CANADA'S FREE(R) TRADE LESSONS FOR THE WORLD

November 2006

After 18 years of free(r) trade, Canada's experiences offer lessons to allay trade fears, but much work still remains to be done by governments and businesses.

Overview

The twin threats of protectionism and policy complacency are among the biggest risks facing the Canadian, U.S. and global economies in the years ahead. Much of this concern stems from fears about the massive trade shock that the rise of South Asian economies have dealt to the global economy and a political environment that is offering uncertain directions in terms of future policy.

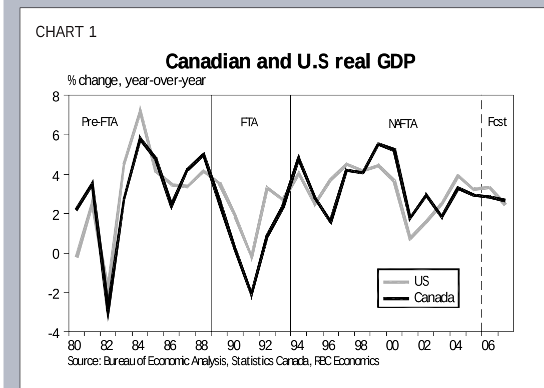
It is within this context that powerful lessons derived from the performance of the Canadian economy after the adoption of the 1989 Canada-U.S. Free Trade Agreement and the 1994 North American Free Trade Agreement are usefully considered. Few countries have provided as shining an example of how to adapt and prosper in a post-freer trade world than Canada. The harshest critics of those agreements stoked fears that would be ultimately dispelled. Life not only went on for the Canadian economy in a freer-trade world — Canadians have prospered.

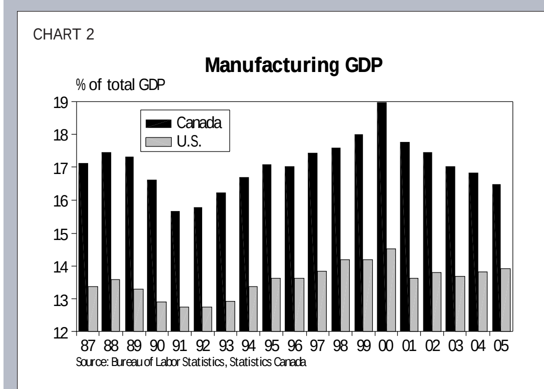
It is not even imperative to demonstrate that all of this was due to the FTA and NAFTA — which would surely be a stretch. After all, there were many competing influences such as a recession in both Canada and the United States in the early 1990s and greater forces of globalization at play throughout this period to name just two. Rather, we only need to demonstrate that the most exaggerated fears failed to arise. Furthermore, while there have definitely been some irritants in specific sectors like the isssues of softwood lumber and BSE, the focus in assessing the overall success of the post-FTA and NAFTA environment clearly has to be on the bigger picture.

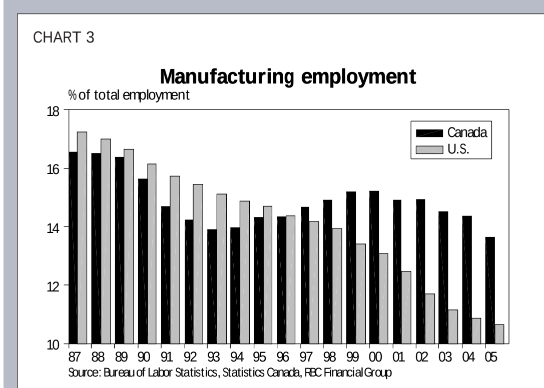
Similar fears are often manifest in today's discussions on the impact of South Asia's rise on Canadian and U.S. businesses. Amidst the twin effects of South Asia's economic rise and 9/11-induced security concerns, U.S. and Canadian policymakers risk shunning increased ties with the rest of the world. Further global and domestic policy reforms remain dangerously stalled. U.S. security concerns in particular add a new dimension that are represented by a thin grey line between national security concerns and the creation of barriers to trade in capital, goods, services and labour.

