NORTH AMERICAN ECONOMIC INTEGRATION: ASSESSING THE OPTIONS

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Introduction

The first purpose of this briefing note is to shake some long-standing myths and presumptions about the nature and consequences of economic relations between Canada and the United States. Once this background is established, it will be used to argue that recent proposals for preferential deepening of North American economic linkages, – such as a customs union or the use of a common currency, or both – would be damaging for Canada and of no interest or benefit to the United States.

Background

Striking but still largely unknown facts: Trade, capital movements, and migration are all much more local and national than international. More than a decade after the Free Trade Agreement (FTA) between Canada and the United States the intensities of merchandise trade (merchandise trade flows include goods but not services, and is reported by Statistics Canada and the media every month) are ten times as intense as those between Canadian provinces as between Canadian provinces and US states of equal size and distance. The differences between domestic and international linkages are even greater for services, for total capital movements, and for migration[1].

How can this be so, since we are told so often that something like a quarter of Canada's Gross Domestic Product (GDP) goes to the United States? This is in part because the United States is ten times as large as Canada in terms of population and production, while Canadian provinces are about the same distance from each other, on average, as they are from typical US states. It is also in part because GDP and merchandise trade measure different things, so that for some countries merchandise exports exceed GDP, even if most GDP remains at home.

To understand this latter point, think about the North American auto industry, best viewed as a factory with an international border running down the middle of the assembly line. Each time a car part or vehicle moves from a Canadian to a US location, the whole item is treated as a Canadian export, even if most of it either originated in the US or had

[1] Recent results and references to the fast-growing literature are reported in my short book **Globalization and Well-Being** (UBC Press, paperback 2003) with fuller but earlier reporting in my earlier **How Much Do National Borders Matter?** (Washington: Brookings Institution, 1998). The UBC Press book also provides references to the well-being research drawn on later in this note, and deals also in more detail with currency union and trade relations.

previously been exported from Canada in a more basic form. Thus total exports of autos and parts easily exceed total GDP (which measures value-added, with double-counting removed) of the car industry.

Trade not only drops greatly as borders are crossed, it also drops with distance, by much more than could be explained by transportation costs. I think that the sharp declines of the intensity of economic linkages as space and borders are crossed arise for the same basic reasons. It is important to establish why the effects of borders and distance are so great, since without such knowledge one does not know whether these effects are costly barriers to a better life (as some recent economic models tend to assume rather than show) or whether they represent an effective and sustainable matching of local goods and service to local tastes.

If there is a limit to the product variety that consumers want, and if local producers have some advantage is seeing and responding to local and national tastes, opportunities, and costs, then it is to be expected that trade networks will extend in space only so far is required to get the desired amount of quality and variety at a reasonable cost. This separation is made even more likely, and more desirable, if local and national networks of trust are denser and more reliable, making it less risky and less costly to deal with nearby or national partners, suppliers and customers.

What are the facts of the matter? At stake is whether there are or are not large economic or other gains from expanding international trade intensities to make them more like those that already exist within countries. There is one simple and fairly obvious test that can be run to see if trade intensities among the industrial countries are below those required to achieve economic efficiency. It has already been established that trade intensities are much greater within than among nations. If it is true that greater trade intensities, among the industrial countries, would increase economies of scale or access to effective technologies in a significant way, then we would expect to find GDP per capita much higher in larger than in smaller economies, since larger economies already have a much wider set of trading opportunities within their borders. But in fact if we look across the advanced industrial countries (using the members of the Paris-based Organization for Economic Cooperation and Development, the OECD, as the representative group), there is no positive correlation between income per capita and country size. That provides at least a rough answer to part of the question, that relating to GDP per capita, a commonly used measure of economic performance.

But what about the loss of product variety, which could leave consumers in small countries unsatisfied even if their levels of GDP per capita are as large as those of consumers in bigger countries? Fortunately, there are now measures of life satisfaction which can be used to answer this question, at least in a rough and ready way. If consumers in small countries are generally unsatisfied with their more limited range of choice then we would expect them to be less satisfied with their lives than those in larger countries where more variety is available within national borders. But the life satisfaction measures show even more clearly than the measures of GDP per capita that being in a larger country does not make for a happier life.

To non-economists, this probably all seems unsurprising, if not boringly obvious. But it is important nonetheless, since it cuts to the core of the arguments often used to support the desirability of ever-greater international trade intensities. The burden of the evidence is that at least among the industrial countries there is already sufficient trade openness to achieve the main gains in efficiency and variety that international trade can provide. For developing countries the story is rather different, as more openness can be advantageous for those with sufficiently strong national-level social capital and institutions to enable them to harvest the gains and deal with the risks. But there is also ample evidence that increasing openness in the absence of adequate domestic social resilience and governance capacity can destroy what was without replacing it with anything better. I shall be arguing later that the biggest gains for the world as a whole, and for Canada, lie in ensuring that international interdependence can be made to work more effectively for the poorer countries.

