Some Issues in Canada's Experience with NAFTA

Edward J. Chambers*

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Since 9/11, crossing the U.S.-Canadian border has become more difficult.

Being neighbor to a behemoth, even a friendly one, is never easy. The complexities of the relationship grow exponentially with the maze of intertwined linkages. Hence the ongoing search for new ways to augment positive neighborly interaction and reduce the pitfalls of misunderstanding. These circumstances were at the root of Canada's 1988 signing of the Canada-U.S. Free Trade Agreement (CUSTA), five years prior to the North American Free Trade Agreement (NAFTA). This brief article provides some Canadian background to CUSTA and NAFTA, assesses the experience of the key manufacturing sector before and after free trade, looks at U.S. trade remedy laws and secure access to the American market, considers public attitudes to economic ties with the U.S., and finally examines some matters that now preoccupy national thinking about trade.

Background

The real debates in Canada over participation in CUSTA came to a head in the 1988 federal election, won by the Progressive Conservative Party which, during its previous 1984 mandate, had espoused a policy of free trade with the U.S. and entered into treaty negotiations. The debates over free trade were very much centered on the economic questions of more secure access to the U.S. market as opposed to the increased risk, and possible hollowing out, of value-added activity in the goods producing sector. Political concerns were expressed about the erosion of sovereignty and threats to Canadian social programs, despite greater market opportunity and the potential welfare gains from freer trade.[1]

CUSTA took effect in 1989. Subsequently, as preliminary discussions between the U.S. and Mexico were underway, Canada's attitude toward a prospective NAFTA was initially one of indifference, but this changed with the realization that a tripartite treaty arrangement would be preferable to two hub-and-spoke structures —U.S.-Mexico and U.S.-Canada. In part this change of policy direction acknowledged that the relationships between two smaller and one dominant economy under a NAFTA with trilateral institutional structures could place the two smaller economies in a somewhat less exposed bargaining position than under separate treaty-based hub-spoke links.

Despite these hopes, however, the reality is that trade relationships remain hub-and-spoke with the U.S. being both Canada's and Mexico's dominant trading partner, while trade between Canada and Mexico, though growing, remains extremely limited. For example, Canadian merchandise shipments to the U.S. in 2001 amounted to Can$325.4 billion, or almost 87 percent of total exports, contrasted with shipments to Mexico of Can$2.6 billion.[2] Of Mexican exports more than four-fifths went to the U.S. Further, despite NAFTA encompassing not only trade but also service and investment flows between the three countries, tripartite institutional structures (apart from the side agreements on labor and the environment) to monitor the agreement are for all practical purposes non-existent. Against this background, any assessment of the experience with Canada's main trading partner must consider the effects of CUSTA as well as NAFTA.

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The Manufacturing Sector

Evaluation of CUSTA/NAFTA must address what has happened to manufacturing —the value-added goods-producing sector highlighted in any trade agreement. Free trade supporters stressed that an agreement would rationalize the sector as scale effects from a greatly expanded market brought about improved productivity, lower unit costs and positive changes in the long-run behavior of capital investment. The real effective exchange rate (U.S.$/Can$) also influences the competitiveness of this sector. From the 1980s through 1991 prior to free trade and continuing into the recession and restructuring of 1990-1991, this rate appreciated by 21 percent; in contrast, from that point through the end of the century the real rate depreciated by 28 percent.[3]

Table 1 summarises manufacturing's actual growth record over the past two decades, pre- and post-trade agreements. Growth rates are estimated from log linear trend lines fitted to the annual real gross domestic product (GDP) of the 21 major components of manufacturing. The table ranks sectors in descending order by 1992-2000 growth rates allowing comparison with the 1982-1989 period. The following criteria were used to determine dating: first, the 1982-89 era is pre-agreement and 1992-2000 is post-agreement; second, while these were years of cyclical expansion in the economy ending in the respective cyclical peaks of 1989 and 2000; and third, 1990 and 1991 are omitted because the sector generally was adversely affected by a combination of recession and restructuring. Table 1 shows that some sectors, such as computer and electronics, furniture and plastics, grew at above aggregate rates in both periods. It also reveals that for manufacturing as a whole, growth rates in the two periods were identical and

* Research professor, University of Alberta School of Business.

