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CANADA-U.S. ECONOMIC RELATIONS--A CANADIAN VIEW

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London, Ontario

This paper contains preliminary findings from research still in progress and should not be quoted without prior approval of the author.

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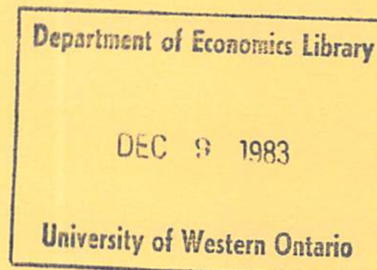
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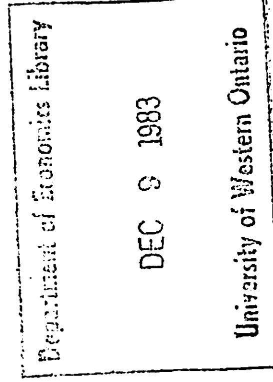
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by

R. J. Wonnacott

September, 1983

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CANADA-U.S. ECONOMIC RELATIONS--A CANADIAN VIEW

INTRODUCTION

Canadians and Americans have quite different perceptions of their economic ties--in particular, the trade flow between the two countries which is greater than any other trade flow that has ever existed. While this trading relationship is clearly important for Americans, it is not a cause for constant preoccupation: The U.S. still has a relatively balanced set of economic interests, based on substantial trade flows with a wide variety of other countries--in particular, with Japan, and the major countries in Europe. On the other hand, for Canadians, this U.S./Canadian trading relationship is of much greater concern, for two reasons: (1) It represents an overwhelming proportion of our total trade: our trade with the U.S. alone is more than double our trade with Japan, Germany, the UK and all other countries taken together. (2) It's not just that the U.S. plays a dominant role in our trade. In addition, trade plays a much greater role in Canadian economic activity: exports generate a much larger proportion of GNP in Canada than in the U.S. These two considerations can best be summarized by noting that while U.S. exports to Canada generated 1 percent of U.S. GNP, Canadian exports to the U.S. generated 16 percent of Canadian GNP.

This means that if the two countries introduce restrictive policies against the other's exports which are nominally equivalent, the relative damage done to the Canadian economy

will greatly exceed that to the U.S. To extend this argument further, consider countervail. The risk that U.S. countervail may be invoked in the future may effectively prevent a company wishing to service the North American market from establishing in Canada--because, by so doing, it would run the risk of a future U.S. countervail that would damage its sales in more than 90 percent of the North American market. (Here we use North America loosely, to represent only Canada and the U.S.) Accordingly, the firm establishes in the U.S., where the threat of exactly the same Canadian countervail would involve little risk: less than 10 percent of its market would be affected.

(This is not necessarily an argument against countervail as an economic instrument--although a strong case can be mounted against it if it is used as a protectionist--rather than a free trade--device. Of course, the problem of sorting out which of these is the real motivation is often a near impossible task, so the issue is one on which it is difficult to be categorical. More on this later.)

But before leaving the subject of countervail tnere are, I believe, some interesting observations to be made, in particular in terms of its "near-miss" application by the U.S. earlier this year to Canadian exports of lumber. The damage this would have done to Canada is obvious, in terms of the shock to the already depressed British Columbian economy. But there would have been severe damage to the U.S. as well, from the more rapid escalation of domestic lumber prices that would have occurred, with the problems this would have raised for the U.S. in its attempt to wring inflationary expectations out of

the system. The progress made so far would have been seriously jeopardized by the more rapidly rising price level in construction--one of the sectors leading the recovery.

The implications for Canada--had this U.S. countervail been imposed--would have also been interesting. Provincially determined stumpage fees, set at a level below the market price, have provided at least some encouragement for Canadian exports (a "de minimus subsidy", according to the U.S. ruling). The problem has been that over time this advantage has not remained with the exporting companies, but has instead been absorbed in higher wage contracts in the lumbering industry. But these contracts have tended to lead wages in other B.C. industries; thus wages and costs in B.C. have become elevated in other industries that can't afford it (i.e.; where an advantage such as low stumpage fees has _not_ existed). This has been viewed by Canadian economists as an important reason for the combination of relatively high wages and high unemployment rates that have been observed in B.C. But for our discussions here the really interesting observation is this: Suppose that advantage to the lumber industry had been captured not only by the labor force in lumbering, but then _also_ by the U.S. treasury this year in the form of countervailing duties. Had these duties been imposed, the encouragement to the industry in the form of low stumpage fees would, in the process of being lost _twice_--once to the local labour force, and once to the U.S. treasury--have made B.C. lumber exports _less_, rather than more competitive in the U.S. market.

To return to the main thrust of this paper, the Canadian

dependence on the U.S. market, plus the existence of economies of market size in Canadian manufacturing make it crucial for Canada to ensure that our economic relations with the U.S. are not jeopardized. This is clearly not an absolute guideline for Canadian policy: We must be prepared, for example on policies of clear political principle, to run the risk of U.S. retaliation against our exports, with the costs this would involve for Canada. But, it makes no sense whatsoever for Canada to risk jeopardizing our relationship with the U.S. by introducing a policy that offers no advantage to Canada--and it is more questionable yet again to introduce a policy that not only offers no benefits, but involves _costs_ to Canada. An example that comes to mind is the National Energy Policy's 25 percent back-in on Crown Lands--a policy that, in addition to affecting the atmosphere in which U.S. trade decisions are made, involved other, even more concrete costs to Canadians as well, due to the adverse pressure generated on the Canadian capital account. These costs may have been subtle and indirect, but they were far from inconsequential: the adverse capital account pressure was offset by a Bank of Canada attempt to support the exchange rate by domestic monetary policy that raised interest rates to higher levels than they would have otherwise reached. Thus the damage to Canada was a more severe recession and a higher level of unemployment. The NEP also increased the financial leverage on the Canadian economy at a time when leverage became very costly. The capital outflow that resulted from the purchase of foreign oil assets by the Canadian government was offset by a capital inflow generated by

the tight (high interest rate) policy of the Bank of Canada in its attempt to stabilize the Canadian dollar. Thus as a nation we were acquiring oil assets by increasing our foreign debt. Moreover we were doing it at the worst possible time--when both the value of oil assets and the interest cost of carrying debt were inflated.]

But while it is true that many of our problems have been self-inflicted, there are many over which we have had little control. The level of real interest rates in Canada has been very high in the early 80's not only because of capital account pressures generated by nationalistic policies such as the NEP, but also because real interest rates have been high in the U.S. Indeed these high U.S. rates have raised problems within the U.S. economy that have indirectly damaged Canada. Specifically, the 1981-82 combination of high real American interest rates and recession generated protectionist pressure in the U.S.--a pressure that was augmented by two other problems brought on by high interest rates: a slower rate of U.S. capital formation, and a high value of the U.S. dollar. Both of these made it difficult for U.S. industry to export and compete with imports, and hence for the U.S. administration to resist protection--protection which is, of course, particularly damaging to the Canadian economy.

(With the recent economic recovery, these pressures are becoming less severe. The question in the short term thus becomes: "How substantial and sustained will the recovery be?" The answer to this will in turn be influenced by what happens to U.S. interest rates: "Will they rise again, as the

recovering business demand for funds augments the continued pressure on financial markets by the U.S. treasury? To what degree, if any, will this pressure be offset by downward pressure on interest rates, as the flow of savings increases with recovery, and the expectation of inflation adjusts to the low inflation rate that now prevails?")

I'd like to turn now to what I judge to be a manifestation of U.S. protectionism that is potentially of great concern to Canadians.

THE NEW U.S. RECIPROCITY[1]

While this could raise special problems for Canada (which I consider later) I begin by considering how the U.S. might apply this policy to Japan--the favourite "designated target". Proponents of the new reciprocity proposals that came before the U.S. Congress in the early '80s argue that, if the Japanese are protecting their economy in subtle ways, they should be told that there will be a clear and unambiguous U.S. response: equivalent barriers to Japanese goods entering the U.S. market. Thus the U.S. can make clear to the Japanese that the protectionist policies they have (correctly or incorrectly) viewed as increasing their welfare will turn out to clearly and obviously reduce their welfare because of the damage the U.S. response will do to Japanese exports. In this way, it is hoped, the U.S. may be able to discourage the Japanese protection that damages U.S. exports.

