CANADA AND THE NEW AMERICAN EMPIRE

Issues in Canada-US Bilateral Economic Integration

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Background/Introduction

Canada's relationship with the United States is arguably one of the most complex bilateral relationships in the world. The growth in trade and the continuing integration of the two economies have forced Canada and the US to think in new ways on how to both capitalize on opportunities as well as to confront common threats.

The ongoing agenda includes many imperatives: managing the common border; converging the operations of respective customs agencies; co-ordinating immigration and refugee policies; co-operation on security priorities; defence cooperation; co-ordination on international treaties signed by both countries; joint management of natural resources and the environment; and energy, where a continental market is already a reality.

Over and above a government to government agenda, there is also a business agenda. Markets are integrated, product development is often North America based, infrastructure is linked, manufacturing processes straddle borders, skills and training are essentially joint for many products and personnel, staff are transferred between both countries, and so on. Even in their personal lives, individual Canadians and Americans find themselves inextricably linked through families, property, education, services and cultural events.

As joint tenants in North America, Canada and the US must co-exist peacefully. The challenge is how to do so as two sovereign and independent nations but two nations of very different size and roles in the world.

Choices for Canadians

The economic history of North America has taken Canada and Canadians through many levels of relationship with the US. From a colonial neighbour with a common parent to two independent nations, the two countries have had a mutually beneficial economic partnership that has positioned North America as an economic powerhouse.

Clearly, Canada has been and will always be the junior economic partner. The reality of size and geography cannot be changed. However, the perennial questions arise about the wisdom of our economic dependence on the US is an advantage or disadvantage. But, if we had the opportunity to move Canada adjacent to any other single nation in the world, would we want to be anywhere else other than where we are now? From an economic perspective, the answer is no. Our proximity to the world's largest and most dynamic economy has meant distinct advantages for Canadians.

Public opinion surveys indicate that the average Canadian does not fully appreciate the depth of the relationship with the US. Citizens may know that over 80% of our exports go to the US but statistics do not capture or measure the way in which Canada and the US interact with one another on a day-to-day basis. Nor do statistics accurately portray how Canadians and Americans live in and/or travel to each other's countries, or the depth of personal, financial, social and cultural ties across the border.

In considering Canada-US economic relations, it cannot be overlooked that for many businesses, it is easier to trade north-south than east-west because of geography, infrastructure and inter-provincial trade barriers.

As the smaller of the two partners, this relationship sometimes puts Canada in an awkward position, particularly when the United States acts as a *demandeur*. This is all the more true in the post-September 11th world, one in which security has become an overwhelming preoccupation of American policymakers. Many Americans expect Canada will react as "family" on broad issues and security matters. Moreover, at a time when strong views abound about US foreign policy and military actions, a dispassionate discussion of economic relationships apart from the broader context is difficult.

This issue has affected attitudes and communications between Canada and the US and there have been more than enough unfortunate labels used. However, a larger question is how well Canada makes its case in the US and how we communicate our views. Both governments and business may not be doing a sufficiently good job.

The principal purpose of this paper is to examine Canada-US economic relationships but an equally important corollary is how Canada can boost its economic relations with other countries and parts of the world while maintaining the required emphasis on Canada-US relationships. In trade policy terms, there are often debates about Canada's heavy, and some say dangerous, dependence on the US. Clearly, diversification of opportunities should be encouraged wherever and whenever possible. But while governments can create a facilitating trade policy framework through bilateral or multilateral agreements, business will go where business goes. This cannot be forced through government policy.

Another dynamic involves Canada's relationship with emerging economic powers -- China, India and Brazil. China's economy, for example, is growing rapidly and may someday surpass the US as the world's largest. How Canadian business should take advantage of opportunities in an economy half a world away instead of next door is a major challenge. A related but equally significant question is how shifting economic geography will affect the Canada-US relationship and for that matter, the economic prospects for the North American economic bloc. Canada's economic future is indeed tied to the US but how do we work together to improve not only Canadian prospects but those for North America, at the same time while maintaining our privileged access to the US market? What are our policy choices?

a) Mutual Recognition Agreements: Do It Only Once

The regulatory approaches and regimes of Canada and the US are similar, and in cases of products that are shipped from one country to the other, many tests and certifications actually duplicate one another.

Streamlining of regulations is one area where Canada and the US can make concrete progress. Former Trade Minister Pierre Pettigrew has suggested that Canada and the US should “move to the principles of mutual recognition and the elimination of duplication”. Some of this work is already being done in areas such as pesticides, aviation safety, biotechnology and pharmaceuticals. The House of Commons’ Standing Committee on Foreign Affairs and International Trade has also recommended that the NAFTA partners should “implement mutual recognition schemes for existing regulations”.

