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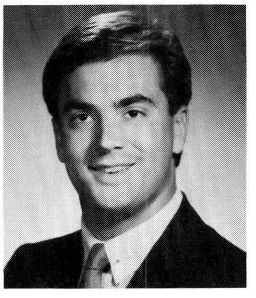

The Canadian-U.S. Trade Relationship

Over a century ago, the economist Friedrich Engels predicted that within a few years the "ridiculous boundary line between Canada and the United States would be abolished" (Wonnacott and Wonnacott, 1985, p. 14). Today the boundary line remains. Canada and the U.S. are nextdoor neighbors and have always been on friendly terms. Moreover, trade between the two countries has been on a steady upswing since World War II, and the current trade flow is the largest ever between two countries (see Table 1). In 1985, 78% of Canada's exports went to the United States and 72% of Canada's imports were from the U.S. (*Bank of Canada Review,* 1986, p. 138).This flow is almost 50% larger than the next largest trade flow—that between the United States and Japan. Indeed, the United States exports more to Ontario alone than to the entire country of Japan. With this volume of trade taking place, the U.S.-Canadian relationship and any changes in that relationship are crucial to the welfare of both nations. The current round of discussions involving the U.S.-Canadian trade relationship is the latest in a long history of debate over free trade between the United States and Canada. These talks will focus on the barriers to trade between Canada and the U.S. and the potential for an "open border" between the two countries.

In the past, changes in the Canadian-U.S. trade relationship have taken place chiefly on a multilateral level through the General Agreement on Tariffs and Trade (GATT). In 1986, for the first time ever, Canada and the United States met with the purpose of creating an across-the-board bilateral free trade agreement. This agreement will most likely involve the removal of both tariff and non-tariff trade barriers between Canada and the United States, and may result in an integrated economy policed by a joint trade commission.

In this paper I examine the merits of free trade from the point of view of both Canada and the United States. First, I analyze the gains and costs of free trade for each country. Then, I discuss the impact of free trade on certain key sectors in both countries.

Table 1—Canadian Trade
($000,000—seasonally adjusted at annual rates)

	Exports:			Imports:		
	Total	**To U.S.**	**% of Total**	**Total**	**From U.S.**	**% of Total**
1975	33,616	22,059	66	33,962	23,058	68
1976	38,166	25,813	68	36,608	25,124	69
1977	44,495	31,196	70	41,523	29,449	71
1978	53,361	37,812	71	49,048	34;845	71
1979	65,582	45,083	69	61,157	44,480	73
1980	76,681	48,975	64	67,903	47,343	70
1981	84,432	56,100	66	77,140	52,777	68
1982	84,560	58,074	69	66,739	47,072	71
1983	90,702	66,329	73	73,054	52,677	72
1984	112,219	85,026	76	91,493	65,890	72
1985	120,258	94,346	78	102,783	73,641	72

Source: *Bank of Canada Review*

The Gains for Canada

The advantages to Canada of free (or freer) trade are many. With a population of only 20 million,Canada is the only major industrial nation in the world that does not have a market greater than 100 million people. The freeing up of trade with the U.S. will provide that much-needed market and thereby clear the way for improved productivity performance by Canadian industries. This productivity adjustment will manifest itself in two ways: 1) a shift away from production of items that cannot be produced on an internationally competitive level, and 2) a subsequent increase in size and efficiency of remaining industries.

With respect to the first adjustment, material and human resources will shift away from those activities in which Canada is relatively inefficient. In the past, certain Canadian manufacturers have had the luxury of protected markets in which their products needed only to be cost-competitive with other Canadian manufacturers. With an open market between Canada and the U.S., products that are not competitive will be phased out. Although this prospect frightens many who fear that a large number of Canadian industries will be eliminated, most economists who have studied the issue believe that the change in overall industry size will be relatively small (Globerman, 1986, p. 43). This is because most of the reallocation of resources will take place within industry boundaries.