Unfortunately, this policy is not that simple; so I'd like

to consider it in some detail. First, as it is currently being used in U.S. debate, it represents an entirely new interpretation of the term "reciprocity". Whereas this term had been used in the past to describe policies aimed at liberalizing trade, it wasn't clear whether the form of reciprocity that's been considered in the U.S. in the last few years would liberalize or restrict trade. To clarify this issue, consider four very different ways the term "reciprocity" can be defined:

1. Active policies to liberalize trade by reciprocally reducing tariff barriers between all countries (multilateral reciprocity) or between two countries (bilateral reciprocity). The expected effect of such policies is increased trade with collective welfare gains (with exceptions in the case of bilateral reciprocity if there is substantial enough trade diversion to make the costs of this policy exceed the benefits).
2. Passive policies of witholding trade concessions to countries that are not prepared to reciprocate.
3. Policies of matching any increases in foreign protection with automatic increases in U.S. protection. Such policies may increase protection; or they may be trade liberalizing (at least in the sense of preventing the present trading system from becoming more protectionist).
4. Policies that would allow the U.S. to impose new trade barriers against countries whose existing barriers

to trade are judged by the U.S. to be higher than corresponding American barriers. Such policies would be more likely to be used as a protectionist device. We shall refer to this category of policies as the "new reciprocity", or in the phrase used by William Cline (1982) "aggressive reciprocity".

Note that the further we go down on this list the less likely that the policy will be a liberalizing device, and the more likely it will turn out to be protectionist. Historically, Americans have used this term "reciprocity" in the first (and perhaps the second) sense. Now it is being used in the third and--particularly before Congress in 1982-3--in the fourth sense. It is this category of policies that we shall now analyse in detail. First we consider, in the light of a "new trade literature" the claim that such policies legitimately deserve public support.

Can Comparative Advantage be "Created" or "Engineered"?

Much of the intellectual credibility of this new U.S. policy proposal is based on the view that, in a wide range of emerging products, comparative advantage may be arbitrary--that is, created or engineered rather than determined by traditional considerations, such as factor endowments. Of course, endowments still determine who produces oil and bananas, but--according to this view--they are becoming less and less influential in a broad range of high-tech products that may now be almost equally well produced in the

U.S., Europe or Japan. Three possible reasons have been suggested for this:

1. Differences in factor endowments--especially between North America, Europe and Japan--are no longer as important as they used to be because some factors have become more freely available. For example, one factor crucial for high-tech industries--namely, capital--has become increasingly mobile between countries. And the more freely capital moves between countries, the less important are differences in labour/capital endowments. Moreover, in many new high-tech products, natural resources are not an important factor.

2. Technology has become a more critical consideration. Indeed, it has been argued that technological capacity should be viewed in its own right as a factor of production--and an increasingly important one, at that. Since technological capacity is, to a substantial degree "created rather than endowed", a natural question is: How can it be created, and thus provide a future comparative advantage in technology-intensive industries--which in many (but not all) cases are rapid growth, high income industries?

3. Economies of scale may mean that the first country to develop a product will be the low-cost producer--even though it may not have the lowest attainable cost curve (i.e., even though, roughly speaking, it may not have a comparative advantage). Its "comparative disadvantage"

may be more than offset by the advantage it achieves from the head start which gives it the highest volume and lowest cost. It may then be able to use this "volume" cost advantage to deter entry by other producers--perhaps even producers with a slightly lower cost curve, but inadequate volume to compete.

In these circumstances, the U.S. concern is that the Japanese may be able to create a comparative advantage in technology-intensive goods through their current policy of "targeting" certain of these products, and then subsidizing and protecting them in the Japanese market--while at the same time enjoying the relatively free access these goods get into the U.S. market.[2] Suppose this targeting policy of the Japanese succeeds in "picking a future winner". (We assume this hereafter, while recognizing that in practice it's not that easy; often the Japanese pick losers instead. But they're not as visible, because winners get across the Pacific, but losers don't.) To the degree that Japanese targeting <u>is</u> on winners, the Japanese may judge, strictly from their own narrow point of view (and assuming no retaliation by the U.S.) that this sort of modern-day "infant protection" may be justified.[3] This justification may follow from the profits that are eventually earned in these activities[4], plus externalities such as the additions these activities make to the Japanese technological endowment that may create a comparative advantage for Japan in future high-tech activities. An example cited has been the Japanese fostering of production in 16K and 64K RAM (random

access memory) semiconductor chips.[5]

Suppose a U.S. policy of aggressive reciprocity were to prevent the Japanese from thus acquiring activities in which the U.S. would otherwise specialize (i.e. activities in which the U.S. would enjoy a comparative advantage if the Japanese can be prevented from artificially creating one). Then aggressive reciprocity may indeed benefit the U.S.

The Possible Effects on Canada, if the U.S. Applies This Policy to Japan

If the U.S. bilaterally applies aggressive reciprocity to the Japanese, Canada may benefit for two reasons:

1. Some U.S. purchases may be diverted from Japan to Canada, with increased export benefits to Canada. (Although this conclusion is reasonably assured, there would be some indirect costs to Canada of the lowered income and higher costs in Japan and the U.S. that might result from a trade conflict between the two.)
2. Canada would benefit from this policy, if it were to replace present non-discriminatory U.S. safeguard protection. (Even though such protection may be aimed at the Japanese it must--to be consistent with the GATT--be applied to all U.S. imports. Thus it damages Canada--in fact, it may damage Canada more than Japan.)

Unfortunately, however, a U.S. policy of aggressive reciprocity involves a number of possible costs for Canada:

1. Such a bilateral U.S. protective measure aimed at a specific partner would damage the multilateral

principle of equal treatment to all MFN partners in Article II of the GATT. (For a small country, in a world of large countries, this is an important principle; it prevents large countries from concluding bilateral deals that exclude Canada and hence discriminate against Canadian exports. A major exception to this principle is the customs union or free trade area which is viewed as acceptable by the GATT----within limits specified in Article XXIV.)
2. Aggressive reciprocity is based on a very special and controversial concept of equal treatment. In trade negotiations in the past, the attempt, by and large, has been to equalize changes in protection; but this new concept of reciprocity attempts to equalize existing levels of protection. In other words, the U.S. would be raising trade barriers against trading partners whose levels of protection may not have changed at all; their only offense may be that their existing barriers are judged by Americans to be higher than those of the U.S.
3. Although the present target for this U.S. policy is Japan, it is easy to see how, once the precedent is accepted, this policy might be turned against Canada: In many industries, Canadian tariffs are higher than in the U.S., thus making us vulnerable to an American attempt to achieve "reciprocity" by increasing U.S. barriers to our exports. (This is particularly important for Canada, because--as already

noted--nominal equivalence of Canadian and U.S. trade barriers leaves Canadians at a disadvantage; hence there is a tendency for Canadian trade barriers to be higher than those of the U.S.--at least in a nominal sense, though perhaps not in the sense of their real restrictive effect.)

Effects on Canada if the U.S. Applies Aggressive Reciprocity to Canada

If the U.S. applies this policy to Canada rather than Japan, the effect on Canada would be entirely different. In particular, when the U.S. threatens its initial "reciprocity" trade restriction, Canada would face a choice: Give up the protective tariffs, export subsidies, and/or tax policies that have triggered the U.S. threat, or face possible U.S. action against our exports.

If we do give up these forms of protection, then in economic terms Canada may benefit or lose, depending on whether these policies have been benefitting Canada or not. (For example, are we having to give up an activity of "created" comparative advantage in which we are getting infant benefits? Alternatively, is this U.S. pressure just "saving us from ourselves"--or more precisely "saving us from those groups in Canada that might otherwise be able to promote their own self-interest through protection and subsidies--at national cost?")

On the other hand, if Canada were to ignore the U.S. threat and the U.S. does introduce these new trade restrictions, the result would be unambiguously damaging for Canada--even if the

conflict were to end here. The efficiency costs for the relatively small Canadian economy would be substantial because reduced export sales would mean lost economies of scale. And Canada would face a terms-of-trade loss from the U.S. tariff.

Moreover, if Canada were to retaliate, and an escalating trade conflict between the two countries were to result, Canada would be damaged even more. Because the Canada/U.S. terms of trade in manufactures is dominated by the U.S., any Canadian trade restrictions in manufactured goods would provide little relief from the adverse effect on our terms of trade from U.S. trade restrictions. In other words, with each round of protective thrust and counter thrust by the two countries in a trade conflict, Canada's terms of trade would, on balance, deteriorate. And, of course, economies of scale would be lost as exports were reduced. Finally, there would also be the familiar efficiency losses in consumption that would result from Canadian trade barriers, including the cost of a more restricted variety of products available to Canadian consumers.

