United States could guarantee a sustained yield of natural resources by buying cheap Canadian resources. A free trade agreement would benefit both Canada and the United States.

Protectionist feelings are growing in the United States as can be seen by the over 300 pieces of protectionist legislation now before the U.S. Congress. If free trade talks fail between Canada and the United States, the U.S. is likely to impose trade restrictions on Canada. The main issue holding up the trade talks presently is the export of Canadian lumber. The U.S. has already placed an import tariff on Canadian Shakes and Shingles and has moved to place a tariff on Canadian softwood lumber imports. The U.S. trend in placing tariffs on Canadian lumber is likely to continue.

A free trade agreement must be reached between Canada and the United States before the fall of 1987 (due to restrictions placed on the U.S. bargaining team by the U.S. Congress). Presently, the negotiations are stalemated over the issue of lumber. A number of discussions have been held between the two nations on the lumber issue but no agreement has been reached. Because of this, the U.S. Department of Commerce moved to impose a 15 percent tariff on Canadian softwood lumber imports. The decision will not become final until December 30, 1986 and Canada will not decide what actions to take in response to the tariff until then. It is certain, however, that the U.S. tariff will not be the end to the lumber dispute. Since both sides have stated that free trade talks cannot begin until the lumber issue is resolved, it seems unlikely that a free trade accord could be reached by the fall '86 deadline. The present trade talks between Canada and the United States are bound for failure. The only hope for a free trade agreement between Canada and the U.S. is if settlement can be reached on the lumber issue and then the U.S. Congress and Canadian government agree to begin a new round of trade talks.

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