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# THE SECURITY DIMENSION OF A CHINA FREE TRADE AGREEMENT: BALANCING BENEFITS AND RISK

Gordon Houlden

## INTRODUCTION

In 2017, Canada engaged in several rounds of exploratory discussions for a potential free trade agreement (FTA) with the People's Republic of China. It seemed probable that this exploratory phase would be followed by the opening of formal rounds of negotiations, to be announced during Prime Minister Justin Trudeau's visit to China in December 2017. An FTA appeared to be a priority for Trudeau since his government came into office in 2015 (Global Affairs Canada, 2017a; Lu, 2017; PMO, 2017); however, such negotiations were put on hold indefinitely, ostensibly due to irreconcilable differences on gender and labour issues. Despite this setback, it is likely that the Canadian government will continue to explore this option in the coming years, particularly with the North American Free Trade Agreement (NAFTA) in jeopardy. While there are many potential benefits of a Canada-China free trade agreement (CCFTA), there are also significant national security implications that will deserve particular attention. The security dimension will be the focus of this paper.

Prospective CCFTA negotiations with China would be both complex and time consuming, in part due to the wide divergences between the Canadian and Chinese economies, as well as differences between Canadian and Chinese administrative and legal systems. Negotiations could therefore take several years to conclude, and might not be finished until well after the 2019 federal election. It took a full decade to sign and ratify the China-Australia Free Trade Agreement (ChAFTA), although it appears that the most difficult portion of the negotiations was wrapped up in the final two years. It is unlikely that a CCFTA will move as slowly as the Australian FTA did, in part because of the established Australian precedent and because of China's increasing familiarity with FTA negotiations that involve advanced economies. For this reason, Canada would benefit from approaching a CCFTA after Australia, but before many other Western countries.

Chinese and Canadian negotiators will be consumed with elaborating the principles of each side's responsive FTA approaches, as well as the myriad of details involving thousands of products and services that a CCFTA's provisions would affect. Canadian negotiators will seek a high-quality FTA that covers a large percentage of our export and import products with China, as well as an agreement that covers all key sectors and industries. There is also likely to be a Canadian focus on addressing China's use of non-tariff barriers to trade which currently inhibit Canadian firms from taking full advantage of the massive China market. Such measures include the Chinese Ministry of Health's 2013 changes to food safety standards which required all imported food products to list detailed nutritional components in Chinese. Procedural barriers such as this represent a significant hurdle for Canadian firms, and cause uncertainty among international exporters that want to break into the Chinese domestic market. In theory, the centralized Chinese economy lacks the regional complexity of the Canadian federal state, characterized by sub-national units, but in reality, China's provinces and municipalities can, and often do, impose barriers to foreign imports, often to protect market share for local substantive industries.

To date, China has FTAs with only a handful of developed countries. Australia, Korea, Switzerland, Iceland, Singapore and New Zealand currently have bilateral FTAs with China, and several others, such as Norway and Israel, are in FTA negotiations. China is also floating ideas for FTAs with developing countries, including India. China is far more trade-dependent than the United States, although by comparison China is not nearly as trade-dependent as Canada is.[1] The balance of trade is currently in China's favour: China exports US$46 billion to Canada, versus the US$16 billion that it imports from Canada (MIT, 2016a). However, it is important to note that China's exports to Canada account for only 2.2 per cent of China's total merchandise exports (MIT, 2016b).

## NAFTA

Since Confederation, Canada has had its closest trade ties with Great Britain, Commonwealth partners, and especially since the Second World War, with the United States. This has meant that our largest trade partners were also our closest political and strategic partners. Trade and investment patterns with our indispensable ally—the U.S.—have tended to be mutually reinforcing, and in recent decades Canada has, with important exceptions such as softwood lumber, been able to largely take for granted the stability of access to the massive U.S. market. The Canada-U.S. Auto Pact, the Canada-U.S. FTA and NAFTA have led sequentially to restructuring of the Canadian economy in response to the export opportunities the U.S. market offers. Many Canadian industry sectors expanded, while others contracted, with closer integration of the two economies.