[If the Canadian trade restriction that "keeps the trade war going" is an export subsidy, then the futility of this measure is transparent--especially if this Canadian export subsidy is set to offset a newly-imposed U.S. tariff. The Canadian export industry would be left unaffected since the export subsidy it would receive from the Canadian government would offset the new U.S. tariff it would have to pay. But there would be a large loss incurred by Canada, since the Canadian taxpayer (via the Canadian exporting firm) would be paying a duty to the U.S. that didn't exist before. Such a

policy is clearly out of the question for another reason as well: the U.S. would be able to tax Canada at will simply by changing the level of its tariff.]

Even if a trade war does not develop, any U.S. attempt to bilaterally monitor its trading relations has serious implications for Canadian sovreignty. True, some Canadian sacrifice of sovreignty results whenever Canada signs trade agreements under the GATT. But this sacrifice is more than made up for by our improved access to foreign markets (i.e., by the sacrifice of sovreignty by our trading partners when they also sign these agreements). But if the U.S. is attempting to partially replace the GATT in monitoring the world's trading system with aggressive reciprocity, the Canadian problem of loss of sovreignty becomes more severe. Our domestic policies that have unavoidable implications for our international trade--such as our programs that subsidize regional industrial development--would be monitored, not by a panel of the GATT, but by the U.S. This raises problems of sovreignty in any case, but especially so if the U.S. Congress becomes more protectionist.

In summing up the effects of U.S. aggressive reciprocity on Canada, the key question is "Who is the U.S. target?" If the U.S. is using this policy on Japan, Canada may well benefit by picking up some of the broken pieces of U.S./Japan trade. But if Canada is the target, then the effects on us are likely to be damaging. In addition to the incursions by the U.S. on Canadian sovreignty (incursions which to some degree are inevitable in any important trading relationship, but which

are now controlled at least to some degree by GATT "due process") there would be substantial Canadian losses from reduced access to the U.S. market. These losses would become more and more serious were this dispute to escalate into a trade war.

I should now like to completely shift focus, from the economic policy (of aggressive reciprocity) that may be more likely than any other to dramatically sour the relationship between the two countries, to a policy that could, in an equally dramatic way, improve relations.

A CANADA/U.S. FREE TRADE INITIATIVE IN MANUFACTURED GOODS? THE CANADIAN VIEW

The essence of the case for such an initiative is this. In manufactured goods in which there are economies of scale and other advantages of a large market, how can Canadian industrialists, producing in a domestic market of about 20 million people, compete with producers in Japan, the U.S. or Europe who have access to tariff-free markets of more than 100 million? By allowing goods to flow freely between the two countries, a Canada/U.S. free trade agreement would provide Canadian producers and consumers with the benefits of a "domestic" Canada/U.S. market of more than 200 million people.

In evaluating the effects on Canada in a more detailed way[6], it is important to distinguish between the effects on Canada of removing our own trade barriers against U.S. goods and the effects on Canada of the removal of U.S. trade barriers against our goods.

The Effects of Removing Canadian Barriers against U.S. Goods

This would reduce the price within Canada of imports from

the U.S. (and of goods produced in Canada in competition with these imports). Moreover, with free entry into Canada, the quantity of imports would increase for two reasons, both beneficial to Canada: (a) Canadians would benefit from being able to increase their consumption of bargain-priced goods (both imports and import-competing goods). (b) To some degree, imports would displace higher cost Canadian production; we would be giving up products in which we have a comparative disadvantage in order to acquire them less expensively by importing them instead. (While employment in Canada would decrease as imports displaced some domestic production, there would be an offsetting tendency for employment to increase because our exports to the U.S. would increase as U.S. trade barriers came down.)[7]

<u>The Effects of Removing U.S. Barriers against Canadian Goods</u>

1. Just as we noted earlier that a new U.S. tariff would cause a terms-of-trade loss to Canada, removal of existing U.S. tariffs would provide Canada with a terms-of-trade benefit. From the point of view of individual Canadian firms, this would manifest itself in the following way: At present, many Canadian industrial exports pay a U.S. tariff at the border which goes to the U.S. treasury. With the elimination of this tariff, Canadian exporters would no longer pay this "tax" to Washington. In other words, the U.S. treasury would no longer collect this slice of income from Canadians. Instead this income would be transferred back from the U.S. treasury to Canadian exporters and eventually to Canadian labour and other factors of production.[8]

2. Whereas the point above applies to <u>existing</u> Canadian exports, the removal of U.S. trade barriers would also provide another, much more important source of benefit to Canada--the opportunity for Canadian firms to <u>increase</u> their exports to the U.S. The resulting increased specialization in Canada in selected export lines where there are economies of scale would reduce manufacturing costs. This in turn would raise Canadian real income.

To sum up: With the elimination of trade barriers between the two countries, Canadian producers would rationalize--that is, specialize in a smaller range of goods, producing each at higher volume and frequently at lower cost. In doing so, Canadian producers would be responding to both a carrot and a stick. The carrot would be freer access to the large U.S. market. The stick would be the removal of Canadian trade barriers, which would leave many Canadian firms unable to compete with less expensive imports unless they did rationalize and thus reduce their costs. The reductions in Canadian costs (that is, increases in Canadian productivity) would allow Canadian firms to be more competitive not only in the U.S., but also in third markets. And eventually, these productivity increases would allow Canadian producers to increase their wages and/or reduce their prices. (Indeed, inexpensive imports would force them to reduce their prices.) Thus, because of a combination of lower prices and increased wages, Canadian real income would rise.[9] Estimates of these and other Canadian income gains resulting from bilateral removal of Canada/U.S. trade barriers are very large--falling in the range of 5-10% of

Canadian GNP (Harris and Cox, 1983, and Wonnacott 1975.)

But with the increase in our income, would the activities in which we engage change drastically? Specifically:

Would Canadians Become "Hewers of Wood and Drawers of Water"?

It is true that removal of only our own trade barriers would move Canada in this direction, at least to some degree. The reason is that the Canadian tariff (like those of other countries) is escalated, providing heavier protection to manufactured goods than to resources; and if only this tariff were to be removed, Canadian manufacturing would be likely to contract. While it is not clear that the resulting redirection of Canadian activity towards resource processing would be as damaging as Canadians sometimes assume (many oil exporting countries have discovered that "drawing water" at $20-$40 a barrel can be extremely rewarding) almost no one suggests a policy of removing only the Canadian tariff. Instead the issue is removing both the Canadian and U.S. tariffs; thus we would be getting rid of a U.S. tariff that is also escalated--and that has consequently deterred Canadian export and production of highly processed goods. (Since these goods have to pay a high tariff at the U.S. border, we have tended to concentrate more heavily on exporting low-duty or duty-free primary products.)

In short, the Canadian tariff encourages us to concentrate more heavily on highly processed goods, while the U.S. tariff pushes us in the other direction, towards concentrating on resources. If both tariffs were removed--with their largely offsetting effects--it's not clear that we would move strongly

in one direction or the other. Indeed, the existing Canadian industrial corridor between Windsor and Quebec City is a reasonably good location to produce highly processed goods for Canada/U.S. distribution--provided trade is completely free across the border. The reason is that this Canadian corridor lies along the Northern edge of the largest market in North America--that is, the market in the Chicago/Boston/Baltimore triangle. In this respect, Toronto is a considerably better location than the "out-of-the-way" Minneapolis-St. Paul area (which despite its distance, has nonetheless been able to attract and retain considerable industry in free trade competition with other U.S. locations.)

The Problem of Canadian Vulnerability

A Canada-U.S. free trade agreement would be a much more irreversible option for Canada than the U.S. (See, for example, Sharp, 1972, p. 15). The relative size of the two countries leads to this conclusion. In a fully rationalized North American economy, firms in the U.S. would have very limited dependence on Canadian markets (less than 10 percent of the North American market is in Canada), while firms in Canada would be heavily dependent on the U.S. market. Accordingly, while the reintroduction of trade restrictions in such circumstances might do considerable damage to the U.S., it would involve a much heavier cost for Canada. Thus the threat of termination of a free trade agreement would give the U.S. a bargaining lever that would be very difficult to resist and might conceivably be exercised to influence Canadian policy in quite unrelated noneconomic areas.

