



## **DIFFERENTIATING CANADA: The Future of the Canada-US Relationship**

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### **EXECUTIVE SUMMARY**

Turbulence will mark the world economy in the coming decade as Canada's traditional trading partners in North America and Europe struggle with slow growth and rising structural unemployment and move, as they must, to restore the health of their public finances. Settling for the status quo is not a compelling option as the US border thickens and Canada stays on the sidelines in two areas vital to its long-term interest: climate change policy and trade liberalization.

In this context, the Policy Brief evaluates the strategic options for Canada's long-standing economic relationship with the United States. The authors propose a two-part proactive strategy. The first part is for Canada to differentiate its economy by building on its macroeconomic, financial and energy strengths relative to the United States and by shaping a best-practice North American climate change policy. The second part of the strategy is to deepen NAFTA by participating in the Trans-Pacific Partnership (TPP), a comprehensive, high-quality FTA that has strategic attention of the US administration. Any country can join by accepting the agreement's provisions. The TPP offers at least two strategic opportunities: a comprehensive negotiation in which Canada, the United States and Mexico could upgrade NAFTA and a way to diversify and deepen trade and investment liberalization with major economies in the Asia-Pacific region.

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## INTRODUCTION

The future of Canada's most important bilateral relationship — that with the United States — should be viewed in the long-term context of a changing economic geography and patterns of growth. The world's centre of economic gravity is shifting inexorably to Asia as China and India top the growth charts as the global recession ends.<sup>1</sup> In anticipation of possible regionalization and the rise of new competitors, North American governments should promote economic competitiveness by eliminating remaining barriers to the free movement of low-risk goods, services, capital, and people within the North American economic space. Yet a preoccupation with security threats and a resurgence of US “declinism,” last experienced in the early 1980s with the rise of Japan, supersede big ideas for deepening the Canadian-US economic relationship. How, then, should Canada proceed?

We argue that Canada should up its game and raise its profile with a two-part proactive strategy. The first part is to differentiate ourselves. Canada can strengthen the core advantages bestowed by its natural resource endowments and earned through the good policies and regulations it has undertaken over the past two decades, and it can diversify markets to reduce both its vulnerability to US policies and its dependence on US investors, producers, and consumers. The second part is to join the newest game in Washington — the Obama administration's strategic Trans-Pacific Partnership (TPP) — while working ceaselessly to roll back the thickening border.

In this Policy Brief, we outline some of the major features of the changing international environment and what this means for Canada's economic strategy. The next section is about *differentiating*, where we examine how Canada can build on its macroeconomic, financial, and energy strengths to diversify its markets, differentiate its advantages from those of the United States and move to shape a best-practice North American climate change regime instead of waiting to harmonize with bad US policy. We then review the most recent suggestions for *deepening* the bilateral relationship, and explain why Canadians should take the TPP more seriously as a way to improve the North American Free Trade Agreement (NAFTA), which has outlived its usefulness. We conclude in the final section with our recommendations.

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<sup>1</sup> See Wendy Dobson, *Gravity Shift: How Asia's New Economic Powerhouses Will Shape the Twenty-First Century* (Toronto: University of Toronto Press, 2009).

## THE CHANGING WORLD ECONOMY

The popular press is full of news and views about the imminent decline of the US economy, even the demise of the US “empire.” This is fed by popular anger at US regulators and financial institutions whose carelessness and greed sparked the 2008-09 global economic meltdown. The Obama administration is perceived to have assembled a huge fiscal package to rescue Wall Street without due regard for the plight of people on Main Street. Even in optimistic projections, the ratio of the US deficit to gross domestic product (GDP) fails to reach the 3% that is commonly regarded as sustainable before 2020.

The United States is now one of the world’s largest debtors, a complete reversal of its position for most of the postwar period, while China has become the world’s largest creditor. China’s position is emblematic of the gravity shift underway as economic activity moves to Asia and the Pacific from the Atlantic. Few Canadians have focused on the fact that, within 20 years, Asia will be home to three of the world’s four largest economies: China, India, and Japan. The new Asian economic powers and other rising states such as Brazil are developing trade and investment linkages among themselves. Governments in east Asia are chalking up a veritable typhoon of trade-liberalizing agreements both within the region and beyond: an estimated 115 free trade agreements (FTAs) and closer economic partnerships (agreements with less coverage than FTAs) have been signed or are in effect, and still more are being negotiated.<sup>2</sup> The 14-member Association of Southeast Asian Nations (ASEAN) is busily turning itself into a hub with “spoke” arrangements with China, India, and Japan.<sup>3</sup> Not only will Asians rely more heavily on regional links and regional demand; they have also learned from the recent recession to rely less on the growth of exports to Europe and North America. Successful policy shifts coupled with deeper linkages within and across developing regions could well see the much-talked about “decoupling” from the mature economies become a reality in the next decade.

Some see this shift in dynamism and relative economic positions as cause for an entire rethinking of Canada’s foreign economic strategy through, for example, convening a successor to the 1985 Royal Commission on the Economic Union and Development Prospects for Canada.<sup>4</sup> More likely, however, is that the United States will continue to provide global leadership on collective issues by virtue of its own preferences, President Obama’s emphasis on multilateral cooperation, and the inherent US economic dynamism and unassailable military superiority. Americans’ ability to face up to and solve their problems should not be underestimated. Recall the anxiety and gloom of the early 1980s, when all eyes shifted to Japan’s seemingly inexorable rise. *Japan as Number One* was a best-selling volume when it

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<sup>2</sup> Asian Development Bank, Asia Regional Development Center, “FTAs by Status (cumulative)” (Manila: Asian Development Bank, 2010); available online at <http://www.aric.adb.org/1.php>.

<sup>3</sup> In the case of India, the trade-liberalizing effects of some of these arrangements are being undermined by the hundreds of exceptions to protect domestic producers.

<sup>4</sup> See, for example, Lawrence Martin, “The US economy is in turmoil. How about a royal commission?” *Globe and Mail*, 11 February 2010.

was published in 1979 and went through eleven printings before Japan fell into its stagnation, now two decades long.<sup>5</sup> At the time, no one foresaw how information and communications technologies would create the productivity gains associated with the “new economy” of the 1990s. Gloom about a seemingly intractable US fiscal deficit was eventually replaced by a bipartisan agreement to balance the budget. Will things turn out differently this time? Will the political system and its leaders be incapable of dealing with the economic challenges? It is too soon to declare defeat. But it might take serious financial market volatility or another crisis to force the necessary bipartisan focus.

Canada’s bilateral strategy should take these factors into account. In his prize-winning 2009 study of the politics of bilateral linkage, Dalhousie University political scientist Brian Bow concludes that Canada has three choices for the bilateral relationship: live with the evolving US power structure and act on an ad hoc basis; try to recreate the “special relationship” of the past by collaborating more closely with US administrations on national security, the top US priority; or continue efforts to entangle the United States in formal institutions such as the free trade agreement to govern deeper integration.<sup>6</sup>

Canada’s response should be to marshal its advantages by building on its strengths both to differentiate itself in bilateral strategies and to use these strengths as bargaining chips. This does not mean engaging in the overt linkage of issues — which, as Bow and others show, is a game Canada cannot win — but using negotiations and market forces to diversify markets and commercial relationships beyond the United States. In some ways, Canada is a rising star despite its slide down to the world’s fourteenth-largest economy on purchasing power parity measures, having demonstrated its ability to escape the worst of the global crisis through fiscal and monetary prudence, sound regulation, sensible entrepreneurs, and natural resources endowments that are highly valued by the dynamic emerging market economies. The other part of the strategy should be to adapt to the US political tumult. Onerous border inspections and restrictive application of NAFTA’s rules of origin, tensions over buy-America provisions in the 2009 stimulus program, and US disregard for the rulings of dispute panels when it is expedient to do so have caused frustration and unhappiness with the status quo. It is time to move beyond NAFTA, not let it sink under its own weight. Every available means should be employed to raise North American productivity through greater scale and scope and through flexible markets in which products and inputs can move freely. As veteran politician and Ambassador Michael Wilson emphasizes, Canada’s strategy should be “generational” and bipartisan, rather than “flavour of the month.”<sup>7</sup> It should recognize that China, for example, with its own lengthy history and facing inexorable demographic and environmental challenges, thinks in 30- or 40-year time horizons.