RBC Economics Research
Toronto, Ontario
economic@rbc.com

www.rbc.com/economics







However, there is some mixed evidence that points to the need for more policy reforms. For example, even within our own borders, Canadians have yet to achieve free trade on goods, services, capital and labour nor have we achieved a level regulatory field across some key industries. On a grander scale, the Doha round of World Trade Organization talks remains stalled indefinitely by the first world's inability to break an impasse over agricultural subsidies and the tendency of emerging markets to protect domestic industries like banking and telecommunications.

While governments deserve considerable credit for turning around Canada's inflationary and fiscal deficit picture in order to set a more orderly macroeconomic backdrop for business, much further work remains to be done. This includes addressing barriers to competitiveness such as high and inappropriate forms of business taxation, infrastructure deficiencies, challenges to seamless borders, skill shortages and ensuring fair protection of intellectual property rights.

The dominant message within the North American political environment of the next few years remains that few would be well served by efforts toward impeding the advancement of freer trade principles. Few people should have come to know this better than Canadians.

I. Dispelling Canada's free(r) trade myths

The 1988 Canadian federal election was fiercely fought over the proposed Canada-U.S. Free Trade Agreement and the North American Free Trade Agreement between Canada, the United States and Mexico sparked a sense of *déjà vu* with the 1992 federal election. Some of the most exaggerated fears have been clearly discounted by history, including the draining of our lakes and rivers to meet the water needs of Americans, the loss of our cultural identity and the inability to have independent domestic and foreign policies. In addition, eight key myths that were promoted at the time have been dispelled in economic terms.

Myth 1: Production would shift south

A popular argument leading up to the 1989 FTA was that, in being a small market, the only reason for global companies to have a domestic presence in Canada was to hop-scotch trade barriers such as tariffs, voluntary export restraints and import quotas by producing in Canada for consumption in the same market. By corollary, it was feared that removing such barriers would cause production to retreat south as U.S. companies bumped up production runs stateside by small amounts in order to export into a market only one-11th the size of their own.

In fact, as chart 1 demonstrates, this did not happen. In the last 12 years, Canada has outperformed the U.S. economy 50% of the time with steady outperformance for four straight years from 1999 to 2002. This demonstrates at least an equal ability to grow the output of goods and services in Canada as in the United States. Even Canada's challenged manufacturing sector has weathered the storm with a similar performance to manufacturers in the United States both in terms of manufacturing as a share of the economy (chart 2) and manufacturing employment as a share of total employment (chart 3). Throughout this period, services employment and output displaced some of the role of manufacturing in both countries. Indeed, further evidence has demonstrated that Canada remains a net beneficiary of onshoring and offshoring activity whereas this has been a more heated source of debate in the United States. This evidence demonstrates that economics is not about carving up fixed pies whereby one country's gain has to come at the expense of another when barriers to trade are lowered or eliminated. Rather, trade agreements typically mean that countries are free to focus on the industries they serve the best.

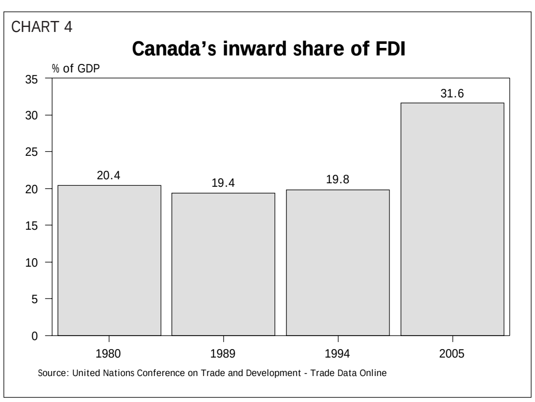
Myth 2: Exports would evaporate

Directly related to the first fear was the view that, as production shifted south, Canada's exports would sharply contract and the nation would possibly face a balance-of-payments crisis. The charts on this page and on page four go a long way towards dispelling this concern. After the FTA and NAFTA, exports would come to be a powerful and needed source of growth as the domestic economy languished in the early 1990s.