It is important to keep this problem in perspective. It is true that, in a free trade area, Canada would be hurt more by the reintroduction of U.S. protection. On the other hand, this is less likely to occur, because a free trade treaty would more strongly bind the U.S. against imposing trade barriers against Canada. Thus it is by no means clear that our vulnerability (in the sense of "expected loss") would be any greater than at present. But, in any case, it is important that as strong guarantees as possible against the reintroduction of U.S. protection be written into the treaty. One important measure would be to formalize the August 1971 precedent. Thus, if the U.S. felt that it must impose surcharges to defend itself against balance-of-payments difficulties, these should be limited to U.S. imports on which a duty is already being paid, with Canada consequently escaping such measures. In fact, far from hurting Canadian producers, such an increase in U.S. protection would benefit Canadians because it would increase our preference in the U.S. market over the Europeans and Japanese. Thus the expectation is that the imposition of U.S. surcharges (with Canada exempt) would paradoxically involve a cost for third countries, and for the U.S. (for the standard reasons that a country is likely to be damaged by its own protection) but a benefit to Canada.

In short, in a free trade area, Canadian vulnerability to changes in U.S. commercial policy--and hence to U.S. political pressure--would be increased in one sense (we'd be trading more) but reduced in another (the U.S. would be less able to impose barriers against our exports). It is not clear on

balance whether we'd become more or less vulnerable. What is certain is that we would still have major problems in getting along with the U.S.--as we do today.

CANADA/U.S. FREE TRADE: THE U.S. VIEW

Many of you here today from South--or West--of the border are more qualified to comment on this than I am, but let me venture a few thoughts to get the discussion going.

Costs: The Loss of Tariff Income by the U.S. Treasury

With Canadian exporters no longer having to pay duty to the U.S. treasury[10], there would be a clear terms of trade benefit to Canada, as earlier recognized. But this benefit to Canada would, of course, also represent a loss to the U.S. While this benefit to the relatively small Canadian economy might be important, the corresponding loss to the much larger U.S. economy would be of far less consequence. Past history suggests that Americans have never even noticed their loss of duty revenue from policies that have liberalize their trade with Canada.

Economic Benefits for the U.S.

With the exception of a number of friendly overtures, there has been no serious recent attempt by either Congress or the U.S. Administration to promote the idea of Canada/U.S. free trade. This reflects the correct perception by Americans that such a U.S. initiative would politically kill the idea in

Canada; it does not reflect an absence of benefits for the U.S.

1. An expanded market. Removal of Canadian trade barriers against U.S. goods would expand U.S. markets, in the process providing gains to U.S. producers able to exploit comparative advantage and/or economies of scale. But such free access to Canada would expand the market available to U.S. firms by less than 10%; would this generate significant benefits?

To get some idea of why the answer is likely to be yes for many U.S. firms, suppose that the 5-10% of the U.S. market that lies northwest of a line running from, say, Minneapolis-St. Paul to Northern California were to be cut off from the rest of the U.S. by exactly the same trade barriers that now exist between Canada and the U.S. Even though this would be a geographically dispersed, relatively small part of the U.S. market, its loss would be important for many firms in the rest of the U.S., and crucial to some--especially those that would be just able to reach (or could not quite reach) their breakeven point before taking into account their sales in this slice of the market. Yet the costs would be roughly the same as the benefit they would acquire from the free access to the Canadian market that they would achieve under Canada/U.S. free trade. In both cases, we are talking about the potentially large change in the profit position of U.S. firms that could result from a geographically dispersed 5-10% change in size of their free trade market.

Such a potential benefit to U.S. firms could exist even if their costs of production were constant. In areas of manufacturing where there are economies of scale, increased

sales volume would mean lower costs on all their units of output, and consequently even greater potential benefits.[11]

2. The advantage to U.S. firms of exporting to Canada, rather than servicing our market with branch plants. Historically, the Canadian tariff has reduced the incentive of U.S. firms to export to Canada, and has thus increased their incentive to service the Canadian market by investing in Canadian branch plants instead. Accordingly, removal of this tariff will, in the long run, induce U.S. firms to export more and invest in Canada less. Given the recent uncertainty about the future climate for foreign investment in Canada, U.S. firms may prefer this export option on both political and economic grounds. (A nationalistic Canadian government would find it more difficult to take action against treaty-bound U.S. exports to Canada than against U.S. investment in Canada which is protected only by non-binding OECD guidelines.)

The reduced long-run incentive for U.S. firms to invest in Canada is, of course, also viewed as an advantage by many Canadians.

3. A free trade area would protect existing U.S. trade and investment in Canada. An approach by Canada to set up a free trade area would leave the U.S. with the choice of saying yes or no. But whereas a yes would draw the two countries together, a no would be likely to push them apart. Indeed if the Canadian approach occurs when, because of increased U.S. protection, Canada views the status quo as no longer an option but has to choose between greater cooperation with the U.S. or a more protective nationalistic approach, then a U.S. refusal

would essentially guarantee a Canadian move in this protective, nationalistic direction.

Thus there are two broad economic reasons for the U.S. to favourably respond to a Canadian initiative: the first is that it would provide benefits; the second is that it would reduce the risk to the U.S. of losses on its exports and investments in Canada if a rebuffed Canada embarks on a more nationalistic set of policies.

While the picture is one of net economic gains for the U.S. that might be large in absolute terms, it isn't clear that they would be large when measured as a percentage of the huge U.S. GNP. But so long as the economic effects are positive--no matter how small--this should be more than enough, given the past U.S. record of accommodating to the wishes of its trading partners. For example, the U.S. supported the formation of the EEC, even though this policy--and in particular the highly protective Common Agricultural Policy--involved substantial costs to the U.S.[12] American support in this (and in other cases) has been forthcoming for political reasons--and there is no *a priori* reason to expect that similar support for a Canada/U.S. free trade area would be withheld.

Political Advantages for the U.S.

While U.S. support for the EEC was tempered by the possibility that the EEC might make Europe more protectionist, there is no such problem in the proposal considered here: Canada/U.S. free trade would, by its very nature, make Canada a *less* protectionist partner. Given the number of hostile

relationships that the U.S. already has to deal with, a strong political case can be made in the U.S. for a policy of accommodating a key partner--a policy that should increase the chance of future cooperation, rather than conflict.

But the incentive for the U.S. may be more than just the defense of an existing relationship. It is possible that the two countries might view a Canada/U.S. free trade area as a focus for a broad new initiative to "get North America moving again". The task of revitalizing Canada/U.S. industry would be encouraged by an important (and paradoxically protective) side effect of a free trade area: industry in each country would get protection from third country competition in the market of the other country. (For example, in selling in the U.S., Canadian producers would get duty free access that third countries such as Germany or Japan would not enjoy. Similarly, U.S. producers would get preference in the Canadian market vis-a-vis third country competitors.) Because tariffs are escalated--i.e., higher on industrial products than on primary products--this "market trading" effect would be stronger in highly-processed industrial goods than in primary products.

Thus there is a reasonable expectation of a favourable U.S. response to a Canadian initiative. But there is, of course, no guarantee. Negotiations we enter into are never guaranteed of success. The normal procedure is for a country to decide what is in its interest, and then attempt to negotiate it.

A CANADA/U.S. FREE TRADE INITIATIVE: OTHER ISSUES

Timing

The longer we delay in reducing Canada/U.S. trade barriers, the longer Canadian industry--and especially those firms that have already expanded to service the U.S. market--will be encumbered directly by U.S. trade barriers and indirectly by Canadian trade barriers. (Canadian trade barriers have a complicated effect on any specific Canadian industry. Although the industry's own barriers protect its output, this is partly offset--in some cases, more than offset--because its costs are raised by Canadian trade barriers on its inputs.)

However, no matter how quickly we move now, it is difficult to see how a free trade agreement could be negotiated and initiated before the current Tokyo Round of tariff cuts is completed in 1987. Moreover, this timing is consistent with the two countries invoking the "interim agreement" rather than the "declaratory" procedure[13] under article XXIV of GATT. (Under the interim agreement formula, Canada and the U.S. would submit a plan and schedule to GATT for the creation of a free trade area. This would inform other GATT members, and allow them to make recommendations. This is the procedure that has been used by other applicants in the past; in none of these cases have formal recommendations been made by excluded countries.)

If tariff cuts were to be thus initiated in 1987 and stretched over a 10-year period, Canadian protection would not be removed until late in the decade of the 1990s. Accordingly

the problem for Canadians would not be so much losses on existing assets as getting the next generation of capital investment pointed in the right direction.

Minimizing Adjustment Costs

Precedents--such as of EFTA and the EEC, along with the Kennedy and Tokyo Rounds--suggest that dislocation costs from reducing trade barriers may be less than expected. Moreover, such adjustment costs must be kept in perspective. Over time we are incurring more and more of these costs simply in an attempt to maintain the status quo. Even if we freeze our tariff policy (which, in practical terms, means restricting any changes in our tariffs to those agreed upon in GATT) we will still face an increasing problem of adjusting to the increasingly rapid changes in technology and trading patterns that are occurring--in particular, the explosive penetration of our market by producers in the Far East. But having said this, it would still, in my judgement, be very important to take special precautions, especially on the Canadian side of the border where most of the adjustment to Canada/U.S. free trade would occur.