A majority of the Canadian public and most economists now view NAFTA's negotiation and implementation in 1994 as a great boon to Canadian economic growth over the past two decades, despite initial skepticism (Angeles Villarreal and Fergusson, 2017; CFR, 2017). NAFTA's very success built a deep dependence on the U.S. market that many Canadians assumed would be unchangeable. Over 75 per cent of Canadian (goods) exports are destined for the U.S., illustrating a high degree of reliance on the U.S. market (MIT, 2016c). NAFTA's net effect has been extremely

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*1* See Graph A in appendix.

positive for the overall Canadian economy; however, with NAFTA facing a substantive renegotiation with uncertain outcomes (and a possible termination) the Canadian trade relationship with the U.S. is in jeopardy. While NAFTA has offered a clear net benefit to the Canadian economy, the challenges that Canada now faces under President Donald Trump are a reminder that even expanded markets for Canadian industries can carry long-term risks. The Trump administration's sustained efforts to force a renegotiation of the NAFTA pact may in turn be a factor that strengthens a Canadian push for an FTA with China.

Canada has been particularly fortunate in its privileged access to the U.S. market, but there is a clear need for the (export-dependent) Canadian economy to diversify its export destinations in the face of uncertain future access to the U.S. market (Statistics Canada, 2017). In comparison to our close relationship with the U.S., Canada is politically and economically removed from Europe, but far more distant from East Asia. This is particularly true with respect to Canadian manufacturing and political centres, which are concentrated in Ontario and Quebec. However, China has an economic structure which is generally compatible with the Canadian economy: China has a prodigious output of industrial goods, but a shortage of many raw minerals, including petroleum, of which Canada is a net exporter. China, with 1.4 billion mouths to feed, is barely self-sufficient in basic foodstuffs and unable to supply the full range of high-quality food products its growing middle class increasingly demands. Canada is well positioned to fill this gap.

## RISKS AND OPPORTUNITIES OF A CHINA-CANADA FREE TRADE AGREEMENT (CCFTA)

At first glance, it would appear that with uncertainties regarding NAFTA's future, there is great advantage to be gained from a more robust engagement with the Chinese economy, and by reducing our dependence on trade with the U.S. However, there could also be down sides to a fundamental shift in market dependence, particularly regarding the durability of a profound re-alignment in Canada's export markets. China retains a high degree of state supervision, even over its largest and most high-profile private firms.

With the negotiation of a CCFTA with China, consideration must also be given to how the opening of the Canadian market to a wider range and volume of Chinese exports would affect our domestic economy, given the competitiveness of Chinese exporters, and the risk of subsidized Chinese exports damaging Canadian production. Simply signing a CCFTA does not automatically make Canadian exports more competitive, even with reduced Chinese tariffs resulting from it. Increased Chinese imports into Canada can be expected, and while this competition may push Canadian producers to increase their competitiveness and productivity, there is no guarantee that they will respond effectively (Dawson and Ciuriak, 2016a). [2] Likewise, many outstanding challenges have plagued Canada-China relations over the last several years, including the protection of intellectual property, the lack of transparency of Chinese trade law and regulations, the impartiality of local courts with regard to trade disputes involving foreign companies, and lack of domestic market access for foreign firms operating in China in certain sectors such as mining or energy extraction, or agricultural production.

While there has been a gradual expansion of Canadian access to the U.S. market since the negotiation of the auto pact (1965), can we assume that this will be the case with a CCFTA? What are the specific risks that may accompany pursuing an FTA with China?

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[2] Laura Dawson from the Wilson Center finds that a CCFTA would have a strong positive benefit on Canada's GDP and economic growth.