The adjustment process within industries represents the second and more important dimension of the productivity argument. Due to the size of the Canadian markets, there are too many small plants which lack the large capital base necessary to support an adequate research department. Thus, technological innovation is stifled. In addition, these small plants often fail to attract top management personnel. Finally, the size of the Canadian market encourages short, inefficient production runs. All these problematic symptoms of a small market will be reduced (or even eliminated) under free trade because of the increased specialization which will be fostered. Of course, the catalyst for this specialization will be the increased competition from U.S. exports that will result from free trade. This competition will result in the reduced production of goods that cannot be profitably produced in an environment of free trade. Through this reduction Canada will emerge as a much stronger competitor in the international markets. Futhermore, the huge U.S. market will offer Canadian producers the opportunity to export so-called"niche products" —products that satisfy a specialized portion of the market, much like Yugoslavia's "Yugo."

The advantages of increased specialization come from product economies of scale—lower per item production costs with larger production runs. Economies of scale are a result of more efficient use of labor and capital arising from specialization, larger run sizes, and movement down the "experience curve." Technological advance is also intertwined with the length of production runs. New production techniques are usually associated with high research and start-up costs, including the purchase of new equipment,the hiring of new labor, and the retraining of existing labor. These costs may be prohibitive unless spread over a large volume of output.

Daly and MacCharles recently conducted a survey of the effects on unit costs of a hypothetical tripling of output, under the assumption that firms specialized in their most profitable product lines (Daly, 1983, p. 11). Estimates were obtained from twenty Canadian manufacturers. The estimated reduction in unit costs averaged about 22% of the original unit cost. The survey showed a reduction in all cost categories, with the biggest drop occurring in non-production costs. These cost reductions represent economies of scale that would take place through longer runs. The report also points out that 70% of the firms that answered the survey believed that increased scale and specialization would make them competitive in the U.S. market. Past Canadian experience has further confirmed the links which exist among trade liberalization, specialization, and increased productivity. Following the tariff reductions under Kennedy and the Canada-U.S. Autopact, productivity rose as product diversity declined and the average length of production runs increased (Wonnacott and Wonnacott, 1982, pp. 412–427).

It is also estimated that a free trade agreement between Canada and the United States would increase the economic welfare of the Canadian people by about 8–10%, both because of the larger assortment of goods which would be available at lower prices and because of higher employment and growth in production sparked by the new demand for goods (Harris, 1984). In fact, this estimate may well be a conservative one. It ignores the recent growth in the "tradeability" of the service industries, such as financial services, food and restaurant services, and health care services. These industries have considerable growth potential, and are one of the major issues in the trade talks. The estimate also ignores the potential for a more rapid rate of technological change in Canada associated with a freer trade environment.

Yet another potentially very important consideration in the debate over the importance of free trade to Canada is the fact that American attitudes seem to be currently shift ing towards protectionism. As discussed above, the U.S. market is vitally important to Canadian producers; yet Canada has no guaranteed access to this market. In the event of U.S.-imposed protectionist measures, the Canadian economy could suffer enormously. (Currently, almost 25% of Canada's GNP comes directly from products manufactured specifically for export to the U.S. [*Bank of Canada Review,* 1986, p. 116, 138]). However, if Canada reaches a bilateral agreement with the United States soon, even should the U.S. trend towards protectionism continue, Canada would find itself exempt from the protectionist legislation, trading freely in an otherwise closed environment.

The Gains For The United States

The fact that the United States is so much larger than Canada often gives the erroneous impression that trade with Canada is an unimportant issue for the U.S. Granted, the U.S. economy would not collapse if trade with Canada were suddenly cut off. However, the importance of the Canadian market to the United States is generally underestimated. During the years 1983 through 1985, U.S. exports to Canada rose by an overall real rate of 40% (*Bank of Canada Review,* 1986, p. 138). This occurred during a time when U.S. exports to the other countries in the OECD actually fell by a total of 2.5%. What makes this rate even more impressive is the fact that this growth occurred in spite of a recession in the Canadian economy and with existing trade barriers in place. Of course, the existing barriers are relatively small. As of January 1, 1987, 80% of Canada's exports to the U.S. are duty free, as are 65% of U.S. exports to Canada (Litvak, 1986, p. 30).