Before turning to specific recommendations for making the adjustment easier, it should be noted that there are two institutions that already exist that should help to reduce the short run adjustment costs. The first is our flexible exchange rate. Although at present its flexibility is limited by the Bank of Canada, it could be allowed to fluctuate more freely. This would provide some braking mechanism against a rapid

influx of imports into Canada and a loss of employment here. Second, U.S. multinationals in Canada may also make the adjustment easier, since they already have the facilities for distributing the newly specialized output of their Canadian plants throughout the U.S.

What are the additional ways to buffer the Canadian economy from severe adjustment costs?

(a) Import Trigger Points. One approach to consider is a variation of the Swedish/EEC free trade triggers that would allow Canada or the U.S. to invoke controls on imports if they exceed an agreed-upon growth rate. Such a brake on imports would prevent a too-rapid displacement of employment in either country. (But Canadians should recognize that such symmetric provisions may be invoked by the U.S.--just as the EEC invoked this mechanism against rapid imports from Sweden.)

(b) Employment or Value Added Guarantees for Canada. The more specific the attempt to protect existing Canadian employment patterns, the greater the administrative difficulties. Many of the problems encountered under the Auto Pact--plus some new ones--would have to be faced, were we to attempt to provide value added or employment protection in a broader, across-the-board free trade arrangement.

But if this approach is taken, any such guarantees should be short-term, with a clearly defined termination date. Otherwise they would tend to block the shift of activity towards our sectors of comparative advantage and could generate severe problems in controlling the wage level.) Short-term

guarantees are probably the most we could negotiate in any case (indeed we might be lucky even to negotiate these) because of U.S. dissatisfaction over misunderstandings arising from the Auto Pact guarantees (were they temporary or permanent?); and because, unlike import trigger points, such guarantees would be assymetrical--providing protection to Canada but not to the U.S.

Indeed, as a condition for conceding such guarantees, the U.S. might seek to broaden the agreement to provide itself with some assurance of access to future Canadian resource supplies. For example, the U.S. might seek the right of first refusal on a substantial quantity of our future resource exports--at the then-prevailing world price. Such an assurance would involve essentially no cost to Canada, since the U.S. is our likely export market anyway, and we would be getting the full world price. The interesting aspect of this diplomatic trade is that the two countries might mutually benefit by reducing each other's risk: Canada would help the U.S. to reduce its resource risk, while the U.S. would, as a quid pro quo, help to reduce Canada's trade liberalization risk by allowing some short term employment or value added guarantees.

(c) Adjustment Assistance. This can take many forms: government-backed loans, special R & D grants, or accelerated depreciation for Canadian firms rationalizing in order to expand into the U.S. market.

How would such measures be financed? One suggestion is this: as the Canadian tariff is reduced, prices in Canada will fall. The government could capture part of this price reduction with a temporary sales tax that could then be used to

subsidize Canadian industry through the adjustment period. In this way, some of the short-run adjustment costs of Canadian industry would be paid for by the Canadian consumers who benefit from the tariff cuts.

Any such subsidies would have to be explictly recognized as part of the agreement and therefore exempt from U.S. countervail. No such problem would be involved in subsidies paid not to firms, but instead to people who have been displaced--such as portable wage subsidies and retraining grants. Such temporary subsidies would be the essential bottom line in any broad programme of adjustment assistance.

(d) Competition Policy. In order to facilitate the rationalization of Canadian production in response to free trade incentives and pressures, Canada should relax its restrictions on mergers of firms producing traded goods. (In these products, adequate protection against monopoly abuse would be provided by the competitive pressure of increased imports.)

(e) A Monitoring Agency. For such a broad agreement, an agency to handle disputes and appeals would be essential. (A number of misunderstandings and complaints might have been reduced or avoided, had such an agency been established for the Auto Pact.) Canada should seek an agency with equal representation from the two countries that would make binding decisions on matters of appeal--even though (as in any other binding international agreement) this would involve some sacrifice of autonomy. The problem is that the U.S. would also be sacrificing some autonomy, so it's not clear that such a

strong monitoring agency could be negotiated. A more realistic expectation might be for an agency that would make strong but non-binding recommendations to the two governments.

Further Observations

Since much of the short-run risk and adjustment cost from free trade would have to be borne by Canadian manufacturers, they have traditionally been one of the strongest sources of opposition. But there is now evidence that this opinion is shifting. In a 1980 presentation to the Senate Standing Committee on Foreign Affairs, the Canadian Manufacturers' Association reported on the roughly 1,000 replies to a nationwide survey of its member firms on the question: 'What would be the net impact on your company of Canada/U.S. free trade?' The answer: roughly one-third of the responding firms expected to contract, about one-third expected no change, and about one-third expected to expand. This apparent neutrality of Canadian manufacturers seems to represent a surprising change from two decades earlier when, at least in our casual observation, business opposition far outweighted support. (This questionnaire result was even more remarkable, because it did not provide a greater weight to larger companies; and they, on average, more heavily favour trade liberalization.)

There is good reason to view this (at least) neutral response as a strong confirmation of the case for free trade. Manufacturing executives--together with labour--are the ones who have to face the risks. And if these risks are judged to be offset by expected benefits, then we are left with the

essentially undiluted benefits that would go to other sectors of the economy; for example, to consumers facing lower prices and to resource producers facing lower input costs.

Finally, let me observe that, if we are to take an initiative, there are two good reasons for doing it now. First, the longer we defer, the more opportunities will be missed. (True, rapid technological advances have made entry possible into certain activities in well-established industries. But there are many economies-of-scale industries that we can break into only when they are being born, but not later, when large firms have become established.)

The second argument for an initiative now is that it may well be more difficult in the future--especially if we wait for a favourable political climate in Canada. Paradoxically, such a favourable Canadian climate of opinion is most likely to occur if and when there is a strong resurgence of U.S. protectionism that seriously threatens our access to the U.S. market. In such circumstances, the status quo would disappear as an option for Canada, and we would have little other option (short of a costly South-American style shift to a more protected and isolated economy) but to seek some form of bilateral trading accommodation with the U.S. But because of the revived U.S. protectionism, this would be the worst time to try to negotiate freer trade; it would be even more difficult than it is today to get U.S. agreement on provisions to reduce Canadian adjustment costs.

FOOTNOTES

[1]This section draws heavily on Bergsten and Cline (1982) and especially Cline (1982). It also draws on, and reports some of the conclusions in my recent report for the Institute for Research on Public Policy (1983).

[2]The view that, relatively speaking, the U.S. is a less protected economy than Japan is disputed by Cline (1982) and Saxonhouse (1983).

[3]The term infant protection is here used in a broad sense. Traditionally, such protection was designed to nurture an infant that might not otherwise survive competition from <u>existing</u> producers in other countries. Here it can mean this, <u>or</u> the nurture of an infant to ensure that it survives competition from <u>simultaneously</u> emerging (or even lagged) infants elsewhere. (When we speak of this sort of infant protection, we include not only import barriers but also domestic or export subsidies.)

[4]Why don't such future profits lead to the <u>unsubsidized</u> development of this activity? The traditional answer has been the failure of capital markets to provide the necessary funds up front.

[Part of this future profit may be realized because the targeted Japanese firms may be able to capture sales and

monopoly rents from, say, competing U.S. firms. According to an analysis developed by Brander and Spencer (1981 and 1983), this rent-capture may more than compensate the Japanese for the contemporaneous losses they incur from infant protection.]

[5]See Bergsten and Cline (1982), and, for much more detail, Diebold (1983).

[6]For much more information on this proposal, see the Senate Standing Committee on Foreign Affairs' recommendation of a Canada/U.S. free trade area in Canada/United States Relations, Vol. III: Canada's Trade Relations with the United States (Ottawa, 1982); and Looking Outward (Ottawa, Economic Council of Canada, 1975). In this abbreviated summary of the issues, these sources--along with previous writings by the author--have been heavily drawn upon. (For reservations about a Canada/U.S. free trade area, see B. Wilkinson, Canada/U.S. Free Trade and Some Options, Canadian Public Policy, October, 1982.)

[7]There would be a trade diversion cost to Canada to the degree that we switched our import purchases from less expensive third countries to the U.S. However, this could not occur in the large bulk of our imports, because they are already purchased from the U.S.