The Canadian Chamber fully supports this idea, and urges the federal government to vigorously pursue this approach with the United States and, where possible, with Mexico. In examination of the respective regulatory system, economic efficiency should be the driver. Does an integrated North America still need regulatory systems that duplicate each other? We think not. Nor does having different regulations just because we are different countries necessarily make sense. Currently, this is being explored on a transatlantic basis between both Canada and Europe as well as the US as and Europe so it should be a logical item for Canada-US cooperation.

This does not mean that Canada would automatically adopt US standards nor vice versa. Each country must retain the sovereign right to regulate as it sees fit, and each should be perfectly free to have regulations differing from the other, should it be deemed necessary to do so. But in many cases, the two governments may find it unnecessary to duplicate work. The regulatory system needs to be assessed with an open mind, allowing the authorities of both countries to examine which system can best accomplish the job and provide the best regulatory outcome. This does not mean reducing standards to a lower common denominator. It means simply that where the two governments are collecting essentially the same information or performing virtually the same health or safety test, it makes little sense to collect the same information twice or perform the same test. Doing so costs time and money, and delivers little tangible benefit to the consumer.

b) Customs Union: Complicated and Controversial But Worth Looking At

A more ambitious idea is that of a customs union. The most commonly accepted definition of a “customs union” involves removal of border tariffs between the participants, and agreement on a common external tariff towards outside countries. Definitions of a “customs union” vary, some include the harmonization of non-tariff measures, such as technical standards and sanitary and phytosanitary measures. Other definitions do not. These are more terms of art than science.

As far as common tariffs are concerned, Canada and the United States are already far down this path. As of January 2004, tariffs on most industrial goods are gone and remaining tariffs are due to be eliminated soon. A similar situation exists with Mexico.

The basic goal of a customs union is to encourage goods to flow more freely. In the Canada-US case, this could mean reducing the need for customs inspection at the border (leaving aside security considerations). It would reduce or even eliminate paperwork, uncertainty and costs associated with rules of origin and reduce administrative burdens.

This is not to suggest that a customs union would solve all outstanding trade issues between Canada and the United States. Indeed, no single agreement or institution could ever hope to do so. In terms of tariffs with the outside world, Canada's external tariffs (that is, on goods coming from non-NAFTA countries) are, on average, almost twice as high as US tariffs, due to the countries to which we extend MFN (Most Favoured Nation) or GSP (General System of Preferences) treatment. Canada also has a tariff system geared to Commonwealth countries, a system that the US does not share.

But there are also issues apart from tariffs. In a Canada-US customs union, it is not clear what would happen to anti-dumping and countervail rules. Non-tariff barriers such as health inspections and safety requirements might or might not be dealt with. Immigration and restrictions on the movement of people would almost certainly remain.

Moreover, how would Canada act at future international trade discussions such as the WTO and FTAA? Would we be required to adopt a common position with the United States and Mexico, in much the same way that the European Union now negotiates as a bloc? What would happen to Canada's "managed trade" or special tariffication measures that protect domestic capabilities (eg, our agricultural supply management systems)?

It is also unclear to what extent a customs union might demand binational institutions or bodies. Currently, there seems to be little or no appetite for approaches creating European style organizations, which overlay domestic institutions. The model might have co-operative bodies like the International Joint Commission or the NAFTA Commission on Environmental Cooperation, which have had an information and assessment mandate but not regulatory powers. The notion of NAFTA permanent bodies in the trade area has been suggested.

In short, the ideas of customs unions and common external tariffs should not be considered lightly, since they could substantially redraw the map of Canadian trade and tariff policy and have consequences for a range of policy areas. But neither should the possibility be tossed aside without due consideration. There may indeed be merits.

c) Dollarization and Exchange Rates

A couple of years ago, new record lows for the Canadian dollar against its US counterpart produced considerable discussion on the causes of the Canadian currency's woes and prompted debate on potential alternatives. Since then, the rebound of the Canadian dollar has created different arguments.

Currencies react to market conditions, influenced by such factors as interest rates, inflation, economic performance, productivity, debt-to-GDP ratios, political stability, commodity prices and the strength of other currencies, especially the US dollar.

Dollarization would mean using a foreign currency to fulfil some or all of the functions of money. Under formal dollarization, Canada would abandon the Canadian dollar and adopt the US dollar as legal tender. Existing Canadian dollars would be exchanged for US dollars at a predetermined rate (a critical issue in itself).