China has a dense network of state enterprises that dominate key sectors from vital agricultural products through energy, transportation infrastructure and strategic industries. China is both the most populous country in the world and the world's second largest economy. China also has a layered economy that encompasses a strong central government, with large provinces and subordinate municipalities. China does not have a true federal system; its provinces and municipalities are still subordinate to the central government. But the governments often operate with de facto autonomy at the sub-national level, and are sometimes poorly supervised by Beijing. The sheer size and complexity of the Chinese governmental and economic system is such that both provinces and municipalities can pursue policies that do not always align with the central government's directives. This creates risks that, regardless of the provisions of a CCFTA, in practice subordinate Chinese governments may either simply disregard those provisions, or may require regular policing and intervention by Canada under a CCFTA. Trade remedies in any trade agreement can be slow to achieve and enforce, but in a country as large as China, the risks could be substantial. For Canada's small- and medium-sized enterprises (SMEs), the costs may be prohibitive. China also has an opaque legal system that can be challenging to navigate for foreign firms, and often favours large and powerful state-owned enterprises (SOEs) in court. A CCFTA would grant Chinese firms enhanced access to an open economy, with easy access to an independent and consistent judicial and legal system. However, an argument can be made that Canadian firms would have the most to gain from a dispute settlement mechanism in an FTA, which would give them legal protections when operating in China.

Another potential risk of a significant shift to China-centric Canadian exports is the prospect of a sharp deterioration in Sino-American relations. In 2018, this is not a theoretical threat. During his 2016 election campaign, Trump sharply criticized China's trade practices, and Beijing and Washington have exchanged tit-for-tat tariff threats since his inauguration. A number of other potential U.S.-China flashpoints remain, from the South China Sea to Taiwan and the Korean Peninsula. While it is currently difficult to imagine the precise circumstances that might trigger U.S. pressure on Canada to alter or restrict its trade with China, such pressure has been brought to bear in the past with regard to Cuba and Iran (Office of the Press Secretary, 2012). Washington will not applaud the conclusion of a CCFTA, particularly with respect to increased Chinese investment in Canada.

## PRODUCT SAFETY

One of the issues that can arise in trade with China is the question of the safety of Chinese products. This question has already emerged in Canada, from lead contamination in toys to the presence of volatile chemicals in drywall. The potential risk is most acute with food products, which can directly affect Canadians' health. To be fair, these issues exist with or without a CCFTA. Chinese food products already enter Canada in significant quantities. However, with an FTA's potential of reduction or elimination of barriers for most food products, there would likely be a sharp increase in Chinese food exports to Canada. It is true that Health Canada's standards would continue to apply to all food imports, as they do now, but with higher volumes can come higher risk given that only limited sampling is possible.

Two factors can mitigate the aforementioned risks. First, China's government is itself seized with the need to improve the food supply's safety record, to enhance the reputation of Chinese food exports, but also to address its own citizens' concerns in the face of multiple food scandals. These scandals range from tainted cooking oils and melamine in food to unsafe milk powder for babies. Second, China's own food safety regime has been gradually increasing in competence, due to a rise in the training and professionalism of the Chinese civil service, and grassroots pressure from disgruntled citizens.

## DIGITAL SECURITY

Security of communication, especially with regard to telecommunications infrastructure and data banks, has also been a source of concern vis-à-vis some Western states. In 2012, the U.S. government concluded that China-based Huawei Communications has “not followed United States legal obligations or international standards of business behavior” (Rogers and Ruppersberger, 2012a). The report accused the company of undermining U.S. security and called on Washington to view with “suspicion the continued penetration of the U.S. telecommunications market by Chinese telecommunications companies” (Rogers and Ruppersberger, 2012b).