[8]Since removal of the U.S. tariff would transfer income from the U.S. to Canada, why wouldn't removal of the Canadian

tariff transfer income in the other direction--from Canada to the U.S.? Technically, the answer has been given in our earlier discussion: because of its relative size, it is the U.S. rather than Canada that determines the terms of trade in industrial goods between the two countries. Therefore the terms of trade between the U.S. and Canada are substantially affected by a change in the U.S. tariff, but little by a change in the Canadian tariff. To state this in another way: because the prices of industrial goods are typically set in the large U.S. economy rather than the small Canadian economy, Canadian importers who accordingly must take the U.S. price as given, must raise the price of imports as they come into Canada by the amount of the Canadian tariff. Thus the Canadian tariff collected by Ottawa is paid by Canadians (namely, Canadian consumers who pay a higher price). In other words, the Canadian tariff transfers income domestically--between groups within Canada. This is quite different from the U.S. tariff which transfers income internationally--from Canada to the U.S.

[9]The specific way in which the real income gain would manifest itself (i.e., the specific combination of price reductions and wage increases) depends on, among other things, the degree to which the Canadian dollar is allowed to float.

[10]There is another reason why the U.S. treasury would lose duty revenue. Americans would be diverting some of their import purchases from a cheaper source (such as Europe or

Japan) to Canada. Imports from Canada would pay no duty, whereas previous imports from Europe or Japan did.

[11] Whereas U.S. firms would be expanding in most lines of activity, in some they would be contracting because of new Canadian competition. But the expectation of benefits remains, a point that may most clearly be seen by considering a firm producing ten goods at roughly a breakeven point on each. Suppose, as a result of trade liberalization, that it has to give up one of its breakeven activities, while expanding its other nine. On these nine it makes a profit where none existed before.

[12] The only way of arguing that the EEC provided net benefits to the U.S. is to argue that it generated a much more rapid rate of European growth (and hence more purchases from the U.S.) than would have occurred otherwise. But this is very speculative territory, since we simply don't know what would have occurred otherwise. It is for this reason that we have not used a parallel argument--i.e., that the U.S. would benefit from more rapid Canadian growth in a Canada/U.S. free trade area. Incidentally there is a stronger argument of this sort in the Canadian than in the European case; estimates of the static real income gains for Canada fall in the range of 5-10% or more, while estimates for the EEC fell in the range of 1% or less.

[13] Under the declatory procedure, the two countries simply declare that a free trade area between them already exists. (By 1987 when the Tokyo tariff cuts are complete, it has been conservatively estimated that 80% of Canada's exports to the U.S. will be duty free, as will 65% of our imports from the U.S. While this is not nearly as close to free trade as it is now fashionable to believe, it is still closer than other regional groups have been when they formed free trading arrangements in the past without GATT objection. Hence Canada and the U.S. could be deemed to qualify under this clause. But the problem with this procedure is that it may well be viewed by other GATT members as "too cute" for such important trading nations to invoke; and these members might accordingly object to Canada/U.S. NTB liberalization, which is not covered by this declatory GATT procedure. (Such NTB liberalization is essential, and is covered by the interim agreement formula recommended here.)

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DISCUSSANT'S REMARKS

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Nov. 18, 1983

Comment on "Canada-U.S. Economic Relations — A Canadian View"
by R.J. Wonnacott

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As Ron Wonnacott rightly stresses, recent trends in U.S. trade policy hold the possibility of not only significant market losses for Canada but a loss of Canadian sovereignty. The particular policy about which he is concerned is the proposal to apply a new concept of reciprocity. Instead of measuring reciprocity in terms of balanced changes in levels of protection, ~~production,~~ as we have traditionally done, the new concept measures reciprocity by comparing the absolute levels of protection between the United States and another country. To use a favorite phrase in trade policy circles, the new approach seeks a "level playing field" for U.S. participants in the competition for international markets and regards reciprocity as being attained only when the playing field is level.

Besides this new concept of reciprocity, there are several other developments in U.S. trade policy that are of considerable concern to Canada as well as the rest of the trading community. These include: (1) a much greater willingness to implement the so-called "fair trade" rules of U.S. law and the GATT, particularly in the area of government subsidization of various forms; (2) a new willingness to bypass GATT procedures and counter foreign export subsidies in third markets with U.S. export subsidies in these same markets; (3) a willingness by some officials to abandon the traditional U.S. support for the most-favored-nation (MFN) principle and to accept the concept of selectivity in protecting industries injured by import competition; and (4) an acceptance by some political leaders of the appropriateness of a comprehensive industrial policy approach to promoting new products as well as to underwriting the viability of certain basic industries faced with severe international competitive pressure.

These developments are, I think, a manifestation of a fundamental change in the attitude of U.S. trade policy leaders that has created a significant disequilibrium situation with regard to the trade policy environment between the United States and such countries as Canada. Although there is clearly a protective component in the changed trade policy outlook, to describe it only as a shift toward protection fails, I think, to capture its full implications. Ron Wonnacott gets at the basic nature of the change that is taking place by using the term "aggressive" to describe the new reciprocity concept. We are witnessing a more aggressive U.S. approach both to reactive trade policy aimed at mitigating the negative income and employment effects of external shocks to the trading system and to active trade policy designed to generate new jobs and higher income levels by taking advantage of changing international economic conditions. Since this new approach has very significant implications for Canada as well as the rest of the trading community, I should like to discuss briefly how it has developed and what it might mean for future U.S.-Canada trade relations.

Basically, I tend to agree with the formulators of the hegemonic model of regime change who stress the dominant international economic position of the United States in the early post-World War II period, as well as the country's subsequent decline from this position, to explain both the openness of the international trading regime during the first period and the gradual deterioration in the system as U.S. international competitiveness decreased. An open trading regime based on the MFN principle has some of the characteristics of a public good. Because of non-discriminatory tariff reductions, it is sometimes difficult to exclude a particular country from the benefits of openness even if the country does not fully contribute to the openness by keeping its own trade barriers low. To some extent, exclusion can be accomplished if

those countries that do participate in making the system open maintain high trade barriers against the products of non-participants in which the non-participants are the principal suppliers in world trade. However, small countries are not principal suppliers in many product lines and thus it is in their interests to try to get a "free ride" on the trade-liberalizing efforts of other countries. However, large countries cannot follow this practice, since they each tend to be principal suppliers to other large countries to the same extent that the other countries are to them. They must, therefore, reduce their own trade barriers to obtain meaningful trade concessions from other large countries.

Immediately after World War II the United States emerged as the dominant trading power, as Japan and the European countries struggled to reach their pre-war production levels. For example, in 1952 the U.S. share of exports of the major industrial nations was 35 per cent, in contrast to only 21 per cent in 1938 and 1928. The export surpluses that emerged in almost every major product category not only masked the underlying competitive weaknesses in such lines as textiles, but served to build a broad base of support for seeking tariff cuts from other nations in return for reciprocal cuts by the United States. U.S. multinationals who wished to invest abroad also pushed for an open trading system as a means of enhancing the profitability and security of their foreign undertaking. Furthermore, the foreign policy goals of the United States played a key role in shaping U.S. trade policies. It was widely believed that the communist countries posed a serious economic and political threat to the United States, its allies, and the rest of the market-oriented economic world, and that economic assistance in the form of economic grants and lower U.S. trade barriers was an essential element in countering this threat.

Not only do these various factors account for the vigorous efforts by the United States to reduce tariffs on a multilateral basis but they explain why the United States was willing to accept extensive free-riding and lack of full reciprocity on the part of other countries. It was evident to all, for example, that the existence of foreign exchange controls in Europe until the late 1950s vitiated much of the trade-creating benefits to the United States of the cuts in European tariff levels. Equally important was the U.S. policy of not strictly enforcing U.S. and GATT rules dealing with foreign subsidies and other so-called unfair trade practices. It became increasingly evident, for example, that subsidies by foreign governments were only offsetting the trade-creating value of their duty cuts but were artifically increasing their exports to the United States. Yet, despite strong objections from certain domestic producers, retaliatory measures were not adopted because of the preeminence of foreign policy considerations.

Significant changes in U.S. international economic and political priorities began to be evident by the late 1960s. The importance of trade policy as a domestic political issue increased, while the importance of trade policy in promoting foreign policy objectives declined. The increased significance of trade policy as a domestic issue was closely related to the decline in dominance of the United States as a trading power. The 35 per cent U.S. exports share among the major industrial countries in 1952 fell to 23 per cent by 1960, [illegible] per cent by 1970, and 15.5 per cent by 1979. Furthermore, the general decline in U.S. competitiveness has been accompanied by the emergence of severe structural problems in a number of politically powerful sectors. At first these consisted mainly of labor-intensive sectors such as apparel and footwear, but more recently they have included capital-intensive and skill-intensive industries like steel and autos. In the foreign policy field, the

decline in Cold War tensions during the 1970s and the reevaluation of the country's military role in the world acted to reduce the importance of trade policy as a foreign policy tool.