An additional consideration affecting the importance of the U.S.-Canadian trade relationship is the fact that Canada actually ran a trade surplus against the United States in 1985 of $22 billion, second only to that of Japan (*Federal Reserve Bulletin,* 1986, pp. 54–59). With increasing pressure on the U.S. government to narrow the huge trade deficit, a bilateral free trade agreement with Canada is desirable because the agreement will allow the U.S. to export more to Canada.

The United States would like a Canadian-U.S. agreement not only to take advantage of its trade relationship with Canada, but also for the signals it would send to the rest of the world. The chief message that an agreement would send is that trade agreements are possible and viable alternatives to tariffs and trade barriers, even in times of strong protectionist sentiment. Additionally, an accord would clearly communicate the message that the United States is willing to look to its own neighbors for an increasing share of its commerce if America's other partners continue trading practices that are in conflict with U.S. trade policy.

The Costs of Free Trade

As discussed above, a free trade agreement between Canada and the United States would cause a "rationalization" of Canadian production, resulting in reduced product lines and increased economies of scale. There would be a shift toward larger, more efficient firms with greater ability to compete in international markets. Of course, these shifts would not come without costs. There would be some dislocation costs associated with Canadian firms becoming more specialized, including shifts in resource allocation in terms of raw materials, the loss of some jobs and the subsequent dislocation and relocation of workers. However, Dr. Edward Neufeld of the Royal Bank of Canada believes that the concern over the costs involved may be exaggerated. According to Dr. Neufeld, "Just as industry adapts to changing conditions such as demand for its product, new technology, and management failures on a daily basis, so too would it be able to adapt to changes brought about by trade liberalization" (Gotlieb, 1986, p. 19). This does not mean, however, that the transition will be completely painless. United States steel and other smoke-stack industries have had to pay the costs of noncompetitiveness, and Canada will also have to endure the adjustment period.

The methods employed to reach a free trade environment will be of paramount importance. It is clear that any free trade agreement will take several years to phase in. With the aid of appropriate government assistance programs, the transition to free trade should take place with minimum upheaval. Concern over this transition has led to several proposals. One proposal is to employ a five or ten year phase-out of tariffs, thereby minimizing the shock to the Canadian economy. Another suggestion is to set specific trigger points which would allow restriction of imports at certain pre-specified levels. These would provide an equalizing force which would prevent any industry from gaining unfair advantage over its counterpart across the border. Other suggestions include special government-backed loans, grants for research and development, and accelerated depreciation for firms rationalizing their plants to become more competitive.

Impact On Individual Sectors

Transportation Equipment

Transportation equipment, made up chiefly of autos and auto parts, is the largest category of trade between Canada and the United States. It is also Canada's largest manufacturing sector, employing over 100,000 workers directly and supporting at least as many indirectly. Over 60% of Canada's exports of manufactured end products are motor vehicles and automotive components (Federal Task Force, 1983, p. ix).

Canada's rich resource base provides this sector with easy access to energy supplies and materials, and because of this the Canadian auto industry currently possesses a cost advantage over that of the United States. This sector is covered by the Canada-United States Automotive Products Trade Agreement (Auto Pact) which guarantees free trade in new vehicles and original equipment parts with the U.S.

under the constraint that "automotive companies that participate in the Canadian market invest, provide employment,and create value within that market commensurate with the benefit they derive from it." (Federal Task Force, 1983, p. xvii).

However, in the event of a free trade agreement between the U.S. and Canada, the future of the Auto Pact is very much in question. Canada currently holds a net surplus in vehicle trade with the U.S., but auto parts production in Canada has fallen substantially since 1965, resulting in an overall net deficit for Canada in Auto Pact trade. Canadian manufacturers are very concerned about this important sector, and the U.S. will need to convince Canada that free trade without the Auto Pact will not result in deterioration in this market.