In fact, there was a surge in all merchandise trade activity in Canada, both imports and exports, following the FTA signing in 1989, including an additional acceleration in trade following the NAFTA signing in 1994. The recent moderation in exports is likely a sign that Canada has almost fully exploited the initial impact of this larger market for its goods as cyclical forces of a stronger Canadian dollar become more influential. Mexico, however, is now challenged by the rise of South Asian nations much more directly than either Canada or the United States as it loses some of its claim to being the first choice for low-margin, mass-produced commodities requiring low labour costs.

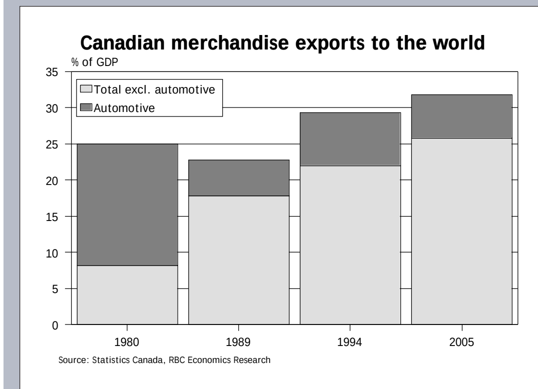
While it's clear that trade has increased, it is nonetheless important to acknowledge the effect of double-counting in the trade numbers. Because of the specialization in production, several intermediate products may pass back and forth across the border before ending up in one finished product. Therefore, Canadian export numbers may be overstated to the extent that they reflect this double-counting. However, studies that attempted to measure this impact still found strong growth in net exports for many industries.

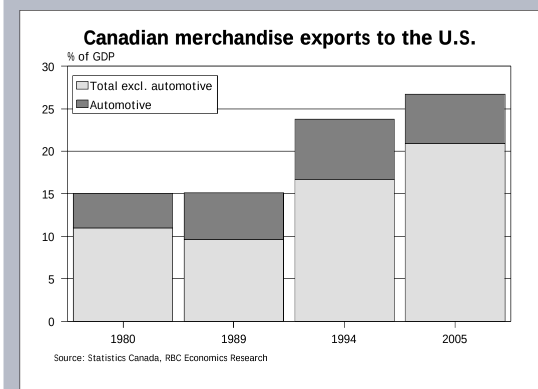
Myth 3: Why invest in Canada?

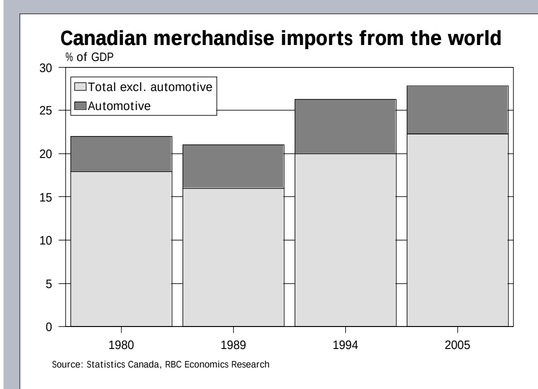


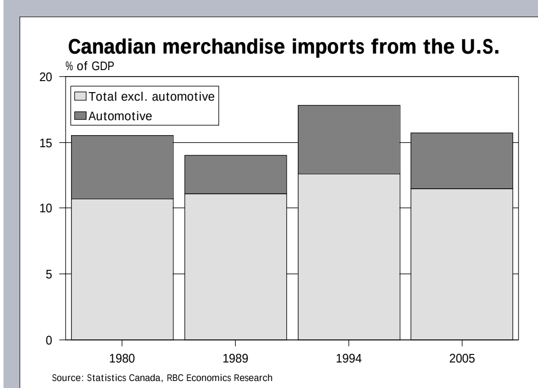
If production and export activity were feared to dry up, why invest in Canada instead of tapping into the U.S. market? The first two myths didn't materialize, making the rejection of this one nearly a forgone conclusion. Even though firms no longer needed to locate within the Canadian market in order to serve Canadian demand, foreign direct investment (FDI) in plant and equipment still flowed in, confirming Canada's ability to attract and retain foreign investment. While FDI as a share of GDP was virtually flat at 20% leading up