A consequence of the decline in U.S. hegemony has been the adoption on the part of U.S. trade policy officials of a more inward, nationally-oriented view of trade policy issues. No longer are they willing to ignore what they regard as the free rides and chiselling on GATT rules of others in return for vague foreign policy objectives. More importantly, they believe that the existing regime has been operating in a manner that works to the disadvantage of the United States. During the Tokyo Round of multilateral negotiations in the mid-1970s, the strategy pursued in attempting to offset these disadvantages was to press for new codes of international conduct within the GATT that would force other countries to follow more closely what the United States regards as good behavior in international trade. However, while improvements in the rules were made, the enforcement of the new codes has proved to be disappointing to U.S. trade policy officials. The panel procedure has continued to be cumbersome and not very helpful in bringing about significant changes in policy.

This has left U.S. officials in a somewhat schizophrenic position. Most think that a strict and general commitment to GATT rules is still the best course to follow for all countries. However, being disappointed by the failure, in their view, to secure adequate enforcement of these rules, either through direct negotiations or the GATT panel procedure, they believe that the only way this can be achieved is for the United States itself to pursue an aggressive strategy of imposing countervailing duties and introducing countervailing subsidies. The objective would be to discourage trade practices that are inconsistent with the spirit of the rules of the GATT by offsetting the short-run

gains from such practices. But there are also some officials who feel that this approach is not likely to achieve its objective. These individuals argue that the United States should itself adopt the subsidizing and trade-restricting practices of other countries. The aim would not be to force these countries to the negotiating table to develop better ways of enforcing existing GATT rules but simply to outdo these countries at their own practices by using the superior resources and market power of the United States. Adopting a comprehensive industrial policy approach is an example of this strategy.

The perception of many in the U.S. trade policy community that GATT rules are not being properly enforced and, therefore, that the present international trading order is working to the disadvantage of the United States may or may not be a correct one. But it is a viewpoint that is beginning to shape U.S. trade policy behavior along lines quite different from those of the recent past and that may bring about considerable turmoil in international trade. It could lead to a sequence of retaliatory actions between the United States and other countries that increased rather than decreased the degree of economic distortion in world trade. For example, recently the European Community (EC) has announced an increase in its export subsidy on wheat flour as a response to the export subsidy to wheat flour provided by the United States. The U.S. subsidy was itself introduced to offset the trade advantage in third markets obtained by the EC because of its export subsidies, and thereby to induce the EC to reduce its export subsidies on agricultural goods. Similarly, if the United States adopts an industrial policy involving significant subsidies to domestic industries, other countries might simply increase their own subsidization with no net advantage being obtained by any trading nation.

The best course of action for all as a group would be to try to resolve the differences in the interpretation of GATT rules through negotiation and the GATT panel procedure. Unfortunately, the outcome of the GATT Ministerial meeting last November does not make one very sanguine about the prospects for this route being followed. But clearly we must continue to press for this approach. The most likely course of international trading relations, in my view, is one in which there will be increased subsidization, counter-subsidization, and the use of countervailing duties and quotas over the next several years until there is a greater appreciation by the large and small participants that the costs of maintaining an open international order must be shared to a greater extent if all are to benefit from the regime.

This change will, I think, be the consequence of the decline in U.S. hegemony and the emergence of a state of affairs in which there are three major trading powers, namely, the United States, the European Community, and Japan, rather than one super trading power. However, unlike some of the formulations of the hegemonic theory of regime change, I do not believe the change will produce a complete breakdown in the trading order. There will be more turmoil for a period of time, but the three major powers do seem to appreciate the benefits of the system sufficiently to keep the basics of the system together. However, in the process of moving to a new equilibrium some of the smaller countries like Canada may fare poorly.

How does the new U.S. attitude toward trade policy affect the U.S. view towards the proposed free trade arrangement between the United States and Canada in manufactured goods? As Ron Wonnacott points out, such an initiative would bring long-run economic benefits to both countries and strenthen political ties between the two nations as well. Unfortunately, I think that the new U.S. attitude makes the United States less receptive to the proposal than formerly.

For example, as I noted previously, there is now a much greater awareness that non-tariff measures not covered by a free trade agreement can offset the benefits of duty reductions. Specifically, Canadian subsidies to domestic firms or foreign affiliates might increase and thereby lessen the extent of the increased exports from the United States. U.S. trade officials are also greatly concerned about the performance and establishment requirements for U.S. firms investing in Canada, and it is unlikely that they would accept a free trade agreement without some understanding about the future nature of these requirements.

The provincial governments in Canada, like the state governments in the United States, also apparently have considerable power to subsidize industries as well as to restrict investment in their regions. It seems to me that U.S. officials will insist that an understanding be reached that in some way includes such activities by the provincial governments. As Ron points out, a major appeal of a free trade agreement for the United States would be greater access to Canadian supplies of non-agricultural primary products. Consequently, U.S. officials are likely to want to be sure that actions by provincial governments or non-tariff measures introduced by the federal government do not offset the greater access to Canadian resource supplies.

It is also hard to see how some understanding concerning Canadian policy toward U.S. direct investment in Canada can avoid being part of an acceptable agreement. Investment and trade are very close substitutes between neighbors such as Canada and the United States. I suspect that differences in social welfare and tax policies and even such matters as immigration policy will also become part of any negotiation aimed at bringing the two nations closer together. Such highly protected U.S. sectors as textiles, apparel, footwear, and various miscellaneous product lines are bound to feel threatened by lower cost labor

in Canada due to what they are likely to regard as an unfair advantage based on different social policies.

Canadian firms could also be hurt by various non-tariff measures introduced by the United States after an agreement covering only tariffs on manufactured goods. For example, if the U.S. pursues the industrial policy approach with significant subsidies to certain domestic industries, Canadian firms that had captured a share of the U.S. market in these sectors could suffer serious injury. The matter of U.S. countervailing duty action that Ron Wonnacott raises is also a matter that should be faced prior to any agreement.

In short, while I favor special economic relations between the United States and Canada, I wonder if we can and should restrict these just to mutual zero-duty treatment for manufactured goods. The increased awareness on the part of both Canadian and U.S. officials of the effects of domestic fiscal and monetary policies as well as exchange rate policies on trade flows and, in particular, the belief by many U.S. officials that these policies have been used by other countries to erode U.S. trade benefits under the GATT are likely to make it impossible simply from a practical political viewpoint to confine any U.S.-Canada trade negotiation only to the issue of tariffs. Would it perhaps not be better to work for a more comprehensive agreement that covered some of these other policies and yet did not undermine the essential degree of sovereignty of each nation.

DISCUSSANT'S REMARKS

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U.S.-Canada Trade Frictions:

A U.S. Response

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Introduction

As the participants at this Conference are well aware, the United States-Canada trading relationship remains the largest and most extensive of any two countries in the world. In 1982, total two-way trade exceeded $80 billion. Because of the vital political and economic links between our two countries, President Reagan, upon entering office in January 1981, placed a high priority on improving relations with Canada and working with the Canadian Government to promote expanded trade and better bilateral economic relations.

Unfortunately, as we all know, the new Administration found itself in the midst of a deteriorating bilateral economic relationship with Canada as a result of efforts by the Canadian Government to enhance Canada's national identity and the role of Canadian enterprise in the Canadian economy. While the United States respected these efforts, they unfortunately were being pursued in a discriminatory manner, at times inconsistent with Canada's international commitments.

The underlying cause of the tension in our bilateral economic relationship during that period was the result of significant differences in our two government's approaches to economic questions. The Reagan Administration entered office advocating a free market approach to trade and investment. A commitment

to maintaining free markets was a central element in the President's domestic economic program.

On the other hand, the Trudeau Government was advocating a much more interventionist approach to economic issues. Nationalism, which translates into increased Canadian control of the economy, was the basic theme of the Canadian Government's economic program. However questionable that theme may have been from the standpoint of the Reagan Administration's economic philosophy, there was no question of the sovereign right of Canada to "Canadianize" its own economy. The main U.S. concern was with a number of the policy measures that the Canadian Government proposed in order to achieve that objective.