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<sup>5</sup> Ezra F. Vogel, *Japan as Number One: Lessons for America* (Tokyo: Charles E. Tuttle; Cambridge, MA: Harvard University Press, 1979).

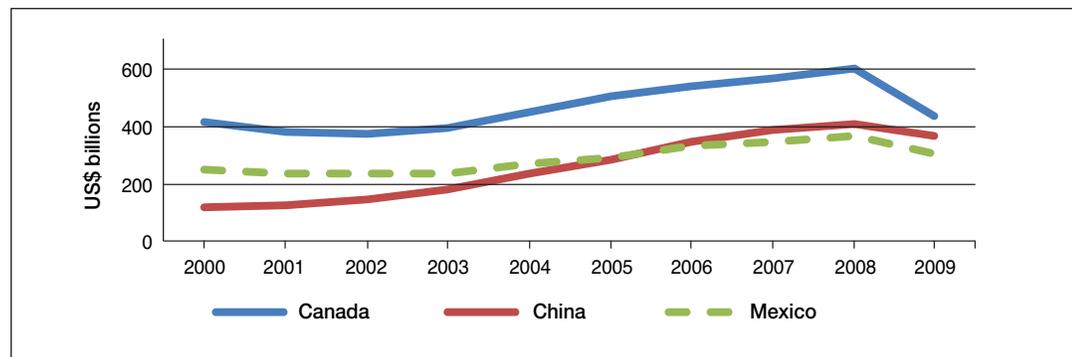
<sup>6</sup> Brian Bow, *The Politics of Linkage: Power, Interdependence, and Ideas in Canada-US Relations*, (Vancouver: UBC Press, 2009). Bow won the 2010 Donner Prize for the best book on Canadian public policy published in 2009.

<sup>7</sup> Michael Wilson, “Canada in 2015” (manuscript).

## DIFFERENTIATING CANADA

While Canada and the United States still have the world's largest trading relationship (Figure 1), in the past decade this two-way trade has grown more slowly than trade between the United States and China. Between 2000 and 2009 the growth rate of Canadian-US trade peaked in 2004, followed by sharp declines in 2008 and 2009 as US demand evaporated with the implosion of the housing and automotive markets (Figure 2). Since 2007, the value of US imports from China has exceeded that of imports from Canada (Figure 3). The value of bilateral trade declined during the 2000-09 period in both exports and imports of goods and services (Table 1), even as stocks of foreign direct investment (FDI) increased on both sides by almost 50% (Table 2). Using 2009 as the end-point, however, undoubtedly exacerbates the impact of the severe US recession, with the share of exports accounted for by vehicles dropping from a quarter to just over a tenth of the total, replaced by energy flows. Exports of commercial services have gained as a share of total exports but imports have declined. US stocks of FDI in Canadian energy assets grew by 140% between 2000 and 2009, underlining the growth of US demand in that period. Even more significant is the near-doubling of Canada's FDI stocks in the United States as Canadian financial institutions respond to a mature domestic market, policy restrictions on domestic mergers, and the opportunities afforded by US financial institutions weakened by the crisis. At the same time, however, Canada's macroeconomic prudence, strong financial services, and generous endowment of natural resources are being undermined by lagging productivity performance relative to US trends.<sup>8</sup>

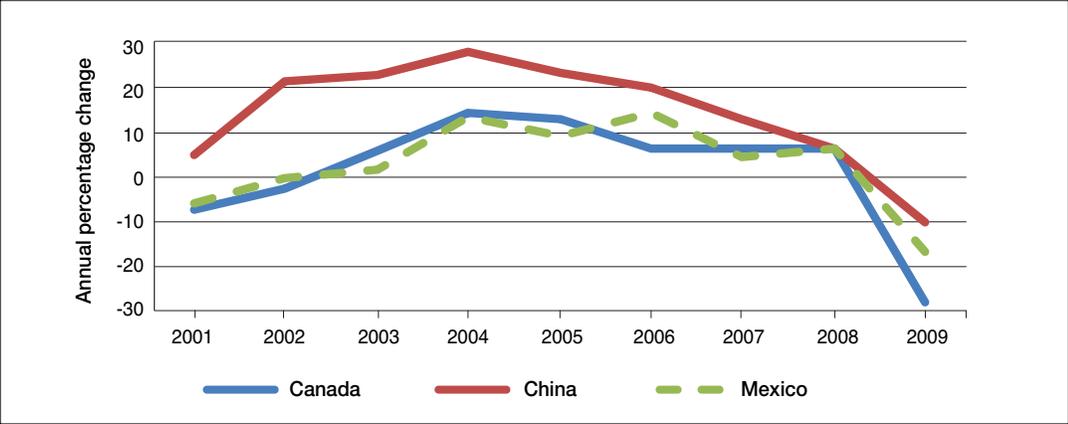
**FIGURE 1: Two-Way US Trade with Canada, China, and Mexico, 2000-2009**



*SOURCES: United States, Department of Commerce, Bureau of the Census, Foreign Trade Division.*

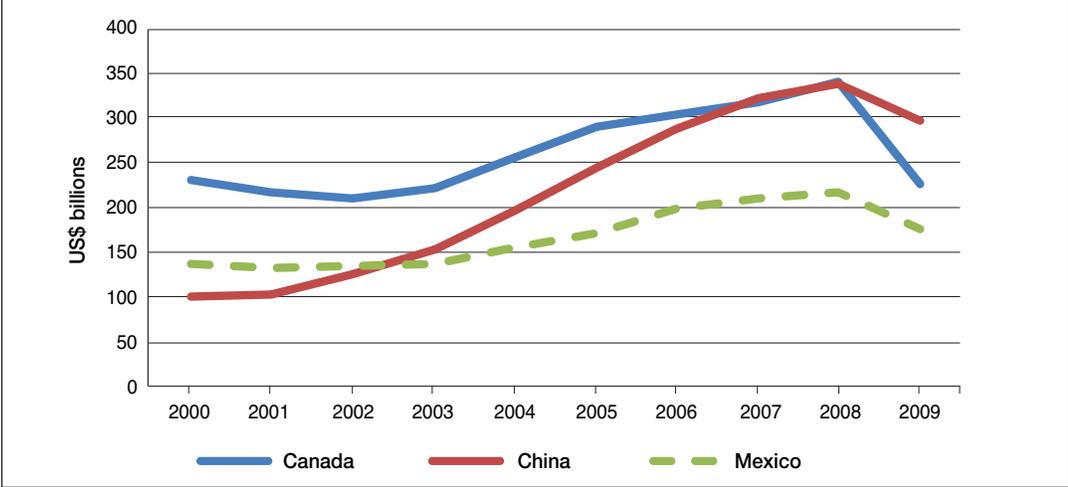
<sup>8</sup> A recent study by the Centre for the Study of Living Standards estimates Canada's rate of investment in information and communications technologies (ICT) per worker in 2008 was 62.1% of that in the United States, down slightly from 62.5% in 2007 but up significantly from 49.7% in 2000. The gap varies significantly by component, being greatest for software, at only 40.6%, and smallest for computers, at 83.7%. Occupying the middle ground is communications equipment, where the gap is 67.7%; see Centre for the Study of Living Standards, "The Canada-U.S. ICT Investment Gap in 2008: Gains in Communications Equipment and Losses in Computers" (Ottawa: CSLS, 2009).

**FIGURE 2: Two-Way US Trade Growth Rates with Canada, China, and Mexico, 2001-2009**



SOURCES: United States, Department of Commerce, Bureau of the Census, Foreign Trade Division.

**FIGURE 3: US Imports from Canada, China, and Mexico, 2000-2009**



SOURCES: United States, Department of Commerce, Bureau of the Census, Foreign Trade Division.