Canada's merchandise trade patterns

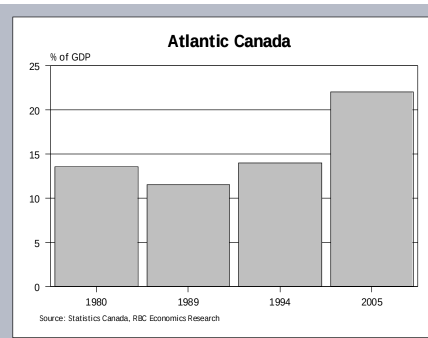


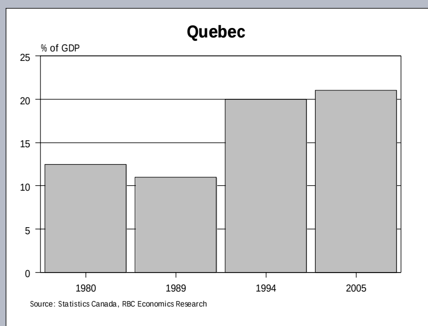


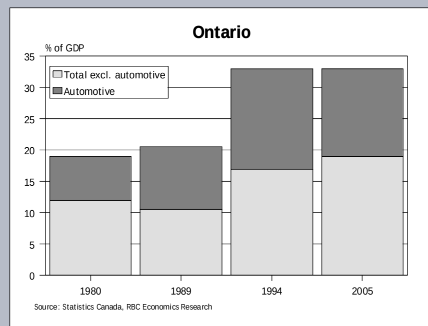


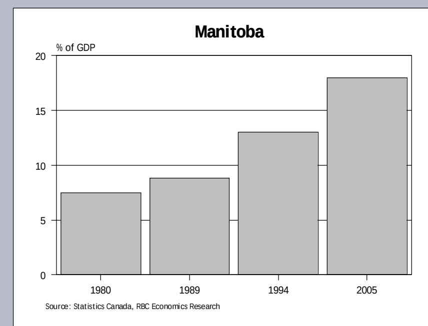


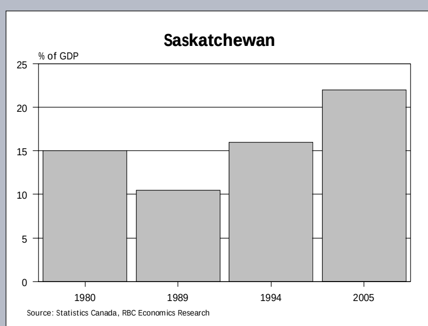
Provincial merchandise exports to the United States

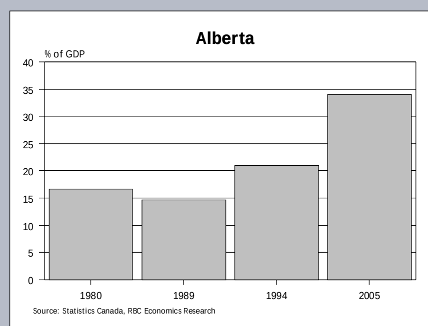


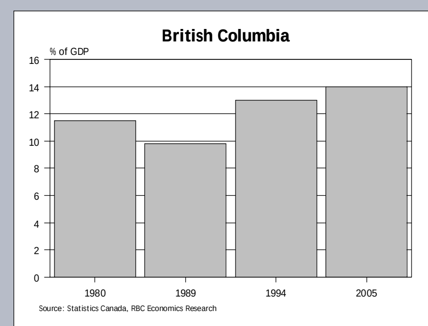












to NAFTA, chart 4 reveals that Canada's FDI share has since risen to 32%. Strong economic growth, favourable domestic demand, competitive direct and indirect labour costs and a favourable investment climate have continued to attract investors into Canada. Canada's ability to retain investment in the face of heightened international competition is a reflection of its ability to compete on the open market without protection.

Myth 4: Politics would require a strong C$

A Canadian dollar trading around the 89 U.S.-cent range rings familiar to business ears of past and present. This was the level at which the currency peaked in 1991, although it went on a wild ride in the intervening period. At the time, it was alleged that one of the unwritten conditions for U.S. willingness to engage in freer trade with Canada was that policymakers in Canada would have to maintain a strong currency in order to detract from the country's export competitiveness.

