

# THE POTENTIAL TRADE FLOW: AN AGREEMENT FOR THE AMERICAS

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## INTRODUCTION

The Americas are considering a new trade agreement at a historic time. International trade in agricultural and food products has received much attention since the beginning of the Uruguay Round in 1986 and its implementation in 1995. Today there is little agreement on the outcome of that agreement, as some argue the Round was successful in making agriculture come in line with other industries while others hold that little was achieved.

In this paper I have been asked to outline the potential trade flows that could occur under a new trade agreement of the Americas. This is indeed a daunting task. One thing we know is that trade flows and exchange rates are almost impossible to predict, especially very far into the future. As a result, my comments will be constrained to a mundane set of topics. First, current trade flows and where they might change because of a new trade agreement are discussed. Second, a more complete definition of what kind of trade agreement are considered. In this regard, I will make a few suggestions and show how different agreements result in very different trade flows. Third, New Institutional Economics (NIE) are used to show that we must have some common set of institutions before we can move much further in trade liberalization. Finally, I will suggest that we need to focus more on trade in processed food products and intellectual property rights and less on agricultural commodities.

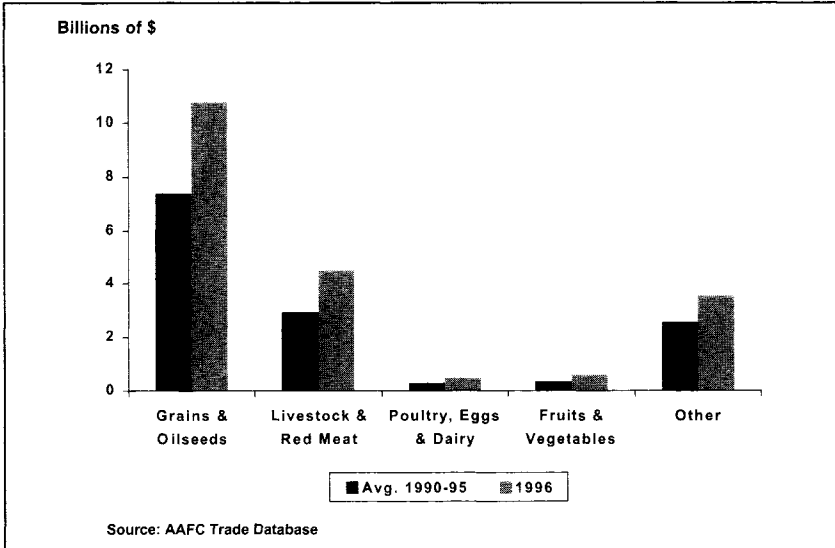
## CANADA'S CURRENT AGRICULTURE AND FOOD TRADE

Canada has always been a trading nation. In its early years the New Territories exported fur, lumber and fish to France and England. With the opening up of the west in the latter half of the 19<sup>th</sup> century, wheat became the staple export and reached its apex in the 1930s and 1940s. Since the end of World War II, Canada has exported a more diversified set of agricultural commodities, although grains and oilseeds remain the most important (Figure 1). Over the last half of this century Canada has been very protective of some agricultural products, the list of which has changed from time to time. In the category of agriculture, vegetables, dairy, poultry, malt, wheat, and to some extent livestock, have had border protection in one form or another.

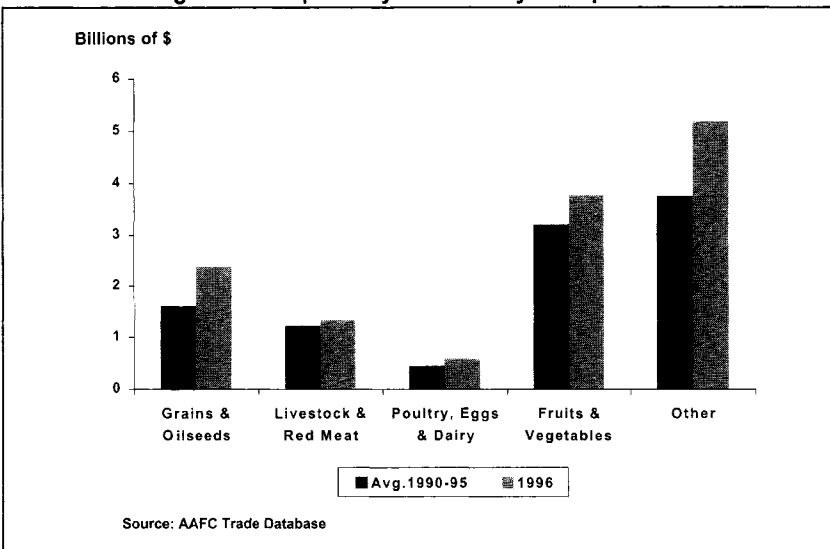
Currently grains and oilseeds receive no border protection and the domestic price is the world price plus some small adjustments for quality and marketing boards (positive or negative depending on your point of view). Livestock products receive some border protection through the health of animal regulations. The major