**TABLE 1: Bilateral Trade, Canada and the United States, 2000 and 2009****A. Merchandise Trade (C\$ millions and % share)**

		2000	2009	
Canada's Total Merchandise Exports to the US		359,289 (100)		270,129 (100)
TOP 5 (by product)	1. Vehicles, except railway	84,615 (24)	1. Mineral fuel, oil	75,263 (28)
	2. Mineral fuel, oil	52,801 (15)	2. Vehicles, except railway	36,396 (13)
	3. Nuclear reactors, machinery	30,520 (9)	3. Nuclear reactors, machinery	20,230 (7)
	4. Electrical machinery	27,361 (8)	4. Electrical machinery	11,541 (4)
	5. Wood	16,618 (5)	5. Paper, paperboard	9,091 (3)
US share of total Canadian merchandise exports		87%		75%

		2000	2009	
Canada's Total Merchandise Imports from the US		229,660 (100)		186,804 (100)
TOP 5 (by product)	1. Vehicles, except railway	48,996 (21)	1. Vehicles, except railway	32,389 (17)
	2. Nuclear reactors, machinery	45,225 (20)	2. Nuclear reactors, machinery	28,473 (15)
	3. Electrical machinery	26,667 (12)	3. Electrical machinery	13,204 (7)
	4. Plastic	10,028 (4)	4. Mineral fuel, oil	10,714 (6)
	5. Optical, medical instruments, etc.	8,715 (4)	5. Plastic	9,347 (5)
US share of total Canadian merchandise imports		64%		51%

**B. Services Trade (C\$ millions and % share)**

	2000	2009
<b>Canada's Total Services Exports to the US</b>	<b>36,601 (100)</b>	<b>34,915 (100)</b>
Travel	9,449 (26)	7,095 (20)
Commercial services	20,813 (57)	22,480 (64)
Transportation and government services	6,338 (17)	5,340 (15)
US share of total Canadian services exports	61%	52%
<b>Canada's Total Services Imports from the US</b>	<b>41,686 (100)</b>	<b>50,540 (100)</b>
Travel	11,517 (28)	15,716 (31)
Commercial services	24,187 (58)	27,358 (54)
Transportation and government services	5,981 (14)	7,466 (15)
US share of total Canadian services imports	64%	57%

*SOURCES: Merchandise trade — based on Harmonized System codes at the 2-digit level, Statistics Canada (Industry Canada/Strategic Trade Data), available online at [www.ic.gc.ca/sc\\_mrkti/tdst/tdo/tdo.php#tag](http://www.ic.gc.ca/sc_mrkti/tdst/tdo/tdo.php#tag); services trade — Statistics Canada, CANSIM Database, table 376-0036; and Department of Foreign Affairs and International Trade, available online at: [www.international.gc.ca/economist-economiste/statistics-statistiques/payments-paiements.aspx?lang=eng](http://www.international.gc.ca/economist-economiste/statistics-statistiques/payments-paiements.aspx?lang=eng).*

**TABLE 2: Bilateral Stocks of Foreign Direct Investment, Canada and the United States, 1990, 2000, and 2009**

	<b>1990</b>	<b>2000</b>	<b>2009</b>
(C\$ millions)			
<b>US stock in Canada</b>	<b>84,089</b>	<b>193,651</b>	<b>288,287</b>
Wood and paper	5,486	9,781	6,603
Energy and metallic minerals	19,626	33,524	80,415
Machinery and transportation equipment	14,634	34,250	36,113
Finance and insurance	11,827	34,890	55,982
Services and retailing	6,700	20,386	30,148
Other	25,815	60,821	79,026
<b>Canadian stock in the US</b>	<b>60,049</b>	<b>177,943</b>	<b>261,326</b>
Wood and paper	2,214	3,996	5,610
Energy and metallic minerals	12,130	29,689	57,109
Machinery and transportation equipment	1,326	6,230	7,636
Finance and insurance	13,780	43,306	127,578
Services and retailing	6,006	32,444	30,939
Other	24,593	62,277	32,455

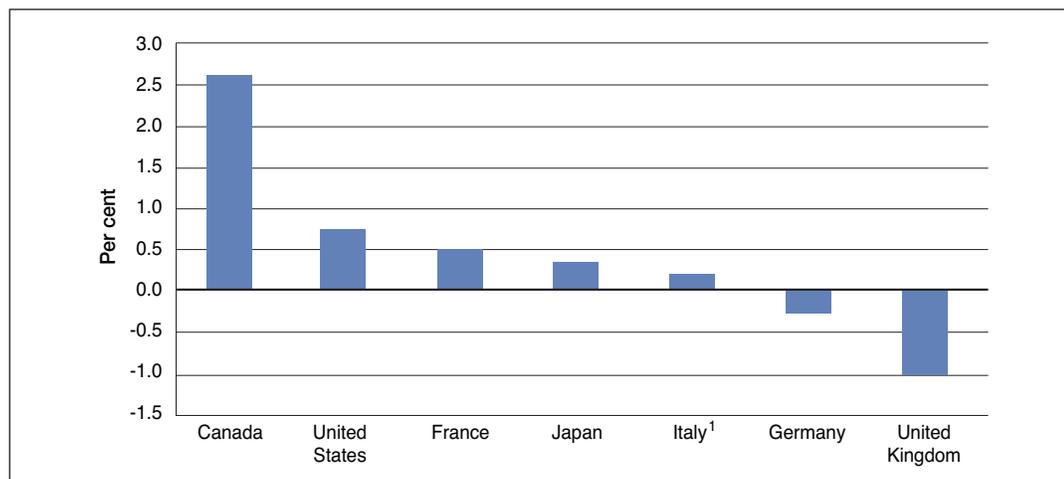
*SOURCES: Statistics Canada, CANSIM Database, tables 376-0051 and 376-0053; Department of Foreign Affairs and International Trade Canada, available online at: [www.international.gc.ca/economist-economiste/index.aspx](http://www.international.gc.ca/economist-economiste/index.aspx).*

## Macroeconomic Prudence

Canada experienced a sharp contraction in economic growth in early 2009 as business investment and net exports plunged, although the contraction was the smallest among the Group of Seven (G7) major industrialized countries (Figure 4). The economy recovered in 2010 with spectacular 6.1% growth in the first quarter, and with unemployment expected to peak at 8.7%. Indeed, Canada has emerged from the global meltdown with a sound macroeconomic base and favourable financial conditions, which give it the flexibility it needs to make choices about its economic future. Although the fiscal year 2010/11 federal budget deficit is expected to total \$55 billion — nearly 4% of GDP — and the federal debt is projected to peak at 35.4% of GDP, Canada has a better record than many major economies, as well as a credible plan for fiscal consolidation over the next five years.<sup>9</sup> There is, moreover, widespread support among the electorate for balancing the books, based on a history of realistic forecasts and prudent fiscal cushions to protect against unexpected shocks.

<sup>9</sup> Organisation for Economic Co-operation and Development, *OECD Outlook: Canada* (Paris: OECD, 2009), pp. 155-159.

**FIGURE 4: Real Domestic Demand Growth, G7 Countries, 2009**



<sup>1</sup> Data 2009Q4 for Italy is based on Moody's Economy.com Global Outlook published on February 23, 2010. Statistics Canada; U.S. Bureau of Economic Analysis; Japan Cabinet Office; U.K. Office for National Statistics; Deutsche Bundesbank; Institut national de la statistique et des études économiques; Istituto nazionale di statistica; Department of Finance calculations.

*SOURCES: Canada, Department of Finance, "Recent Economic Developments and Prospects" (Ottawa, 2010).*

The federal fiscal strategy is a good example of a generational approach inasmuch as this prudent framework has been adopted by successive governments, both Liberal and Conservative. Very low short-term interest rates have encouraged the recovery of consumer and investment spending; housing has also benefited from these rates and from a well-received home renovation tax credit. Stimulus spending has targeted infrastructure projects that got under way in 2009 and continue in 2010. Prudent monetary policy has contributed to well-anchored expectations. Still, the strength of the recovery will depend in part on what happens to US demand and to the Canadian dollar, with a strengthening currency exerting price pressures on exporters and the current account balance shifting to a deficit in 2009 that is expected to persist through 2011.

### **A Sound and Stable Financial System**

Canada's ability to escape the worst of the US financial crisis without serious banking problems has stimulated a debate about the lessons others might learn from the structure of the industry, Canadian financial regulation, and the leadership and culture of Canada's financial institutions. This debate, however, should take into account the concentrated nature of the Canadian banking system, which blunts competitive pressures and risk-taking — unique characteristics that some argue limit the implications for other jurisdictions with respect to regulatory oversight and restrictions on large complex financial institutions.