While the Chinese regulators have denied these claims, cyber-security and digital privacy concerns remain a potential risk associated with a China-Canada FTA, and may raise public concern and partisan opposition, regardless of the accuracy of such criticism. In mitigating these concerns, Canada and China signed an “agreement vowing not to conduct state-sponsored cyber-attacks against each other aimed at stealing trade secrets or other confidential business information” (Reuters, 2017). Further research to assess the level of compliance with this agreement will be required. Even if Canada is satisfied that the risks posed by close involvement with a Chinese electronic or digital company are low, there is also a risk that the U.S. may raise objections if there were exports from a Chinese enterprise operating in Canada but exporting to the U.S. Norsat, a Canadian takeover target by the Chinese firm Hyrera, is a case in point. The U.S.-China Economic and Security Commission objected to the Norsat sale, given that Norsat was a supplier to the U.S. Defense Department (Fife and Chase, 2017).

A greater integration of Canadian industry into Chinese supply chains following a conclusion of a Canada-China FTA might risk increasing the leakage of Canadian defence technology to China, in turn leading to increased friction between the U.S. and Canada over defence production sharing. There are provisions in the Investment Canada Act to increase scrutiny on security grounds of the purchase of Canadian firms by foreign SOEs, but the elimination of this provision may well be one of the objectives for Chinese negotiators in any FTA negotiation.

There is also a risk that China, with industrial scale only matched by the U.S. and the EU—and with the world’s largest foreign currency reserves—could, with loosened foreign investment criteria following an FTA, embark on a rush of acquisitions in Canada. For example, there are a handful of large Chinese state electricity providers, some of whom operate with a capacity of scale that is larger than Canada’s total electricity generation. Combined with a formidable manufacturing prowess, these firms could seek to acquire the more modestly sized Canadian producers. While such acquisitions would still require Investment Canada Act approval, China will likely expect accelerated and looser investment scrutiny under the Investment Canada Act, post-FTA. These issues are critical for Canada, and were particularly evident in the Comprehensive Economic and Trade Agreement (CETA) recently signed by Canada and the European Union. CETA “contains commitments to treat investors fairly and equitably…and the elucidation of standards for the protection of investors and rules for efficient and transparent resolution of investor-State disputes” (Ackhurst, Nattrass and Brown, 2016).

It is normal that the focus of Canadians and Canadian officials in consideration of a CCFTA would be on the potential impact on Canada. However, China in particular has both historical and contemporary concerns of its own regarding foreign penetration of its economy. The central government put policies into place to ensure that the “commanding heights” of its digital, social media and broadly defined information technology industries remain in Chinese hands. While there are significant exceptions, (i.e., Microsoft) such foreign companies and technologies are gradually replaced by China’s own indigenous technologies wherever possible, especially under the ambitious China 2025 program, which aims at national domination of key technologies.

## U.S. OBJECTIONS

There are reasonable prospects that a successful and ambitious CCFTA would reduce, to some extent, Canada's extreme dependence on the U.S. market, and this is particularly appealing in 2018, given the Trump administration's challenge to Canadian exports to the U.S.[3] Distance, inertia and limits imposed by the very different business cultures in Canada and China will almost certainly mean that the U.S. will remain Canada's premier export destination. However, there is a risk that rapid growth in Canada-China trade, and in particular, Chinese investment in Canada, will make Washington nervous, particularly if China were to situate major manufacturing plants in Canada that would be exporting goods to the U.S. market. Even today, with NAFTA's stability in question, it is likely that some Asian investors, including those in China, may already be determined to put manufacturing facilities in the U.S., fearing that changes to NAFTA, or perhaps even its disappearance, might mean that such a plant's export footprint might be limited to Canada (rather than all of North America). We will not know whether foreign firms have already made such determinations in their boardrooms, but the slowed pace of foreign investment in Canada since 2015 may be due in part to this fear.

As a medium power, but effectively a minor player in the competition between the mature power (the United States) and a rising China, Canada is particularly vulnerable and has limited options. Canada is joined at the hip with our principal economic partner and security guarantor, and is locked into an intimate and sometimes suffocating embrace with the United States. This tyranny of geography limits our options. However, buffeted as we are by the 21st century uncertainties of our relationship with the Trump administration, Canada cannot ignore our 21st century strategic positioning. We cannot be merely a satellite of the United States, but nonetheless we are inextricably linked to our giant continental neighbour. This close relationship both pushes Canada to seek market diversity through means such as a CCFTA, but also highlights the need to ensure that a CCFTA does not threaten our relationship with Washington.