Fabricated Materials

The next largest category of trade between Canada and the U.S. is fabricated materials. The transportation equipment and fabricated materials sectors alone comprise almost three-quarters of the total exports from Canada to the United States. This sector is made up of products that are used chiefly as inputs to U.S. manufacturing (such as heavy electrical transformers, generators, forest products, and steel) and represents a historical stronghold of Canadian production. The U.S. market has been and continues to be of major importance to this sector, and the expansion of trade between these two countries is strongly tied to the continuation of growth in this sector.

Due to Canada's relative cost advantage in the area of fabricated materials, this sector has experienced significant protectionist pressure emanating in the U.S. (such as pleas to "Buy American,"etc.). A good example of this is the steel industry. Canada produces steel more cheaply than the United States and has felt pressure from the U.S. government to restrict its steel exports. This is an example of an industry in which the U.S. would profit in the long run by funneling its resources elsewhere. In fact, steel imports from Canada could prove extremely valuable in the event of a major war involving the U.S. Steel from Japan, Korea, and other Asian countries would almost certainly be cut off, and a supply of steel from the United States' nextdoor neighbor would prove invaluable. If the United States opens all sectors for negotiations, Canada will benefit greatly from unrestricted markets in this sector.

Crude Materials

The third largest sector is crude materials, made up of unprocessed raw materials, 80% of which is oil and natural gas. Canada is not very cost efficient in oil production in comparison to the United States, with Canadian unit labor costs almost four times higher. However, because of the strong U.S. demand for petroleum, exports from Canada have always been welcome in the U.S. and have never been the subject of trade barriers of any kind. Indeed, the U.S. highly values suppliers outside of OPEC. The Energy Crisis of 1973 is still vivid in the minds of most Americans, and the U.S. wants desperately to lose its dependence on OPEC for its oil supply.

In addition, the Middle East is dangerously close to the Soviet Union. The more dependent the U.S. is on Middle East oil, the more vulnerable it will be in the event of a conflict with the Soviets. If the Soviet Union should one day cut off the Middle East oil supply, U.S. defense will be in grave danger, forced to depend chiefly on reserves that would not last indefinitely. Because of the unique supply/demand situation in this industry, crude materials will not be affected by the free trade discussions.

High Technology

Although the three sectors discussed above comprise seven-eighths of Canadian exports to the United States (Laxer, 1986, pp. 31–32), the high-technology sector is yet another area in which Canada feels it would gain from a free trade environment. One of the leaders in this sector is the aerospace industry. This $5-billion-dollar-per-year business has already been forced to look to the U.S. market for lack of a domestic market, and it now exports 80% of its production to the United States. As C. A. Bishop, Vice-president of the Aerospace Industries Association of Canada, points out, "We've become very specialized and are world leaders in several fields. We don't think we're going to lose under free trade" (CMA, 1986, p. 15). The fields in which Canada holds leadership include Pratt-Whitney gas turbines and the Garrett temperature control system, which holds 90% of the world market. As Bishop goes on to explain, "There's relatively free trade now. The problems are in the non-tariff barriers" (CMA, 1986, p. 15). For example, he cites non-tariff barriers such as the small business set-aside law, which reserves a certain percentage of business for small U.S. firms, and the control of technology, which limits opportunities in the defense field. The removal of non-tariff barriers will clear the way for Canadian expansion in this still young field.

Business equipment is another part of the high-tech sector in which Canada can claim to be very competitive. John Nutter of the Canadian Business Equipment Manufacturers Association believes that "The majority of our members would welcome free trade tomorrow.... Computers are very much an international thing and free trade is necessary for the industry to grow and be healthy" (CMA, 1986, p. 15). Although the current tariff on computer equipment is rather small, this growing field is important to the continued success of the high tech sector. Canada is also in a very strong position in the telecommunications market. In spite of a 15% U.S. tariff, this industry is enjoying expansion into U.S. markets, and the abolishing of this tariff would open the way for significant expansion into the U.S. market.