While the dollarization notion makes for an interesting theoretical debate, it is not an option for serious consideration. A floating exchange rate has served Canada well and this approach should continue. It is especially important given the significant differences in the underlying structure of the Canadian and US economies. At some point, if the two economies became more similar in structure, the advantages of a floating exchange rate may diminish and alternative exchange rate regimes could be explored.

The focus should be on growing Canada's economy on a long-term sustainable basis. This, in turn, would raise the value of the Canadian dollar over time. Getting the economic fundamentals right and allowing the economy to generate strength is the most appropriate course of action.

d) Sectoral Agreements/Sector Tariffs: A First Step?

Many years ago, the European Union began its process of integration with a few institutions in specific sectors - the first two were the European Coal and Steel Community and the European Atomic Energy Agency. While recognizing that the European process was very different from what is underway in North America, sectoral institutions or arrangements may be a means for Canada and the US to test a model without plunging into a full customs union.

One possibility is a common framework for a North American steel industry that is already highly integrated. Companies have plants on both sides of the border and materials are sourced in both countries. However, the trade institutions which apply in times of dispute are anachronistic, a hold over from times when economies were not as interdependent as they are today.

It may be timely for the governments of Canada and the United States to examine the idea of sectoral tariff agreements. Such a "trial run" could be a good way for Canada and the United States to not only improve the efficiency of the current industry but also assess the real impact of a move to a common external tariff.

e) Trade Remedies: Unfinished Business in NAFTA

In the FTA and NAFTA, each of the partner countries remained fully armed in terms of retaining the right to apply its respective trade remedy mechanisms, in addition to the dispute settlement mechanisms put into the agreement. Trying to make further progress on these mechanisms remains a key part of unfinished NAFTA business.

The softwood lumber and steel disputes, among others, are symptomatic of the trade remedy question in NAFTA. This was the point made in recent remarks by both Prime Minister Martin and International Trade Minister Peterson at presentations in the US.

However, these cases both point to a larger issue -- an increasingly integrated North American market is essentially an extended domestic market but still subject to rules originally intended for totally separated export markets.

Canada has its own system of trade remedies but it is not as affected by political or protectionist pressures. The US has indicated that reform of its antidumping/countervail system may be on the table for discussion during the WTO and FTAA negotiations but this will likely face serious resistance within certain factions in Congress. Moreover, the complexity of such negotiations means that the possibility of real change is distant.

The SCFAIT Committee has suggested a common North American anti-dumping and countervailing duty mechanism, under NAFTA article 1907. Another idea was a permanent NAFTA "court" on trade and investment disputes. These are ideas worth further exploration. Suggestions made to date are long-term ideas that would take time to develop, and would need the right political and economic consensus.

f) A "Big Picture" Initiative to Deepen NAFTA

The creation of the FTA was the culmination of a bold political stroke in which Canada carried the momentum to the United States. Similarly, creating NAFTA required forward-looking and courageous policy-making. The history of the FTA and NAFTA has not been a smooth one politically – essentially the 1988 Canadian federal election was fought on free trade and it has almost been a perennial issue in Canadian politics.

Looking forward, the question of the economic relationship with the US is far higher on the minds of Canadians than it is for Americans. To take a bold step requires a political or economic consensus, the right timing and a clear vision. In short, the scenario must be "ripe" for success.

Currently, these conditions do not exist. Political circumstances, especially a minority government in Canada, do not support a major initiative in the short term. Moreover, a bold stroke is not currently high on the business agenda either in Canada or the US and a groundswell of opinion in favour of a major new initiative is not evident.

In short, a serious push for an extended agreement, as happened for both the FTA and NAFTA, does not seem to be feasible at this time. However, this should not limit making practical incremental improvements that benefit both Canada and the US, and allow both countries to make North America a more competitive economic platform. Moreover, it should not limit looking at potential new initiatives when the time is right. If new initiatives are a means to safeguard our current privileged access to US markets (potentially under threat if the US continues on course with new bilateral agreements), then we must do what is required to retain our current favourable position.

Potential Flash Points

Consideration of the Canada-US economic future and directions cannot be undertaken in isolation from political realities and trends. But potential issues arise:

1. The border agenda is vital in any discussion about potential flash points in economic integration. Since 9/11, operation of the border has moved from benign neglect to an up front symbol of sovereignty and security. The longest undefended frontier in the world is no longer what it was. For Canadians and their economic dependence on the US, the border is not just symbolic – it is a vital part of the linkage. It is a strategic issue because if the border does not function efficiently, effectively and securely, Canadian economic prospects dim considerably. Managing border risks, improving infrastructure and taking to steps to make it work better are essential. Taking a “perimeter” approach to North American security is also in the mix.