## SECURITY

With the April 2017 Mar-a-Lago summit between Trump and President Xi Jinping, Sino-American relations entered a honeymoon period based in part, it seemed, on the chemistry of the meeting, hard-nosed assessments of respective national interests, and Trump's understanding that China offered the best prospects for progress on the North Korean security challenge. But will this situation persist? As of 2018, there are signs of a fraying relationship with the U.S., particularly in terms of trade. It is entirely possible that a sharp deterioration in the U.S.-China relationship could be detrimental for Canada. As a full security partner of the United States with both North American Aerospace Defense Command (NORAD) and North Atlantic Treaty Organization (NATO) commitments, Canada would almost certainly be tugged strongly towards Washington by our own national security needs, but also by the almost certain U.S. push for Canada to distance ourselves from China, regardless of the trade costs this would impose upon us.

Canada has enjoyed a remarkable run of prosperity since the end of the Second World War in 1945. For the entirety of those 73 years, the U.S. has been our leading market and our security guarantor. While the U.S. has is not weaker today in military terms, and continues to expand economically, the U.S. is far weaker in relative terms than it was in either 1945 or post-Cold War in the 1990s (Kagan, 2017). In no small measure, this is due to China's rise: in 1970, when Canada first

[3] For example, on June 7, 2018 President Donald Trump tweeted: "Prime Minister Trudeau is being so indignant, bringing up the relationship that the U.S. and Canada had over the many years and all sorts of other things…but he doesn't bring up the fact that they charge us up to 300% on dairy—hurting our Farmers, killing our Agriculture" in reference to NAFTA renegotiations.

established diplomatic relations with the PRC the latter had a mere two per cent of global gross domestic product output (World Bank, 2017). This has now expanded to 15 per cent, and China's international trade has become the greatest trading volume of any country (MIT, 2016d). The China challenge to American global leadership could shrink the Canada *marge de manoeuvre*.

## INTELLECTUAL PROPERTY

Particularly since 1978—the beginning of China's comprehensive economic reforms—China has thrived, in part, by borrowing technical know-how and industrial designs from abroad. China is hardly the only state to have done so—the United States, particularly in the 19th century, adopted the key components of Britain's industrial revolution by copying, and eventually improving, Europe's techniques and products. Much of this rapid U.S. industrialization took place before there was a comprehensive and enforceable international intellectual property regime. Although China had modelled its post-1949 economy on the Soviet Union, it had been deprived of modern Soviet technology since the Sino-Soviet split in the late 1950s, and desperately needed the full suite of modern technologies available to industrialized countries. With the ending of Western sanctions in the 1970s, much of this technology could simply be purchased from eager Western economies, conscious of the long-term potential of the China market. But China was never going to be content simply to purchase off-the-shelf technology indefinitely from the West, and undertook a broad policy of adapting foreign technologies to its own needs.

While China is hardly the only state adept at securing advanced technology, it has an extraordinary absorptive capacity, and also possesses a state apparatus capable of sophisticated gathering of foreign technologies. In the early years of economic reform, China lacked the sufficient industrial and technological capacity to reverse-engineer many products, or even to manufacture advanced goods that originated abroad. This is no longer the case. China's manufacturing prowess has advanced to the point where it is producing, often under licence or in a foreign-owned plant, some of the world's most advanced electronics.