Canada's financial system is subject to strong principles-based regulation, with close relationships among regulators and the regulated institutions. Financial products are overseen, those seeking mortgages for more than 80% of the purchase price are required to buy insurance from a public sector agency, and banks are encouraged to hold onto the mortgages they originate. Healthy capital requirements emphasize equity over other components, and Canada imposes a strict ratio of assets to equity, or leverage ratio.<sup>10</sup>

It has been suggested that Canada build on its strong and stable macro and financial position coming out of the recent crisis to develop an international capability in financial services. A study prepared for the Toronto Financial Services Working Group (FSWG) argues that Toronto has the potential to become one of two leading financial clusters in North America, which, over a five-year period, could add 25,000 to 40,000 new jobs and generate an additional \$4-5 billion in annual output. As international financial services concentrate increasingly in hubs, Canadian capabilities and expertise could drive a larger Canadian market share of equity listings in mining, metals, energy finance, and energy trading. Already Canadian markets account for 43% of energy and 55% of mining equity listings globally.<sup>11</sup> Capabilities in retirement finance solutions could also be expanded to optimize private pensions and personal savings for retirement. A global institute for risk management has also been suggested, one that builds on collaboration among regulators, risk expertise, and industry practitioners.

The FSWG study suggests that Canada, in turn, could learn lessons from other international financial centres — it cites Singapore, Zurich, Chicago, Dublin, and London as examples — about developing inherent advantages, areas of focus, and ways to increase the attractiveness of business environments. Much of that study, however, was completed before the global financial crisis, and London and Dublin now could teach Canada additional lessons. Both were badly hit by the crisis, and macroeconomic and regulatory policies in the UK and Ireland were perhaps too heavily influenced by the desire to make those centres attractive to global business, at the risk of jeopardizing first principles of strong oversight and fiscal and monetary prudence.

There are also pressures for a made-in-Canada hub strategy whereby expertise located in Vancouver, Calgary, and Montreal complements what is available at head office locations in Toronto. As the Quebec and Alberta governments' opposition to the federal proposal for a single securities regulator makes clear, however, there are strongly held political positions against such centralization even in the face of globalized capital and financial markets. These differences might be resolved by the federal government's reference to the Supreme Court of Canada, but if they are not, other ways would have to be found to achieve a common, if decentralized, alternative that delivers an internationally competitive cost of capital.

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<sup>10</sup> Some argue, however, that well-run US commercial banks such as JP MorganChase and Wells Fargo have lower leverage ratios; see, for example, Peter Boone and Simon Johnson, "Canadian Banking Is Not the Answer," *New York Times* Economix, 25 March 2010. Boone and Johnson also argue that restructuring the US system to function like the Canadian system would see even fewer larger banking institutions and the "re-inflation of [quasi-government mortgage institutions] Fannie Mae and Freddie Mac to guarantee mortgage portfolios of banks."

<sup>11</sup> Boston Consulting Group, "Partnership and Action: Mobilizing Toronto's Financial Sector for Global Advantage," An Action Plan for the Toronto Financial Services Working Group (Toronto: Boston Consulting Group, 2009).

## Diversified Trade and Investment Relationships

As part of its differentiation strategy, Canada should diversify its direct economic links with the dynamic emerging market economies – indeed, trade and FDI trends already signal that market forces are moving the country (slowly) in this direction. While the United States still accounts for nearly three-quarters of Canada’s goods and services exports and two-thirds of its imports, these transactions are growing at less than 5% annual rates. In contrast, Canada’s trade with the rest of the world is growing at double-digit rates, though a trade deficit with non-US trading partners emerged in 2008 as Canada imported more from them than it exported; see Table 3.

**TABLE 3: Canada’s Diversifying Goods and Services Trade, by Major Partner, 2008**

	EXPORTS			IMPORTS			TRADE BALANCE
	2008	2008 SHARE	% GROWTH 2007-08	2008	2008 SHARE	% GROWTH 2007-08	2008
	(C\$ billions)	(%)	(annual % change)	(C\$ billions)	(%)	(annual % change)	(C\$ billions)
World	557.9	100.0	5.2	533.3	100.0	6.3	24.6
United States	407.1	73.0	3.8	332.4	62.3	4.6	74.7
EU	52.6	9.4	3.1	62.2	11.7	6.8	-9.5
Japan	13.3	2.4	16.5	14.2	2.7	-6.5	-0.9
Rest of world	84.8	15.2	12.1	124.4	23.3	13.0	-39.6

*SOURCES: Canada, Department of Foreign Affairs and International Trade, Canada’s State of Trade: Trade and Investment Update – 2009 (Ottawa: DFAIT, 2009).*

Clearly, more needs to be done to deepen and balance these trade relationships, but some are already healthier than might be apparent. For example, a comparison of Canada’s actual exports to emerging market economies with what a model predicts based on such factors as distance, relative price levels, language, and the existence of trade agreements that influence transactions costs finds that, while exports to the United States are in line with Canada’s proximity to that country, trade with China is twice what the model predicts while trade with Brazil, Mexico, and India is much lower.<sup>12</sup> At the same time, Canada exports to China smaller shares of paper products, power-generating machinery, and inorganic chemicals than the model predicts, given its comparative advantage in these products; exports of these items to Brazil, Mexico, and India are also comparatively weak, as are exports of animal products to India and ores and concentrates to Brazil and Mexico. The Department of Foreign Affairs and International Trade (DFAIT) estimates that, if the so-called BRIC countries (Brazil, Russia, India, and China) sustain their long-term growth, “a gain of just 0.1 percent in Canadian market share in 2038 would mean a \$29 billion gain in exports.”<sup>13</sup> While Canada has a

<sup>12</sup> Canada, Department of Foreign Affairs and International Trade, *Canada’s State of Trade: Trade and Investment Update – 2009* (Ottawa: DFAIT, 2009).

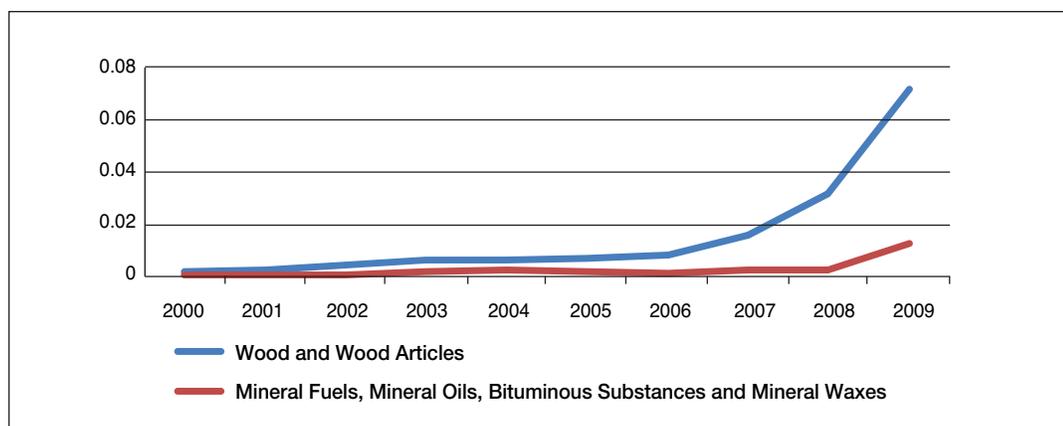
<sup>13</sup> *Ibid.*, p. 108.

comparative advantage in the US market in automotive, wood and paper, and energy products, elsewhere Canada's trade advantages reflect its strengths in primary goods and aerospace products and the large appetites of emerging economies for Canada's raw materials. All these are indicators of the role of market forces in diversification; clearly, business interest, which until recently focused mainly on the US market, is a key building block.

The role of government is also important, since the state plays a stronger role in most emerging market economies than in Canada. State-to-state relationships, such as the high-level visits to China and India by Canadians prior to those countries' leaders coming to Canada for the June 2010 G20 summit, help pave the way for intergovernmental agreements on trade and investment that create more certainty for firms' international transactions. The federal government has pursued investment protection agreements with both countries as well as education and technology exchanges. While China has shown no interest in comprehensive trade liberalization, India has responded positively to a closer economic partnership. Since powerful interest groups in Indian agriculture and manufacturing are highly sensitive to market opening, liberalization is likely to be limited to a services-only FTA.<sup>14</sup> At the same time, measures could be taken at home to develop infrastructure such as the pipelines needed to transport oil and natural gas to Asian as well as US customers.

Strategically, by creating alternatives to US markets, Canada could improve its potential bargaining position and undermine US protectionist pressures. The Canadian lumber industry, for example, has pushed into China, which is now its second-largest export market. As Figure 5 shows, however, even fast-growing exports to China reached only 7% of cyclically depressed exports to the United States in 2009. The future trend of such exports depends on a US recovery, but China's share of Canada's export markets seems set to increase.