Secondary Products

All of the sectors discussed above would profit from free trade between Canada and the U.S. However, there are sectors of the Canadian economy that may not fare as well. The sector that has the greatest potential of being harmed by free trade is secondary product manufacturing—finished products such as appliances and furniture. This is an area in which Canada suffers from an unfavorable cost position in relation to the United States. U.S. raw material costs are lower due to quantity discounts, and productivity is far above that of Canada due to economies of scale. Nowhere is this fact more evident than in the furniture industry, where five U.S. manufacturers each produce more than the entire Canadian market. In 1976, Canadian unit labor costs in the furniture industry were 80% higher than those of the U.S. Although the gap has since dropped to 30%, it is clear that an open market between Canada and the United States could be disastrous for the Canadian furniture industry (McCormack, 1984, p. 3).

The paper products industry is another secondary products industry that could be hurt by free trade. Newsprint, market pulp, and groundwood papers are currently competitive and would continue to be competitive in a free trade environment. However, secondary paper products such as container board, craft and specialty papers, and facial tissues have developed in a protected environment and lack economies of scale in transportation, labor, and equipment.

The future of the Canadian appliance industry in a free trade environment is uncertain. The industry employs over 10,000 Canadians and enjoys annual domestic sales of over $1 billion Canadian. It is made up of multinational companies, which comprise approximately 50–60% of industry sales, and a number of small businesses. The position of the Canadian Appliance Manufacturers Association on the free trade question is basically neutral. According to David Armour, Association spokesman, "The electrical and electronics area are already big exporters with 80–90% of their products going abroad. They have nothing to fear from bilateral trade.... But manufacturers of off-the-shelf transformers and white goods are very vulnerable and could be wiped out" (CMA, 1986, p. 16).

While the secondary products manufacturing sector is the most vulnerable of those being described, it is also the sector with the greatest potential to take advantage of the environment that free trade would bring. After the initial shake-out in which this sector would go through significant changes, the opportunities to be gained from new markets, cost efficiencies, and specialization could make secondary products manufacturing a sector with exciting growth opportunity.

Canadian Culture

There has been concern by some that

further integration of the Canadian-U.S. economy will lead to increased deterioration of Canada's cultural identity. There is no question that the United States has a strong influence on Canada. The U.S. is the most powerful nation in the world, and Canada is its closest neighbor. Apart from the French region,the two speak the same language; and almost 70% of Canadian English-language television viewing time is spent watching U.S. programming (Campbell, 1986, p. 33). It is no surprise that Canadians are strongly affected by the U.S.

The U.S. has had and will continue to have a large trade balance in the cultural industries such as tourism, entertainment, and the arts. However, one point is very important. If one supports the scenario that free trade would improve the economic welfare of Canadians and Canada as a whole, then there would be several significant advantages for Canadian culture. First, more disposable income would be available for Canadians to spend. One can assume that a portion of that additional disposable income would be spent on cultural activities. Second, more leisure time would be available for Canadians to enjoy those activities. Third, more funds would be available for use by the Canadian government and private sectors to spend on cultural development. Therefore, in this respect free trade would actually aid in the development of Canadian culture.

Conclusion

Free trade between Canada and the United States would benefit both countries. It will stimulate productivity and lead to higher income levels for Canadians. It would help shield the threat of protectionist measures for Canadian producers and would allow Canadian industries to take advantage of economies of scale and become more competitive in world markets. These benefits, however, will not come without costs. Canadians must be prepared for the reallocation of labor and materials that will inevitably come with free trade, including the possibility that certain industries will be phased out.

The responsibility of initiating a smooth transition into a free market environment ultimately falls on the Canadian government and its negotiators. Any type of expanded trade policy, whether calling for liberalization or completely free trade, must be phased in carefully and over an extended period of time. Canadian proposals include the following: phasing the program in over a ten-year period; the use of trigger points, where restrictions would be imposed when imports reached a specific level; and adjustment assistance, such as government loans, grants, and the use of accelerated depreciation (Wonnacott and Wonnacott, 1985, p. 16). The process will be arduous, but in this increasingly global market, no country can long afford to shield itself from the world economy. Ultimately, a free trade agreement between Canada and the United States would strengthen the positions of both countries.

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