TABLE 1
ANNUAL GROWTH RATE (%) IN REAL GDP
CANADIAN MANUFACTURING SECTORS FOR SELECTED PERIODS

SECTOR	1992-2000	1982-1989
Computer and electronics	14.0	12.0
Furniture	9.8	6.5
Fabricated metals	8.1	4.0
Plastics	7.7	9.9
Transportation equipment	7.2	7.6
Machinery	6.4	8.3
Rubber products	5.9	4.2
Total Manufacturing	**5.1**	**5.1**
Miscellaneous manufacturing	4.9	3.1
Wood products	4.8	8.5
Non-metallic minerals	4.8	6.0
Electrical equipment	4.5	2.9
Primary metals	3.8	5.7
Textiles	2.8	1.8
Chemicals	2.6	5.6
Petroleum and coal products	2.3	6.0
Paper products	2.0	2.6
Food products	1.7	1.0
Clothing	1.6	2.9
Beverages	1.0	1.1
Printing and publishing	-0.7	3.2
Leather products	-5.4	-1.4

Source: Statistics Canada, CANSIM II, Table 2790017.

also that there has been some realignment within the sector: five components grew more rapidly than the entire sector in both eras, and five which were above the overall growth rate in the first period fell below it in the second. In the post-agreement period, two sectors below the aggregate rate in the first period exceeded it in the 1992-2000 period. More generally, 13 of the 21 sectors registered lower growth rates in the post-free trade era.

What of productivity in Canadian manufacturing? The evidence in table 2 is disappointing in light of the stress given free trade's potential for improved productivity performance in this sector. The table contains two alternative measures: labor and multi-factor productivity over the respective periods. Estimates are also derived from log linear trends fitted to the annual data. Labor productivity increased at an annual rate of 2.0 percent between 1982 and 1989, slightly higher than the 1.7 percent recorded in the later period while multi-factor productivity (which accounts for capital as well as labor inputs) increased at a 1.5 percent annual rate in the first era compared with 1.0 percent in 1992-2000.[4]

Manufacturing appears to have held its own, justifying neither the optimism nor the pessimism which characterized domestic debate over CUSTA. Some restructuring occurred, frustrated by the continued exchange rate appreciation during the 1989-1991 years. At best no acceleration in productivity is apparent, and at worst productivity improvement decelerated.

Separate from, but clearly related to a U.S. security perimeter, are the arguments for expanding NAFTA into a customs union.

Secure Market Access

Secure access to the American market —self-evident from the fact that in the 1980s up to four-fifths of merchandise exports went to the U.S.— was at the core of Canada's search for a free trade agreement. The highly successful 1965 Canada/U.S. Auto Pact, effectively a sectoral free trade arrangement, was suggestive of the possibilities inherent in the more general approach. Canadian CUSTA negotiators sought treaty clauses exempting Canada from U.S. Trade Remedy Laws, namely anti-dumping, countervail and safeguard provisions. However, for the U.S., this exemption was a "deal breaker." The compromise was a panel-based dispute settlement procedure, reflected presently in Chapters 18 and 19 of NAFTA, with a provision for continuing negotiations on the trade remedy laws with the intent of arriving at a common approach. Efforts at the latter, however, went nowhere and were abandoned prior to the signing of NAFTA.

How has market access worked out? First, we should be clear that an overwhelming proportion of two-way Canada/U.S. trade flows smoothly on a daily basis, meeting the expectations of a free trade agreement. Much of that is intra-company trade in transportation equipment which accounts currently for just under 25 percent of merchandise exports.[5] Second, we should also recognize that Canada/U.S. border passage has —at least until 9/11— been relatively easy and straightforward, moved along, in large part, by the provisions for bi-national working committees in CUSTA/NAFTA.[6] At the same time, there have been a number of recurring trade issues involving up to 10 percent of Canadian exports (excluding intra-company trade) where experience has been unsatisfactory. These disputes are concentrated in softwood lumber, steel industry products, magnesium and agriculture (mainly with regard to pork products and the existence of the Canadian Wheat Board).