**FIGURE 5: Canada's Lumber and Energy Exports to China as a Ratio of Exports to the United States, 2000-2009**



*SOURCES: Based on Harmonized System codes at the 2-digit level, Statistics Canada (Industry Canada/Strategis Trade Data), available online at [www.ic.gc.ca/sc\\_mrkti/tdst/tdo/tdo.php#tag](http://www.ic.gc.ca/sc_mrkti/tdst/tdo/tdo.php#tag).*

<sup>14</sup> See Wendy Dobson, "The Indian Elephant Sheds its Past: Implications for Canada," *C.D. Howe Institute Commentary* 235 (Toronto: C.D. Howe Institute, June 2006).

## Natural Resources and Energy

Natural resources, particularly energy, are a strong card in any diversification strategy, and could be Canada's strongest card in its relationship with the United States. That country is the world's largest oil consumer, but most Americans are unaware that Canada is their largest foreign supplier of oil, gas, and electricity through a highly integrated network of pipelines and electricity transmission grids. In 2008, Canada supplied 19% of US crude oil imports, representing 13% of total US oil consumption, and fully 90% of US natural gas imports, accounting for 15% of total US consumption. In addition, a particularly attractive feature of Canada's electricity exports is that roughly 77% come from non-fossil-fuel sources, most of it hydroelectric generation.<sup>15</sup>

Because Canada is largely dependent on US markets for its oil and gas exports, however, it bargains from a weak position in bilateral energy matters and is vulnerable to future trends in US demand. In the wake of the BP oil disaster, politicians and environmental groups have intensified demands for less reliance on any oil. Recent criticism of large cross-border energy projects such as TransCanada's Keystone XL pipeline from Alberta to the Gulf of Mexico already signals this possibility.

But Canada need not be a passive supplier to the United States. It can protect its strategic interests and improve its bargaining position by seeking alternative markets. Indeed, Canada's energy abundance is becoming increasingly attractive to China and other Asian oil-consuming countries with the capital to invest in developing new supplies and sources of transportation. The International Energy Agency estimates that, between 2015 and 2030, oil demand by China and India will grow by 3.5% annually, accounting for 60% of the growth in global energy demand during that period.<sup>16</sup> Indeed, recent investments by China's huge state-owned petroleum companies and sovereign wealth funds underline the growing importance of Canada's oil sands production.<sup>17</sup> In 2010, the premiers of the western provinces organized their own trade and investment mission to North Asia (known as the New West Partnership), during which Saskatchewan's premier signed a memorandum of understanding with China National Petroleum Company on possible investments in that province. These recent deals reveal an increasingly sophisticated Chinese strategy of investing in new sources of supply for sale into the world market, rather than merely accessing existing productive assets for their own use.

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<sup>15</sup> Canada, Department of Foreign Affairs and International Trade, "Canada-US Energy Relations" (Ottawa: DFAIT, 2010); available online at <http://www.canadainternational.gc.ca/washington>.

<sup>16</sup> IHS Cambridge Energy Research Associates, "Growth in the Canadian Oil Sands: Finding the New Balance," *IHS CERA Special Report* (Cambridge, MA: Cambridge Energy Research Associates, 2009), pp. 1-2.

<sup>17</sup> Since 2005, when China National Offshore Oil Corporation paid C\$122 million for nearly 17% of the private company MEG Energy Corporation, other large Chinese state-owned petroleum companies have followed. In 2009, Sinopec augmented its stake in the Northern Lights project to 50% through its acquisition of a 10% stake in Total SA's share and a US\$4.65 billion stake in Syncrude Canada Ltd. by acquiring ConocoPhillips's 9% stake. As well, PetroChina has acquired a 60% stake in two properties owned by Athabaska Oil Sands Corp. See Shawn McCarthy, "China's big move into Alberta," *Globe and Mail*, 13 April 2010.

Asian interests are also potential catalysts for major new energy transportation projects. The Gateway pipeline project being developed by Enbridge would import condensate (gasoline, naphtha, and light oil) needed to liquefy the bitumen that would then be exported from Edmonton to the port of Kitimat, British Columbia, for onward shipment to Asian customers and the US west coast. As many as ten Canadian and Asian shippers already have made commitments, but these depend on regulatory approval, which could take several years. Intense scrutiny of the project is expected by environmental and aboriginal groups concerned about environmental risks and land use. How these issues are handled will be important factors in the delivered cost of such oil to Asian users; the risk is that those costs will be sufficiently higher than Middle East sources to render the project uneconomic.

Public concerns about growing inflows of FDI and portfolio capital into western Canadian energy assets are twofold: one is Canadians' concerns about the impact of foreigners owning Canada's natural resources and the other is broader concerns about 'dirty' oil. With respect to foreign ownership, it is argued that the decisions of state-owned enterprises and funds, at least at times of political tension, could be influenced by the home government's political priorities rather than by commercial factors. While the federal government relies on and monitors specific undertakings with respect to oversight, management, employment, and transparency, some question whether these will work; better, it is argued, to retain ownership of Canada's natural resources while welcoming foreign investment in transportation and infrastructure projects.

Oil sands production is receiving close scrutiny by politicians and environmental groups concerned about the reported effects of these large projects on CO<sub>2</sub> emissions, land use planning, and water management. Oil companies face significant challenges in managing reputational damage as consumers and activists take aim at the industry. Environmental groups have successfully labelled Canada's oil sands as 'dirty' oil and targeted it in the wake of the Gulf of Mexico oil spill despite the lack of alternative energy sources for transportation. Americans have a basic choice: do they want to buy their oil from the volatile Middle East or from dependable Canada?

On the first issue, the federal government has publicly stated that it welcomes foreign investment in Canada's natural resources and energy sectors, and so it seems that government approval of these investments is likely. On dirty oil, it is inevitable that Canada and, indeed, North America will have to adapt to a low-carbon future. A more forward-looking policy stance on climate change is needed that employs effective measures to balance economic growth and sustainable development as well as anticipating the rise of green protectionism in world markets. We examine this challenge next.

## **Climate Change**

Rising public concerns about dependence on offshore fossil fuels, climate change, and clean energy are shaping future energy and climate change policy. Canadian policymakers face two major challenges in this regard. The first relates to domestic concerns of balancing consumer prices with incentives to conserve. The second is reducing vulnerability to US green protectionism so that, if Canada adopts a different climate change regime from the United States, Canadian firms are not at risk of border-adjustment charges on goods sold into the US market.

The international context is difficult in the wake of the failure of the Copenhagen conference on climate change in December 2009. All big emitters must be at the table and agree to hard targets. But China and India argued against global targets and for major funding commitments by the mature industrialized countries to assist developing countries with new technologies and mitigation. The United States, embroiled at the time in political negotiations on health care, failed to pass any binding legislation on climate change. The recently introduced Kerry-Lieberman bill (preceded by the Waxman-Markey bill)<sup>18</sup> attempts to spearhead a federal cap-and-trade system, but the prospects for comprehensive climate change legislation in the current political climate remain uncertain. Equally uncertain is what might fill the gap in the absence of such legislation.

Like the United States, Canada is tackling the problem in a bottom-up fashion, resulting in a patchwork of carbon-pricing approaches. Overall, more than twenty US states and seven Canadian provinces are either implementing or proposing climate change strategies locally, or are participating in or observing a regional trading system.<sup>19</sup> Meanwhile, the Canadian federal government is largely on the sidelines, while businesses are asking for a predictable price and regime so they can make production decisions.

Canada, a major emitter in per capita but not in absolute terms, is arguing that any commitments should be harmonized with those of its largest trading partner. But is this the best strategy for Canadians if it means harmonizing to suboptimal policy? US legislation inevitably will reflect US political priorities, as was evident in the political bargaining around the Waxman-Markey bill, which was dominated by well-organized interests representing coal-producing states and power companies.<sup>20</sup> Concession and political compromise soften the price impact on end users and consumers, and so undermine the core objective of encouraging them to turn away from carbon-intensive products. Policy that is harmonized with this type of inefficient and unfair model would deny Canadians a superior policy, which economists agree would be to put a price on emissions broadly across the economy through a carbon tax and/or a cap-and-trade system (with auctioned credits). Rather than following the United States into bad policy, Canada should consider a smarter approach, one that proactively shapes North American climate change policy around a more optimal outcome.

