Shaping the future of the North American economic space

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The issues

1. Canada’s economic challenges
   - Growth in living standards lag US
   - made-in-Canada weaknesses (stagnant productivity growth)
   - Even when we do our homework, access to the large wealthy US market is essential
     - NAFTA negotiated in early phases of North American production networks and growth of knowledge-based clusters
     - NAFTA didn’t take account of services trade
     - Cross-border flows of services, technology and people now essential to firms’ success
     - Canada not getting its share of FDI headed to N America from ROW
2. Asymmetric interdependence

- While US exports more to Canada and Mexico than to 15-member EU
- Canada and Mexico export 90 percent of total to US
The issues

3. Current depth of integration unsustainable

- Pre-Sept. 11: FTA/NAFTA had outlived its usefulness

- Post-Sept 11: Market access is less assured
  - Higher transactions costs for people/services, goods
  - Effectively a higher tariff
Addressing Canada’s problems in North America
(Three to tango nice but not necessary)

- Deeper integration with US is the only way to address the obstacles to flows of services, technology, people

- How to interest the US in deeper integration?
  - Survey Canada’s interests – what we want
  - Survey US interests – what they want
  - What are the outlines of a mutually-interesting bargain?
Canada’s interests

- Secure the border, but make it *seamless*: remove the border as a factor in economic decisions
- Factor mobility
  - **People**: As trade and investment flows increase and production networks growth, people must move too
  - **Capital**: different withholding taxes inhibit capital flows into Canada; CIT tax base differentials complicate intra-firm trade in production networks
- Trade: US trade remedy law
  - Canada’s long-time goal of modifying US CVD and AD laws still needs work as the softwood lumber case demonstrates
Choosing the route to deeper integration

- Choices influenced by such factors as:
  - Attitudes to sovereignty
  - Attracting and retaining US attention
  - Why focus even more on US over other alternatives?

- Two models, three paths, to choose from:
  - European model:
    - (1) customs union
    - (2) common market
  - Unique North American route
**Degrees of economic integration** (based on European experience)

<table>
<thead>
<tr>
<th>Form of integration</th>
<th>Free trade in goods and services</th>
<th>Common external tariff or commercial policy</th>
<th>Free movement of people and capital</th>
<th>Harmoniz’n (or mutual recog) of rules, standards, tax &amp; monetary policies</th>
<th>Supranational institutions</th>
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<td>FTA</td>
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<td>Customs Union</td>
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<td>Common Market</td>
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What would interest the US congress?

- Proposals that are perceived to affect US sovereignty. Two do:
  - Common trade policy would catch wide interest
  - Common market proposal could not be ignored either

- Stand alone trade negotiation not a starter
- Incremental ad hoc issues (softwood lumber) to small to notice

A Big Idea
- The US political system responds to Big Ideas
- But only one at any time
US interests

- US has a different problem:
  - Openness necessary for globalization is a source of vulnerability
  - Homeland security is highest policy priority
- Any proposal should address security:
  - Securing the border: Smart Border Declaration is regarded to be a good start and a good example of bureaucratic and political cooperation
  - North American defense
  - Immigration: immigrants from third countries
  - Energy security
    - Saudi Arabian share of US oil imports almost the same as Canada’s
    - Canada seen to have vast reserves
- (Canada’s economic insecurity is not on the US radar screen)
What might be the Big Idea?

Assumptions:
- Proposal must be strategic and large or becomes orphan in US political system
- European experience unique:
  - deeper integration a step toward ultimate goal of political union to end wars
  - Willingness to create common economic institutions in light of political goals
- Canada and US already more integrated than Europe when it began

No desire to give up political independence or distinctive institutions
Unique North American route to deeper integration: A *strategic bargain*

- Address key US interests in exchange for Canadian interests
Canadian Initiatives addressing US interests

- Border security
  - Implement Smart Border Declaration to speed low risk cargo and people (eg, “erased” border more attractive to FDI)

- Immigration
  - Reorganize policy frameworks: low risk NAFTA migrants move freely
  - Third country migration: build trust in common procedures and standards, but insist on mutual recognition

- Defense
  - How much are Canadians willing to commit to NA military defense?
  - Public debate of costs of various options leading to choice between shouldering our burden or continuing to free ride
Canadian Initiatives addressing US interests

- Energy
  - Disruptions in offshore supplies to US likely
  - Market forces drive the sector but market signals may not bring forth supplies in time if supply shortages emerge as critical US security issue
  - Canada would have to produce more
  - Anticipate US policy framework; define what Canada is prepared to do
  - Head off ad hoc reactive response (fed-prov disputes; utilities competing with each other; inadequate resource and infrastructure investment)
Canadian interests – deepen the FTA/ NAFTA

- Erase the border as a factor in economic decisions
- Be prepared to make mutual concessions
- Aim for customs-union–like and common market-like arrangements, but short of widespread harmonization; common institutions as necessary but not necessarily common institutions
Customs union (CU)- and common market (CM)-like arrangements (illustrative list)

- Harmonize/ bilateral eliminate tariffs; common tariff with third parties (CU)
- Extend business and professional visa to technicians (CM)
- Hi-tech border processing for low-risk business and tourist traffic (away from the border)
- Common competition policy (CM)
- Be prepared to harmonize/ give up supply management, state trading, government procurement (CM)
- Canadian content and IP
- Supportive institutional arrangement (as necessary; many exist but not used)
- North American natural resources area: mutual recognition of each other’s regulatory regimes (oil, natural gas, electricity, forest products)
Macroeconomic convergence and common currency? (no)
- High degree of macroeconomic convergence
- US shows no interest in common institution or currency
- Would common currency fix Canadian economic performance?
- Unilateral dollarization without common institutions and buffering mechanisms could force Canada to harmonize
- A red herring
Risks of the Big Idea

- Better to stay invisible and accept the status quo
- Already too dependent on US market; better to diversify
- Deeper integration initiatives impossible because of asymmetry
- Deeper economic integration inevitably leads to political union
Conclusion

- Official resources and attention span are scarce resources: allocate them wisely

- A window of opportunity is open, but it is closing

- Canada must initiate -- exercise sovereignty

- Lots of domestic homework to be done:
  - Strategic Team Canada

- Bilateral initiative; include Mexico when it makes sense
The Strategic Bargain

- Big Idea needed to attract and retain US attention

- Strategic Bargain allows linkages and tradeoffs not available in stand alone, ad hoc, reactive mode of status quo
  - Wrap Canada’s trade, investment and people interests in an initiative that addresses US security objectives
  - Enough US interests at stake that interest groups might cancel each other out