Choices for Canadians

I shall deal with four key choices relating to future economic relations between Canada and the United States. The first is a general one, how to frame Canada-US issues within the larger framework of international economic and political relation. The second and third are relate to two specific proposals that have been highlighted for consideration at this conference: a customs union between Canada and the United States (or would it have to be NAFTA?) and the use of a common currency (which would in practical terms mean the adoption of the US dollar). Finally, I shall deal briefly with a strategy for managing the critically important aspects of Canada-US economic relations; the size and closeness of the United States make these issues fundamentally important for Canadians, even if they are much less so for the United States, and even if domestic intensities remain far larger than international ones.

The Broad Context

Those who make the case for seeking to make Canada-US economic linkages tighter, even at the expense of opportunities, elsewhere usually support this position in one of three ways. First, it is sometimes argued that the increases of Canada-US trade relative to total Canadian trade in the 1990s reflect a trend that is likely to continue. Thus if the United States is destined to be a relatively larger part of Canada's economic environment, then why not use extra efforts to develop those opportunities? This position reflects a serious misreading of the evidence, in my view. All of the empirical evidence of bilateral trade shows that it increases with the economic size of a country's trade partners. Looking ahead, there is no model of global development that does not show the US and Canada both as declining shares of world population, output and trade. Thus Canada's other trading partners are bound to be growing faster than the United States, and our trade patterns will follow accordingly.

In addition, most of the unexploited trading opportunities waiting to be developed are between countries with very different types of human and natural resources. Where the gaps are great, so are the potential gains, but they take time and care to develop in ways that are politically, economically, socially and environmentally sustainable for all parties. These opportunities are far more prevalent for Canada in the world at large than within North America. The past growth in Canada-US trade as a share of total trade is thus to be seen as a working out first of the Auto Pact and then of the FTA, with increases in the trade share with the United States in the wake of each.

Second, it is sometimes argued that if the United States is increasingly likely to use economic policies for political objectives, and if there is likely to be a proliferation of regional trading blocs, then Canada has little realistic choice but to be under the US umbrella. It is true that there has been an increase in the number of preferential trade agreements in the world, and most analysts think that this poses both economic and political costs for the world as a whole. Unfortunately, Canada must take a substantial share of the blame for this, as most of these arrangements (including NAFTA and many others) were developed in the wake of the FTA and used many of the templates developed for the FTA. When the FTA was being debated in the 1980s, most economists accepted that there were costs of taking a preferential rather than a multilateral route, but thought that these costs could be accepted if the FTA rules could then be applied multilaterally. Unfortunately this was just what did not happen, and the undesirable flowering of preferential trading arrangements followed instead. But the best way of proceeding from here is surely to make changes in the broad direction of movement, by making sure that future developments of the FTA make it more rather than less compatible with globally open trade. More on this in a moment.

Third, it is sometimes argued, just as was done in the case of the FTA, that expanding preferential access between Canada and the United States can be done in parallel with increasing trading opportunities elsewhere. This third point should be made a primary objective, as it implies less rather than more use of preferential trading rules. I have argued elsewhere that for Canada to operate to global and national advantage in the development of international institutions, and to operate effectively in helping other countries, it is important to be seen as a small but independent player with no ambitions to global power. This is increasingly difficult to do if Canada is seen as giving special preference to its economic and political relations with the United States. In these circumstances Canada would lose much of its perceived capacity to contribute and gain at the global level, with no offsetting benefits for either Canada or the United States.

Conclusion: all of the advantages favour viewing Canada-US relations as part of a consistent world view, and not as a target for preferential treatment.

Towards a Customs Union?