agricultural protection in Canada today is the supply managed industries of dairy and poultry products. This is evident from Figures 1 and 2, which show the limited trade in dairy and poultry products.

**Figure 1: Canadian Agri-Food Exports by Commodity Group**



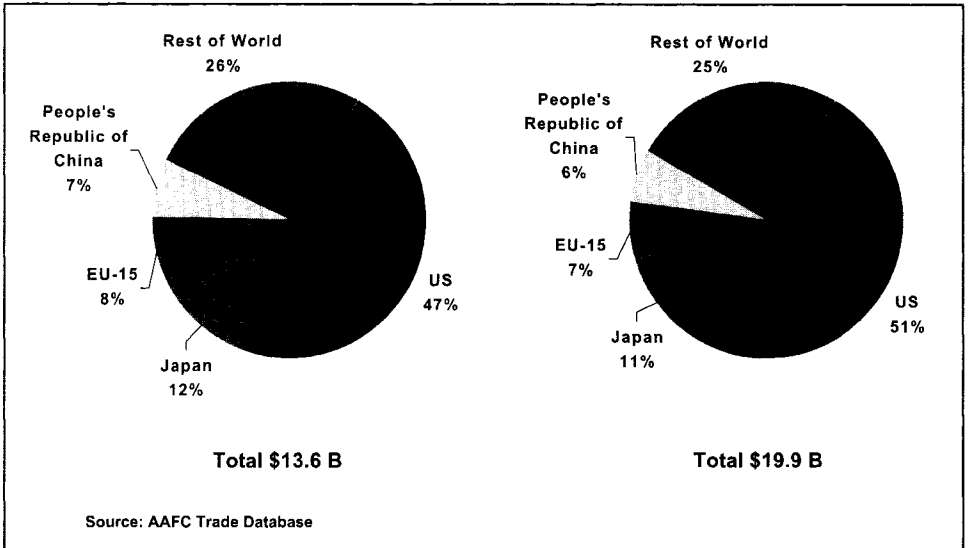
**Figure 2: Canadian Agri-Food Imports by Commodity Group**



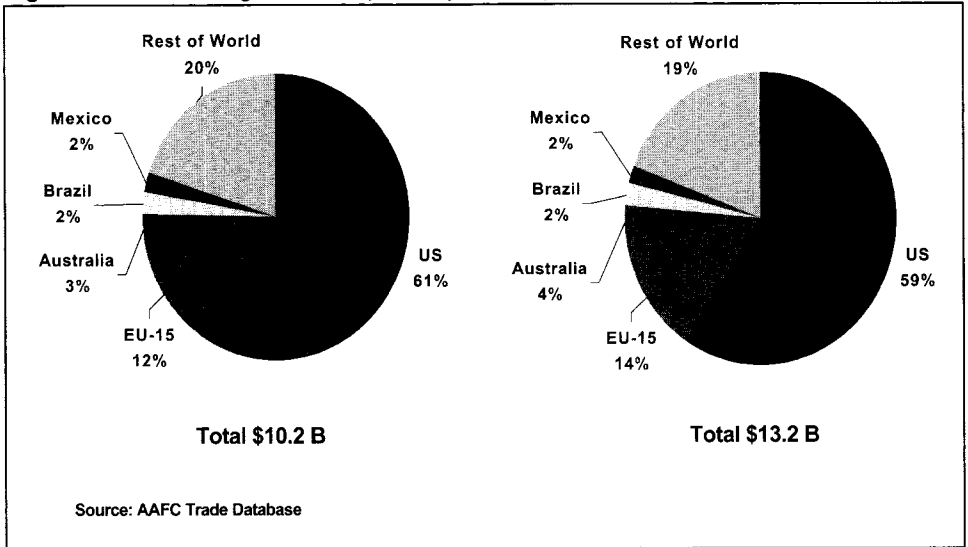
Country of destination for Canada's exports and imports are summarized in Figures 3 and 4. The most obvious characteristic of Canada's exports and imports is the importance of the United States as a trading partner. Moreover, the United States is growing in importance for Canada, largely as a result of the NAFTA. On the export side, Japan and China make up 15% of Canada's export market, largely for grains and oilseeds. This leaves 35% for the rest of world. On the import side the situation is similarly weighted towards trade with the United States.