2. Improving trade remedy and dispute settlement mechanisms in a way that reflects integrated economies will be politically contentious. In various trade negotiations, the US has faced demands for reforms to its trade remedy system. Chapter 19 is unfinished business from NAFTA, where both countries left their trade remedy system fully armed. Major reforms could involve circumscribing the rights of the US Congress, something that would be a tough sell. However, both countries must look at the potential for improving the current system, the possibility of new joint institutions and ensuring dispute resolution systems work as designed.

3. Legal issues on the part of regulators and legislators arise if there is mutual recognition of standards or rules are harmonized. Business hopes that common sense can prevail and the most efficient and effective rules or processes can be agreed on.

4. New bilateral arrangements on economic integration could bring sensitive sectors to the fore. For Canadians, this means our supply managed sectors for agricultural commodities, and in the US, commodities like sugar. Political realities could make substantive changes a tough sell on both sides of the border.

5. Closely integrated economies can mean fierce competition for the location of investments and their resultant jobs and economic spin-offs in both countries. In such a scenario, protectionist pressures often arise, accompanied by a high level of rhetoric. A key challenge is to manage expectations and minimize protectionist actions.

6. Chapter 16 of NAFTA, which governs the transborder movement of people, is another piece of unfinished business. Economies which are closely tied and which are increasingly oriented to the service sector require that people are able to cross borders as easily as goods. But, this is far from the case. Issues around immigration, refugees, safeguarding jobs and work visas have essentially ground progress to a halt. Problems continue on both sides of the border and await resolution.

7. The reality of economic integration means spillover into other policy arenas because of interconnectedness. Be it social matters, health care, energy, pharmaceuticals, taxation, education, security, culture, defence or foreign policy, closer economic ties inevitably produce collateral impacts on other policy areas. To some, this interconnection represents a slippery slope leading to loss of “independence”, autonomy and our own way of doing things consistent with our strategic needs. To others, it does

not have to be negative – indeed, a strong economic relationship can be seen as giving Canada the freedom to pursue its own needs in other areas.

As economic integration proceeds, finding the balance in these many conflicting areas will not be easy. Moreover, the Canada-US economic relationship will always be asymmetrical. Rather than bemoaning this situation, Canada needs to accept reality, define its core interests and defend them vigorously and strategically.

8. What do deeper Canada-US economic relations mean for Mexico? Would an extended agreement involve just Canada-US, or would Mexico be in the mix as well? Mexico has recently ventured interesting thoughts on greater continentalism involving more coordination on issues by the three countries but the idea has really not flourished.

9. Finally, the economic future of Canada and its partnership with the US raises questions about how to maintain our competitiveness and attractiveness for investment, a race in which we have been facing a declining relative share of developed country investment. While Canada benefits from geographical proximity to the US, we are also easily compared to the US. In analyses of productivity, competitiveness, regulatory and tax climate, Canada does not always compare favourably. The lesson is that Canada must work diligently to position itself as a destination of choice for inbound NAFTA investment, as well as demonstrate that it is a full partner in the North American economic unit.

Options/Recommendations

1. The border agenda must be a priority, especially completion of the initiatives undertaken under the December 2001 30 Point Plan and full implementation of the infrastructure spending initiatives to ensure a secure yet efficient border.

2. The government must assess the potential for more focussed and permanent structures, especially for border management and trade dispute resolution.

3. Canadians must examine all ideas to manage the ongoing economic integration with the US with options ranging from pragmatic incremental improvements to bold new initiatives. Of immediate attention should be ways to reduce cross-border impediments or inefficiencies to approvals, standards and product processes. As these options are considered, Canadians should not be reticent about new approaches to integration, cooperation, harmonization, and partnerships. We can and must approach the bilateral agenda with the US with confidence. It is in our vital strategic interest to safeguard our privileged access to the US market and to enhance it.

5. Canada needs to rethink how its messages are heard at the highest levels in Washington and beyond. At a minimum, there is need for systematic and regular contact at the highest political levels to complement to the regular ongoing contacts between Ministers and government officials. Canadian and European political leaders meet semi-annually, the Canadian Prime Minister and the US President should do so as well.

6. The business community must maximize its linkages with American counterparts in the US to ensure that Canadian priorities, ideas and perspectives are heard throughout the business community. As the engine of economic activity between the two countries, business has a vital role to play in the forward relationship.