If at all true — and there is no known credible reason for believing this — then it has often been quipped that the execution of such a policy was rather inept. It wouldn't be long after its peak before the currency would go into a decade-long slide, dipping to as low as 62 U.S. cents in February of 2002. In fact, in a demonstration of how malleable this argument was, it was then asserted by some American commentators that the Government of Canada had then shifted to a soft-dollar policy in order to stimulate exports. The currency would then go on a breakneck recovery to the 89 U.S.-cent range today.

There is no doubt in our minds that this has been a fully market-driven ride. Both economists and central bankers know full well the futility of attempting to target exchange rate policies within flexible exchange rate regimes over the long-run. Commodity prices, interest rate spreads, overshooting in the U.S. dollar against every major currency during its investment bubble and relative fiscal policies were more likely sources of explanation for the oscillations in the Canadian dollar throughout this period.

Myth 5: Jobs would dry up

Canadian job fears created by the FTA debate would soon be mirrored in the United States in the debate over NAFTA. Along with the feared shutdown in production on the Canadian side of the border, there was supposed to be a massive wave of permanent job losses. Further, with wages in Mexico lower than in both Canada and the United States, there was a fear that post-NAFTA many jobs in Canada and the United States would relocate to Mexico and have a depressing impact on wages. This notion was never clearer than in the comment made by a U.S. presidential candidate at the time, Ross Perot, when he said that the United States would hear a "great sucking sound" emanating from south of the American border as companies relocated in search of cheaper labour.

Despite such animated fears, the evidence suggests that this has not at all been the case (chart 5). To be fair, some industries gained while others lost, but the net picture has been overwhelmingly positive. The United States has witnessed an unprecedented wave of job creation that has driven its unemployment rate to postwar lows in the past decade. In Canada, a similar story unfolded as the nation witnessed its unemployment rate go along the long path towards a 32-year low. Moreover, in recent years, a skilled labour shortage has emerged, driving wages up for consumers, and challenging business competitiveness.

Myth 6: Canada for sale

A large part of the FTA debate was centred on the removal of ownership restrictions. There was a fear that U.S. companies would buy up their affordable Canadian counterparts, pulling profits and interest flows out of Canada. However, an analysis of merger and acquisition (M&A) deals in Canada shows a very different picture despite the headlines covering just the megamergers. To be fair, one cannot entirely dismiss such concerns given that many of our top companies have changed into foreign hands, especially within the past two years. The role of small- and medium-sized enterprises, however, has balanced out the overall picture.

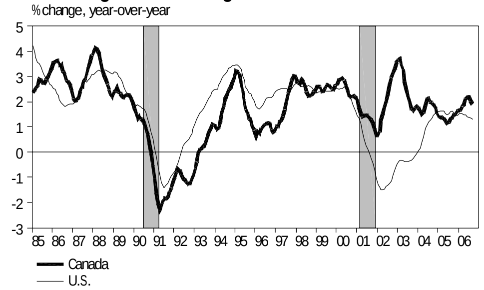
Looking at the total number of M&A deals since the NAFTA agreement took effect in 1994, there have been more foreign companies purchased by Canadians than Canadian companies purchased by foreigners. This is true whether looking at all non-U.S. companies, or just by looking specifically at transactions involving U.S. firms (chart 6). In both cases, more Canadian companies are doing the acquiring, and the trend has been largely increasing since NAFTA took place.

To get a sense of the magnitude of the companies involved, it is useful to also look at the dollar volume of these deals. Since Canada tends to have more small businesses, it is likely that much of the M&A activity is concentrated among these firms. When considering the direction of deal flows between Canada and all non-U.S. companies, the net dollar value of deals are flowing out of Canada in the past two years and are down on net since the late 1990s (chart 7).

When just looking at U.S. companies, however, although there have been more fluctuations, the net sum shows that the dollar weight of deal flows has been in Canada's favour since 1994. This is the opposite of what many feared would happen, even despite some large energy-patch deals in recent years. Therefore, in both cases, there is strong evidence that Canada has resisted becoming a branch plant economy and that, instead, it has been very active on its own in acquiring foreign firms. The swing in net deal flows towards non-U.S. foreigners, however, is clearly not an FTA/NAFTA matter.