In terms of consumer-oriented agricultural trade, Canada has had a problem in developing export products and markets (Figure 5). Almost every government in Canada has the policy objective to increase the export of processed food products, however they have met with limited success. This objective is based upon the belief that the value-added products have the greatest return and improve employment opportunities. This is an aspect of the market that Canada will have to develop in the future.

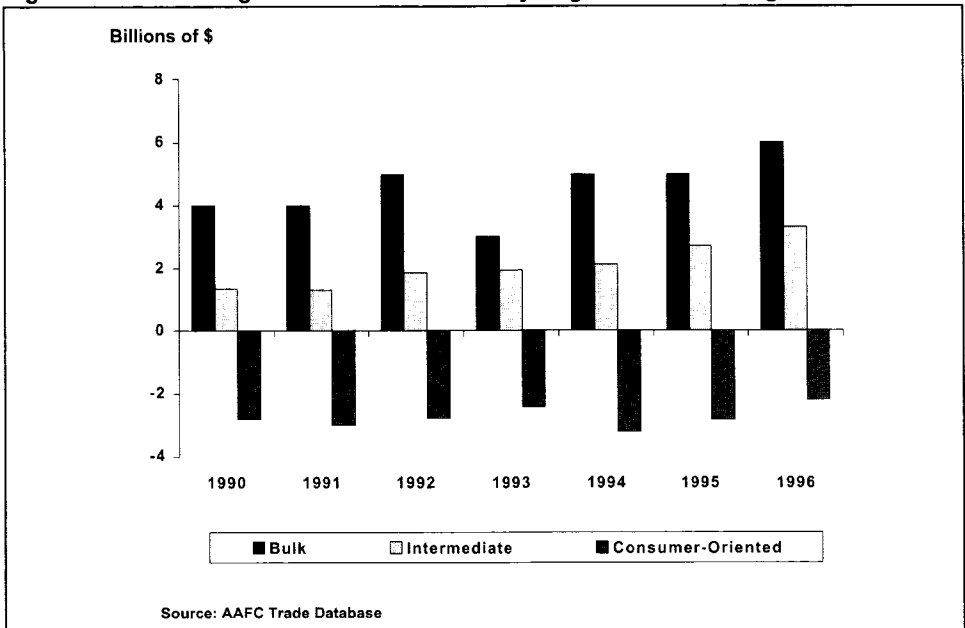
**Figure 3: Canadian Agri-Food Exports by Destination**



**Figure 4: Canadian Agri-Food Imports by Country of Origin**



**Figure 5: Canadian Agri-Food Trade Balance by Degree of Processing, 1996**



It is difficult to draw many hard conclusions from these data. I would suggest that trade with the United States, Japan and China is not likely to decrease, which implies that trade with new partners will be limited. In the all-important, consumer-

oriented products, the critical variable in achieving increased trade is economies of size and scale of the multinational food processors. This is an area where agricultural economists have little to offer, unfortunately. Canada exists beside the largest and most prosperous market in the world and it is difficult to see that new partners from the Americas will displace the US.

## MEANING OF A WESTERN HEMISPHERE FREE TRADE AGREEMENT

It is not clear what is meant by, or included in the term, Western Hemisphere Free Trade Agreement (WHFTA). The definition is difficult because it probably means different things to different governments, and governments will not want to define the term to carefully as part of a negotiating strategy. There appear to be at least three possibilities: (1) a trade agreement modelled on the World Trade Organization (WTO); (2) an expanded NAFTA; and (3) an European Union (EU) type of agreement with complete monetary union. Each of these three types of trade agreements requires different institutional arrangements including dispute settlement and policy harmonization mechanisms. It is very important to have clarification on definition before we can talk sensibly about the outcome of a WHFTA. The significance of this point is illustrated by a few alternatives.