The prime example is Canadian exports of softwood lumber, an industry not concentrated geographically, but significant in all regions of the country, particularly in British Columbia, Quebec, Ontario and Alberta, where virtually all timber is on provincial government land. Historically, in British Columbia and Quebec this industry has been considered an instrument for rural regional development. Current difficulties in this sector's trade with the U.S. go back to 1982 (indeed they go back to discussion over the proposed Reciprocity Treaty of 1911), prior to CUSTA and have been the subject of anti-dumping and countervail in 1982, 1986, 1991 and 1998. Accommodation —not resolution— has been secured through a variety of *ad hoc* protocols ranging from an export tax to quotas. Presently the U.S. application of subsidy and countervail to this industry is

Table 2
Annual Rate (%) of Productivity Growth In Canadian Manufacturing

YEARS	LABOR PRODUCTIVITY	MULTI-FACTOR PRODUCTIVITY
1982-1989	2.0	1.5
1992-2000	1.7	1.0

Source: Statistics Canada, CANSIM II, series v720309 and v204354.

once again being challenged, this time simultaneously, before both NAFTA Chapter 19 panels and the World Trade Organization (WTO), while protracted negotiations for yet another *ad hoc* agreement are also underway.

The range of steel products subject to anti-dumping, countervail and safeguard investigations and actions include, but are not limited to, steel pipes, iron construction castings, tubular goods, new steel rails, flat rolled carbon steel and steel wire rods. While this is not the place to explore the record of these disputes, an objective observer would most likely conclude that for all practical purposes the softwood and primary steel sectors are *de facto* "carve outs" from NAFTA.

The NAFTA dispute settlement process in Chapter 19 falls short of an adequate substitute for exemption from U.S. trade remedy laws. These laws are relatively easy for domestic producers, trade associations or labor unions to trigger: in the case of anti-dumping and countervail an application will be entertained if put forward by petitioners accounting for 25 percent of domestic production and 50 percent in that segment of the industry seeking protection. Incentives to meet these conditions are contained in the "Byrd Amendment" which provides for the transfer of duties, once authorized, not to general revenues but rather to domestic producers and only to those who were signatories to the case.[7] (In January this year 61 members of the U.S. Senate passed a resolution requesting the President to maintain the provision despite adverse WTO rulings). Additional difficulties are the methodologies used by the International Trade Administration (ITA) in determining the fact of dumping or subsidy, and the International Trade Commission (ITC) in assessing domestic injury are not always reconcilable with economic analysis in the sense that the assumptions are narrow and empirically insupportable. Finally, trade remedy laws provide that administrative reviews can be requested by any party within 12 months of the anniversary date of an order. In some cases (for example, pork products and magnesium), annual administrative reviews have gone on for a decade or more. One can be pardoned for concluding that while from the U.S. perspective, trade remedy laws in their present form assure "fair trade," others see them as an invitation to harassment.

> Secure access to the American market was at the core of Canada's search for a free trade agreement.

Public Attitudes

Recent studies reveal that Canadian support for closer ties with the United States, strongly positive in 1990 (71 percent), increased in 2000 (79 percent).[8] On the other hand, a significant majority in both years opposed doing away with the border though the percentage favoring this option increased in the decade from one-quarter to one-third of the sample. As the authors suggest increased border elimination follows from free trade and from greatly expanded cross-border transactions of all types. The research also finds that cross-national trust was a uniformly significant predictor of Canadian support for closer economic ties with the U.S. in both 1990 and 2000. Trust, however, is a multi-dimensional concept arising from a host of political and social facts and perceptions.

Economic and business ties are just one element in trust, albeit an important one. Numerous Bush administration policies visible in the failures to sign Kyoto, the Land Mines Treaty and the Biological Weapons convention and join the International Criminal Court, coupled with abrogation of the nuclear weapons treaty appear to reverse the multilateral policies pursued by administrations of both political parties in the half century following World War II. Such policies clearly signal a unilateral rather than multilateral approach. These and other events such as the apparent racial profiling at the U.S. border of Canadian citizens of Middle Eastern lineage have reinforced the towering importance of homeland security —an issue certainly trumping trade— and have altered the setting of Canada/U.S. trade relationships bringing about not only renewed Canadian debate on NAFTA's future directions but also, according to an October 2002 poll, a reduction in public support for closer economic ties with the U.S.[9] In that poll, the 66 percent favoring closer ties has fallen from 79 percent in 2000 to below the 1990 level of 71 percent.

What's Next?