CHART 5

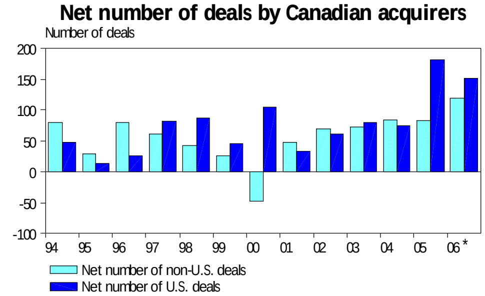
Job growth strong in both Canada & U.S.



Source: Statistics Canada, Bureau of Labor Statistics

CHART 6

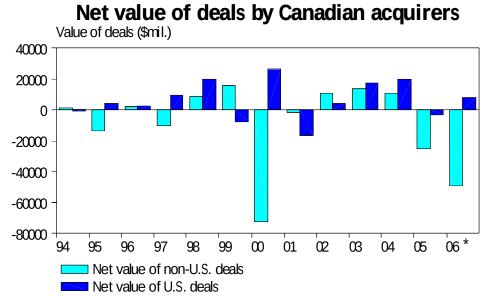
Net number of deals by Canadian acquirers



*Note: 2006 figures annualized as at Oct. 2006
Source: Crosbie & Co., FPinfomart, RBC Economics

CHART 7

Net value of deals by Canadian acquirers

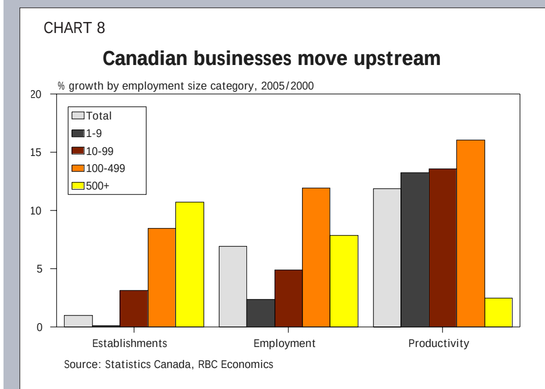


*Note: 2006 figures annualized as at Oct. 2006
Source: Crosbie & Co., FPinfomart, RBC Economics

Myth 7: Canadian businesses would be hard-pressed to restructure

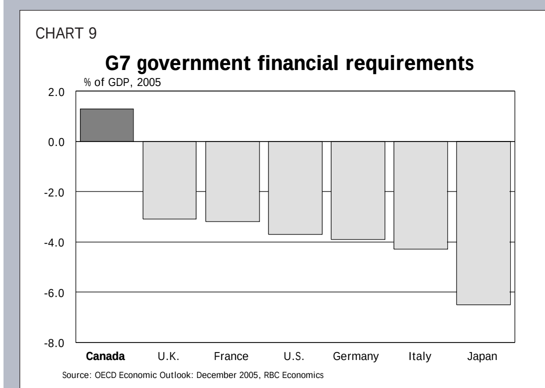
NAFTA may have contributed to strong market forces, but ultimately accelerated a necessary reshaping of Canada's business community. As more fully argued in other work,[1] the 1990s brought forward a sharp rise in the number of small businesses in Canada, while this decade is shaping up to be all about their maturation to a more powerful growth phase. The forces of creative destruction have been at work in the Canadian economy.

As chart 8 demonstrates, micro-, small-, and medium-sized employers now lead big companies on productivity growth and they have done this in part by slowing the pace of new business formations and employment gains while retooling and driving efficiency improvements. This is the maturation to a new cycle of growth from the foundations established during the wave of business start-ups in the 1990s, although the slip among large businesses is a risk.