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<sup>18</sup> The US House of Representatives passed the American Climate and Energy Security Act (also known as the Waxman-Markey bill) in June 2009 by a narrow vote of 219-212. A similar proposal, the American Power Act, was introduced by senators Kerry and Lieberman in May 2010, but was not able to garner enough support due to strong opposition from Republicans and some Democrats.

<sup>19</sup> Lanette Wilkinson, "CCS: Identified Challenges to Implementation," *Stikeman Elliott Emissions Trading & Climate Change Update* (March 2010).

<sup>20</sup> Their support of the bill came only on the condition that 85% of emission permits be allocated to them, rather than being auctioned at a price dictated by supply and demand.

Weighing the costs of climate change is both difficult and controversial. For this reason, policymakers need to proceed with caution by phasing in good policies that take into account new developments and evolving evidence. A recent study for two Canadian environmental organizations argues that Canada can implement stronger climate policies than those in the United States and still prosper economically. The study estimates that, by 2020, using the carbon-pricing schemes in its model could generate between \$46 billion and \$72 billion in government revenue annually.<sup>21</sup> While there are some questions regarding the underlying assumptions of the study,<sup>22</sup> it is one of the few sources on which the policy debate can currently rely. The federal government could also inform its carbon-pricing approach by assessing implicit carbon prices across provinces. British Columbia and Alberta have established carbon prices in different ways, each producing a wide range of outcomes (and government revenues). These divergent approaches suggest that governments have significant latitude in their policy design decisions.

Achieving a given emissions reduction would require a comparable increase in the price of CO<sub>2</sub> emissions, whether through a carbon tax or cap-and-trade. The main benefit of a carbon tax is that it would make costs more visible, thus providing more certainty to businesses and minimizing the complexities involved in implementing a cap-and-trade scheme. Under cap-and-trade, administrative and legal costs would be higher and the system less practical at the level of individual households. Also, volatile and unpredictable permit prices could oblige businesses to develop hedging strategies to minimize risk.

Introducing a carbon tax at a modest level would create incentives to reduce emissions while also giving positive and predictable signals to innovative Canadian firms to develop green technology. Indeed, some idea of the potentially huge market for climate-friendly technologies is provided by reports on alternative energy's becoming a centrepiece of China's 12th Five Year Plan, which will be phased in beginning in 2011. Canada is already a world leader in carbon capture and sequestration due to technology developed by Encana's operations in Saskatchewan, and home to a strong base of innovative companies that are developing emerging technologies in electricity and smart grid markets.

In order to create a single, cost-effective, national carbon regime, the provinces would need to be persuaded to give up their individual carbon taxes and permit schemes. However, a national carbon tax that shifted large revenues to the federal government would be politically unacceptable to provinces that rely heavily on fossil fuel production. Federal-provincial negotiations would be required on the use of carbon-pricing revenues to ease provincial concerns about regional burden-sharing. Such an agreement could be structured to let provinces choose how to spend their share of revenues in a way that would mitigate any loss of competitiveness and transitional effects. In the case of the energy-producing provinces, their use of carbon revenues to fund new clean-energy technologies would help further both economic and environmental goals.

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<sup>21</sup> Matthew Bramley, Pierre Sadik, and Dale Marshall "Climate Leadership, Economic Prosperity: Final Report on an Economic Study of Greenhouse Gas Targets and Policies for Canada" (Drayton Valley, AB; Vancouver: Pembina Institute and the David Suzuki Foundation, 2010).

<sup>22</sup> Critics argue that the modelling does not take adequately into account the impact of a carbon tax on capital investment or technological change, likely underestimating the growth of higher costs for carbon.

Thus, Canada could adopt a superior policy to that of the United States by imposing a carbon tax that could be scaled up as US policy became more focused and serious. But it would require a major cross-sectoral and interregional set of negotiations within Canada. And it would have to take account of the possibility of US green protectionism that would see the imposition of border adjustments on goods imported from countries with less stringent climate change policies. The rationale for such measures would be to level the competitive playing field to ensure that US firms and employees were not placed at a disadvantage. While China and other Asian countries would be the main targets of green protectionism, most US imports of carbon-intensive goods actually come from Canada.<sup>23</sup>

If Canada were judged as failing to pursue reductions with the same stringency as the United States, Canadian exporters could be subject to such surcharges. Yet, considerable discretion would be required to measure the value of carbon in traded goods and to determine required adjustments.<sup>24</sup> For products produced by global supply chains, it would be nearly impossible to determine which country's carbon regime to attribute to a product. In this context, protectionist pressures present a concern for Canada since the distinction between environmental stewardship and raw trade protectionism is evolving and uncertain. Indeed, green protectionism is a sufficiently serious prospect that changes to NAFTA have been proposed to inhibit such actions.<sup>25</sup> Even inside the European Union, whose climate change policies are ahead of those in North America, protectionist pressures are already evident.<sup>26</sup>

Any climate regime that Canada chooses would have to be recognized by US regulators as superior or equivalent to US measures for Canadian exporters to be exempt from US border adjustments. A best-policy carbon-pricing regime would allow Canada to signal the stringency of its own emissions-reduction plans and help shield Canadian producers from green protectionism. Being more ambitious would not undermine the goal of harmonizing with US policy, however, but would ensure that Canada is well positioned to protect its own interests. Past Canadian efforts influenced the formulation of US policies on both trade and acid rain policy, and Canada did not sit back and wait for the United States to initiate a bilateral free trade agreement in the 1980s but took the lead in proposing negotiations. Rather than being a passive policy taker, Canada should build on this track record and push for negotiations to fashion North American climate change policy around a more optimal outcome.

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<sup>23</sup> Jeffrey J. Schott and Meera Fickling, "Setting the NAFTA Agenda on Climate Change" Policy Brief PB09-18 (Washington, DC: Peter G. Peterson Institute for International Economics, August 2009).

<sup>24</sup> See Jack Mintz, "A made in Canada solution?" *Globe and Mail*, 22 May 2009.

<sup>25</sup> Schott and Fickling, "Setting the NAFTA Agenda on Climate Change."

<sup>26</sup> Christopher Ragan, "From the Fiscal Squeeze to Climate Change: Canada's Coming Economic Challenges," *Policy Options*, October 2009.

## DEEPER INTEGRATION OF THE NORTH AMERICAN ECONOMIC SPACE

The terrorist attacks on the World Trade Center and the Pentagon in September 2001 deeply scarred the American psyche by demonstrating that ocean borders no longer protect the homeland from foreign incursions. Nearly a decade later, the current US president has a formidable list of priorities: two wars in countries accused of harbouring the terrorists; continuing terrorist threats, including nuclear terrorism; ensuring the financial crisis never recurs and dealing with the fallout of the severe recession on the US economy; climate change legislation; and the president's own election commitment to major health care reform. A domestic and global agenda of this magnitude leaves little attention for neighbours' concerns and priorities.

For Canadians, access to the US market has become less assured as the Department of Homeland Security has tightened security and the scrutiny of cross-border transactions and movements of people. Initially, it seemed that the shift in US priorities to homeland security and defence would provide an opportunity both to address US objectives and to create new economic opportunities. Recognizing the dispersed nature of US power, a Big Idea to secure but deepen the North American economic space seemed the best way to focus US attention on integrating the neighbourhood. Canadian initiatives on energy, border security, and immigration would be the *quid pro quo* for a negotiated common external tariff or common-market-like arrangement.<sup>27</sup>

NAFTA is also outdated for a number of reasons. The first is that its rules of origin, considered essential at the time of its negotiation, have become an irritant as US bureaucrats have made their application sufficiently onerous that businesses find paying the tariff a lower-cost course than compliance. Second, regional production networks in autos, steel, energy, and finance have grown up since the agreement was negotiated; business segments are now located where production is most efficient, and services functions have gained in importance. Third, buy-American provisions in the 2009 US stimulus package highlight the failure of both NAFTA and Canada's provinces to recognize such interconnectedness in government procurement. Significantly, NAFTA is mainly about goods and very limited in its treatment of services and FDI. For many services, the "tyranny of small (regulatory) differences" in the two countries raises transactions costs unnecessarily.