In the short run Canada's prime objective is border access, first to address security concerns thereby maintaining an expeditious flow of hour-to-hour border traffic, and secondly to provide better infrastructure to deal with the bottlenecks created by the greatly increased volume of trade flows abundantly evident before 9/11. Recognizing that Canada/U.S. border issues differ from those at the Mexico/U.S. border, Canada entered into bilateral negotiations with the U.S. on these questions. The result is the 30-point Smart Border Action Plan (SBAP) signed in December 2002. Security provisions include improved screening technology, joint enhancement coordination at the border, common visa policies, enhanced seaport security including container targeting with joint teams, and coordinated refugee claims. Infrastructure needs are included in the action plan and funding for the improvements authorized by both governments. These are long overdue but will still require substantial time to implement.

Security overlays intermediate and longer term trade policy questions. In response, some have expressed support for bold new initiatives such as a North American security perimeter suggesting that this will eliminate most, if not all, border access difficulties. The question is whether this step would involve an unacceptable erosion of sovereignty occasioned —in the absence of reciprocal acceptance of each nation's security personnel and clearance procedures— by the presence of measurable numbers of U.S. security officials on Canadian territory. Others prefer getting on with prompt execution of SBAP rather than exploring a grand new design. Separate from, but clearly related to a security perimeter, are the arguments for expanding NAFTA into a customs union. While a common supernational external tariff would have the advantage of that portion of costly regulation and paper work associated with cross-border rules of origin problems, it would not ameliorate a major irritant, i.e., U.S. trade remedy laws (nor for that matter would a North American security perimeter). Since it is highly unlikely that the U.S. has any interest in amending these laws, a helpful step would be to pursue revision of the dispute settlement chapters of NAFTA with the aim of substituting a permanent court capable of developing case law and establishing precedents in lieu of present *ad hoc* tribunals. While unlikely in the near future, this is a longer term objective of much merit, one in Canada's vital interest.

Meanwhile, in the background overshadowed by the need to address security questions, Canada's current free trade initiatives include Free Trade Area of the Americas negotiations as well as distinct discussions with the countries of Central America. Should either or both of these come to fruition, it is unclear how they might relate to NAFTA. A new continental priority on trade issues may emerge from the present uncertainties but that probability appears fairly remote. VM

NOTES

1 For a consideration of the economic arguments and the estimates underlying them, see Charles Coughlin, *Review of the Federal Reserve Bank of St. Louis* (September-October 1990), pp. 40-58, and Randall Wigle, *Canadian Journal of Economics* 21 (1988), pp. 539-564.

2 These are Statistics Canada data (CANSIMII series v196448, v196806 and v192150). Mexican data from INEGI report Canadian imports into Mexico at about 2.5 times the Statistics Canada figure.

3 The measure of the real exchange rate was calculated by dividing the nominal U.S.$/Can$ rate by the ratio of the Canadian CPI index for goods to the U.S. CPI index for goods. Appreciation was concentrated in the 1985-1991 period which in 1990 and 1991 exacerbated the recession and impeded restructuring; depreciation was strongest in the 1991-1994 years.

4 An alternative measure of productivity is from the cyclical peak in 1981 to the peak in 1989 and from the latter to the most recent peak in 2000. This alternative indicates that labor productivity increased at 2.2 and 2.3 percent in the respective eras, while multifactor productivity rose at the rate of 1.65 percent pre-CUSTA and 1.3 percent from 1989 to 2000.

5 Canadian merchandise exports, like those of Mexico, tend to be concentrated in a relatively few establishments. In 2000, the 50 largest exporting enterprises accounted for 49 percent of total export values, and 47 percent was in the transportation equipment sector. See Statistics Canada, *Canadian Export Registry 1993-2000* (Ottawa, Cat. 65-506-XIE).

6 Illegal migration in either direction is not a problem on the Canada/U.S. border. Further, direct international trucking service between Canada and the U.S., based on reciprocity in vehicle safety regulations and driver certification, has been permitted for years. Generally, customs regulation and border crossing congestion, while far from perfect, has been handled more efficiently at the Canada/U.S. border.

7 The Continued Dumping and Subsidy Act (2000), an amendment to the U.S. Tariff Act of 1930.

8 Neil Nevitte *et al.*, "Ten Years After: Canadian Attitudes toward Continentalism," E. J. Chambers and P. H. Smith, eds., *NAFTA in the New Millennium* (Edmonton: University of Alberta Press, 2002).

9 This poll was conducted in October 2002 and reported in Douglas Fife, *National Post*, 21 October 2002.