Myth 8: Governments would see their tax bases shrivel

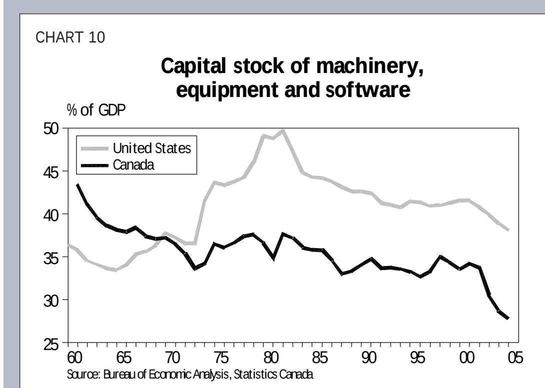
As production, exports, foreign direct investment and jobs were supposed to retreat south of the border, Canada's fiscal position was feared to be a bleak picture. Canada's fiscal back was, indeed, up against the wall by the mid-1990s, but this reflected forces in play long before freer trade arrived. What is noteworthy is that there has been a marked turnaround since the mid-1990s as the federal government has reported its ninth consecutive budget surplus. The federal debt-to-GDP ratio in Canada fell below U.S. levels in 2003-04 for the first time in 25 years. Canada's net foreign debt as a share of the economy went from more than 40% in the mid-1990s to about one-quarter of that share today. These broad fiscal improvements have strengthened our international fiscal credibility and proven that our tax base remains a solid support to the Canadian economy. Compared to other countries, Canada is the envy of many other nations; it is the only one of the G7 to be running a surplus on a consolidated, all-government basis (chart 9), and it currently stands as the only G7 country to record a surplus in each of the past three years.



II. Areas of mixed evidence

Despite laudable progress in meeting the freer trade challenge, some evidence remains mixed. They point towards the need for further complementary policies that could unleash Canada's full freer-trade potential.

Still under-investing



Canada has always tended to under-invest in productivity-enhancing machinery and equipment compared to the United States and nothing of late challenges that long-standing shortfall. Relative to the respective sizes of the two economies, M&E spending in Canada has tended to lag U.S. levels (chart 10) despite the confluence of factors that should be supporting a much

[1] *Small- and medium-sized businesses driving productivity gains*. RBC Economics Research, October 2006. Click on the following link for access to this report, www.rbc.com/economics/market/pdf/business_reshaping.pdf.

stronger investment performance than stateside. The Canadian dollar's rise, record high corporate liquidity in Canada that lies beyond reasonable precautionary needs, low debt-equity ratios and excellent interest coverage lend support through strength in balance sheets across many sectors.

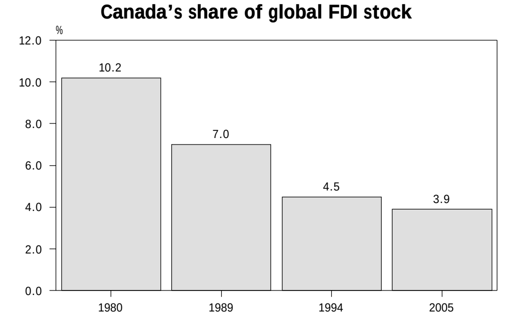
Large-firm productivity

Whereas small- and medium-sized businesses in Canada are successfully engineering a wave of creative destruction, big business is slipping (chart 8 again). Average annual compound growth in labour productivity at business establishments employing over five hundred workers stands at a paltry one-half of one percent per year so far this decade. Faster SME productivity growth has positioned smaller firms to be nipping at the heels of bigger producers.

Slipping share of in-bound North American foreign direct investment

Although Canada has definitely witnessed a pick-up in the pace of foreign direct investment relative to the size of our economy post-NAFTA, we have not kept up with a broad-based global expansion of this type of investment. Forces beyond NAFTA have led companies around the world to engage in more cross-border investment, and the fact remains that Canada's share of global FDI continues to slip (chart 11), albeit at a slower pace indicating that we have been able to keep our share relative to the global stock fairly steady in recent years after huge deteriorations during prior periods.