Today, the U.S.-Canada trading and investment relationship is on a more positive footing. The Trudeau Government, perhaps as a result of its domestic economic and political problems, is attempting to better manage the trade irritants which inevitably occur between such large trading partners. However, many of the trade policies of the Trudeau Government which caused such an uproar in the 1980-81 period are still in place. In addition, even during the more recent period of "improved" U.S.-Canadian trade relations, protectionist policies continue to be implemented by the Canadian Government. Let me briefly describe some of these policies.

National Energy Program

Canada's National Energy Program (NEP), announced in October 1980, remains substantially unchanged today. Its discriminatory provisions, such as the Petroleum Incentives Program (PIP), and its retroactive provisions, the 25 percent "back-in", continue to be of serious concern to the United States. From a trade perspective, U.S. concerns center on the operation of the Canada Oil and Gas Lands Administration (COGLA) and the Committee on Mega-Projects Industrial Regional Benefits (CMIRB) where reports of pressure being exerted on foreign firms to procure goods and services from Canadian sources have been reported. Such practices would be a clear violation of Article III of the General Agreement on Tariffs and Trade (GATT), the national treatment provision. These reports continue today.

Foreign Investment Review Agency

The Canadian Foreign Investment Review Agency (FIRA) was established in 1973 to increase Canadian control and ownership of investment in Canada and to ensure benefits for Canadian firms from such investment. U.S. concerns over FIRA were not aimed at its existence or its screening of new foreign investment, but certain aspects of its administration. Particularly troublesome are the legally enforceable commitments exacted by FIRA from firms investing

in Canada, such as specifying when firms must purchase Canadian goods and/or requiring firms to export a specific share or volume of its Canadian production. The U.S. initiated a GATT complaint against these FIRA practices which is still outstanding. In addition, FIRA's veto power over the transfer of Canadian assets from one foreign owner to another is of great concern to us.

The administration of FIRA has improved significantly over the past year since the appointment of Ed Lumley as the Minister responsible for FIRA and Bob Richardson as its Administrator. Processing time for applicants is much improved and other bureaucratic problems have been minimized. However, it should be emphasized that the FIRA Act remains unchanged, and the serious problems associated with FIRA in 1980-81 could easily reappear should different personnel with nationalist tendencies take over the administration of FIRA.

Border Broadcasting

In 1976, Canada adopted a tax provision denying Canadian enterprises tax deductions for the cost of advertising in foreign media when the advertising is directed primarily at Canadians. The main targets of this legislation were ads placed on U.S. television stations beaming into Canada. Years of government-to-government and industry-to-industry consultations failed to provide a compromise solution. The U.S. Administration, as a result of an investigation

and determination under Section 301 of the Trade Act of 1974, has proposed mirror legislation to the U.S. Congress, but until now it has never been acted upon. In March of this year, the United States proposed a new compromise which would have reinstated the tax deduction for a certain percentage of the advertising placed in the United States based on the percentage of the border stations audience share which is accounted for by U.S. viewers. Unfortunately, the Canadian Government does not appear interested in reaching a compromise on this issue, and mirror legislation is expected to be enacted shortly by the U.S. Congress. (This apparently is one of those instances anticipated by Professor Wonnacott where for political principle Canada is prepared to face the cost of retaliation).

Compulsory Licensing of Pharmaceutical Patents

Section 41 of the Canadian Patent Law provides that any company may request the Canadian Commissioner of Patents to provide a compulsory license for pharmaceutical patents, and that only a nominal royalty of four percent is paid. While the legislation was intended to address assertions that foreign pharmaceutical companies were making inordinately high profits, its effect has been to allow companies that have not contributed to the costly and risky research and development process to invade the market of the innovator, reducing his return and his incentive to invest in new product research and development. This past

summer, it appeared that this dispute was about to be resolved when Andre Ouellet, then-Minister of Consumer and Corporate Affairs, announced the Canadian Government's decision to introduce modifying legislation in the fall. Unfortunately, the new Minister, Judy Erola, does not appear to share her predecessor's inclination to modify Section 41.

Postal Rates

Canada has had regulations providing for second-class classification differentials on non-Canadian publications since 1969. It was not until April 1, 1979, however, that a discriminatory rate system was enacted. Under the system the lowest second-class rate is afforded to Canadian publications (magazines and newspapers). A somewhat higher rate is applied to non-Canadian publications printed and mailed in Canada (e.g., Time Magazine). The highest rate, which was considerably higher than the other two, is applied to non-Canadian publications printed outside of Canada, trucked into Canada in bulk, and mailed to Canadian subscribers, newsdealers, etc.

The rationale for these differentiated and discriminatory rates has always been to provide support to Canadian publications and to Canadian cultural policy, which seeks to foster "Canadianness" and shield Canadians against the influence of foreign, particularly U.S., culture.

A number of bilateral discussions on this matter have been held over the years. Formal GATT Article XXII consultations were held in Geneva late last year, to no avail.

On July 14 Canadian Communications Minister Francis Fox announced that preferential postage rates for second-class publications in Canada will begin to be phased out. The result of this action will be an increase in already discriminatory postal rates on U.S. magazines and periodicals printed and mailed in bulk in Canada, and the U.S. publications printed in the United States, trucked to Canada, and mailed in Canada.

Extension of Canada's Customs Territory

This past summer, Canada extended its customs territory from 12 to 200 miles. The purpose of this policy was purely protectionist -- an attempt to increase benefits for Canadian manufacturers from offshore drilling. With the extension, all supplies, equipment, and the drilling rigs themselves became dutiable. While the change in Canadian practice technically conforms to current U.S. practice, in reality only those drilling rigs actually attached to the ocean floor are sbject to duty in U.S. territorial waters. The great majority of the drilling rigs in U.S. waters are floating rigs and therefore not subject to duty.

Protectionism on Both Sides of the Border

These are but a few examples of the protectionist policies being pursued in Ottawa. Some of you here today can correctly point to protectionist measures being maintained south of the border, such as a number of "Buy America" restrictions under various U.S. laws. There is, however, a subtle, yet important, difference. The current Administration in Washington is committed to pursuing free trade policies, but is faced with a legislature which does not generally share those views. A myriad of protectionist legislation is introduced in the U.S. Congress each year, which is strenuously opposed by the Reagan Administration. At times, despite Administration efforts, some protectionist legislation, such as "Buy America" restrictions, is enacted. At other times, the Administration takes temporary measures against imports, such as import quotas on specialty steel, in order to forestall more drastic action by the Congress.

In Ottawa, protectionist measures originate in the Government, not the Parliament. Many of the trade irritants affecting the U.S.-Canada economic relationship today could be avoided if the Government in Ottawa undertook the same efforts to oppose protectionist measures as does the Reagan Administration in its dealings with Congress.

A perfect example of the divergent approaches of the two governments

on this issue is the current debate over domestic content requirements. In the United States, a major effort has been underway for over a year in the U.S. Congress to enact domestic content requirements on automobiles. The Reagan Administration has been publicly and actively opposing this effort and is spending considerable political capital in this endeavor. A similar proposal was made last summer in Canada by a federally-appointed private sector task force. Instead of unequivocal opposition to this concept as voiced by the Reagan Administration, the Canadian Government has failed to take a strong stand on the issue, leading many to fear that Ottawa may succumb to the protectionists.

U.S.-Canada Free Trade

While there has been a great deal of attention given lately to the concept of a free trade arrangement between the United States and Canada, the Canadian Government has decided that such an approach is perhaps too ambitious at this time. Instead, they are examining the concept of limited sectoral free trade arrangements similar to the Auto Pact. Ambassador Brock has indicated that the United States would be willing to discuss such an approach if the Canadian Government decides to pursue it.

While sectoral free trade falls short of the broader approach

advocated by Professor Wanacott, it could be a significant step in the right direction. Of course, a number of basic conceptual questions will need to be answered first. Will these sectoral agreements only address tariffs, or all barriers to trade? Would such sectoral arrangements be consistent with the GATT? How will foreign investment be dealt with under the Canadian proposal? How will states/provinces be dealt with? In addition, the sectors currently under examination in Ottawa appear to be geared to Canadian interests. For such an approach to gain necessary support in the United States, other sectors of interest to U.S. industry may also have to be addressed.

Despite these obstacles, the Canadian initiative is well worth exploring. Whether or not any agreements are ever reached, it marks an important step by Ottawa in the direction of trade liberalization. If the Trudeau Government, or its successor for that matter, truly desires a reduction of trade barriers on both sides of the border, then perhaps the incidence of trade irritants between our two great nations can be reduced, if not eliminated. If such a commitment is not forthcoming from Ottawa, then I am afraid that Professor Wannacott's concerns over U.S. reciprocity aimed at Canada may become a reality.

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