For these and other reasons, the idea of establishing a common external tariff that would do away with rules of origin has gained momentum in Canada. But such an arrangement would have to be pursued with Mexico as well. Instead, the status quo remains the least-cost avenue for the US administration, which is concerned about attracting Hispanic voters and about the complexities of differing issues on the northern and southern borders — facilitating low-risk travel and economic exchange in the former case, combating security threats from organized crime, narco-trafficking, and illegal immigration in the latter. While technology is gradually moving clearance procedures away from the border for cargo movements in cross-border

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<sup>27</sup> See Wendy Dobson, "Shaping the Future of the North American Economic Space: A Framework for Action," *C.D. Howe Institute Commentary* 162 (Toronto: C.D. Howe Institute, April 2002); Allan Gotlieb, "A North American Community of Law" (paper presented to the Borderlines Conference at the Woodrow Wilson International Center for Scholars, Washington, DC, 27 February 2004); and idem, "Romanticism and Realism in Canada's Foreign Policy," *Benefactors Lecture*, 2004 (Toronto: C.D. Howe Institute, November 2004), p. 40.

supply chains in the auto industry and for low-risk travellers, incremental change remains the order of the day: the Security and Prosperity Partnership aimed to improve the secure flow of goods and people, harmonize regulations, and remove irritants one at a time, but even this effort has died.

A decade after the events of 9/11, the border is still a central issue. Indeed, rising transactions costs act like a tariff, just the opposite of what the free trade negotiations intended. Economic studies estimate that goods trade, excluding energy and forest products, was 12.5% lower in 2007 than models would predict, and that the thicker border has had a negative impact of 8% on services exports and 13% on services imports.<sup>28</sup>

Recognizing that both cost and security concerns are genuine, the list of incremental and “smart border” initiatives is a long one: build common border posts; improve border infrastructure; adopt common regulations; create a new research institute; make the border the responsibility of a binational Border Commission empowered to streamline customs and entry provisions and remove protectionist obstructions that have nothing to do with security; spearhead a new effort to harmonize standards and regulations; harmonize immigration and refugee policies; and intensify policy collaboration on drugs and organized crime.<sup>29</sup>

These thoughtful proposals should be pursued. But there should be no illusions; they do not address two central strategic issues. First, the trade gains from NAFTA have been exhausted and the stronger Canadian dollar, structural changes in the auto industry, and growing competition from low-cost Chinese suppliers are having a similar effect.<sup>30</sup> The expiration of the softwood lumber agreement in a few years will see a very different forest product industry on both sides of the border, with smaller US firms and a shrunken Canadian industry in the wake of mountain pine beetle attacks. Further gains could be made only by doing away with regulatory obstacles and differences that NAFTA did not tackle. Indeed, bilateral disputes appear to have migrated away from trade — following the massive softwood lumber agreement in 2006 — to investment disputes.<sup>31</sup> The reason is not clear but probably is linked to the effect of production networks that have integrated goods production in key sectors and to the growing importance of regulatory differences.

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<sup>28</sup> Patrick Grady, “A More Open and Secure Border for Trade, Investment and People” (paper presented to the Carleton University US Project Conference, Blueprint for Canada-US Engagement under a New Administration, Ottawa, 8 December 2008), pp. 41-42. Grady reports that energy trade, through pipelines and transmission conduits, was unaffected, while forest products were already affected by the softwood lumber dispute.

<sup>29</sup> See Derek Burney, “Working towards a thinner border,” *National Post*, 12 April 2010; and Canadian International Council, *Open Canada: A Global Positioning Strategy for a Networked Age* (Toronto: CIC, 2010); available online at [www.canadianinternationalcouncil.org](http://www.canadianinternationalcouncil.org).

<sup>30</sup> Glen Hodgson, “Making Integrative Trade Real: Creating an Value-Chain Trade Policy for North America” (paper presented to the Carleton University US Project Conference, Blueprint for Canada-US Engagement under a New Administration, Ottawa, 8 December 2008).

<sup>31</sup> Lawrence L. Herman, “Trend-spotting: NAFTA Disputes after Fifteen Years,” *Backgrounder* 133 (Toronto: C.D. Howe Institute, July 2010).

Second, there is little or no US interest or internal pressure for changing NAFTA on a stand-alone basis. Renegotiating NAFTA surfaced as an issue in the 2008 presidential campaign when Democratic candidates for whom trade liberalization is distasteful outdid each other with rhetorical vows to get a better deal for the American worker.<sup>32</sup> While the Obama administration is interested in friendly and productive economic relationships with the United States' neighbours, its preference is to manage the status quo. The administration has kept a very low profile on trade issues: the US Trade Representative's office was instructed by the White House to refrain from any trade initiatives during the heated and protracted health insurance legislation debate. Three already-completed free trade agreements, with South Korea, Colombia, and Panama, await ratification.<sup>33</sup>

There is another way. When the president visited Asia in November 2009, he gave a major policy speech in Tokyo stating that, as America's first Pacific president, he would launch US participation in the Trans-Pacific Partnership (TPP) initiative, a free trade agreement completed by four countries in Asia and Latin America in 2006, with a 2011 time line for completion.<sup>34</sup> US goals are primarily strategic, as US Trade Representative Ron Kirk explained in his letter of notification to leaders of the House and Senate, "to create a potential platform for economic integration across the Asia-Pacific region" and to expand US exports and promote US interests with the world's "fastest-growing economies." While the initial TPP negotiating partners are a group of "like-minded countries that share a commitment to concluding a high-standard trade agreement," US participation is "predicated on the shared objective of expanding this initial agreement to additional countries throughout the Asia-Pacific region."<sup>35</sup> Indeed, the payoff for the United States lies in extending the TPP to larger economies such as Japan, Mexico, and Canada.

But joining the TPP and hitching our wagon to the world's most dynamic economies is still below Canadians' radar. The TPP is strategic in that it seeks trans-Pacific economic links that have so far eluded the Asia-Pacific Economic Cooperation (APEC) forum, which President Obama will host at a leaders' summit in Honolulu in 2011. The TPP is a high-quality, comprehensive free trade agreement — one of the few in existence; most fail the test of including "substantially all trade" — initially negotiated among four economies on both sides of the Pacific: Singapore, New Zealand, Chile, and Brunei Darussalam.<sup>36</sup> It was relatively easy to create because of the complementary industrial structures of the four founding partners. The

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<sup>32</sup> Apparently oblivious to economic evidence that technology, rather than imports, has had the larger employment effect.

<sup>33</sup> Although the administration has set a target of the Seoul G20 summit in early November 2010 to finalize the Korean-US FTA (KORUS) for submission to Congress.

<sup>34</sup> The administration consulted actively with Congress before this speech and received a green light to proceed despite — or because of — the need to balance the costs of US adjustment with the significance of this strategic initiative in Asia. See Fred Bergsten, "Asia-Pacific Regional Economic Integration and Architecture" (speech to the Conference on Asia-Pacific Regional Economic Integration and Architecture, Auckland, New Zealand, 25 March 2010); available online at [www.iie.com/publications/papers/paper.cfm?ResearchID=1525](http://www.iie.com/publications/papers/paper.cfm?ResearchID=1525).

<sup>35</sup> United States Trade Representative, Letters to Hon. Nancy Pelosi and Sen. Richard Byrd notifying them of the President's intention to enter into negotiations of a Trans-Pacific Partnership Agreement, Washington, DC, 12 December 2009; available online at [www.ustr.gov/webfm\\_send/1559](http://www.ustr.gov/webfm_send/1559).

<sup>36</sup> Details are available on the websites of trade negotiators for each country; see, for example, [www.mfat.govt.nz](http://www.mfat.govt.nz); [www.dfat.gov.au](http://www.dfat.gov.au); and [www.ustr.gov](http://www.ustr.gov).

agreement has a dispute-settlement mechanism as well as a mechanism for other countries to join provided they meet its provisions. Commitments under the World Trade Organization (WTO) remain untouched, but FTAs already in force — for example, those between the United States and, separately, Chile (2003), Singapore (2004), and Australia (2005) — may be upgraded as part of the TPP negotiating process. The United States, for example, is participating in negotiations on financial services and investment, which were delayed in the initial agreement. An environmental cooperation agreement and a labour cooperation understanding are also directly linked to the agreement.