First, the WHFTA might be an extension of the WTO trade agreement. The WTO is reducing tariffs and quantitative barriers as fast as negotiation allows. The WTO has not greatly expanded its influence into a few important areas of goods and services such as intellectual property. New multilateral agreements such as the Multilateral Agreement on Investment (MAI) have not been successful, which indicates the limited ability to move such agreements into new areas of jurisdiction. Countries can appeal to the WTO for trade interpretation but the organization has very limited enforcement power. This has reduced the WTO's ability to create a level-trading environment as most countries retain an arsenal of trade distorting policies available for use at a moment's notice.

Alternatively, we might think of a new trade agreement being similar to that of NAFTA. The NAFTA does not treat all countries the same and has some small differences among the three signatories. This type of agreement would require extensive negotiations unless one country joined at a time, much like the process that occurred with Mexico, and now Chile. What the final arrangement would look like is open to question, as all countries may have a different agreement.

How does the NAFTA differ from the WTO? First, NAFTA put in place a dispute settlement mechanism with representatives from each of the countries. Five members are chosen, two nominated by each country and the chairperson a joint appointment. The panel hears a case and makes a binding ruling (even though disputes have arisen again). Since 1993, this panel process has ruled on a number of controversial agricultural trade cases and the two countries have respected the results. As well, NAFTA allows for firms from the other country to challenge

legislation in the offending countries' court. This has happened in Canada where U. S. firms have challenged (successfully in some cases) Canadian legislation because it would cause injury to US firms in the Canadian market.

A third approach is to follow what has happened in the EU where economic integration has included trade barriers, monetary union and labour mobility. The most recent move by the EU to invoke the Euro would be equivalent to the Americas adopting one currency with one central bank and therefore one monetary policy. Given the unequal size of the economies in the Americas this would most likely mean adopting the U.S. dollar. However, would the United States be willing to give up control over the Federal Reserve? As well the EU has adopted minimum labour and environmental standards. This type of agreement would create a trading block of the Americas and would allow for major changes in the economies of all the participating countries. The economic impact of such an agreement would be large. It is difficult to see this type of agreement in the near future but it may be the ultimate end point of the negotiations.

Finally, in defining any new agreement the role of the United States will be paramount. The U.S. economy is not only the largest but it is also the strongest. With political power moving away from the White House and to the Congress it is difficult to see the United States risking the current economic environment for any new aggressive agreements.

## **INSTITUTIONAL STRUCTURE AND TRADE AGREEMENTS**

Institutions are the rules and norms of society (Coase, 1937). Those rules and norms may be written down in a formalized (legal) manner or be very informal. (Williamson, 1983). Trade rules are embedded in the institutions of any country and thus, when trade agreements change, major changes to a countries institutions may be required. We need only think of a country like China, which is potentially entering the WTO to understand how entering a trade agreement would effect China's institutions (many of the rules governing day to day business in China are not written down). It is difficult for two countries to integrate their economies if one country uses unwritten rules and the other has a legal system with clearly written rules. In order for the WHFTA to work in a positive way there must be some link between the laws of the nation and the international laws.

The three options discussed in the previous section are different because of the amount of institutional change or institutional harmonization they represent. We can think of these agreements as different points on a spectrum of economic and political integration. The more the integration the more similar must be the institutional structure (therefore policies) and the greater the impact on trade patterns. For example, the WTO requires some reduction in border protection and some limited reduction in domestic support. The so-called "green box" programs also affect agricultural production and trade, but more indirectly. They are fully allowable under the WTO agreement (example research, development and State Trading

Enterprises). It is difficult to see how the WTO will make much more progress in enhancing trade without demanding more institutional change within member countries.

The three different trade agreements represent three degrees of trade-off between institutional sovereignty and institutional integration. As countries move toward more complete institutional integration the amount and value of trade should increase because of the lower transactions costs. This does not mean that all countries will gain equally but that the overall welfare level of the trading partners should go up.