The argument here is that if the FTA has done more to generate trade than to erase the bilateral gap in income per capita, and especially in manufacturing productivity, then the answer must be that north-south integration has not gone far enough to produce the hoped-for gains. There are two aspects of the proposal, one to move directly to reduce the binding nature of the NAFTA rules of origin (which set limits on the amount of overseas content there may be in duty-free shipments from one NAFTA country to another), and the other a move to a full customs union. The first is sometimes viewed (confusingly, in my view) as a first step toward the second. I think the reform of the rules of origin, which is the only element of a full customs union that is modeled to produce any substantial economic efficiencies, is worth attempting, but in the context of moving away rather than towards a preferential north-south trading relation. What are you talking about? (I seem to hear). Here are several key points. First, the FTA and NAFTA rules of origin are indeed the most restrictive (and hence damaging to multilateral trade) of those in any other preferential trading arrangement. I suspect that this rather shameful result arose because the working out of the details of the rule of origin was delegated to industry groups reflecting the interests of the key North American producers, who then developed rules that made it hard to include off-share content. The time may be ripe to change this state of affairs. First, many of these same firms are now becoming more global themselves, and hence more open to a softening of the rules. Second, if NAFTA is intended to be a 'best practice' agreement', then it cannot afford to represent worst practice in this important respect. But it must be recognized that reforms will not happen that are of general advantage if they are once again left to the currently powerful producers, and where else is political support likely to be coming from? But it should remain an objective, because any general relaxation of the rules of origin amounts to extending some of the benefits of NAFTA to producers in other countries, thus achieving in some measure the hoped-for conversion from bilateral to multilateral.

But what about a customs union? This is a non-starter in both economic and political terms. It clearly is a move towards a deepening of a preferential trading area, and hence bad for Canada and for the world. It would require the two countries to have the same rules and preferences for all of their foreign trade. In a world where trade access is part of politics, this would be of interest to neither country.

A Common Currency?

This can be dealt with briefly, given all that has already been said. The gains from a common currency relate to expanded trade among those using a common currency, often at the expense of other trade. I have already argued that the gains from international trade intensities have already been reaped, and that a more balanced multilateral policy is the best way to go. This is best achieved by a flexible exchange rate supported by a stable macroeconomic environment.

There are some countries which have joined currency unions in order to gain credibility for policies intended to produce low and stable inflation, present and expected. Canada is certainly not one of these countries, so that adopting the US dollar would mean abandoning a key macroeconomic policy. Within the Euro area, the smaller countries previously tracking the Deutsch Mark have actually gained more control of their monetary policy by adopting the Euro, since they now have some say in the policies formed by the European Central Bank. But for Canada, the reverse would be true, with policy autonomy, which is real for a country operating under flexible exchange rates, would be lost, without acquiring any say over US monetary policy. Furthermore, recent research on the determinants of the value of the Canadian dollar shows an important role in cushioning world swings in raw material prices, something that would be lost if the US dollar were adopted. Finally, of course, the US dollar is not the stable centre of the world monetary system, but the currency of a country with unsustainably large fiscal and external deficits. Most research suggests that the removal of these deficits will entail, among other things, further changes in exchange rates against major world currencies. But no one knows what changes, by how much, and when. In these circumstances, it would be especially threatening to Canadian macroeconomic stability to attempt to track, let alone to adopt, the US dollar.

Managing Bilateral Economic Relations

While the evidence seems to me to support strongly a multilateral strategy, and rejection of any preferential deepening of the north-south economic relation, whether through customs union or a common currency, there are nonetheless bilateral issues that require bilateral attention. The biggest practical issues, relative to the movements of trade and people, relate to border crossings. Here the solution lies in the development of practical means of improving access without decreasing security. This is easy to do, because the border is never likely to be a high-return place for interdictions of terrorists. The issues and resolutions differ from one region to another, depending on the types of trade and modes of transport. It is important to make the case, both in Canada and in the United States, that to close the Canada-US border in a time of terrorist attack is simply doing the terrorists' job for them – inflicting major damage on North Americans at no cost and no significant risk to terrorists.

On the development of trade, there has been a Canadian expansion in consular missions throughout the United States. I think that this reflects a misreading of the depth and asymmetry of the existing pattern of information flows and economic linkages between the two countries. Consular missions can provide eyes and ears, and contacts, for Canadians in circumstances where such networks might otherwise be costly for them to construct or access. Seen in these terms, consulates in the United States are likely to be much less effective than those in other countries, since the existing extent of Canadian business networks and institutional knowledge in US markets is likely, for a number of reasons, to be greater than that available through consular channels. The reverse is likely to be true in many other parts of the world.

To deal effectively with continuing bilateral trade disputes, a long view is necessary, letting the dispute resolution mechanisms, both in NAFTA and the WTO, work their slow cures. It is helpful to remember that on each previous occasion the Canadian softwood lumber producers got their duties back with interest at the end of the process. If and when the case is a good one, patience may be the primary requirement.

Finally, it is most important to treat bilateral relations between the two countries not as a series of problems and issues, but as a success. The bilateral relation provides a deep, peaceful and co-operative set of linkages serving individuals, families, firms and communities in the two countries. It is a remarkable success story, and deserves to be celebrated.