The United States, Australia, Vietnam, and Peru have opted to join in the next round; Japan and most of the significant East Asian economies other than China have not yet decided whether to participate. The current extension of the TPP will build a baseline for future participants. Significantly, the negotiating framework uses a negative-list approach whereby liberalization would apply to all sectors unless specifically excluded.<sup>37</sup> Coverage already includes goods (even agriculture), services obligations, intellectual property, screening of foreign investment, pharmaceuticals, government procurement, services that improve the business environment such as customs arrangements, and standards such as sanitary and phyto-sanitary ones.

The negotiations are moving swiftly. The third round of talks scheduled for early October 2010 will consider a negotiating text. By including services and investment provisions, the TPP's broader reach would provide a route to upgrading NAFTA following the process used with Chile, Australia, and Singapore in the current round. NAFTA's deficiencies — services, regulatory harmonization, investment — are integral features of the TPP, and its broader reach would widen the opportunities for the tradeoffs that are vital to a comprehensive agreement. To that end, however, the TPP partners will have to be willing to address sensitive sectors such as agriculture. In Canada's case, that might mean having to rationalize its infamous supply-management schemes for farm produce, which are protected by stiff quotas on imports and high tariffs that cost the Canadian consumer dearly.<sup>38</sup> Australia and New Zealand, in contrast, have successfully rationalized such programs by abolishing subsidies (in New Zealand nearly 30 years ago) and by buying out farmers (in Australia).<sup>39</sup> Agriculture has been a sensitive issue for Chile as well, but under the TPP it has agreed to phase out its tariffs by 2017 using safeguards during the transition period to protect the dairy industry.

It would be a mistake to accept the status quo or to rely exclusively on incremental changes. Canada should be seeking all available means to reduce the obstacles to the movement of people, goods, services, and capital in North America. The ambitious TPP option likely will become available to new applicants in the next two years. By then, Canadians will have to become much better informed about the advantages and the costs of participating.

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<sup>37</sup> This would be a significant improvement over the WTO's cumbersome positive-list approach, where only identified sectors are included in the final agreement.

<sup>38</sup> Supply-managed sectors include dairy, eggs, and poultry, and are concentrated mainly in rural regions of Ontario and Quebec. The Canadian government allows only small amounts of supply-managed products to enter the country under low tariffs, and imports above those amounts attract a tariff of around 250% on average; see Richard Barichello, John Cranfield, and Karl Mielke, "Options for Reform of Supply Management in Canada with Trade Liberalization," *Canadian Public Policy* 35(2, 2009): 203-217; and William B.P. Robson and Colin Busby, "Freeing up Food: The Ongoing Cost, and Potential Reform, of Supply Management," *Backgrounders* 128 (Toronto: C.D. Howe Institute, April 2010).

<sup>39</sup> Jeffrey Simpson, "Everyone knows Canada's a double-dealer in world trade," *Globe and Mail*, 21 April 2010.

## POLICY IMPLICATIONS AND RECOMMENDATIONS

Generally, the federal government's approach to the Canadian-US relationship resembles the strategy we have presented in this Policy Brief of differentiating and deepening. It is the tactics that differ. The strategy is difficult to discern because of the federal government's reliance on incrementalism, diffused FTA initiatives that are unlikely to produce much real trade liberalization, and a follower approach to climate change policy. More ambition is needed to anticipate and respond to the large and likely irreversible changes underway in the world's economic geography, in technology, and in the degree of competition North American producers face in this new world. New Zealand's decade-long advocacy for the TPP is an example of such ambition, in both its vision and execution.

Our recommendations build on Canada's revealed comparative advantages in the financial and energy sectors and anticipate the big changes that are reshaping the North American economy.

### Differentiating by Building on Our Strengths

**Promote finance and energy.** The financial and energy sectors are Canadian strengths. In the financial sector, Canada should leverage this strength by promoting Toronto as an international financial centre, building on the head-office capabilities that are integral to the city's financial cluster as well as on demonstrated strengths in energy and mining investment in other Canadian centres. The federal government's resolve to rationalize Canada's 13 securities regulators into a national regulator is commendable and should be seen through to its conclusion. As the Financial Sector Working Group points out, Canada is the only major industrialized country without some form of a national securities regulator. This patchwork arrangement puts Canada at a competitive disadvantage internationally and makes doing business in domestic capital markets more complex and expensive. A common regulator would help to enhance compliance and enforcement, and reinforce Canada's otherwise strong reputation in financial regulation. Canada should also build on the growing international interest in its energy supplies by welcoming foreign investment, particularly in transportation infrastructure, to diversify its markets and strengthen its bargaining position with the United States.

**Diversify Canada's trade and investment relationships.** Canada's Global Commerce Strategy identifies no fewer than ten priority countries as well as Latin America and the Caribbean, ASEAN, Europe, and the Gulf Cooperation Council.<sup>40</sup> With so many priorities, are there any priorities? Diversification is also flawed by the "flavour-of-the-month" tendency of recent years. Better to guide diversification by the principle of anticipating and exploiting opportunities in the world's shifting economic geography. Canada should use negotiations and market forces to diversify further the markets for its natural resources beyond the United States. The realities and requirements of G20 leadership have helped shift Canadian leaders' attention back to the largest and most dynamic economies. Recent leadership and business exchanges with India and China are helping to reverse a period of neglect.

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<sup>40</sup> Canada, Department of Foreign Affairs and International Trade, "Seizing the Global Advantage" (Ottawa: DFAIT, 2009); available online at [www.international.gc.ca/commerce/strategy-strategie/index](http://www.international.gc.ca/commerce/strategy-strategie/index).

## Shape a Best-Policy Carbon-Pricing Regime

Canada should adopt a best-policy carbon-pricing regime, while advancing a regime that would cover the other NAFTA countries. Current policy settles for too little by simply harmonizing with the United States — whether that represents good or bad policy. A phased-in carbon tax, for example, would be superior in its effects and would shield Canadian producers from US green protectionism. As the bipartisan National Fiscal Responsibility Commission comes to grips with the realities of putting the US government's books in order with both tax increases and spending cuts, carbon taxation could gain political acceptability. Such a policy would entail federal-provincial negotiations that recognize the provinces' desire to control the allocation of the revenues, but Canada is not alone in facing difficult tradeoffs in cleaning up its patchwork of climate change policies. The United States, facing similar challenges in the Kerry-Lieberman bill, proposed federal primacy over the states and compensation for withdrawing their own initiatives.

## Deepening the North American Economic Space

**Join the Trans-Pacific Partnership.** Deepening the North American economic space is essential if North American producers are to keep ahead of their competitors in Asia and other regions where economic integration is gathering momentum. While the United States will remain Canada's main economic partner, the Obama administration's crowded policy agenda leaves little room for more than managing the status quo. This is not to deny the urgency of rolling back the thickening of the border and updating and deepening NAFTA. Canadians have observed repeatedly over the past two decades, though, that US administrations are attracted to strategic proposals and Big Ideas. The strategic imperatives of US interest in the TPP are to deepen integration with the fast-growing Asian economies, to reduce the likelihood that Asia will become China's backyard, and to upgrade and modernize existing FTAs. For Canada, the economic opportunity is that the TPP's comprehensive, high-quality free trade agreement is the best available route to liberalizing trade in services and investment that were not included in NAFTA. The TPP's structure allows any country that is willing to accept the terms to join. Canada might need to rationalize its supply-management programs by, for example, phasing in the liberalization of quotas. Yet it is not inconceivable that Canada's agricultural producers, like wine producers before them, could become internationally competitive as a result.

## CONCLUSION

For at least the next decade, the world economy will be remarkably turbulent as traditional trading partners in North America and Europe struggle to restore economic growth, reduce high unemployment, and repair their balance sheets. In contrast, Asian economies are emerging from the crisis with their finances intact but overly dependent on these same Western markets for their export-led growth. As these economies restructure in the years ahead to rely more on domestic and regional demand, deeper integration of the region is likely to continue. The big question is whether it will remain as open to the rest of the world as in the past.

The status quo in Canada is not a compelling one: the border with the United States is thickening, and Canada has been left out of the potentially game-changing Trans-Pacific Partnership agreement. Canadian policymakers now must up their game. They need to differentiate Canada as a location in North America that anticipates global changes. They need to make bolder moves to build on Canada's strengths — good policy and generous endowments — to diversify Canada's options and to join the ambitious trade negotiations underway in the Asia-Pacific region. Such moves risk some domestic political turbulence as Canada's federalism adapts to changing global realities. But the case for change has been made. Can Canadians afford not to try?

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