Chart 11



Source: United Nations Conference on Trade and Development - Trade Data Online

III. Complementary policies are stalled

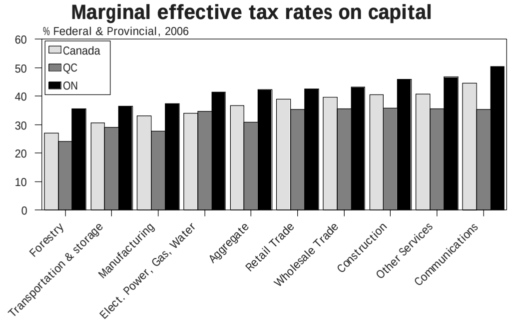
Notwithstanding the accomplishments of the Canadian economy, policymakers cannot afford to be complacent and assume that they have handed businesses all they need in order to drive a freer-trade prosperity agenda.

Business taxation

Canada currently has the sixth highest marginal effective tax rate on capital compared to 36 industrial and leading developing countries studied in a recent CD Howe Institute report. This properly measures tax disincentives to invest at the margin by adding up taxes on corporate income, sales taxes on capital goods purchases that represent double taxation when income streams are then taxed further, and the large corporations capital tax.

Capital taxes are particularly ill-advised in that they represent double taxation on the lifeblood of a company after it has already paid taxes on its income streams. Capital taxes are also profit insensitive. Plans to drop them for non-financial companies but not for financial firms in Ontario are drawing a false distinction between types of firms that still discourage investment, and a small measure compared to that province's high taxes (chart 12). Further, a growing reliance on profit-insensitive levies is a clear disincentive to invest, including soaring business property taxes at the municipal level.

Chart 12



Source: C.D. Howe Institute and International Tax Program, University of Toronto, RBC Economics

Seamless borders

With more than $1 billion worth of goods crossing the U.S.-Canada border every day, reliable and efficient borders are critical to the Canadian economy. But, the terrorist attacks on September 11, 2001, served as an important wake-up call exposing Canada's vulnerability to inefficient borders. Since then, heightened security combined with inadequate infrastructure and staffing at the borders have increased congestion and disrupted cross-border travel. As well, the advent of just-in-time inventories has left minimal tolerance among businesses for any production delays. Canada needs to take additional measures, including a continued devotion to upgrading infrastructure, creating alternative border access sites, and improving programs like FAST and NEXUS that focus on border pre-clearance.

The latest upcoming challenge is the approaching deadline for the Western Hemisphere Travel Initiative (WHTI). The WHTI will require everyone entering the United States to have a passport or authorized travel document. With only 35% of Canadians currently holding a passport, the government needs to ensure low-cost and easy access.

Further trade liberalization

Canada's domestic trade and regulatory barriers currently prevent the necessary mobility that allows for the efficient use of resources and labour. There have been some steps taken toward reducing these impediments. For example, the newly signed B.C.-Alberta Agreement on Trade, Investment and Labour Mobility will help streamline many business functions in these economies and allow for the freer movement of goods, services and investments between the two provinces. The Ontario government has recently expressed interest in joining the B.C.-Alberta agreement, which is a welcome and critical step in the right direction.

Beyond interprovincial trade lie stalled global trade WTO talks within the Doha round and the absence of progress towards liberalizing ownership barriers affecting several industries.

Infrastructure investment

Although there have been some recent encouraging signs, Canada continues to be faced with the challenge of infrastructure shortfalls. Compared to U.S. cities, Canadian cities spend considerably less on infrastructure, which makes it difficult to distribute people and goods throughout cities and to surrounding areas. Part of the difficulty lies in the fact that cities have a limited ability to raise funds, requiring a fuller debate on municipal funding options and private-public partnerships.

Skill shortages

Canada faces a growing skilled labour shortage. Not only are labour shortages already acting as a constraint for some sectors, but they are poised to become an even greater challenge in the coming years, due to an aging population and low fertility rates in Canada. For this reason, we argued in our 2005 paper *The Diversity Advantage* (www.rbc.com/economics/market/pdf/diversity.pdf) that Canada must raise immigration rates to as high as 400,000 from 225,000 a year at present. While Canada's track record is already among the best in the world, there is also room for improvement in terms of policies that do a better job at integrating immigrants.

Intellectual property rights and contract law

Finally, in our view, the absence of a global level playing field on contract law and the protection of intellectual property rights must also be addressed by the Canadian and U.S. governments. One cannot have truly free trade without common acceptance of the rough parameters.