A case in point is the changes that Mexico made to its institutional framework to join the NAFTA. Yunez (Workshop Proceedings, 1997) and the Lake Louise Workshop (Workshop Proceedings, 1998) detailed how Mexico completely modified farm programs as NAFTA was implemented. These changes have come at a high cost to many Mexican people but the government was willing to make major changes to the institutional structures to join NAFTA, with the expectation that longer term benefits would offset short term losses. On the other hand, Canada has not been willing to change many of its farm programs, rather it has just lowered the level of domestic support. In one of these areas, dairy, it could be argued that Quebec wants protection for its dairy sector because it places a higher social value on small farms. This proposition is supported by the fact that the province of Quebec contributes to very expensive farm programs outside supply management like the ASRA program. Is this difference based on a difference in culture and thus different institutions, or is it just superior farm lobbying? Whatever the answer, it will have a major impact on the patterns of trade.

One of the benefits of integration is the responsibility other countries may assume to help countries through economic problems. For example, the United States provided the Mexican government with billions of dollars when the peso lost value, argued to be in United States interest. Without integration, these types of arguments are more difficult to make. Here we see that there are trade-offs between the benefits of integration and the potential loss of cultural institutions.

## **LESSONS FROM NAFTA**

Let us now return to the trade data that were discussed in the first section of this paper. Before doing that it might be useful to note that Canada and the United States are very similar in a number of ways. Both countries are democratic and enforce their laws through the courts. However the United States is a Republic and Canada is a Federation; consequently our constitutions are very different. This institutional difference means that the power of the central government is different, and that in turn limits how institutions can be brought together.

In the United States the national government is responsible for farm support programs. In Canada the two levels of government share the cost and responsibility of farm programs. This difference means that in Canada the federal government must

negotiate farm programs with provinces. In Quebec the farm programs are very different than in Alberta. This has an important impact on Canada's ability to harmonize farm policy with the United States, and to integrate the two economies. (*Editors note:* the first workshop on grains disputes (1995) provided discussion of this point in the first two papers by Hedley and Gellner, and Knutson).

Canada blocks trade in poultry and dairy products through supply management. Canada has a single desk seller for western wheat and barley while the United States uses the Commodity Credit Corporation (CCC) to implement its grain policy of farm support (Schmitz et al. 1999). It is doubtful that these policies would change much with the WHFTA and thus would limit the potential for increasing agricultural trade. U.S. based processing firms which had branch plants in Canada have used the freer trade environment to consolidate many of their processing plants in the United States in order to capture economies of scope and scale (Romain et al., 1998). They see the North American market as one and are investing accordingly. In this case the integration of the two economies is much further along than in the production of the raw farm commodities.

## **POTENTIAL TRADE FLOWS FROM THE WHFTA**

The potential for new trade patterns to develop from a WHFTA will depend upon the degree to which the institutional structures of the trading partners are harmonized. The more similar the institutional structure the greater the integration of the economies and therefore the greater the trade flows. This follows because the more harmonization of rules and policies the lower the transaction costs. Lower transactions costs will increase the profit from trade thus encouraging more trade between the countries. The question then is how much can the institutional structures be brought together?

If Canada and the United States are an example, then the potential is limited. Even with the large number of similarities between the two countries they have been limited in the process of policy harmonization because of constitutional and cultural differences. As a result of past agreements such as the NAFTA these two economies are moving closer together. Even with the changes that have taken place the institutional differences still cause friction. Any new agreement that hopes to have much impact on trade patterns will have to go at least as far as the NAFTA which may be difficult for the Americas. To achieve an agreement as comprehensive as the EU is almost beyond reach.

## **CONCLUSIONS**

The pattern of trade is very difficult to predict at the start of negotiations. Depending on the type of agreement the potential for new trade flows can be very different. If the WHFTA is aimed at lowering tariffs (and some are still very high)



then there is the potential to increase trade. However it is likely a number of exemptions for developing economies would be made, reducing the increase in trade flows in the near term.

A major point made throughout this paper is that trade agreements alter the institutional structure in a country. The degree or amount of change made to the institutions will have the greater affect on trade flows. We should focus more on the harmonization of institutions if we want to understand the constraints to trade in the Americas.

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