Despite this, inward domestic innovation capacity does not mean that China has ceased its efforts to acquire advanced technologies abroad. Given Canada's defence linkages through both NATO and NORAD, and Canada's small but advanced high-technology sector, a closer integration of the Canadian and Chinese economies does risk further technology leakages to China. In turn, this may have implications for Canada-U.S. bilateral relations, given U.S. fears that defence-related production in Canada may be at risk from Chinese industrial espionage. A desire to attract Chinese investment should be balanced with a measure of caution. The U.S. has demonstrated that it does not want NAFTA or some Canada-U.S. bilateral replacement to become a means for foreign firms (especially Chinese companies) to gain access to the U.S. market that would otherwise not be possible. Canada, on the other hand, still promotes itself as a springboard for the North American market through NAFTA in its investment attraction efforts, even though the rules regarding tariff-free entry to North America through Canada may be tightened under the protectionist policies Washington is pursuing, assuming that NAFTA survives the current trade climate there.

There are, of course, sharp legal differences between Canada and China. Such differences would suggest that a dispute resolution mechanism would be the most useful tool to ensure fair treatment for Canadian firms operating in China. While Canada has widely used the NAFTA dispute resolution mechanism in the past, there are also a variety of other judicial options available to Canadian firms in U.S. courts. In the case of dispute resolution with China, an inconsistent and opaque legal system makes the option of legal action in Chinese courts less attractive. The dispute resolution mechanism would in fact be of particular benefit to Canada to protect the security of Canadian intellectual property in a CCFTA compared with the status quo.

The Chinese legal system has other failings, including tolerance for government and corporate corruption, the jailing of dissidents, etc. However, these flaws will plague the Chinese legal system, regardless of an FTA with Canada. A free trade agreement is not likely to address these failings, nor would it be appropriate for it to do so. An FTA is a tool to increase trade and improve market access, and it cannot be a means to change the domestic laws of a foreign country, especially in the case of China, which has a long memory of foreign intervention in its domestic affairs.

## CONCLUSION

A state's trading partnerships cannot be completely divorced from its security concerns and those of its allies. But taking these into account should not immediately disqualify Canada, a trading nation (Global Affairs Canada, 2017b), from exploring economic opportunities with China—the world's second largest economy and the world's largest trader. Canada must face this dilemma. Canada currently enjoys highly privileged access to the U.S. market, including a unique Canada-U.S. defence production agreement. Our close defence and trading relationship with the U.S. will be a challenge to manage during any CCFTA negotiations.

Canada has entered into not only multiple and close trade regimes with the United States, but also two security treaties (NORAD and NATO) that compel us to join in the defence of our North American and European allies. It is in Canada's net interest to hold FTA discussions with China, and a fair and comprehensive CCFTA would almost certainly grow Canadian exports (Dawson and Ciuriak, 2016b). However, two guiding principles must be kept in mind:

1. During the negotiations and following the initialling of a CCFTA, a clear-eyed and in-depth examination of the benefits and cost, for provinces and territories, of engagement with China must be undertaken by the government of Canada, as well as ongoing consultations that should be held with the full range of Canadian stake-holders;

2. Canadian governments, both during CCFTA negotiation and upon the completion of such a draft, must include careful consideration of its likely impact on our economic and political relationship with the United States, which will remain our principal trading partner and our security guarantor.[4]

Canada also must ensure that, following the negotiation and implementation of a CCFTA, there is an effective monitoring and reporting function in place to gauge the impact on Canada's economy, including national security issues. During Canada's 151-year history, our principal trading partner has always been a state that had a close proximity to our own national ethos—Imperial Britain, or the dominant continental power, the United States. Our political culture is, of course, distinct from the United States, but is often viewed by outsiders (including China) as similar to the American model. Canada imagines that it can be an independent player, readily separated from the United States, and so viewed by China. But it is not a given that our future can be truly independent from America's gravitational pull, particularly with our geographic proximity. Historical bonds with the U.S. may ultimately act as a barrier to a more intimate relationship with China.[5]

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4 However, negotiations on CCFTA may also prove useful in NAFTA discussions with the U.S., demonstrating that we have the means by which to avoid damage to the U.S. relationship. This will be a test of Canadian diplomacy and negotiation. But we are also challenged that both Washington and Beijing hold much more powerful cards than does Ottawa, and that Canada is more likely to be somewhat reactive in its management of the Canada-U.S.-China triangle.

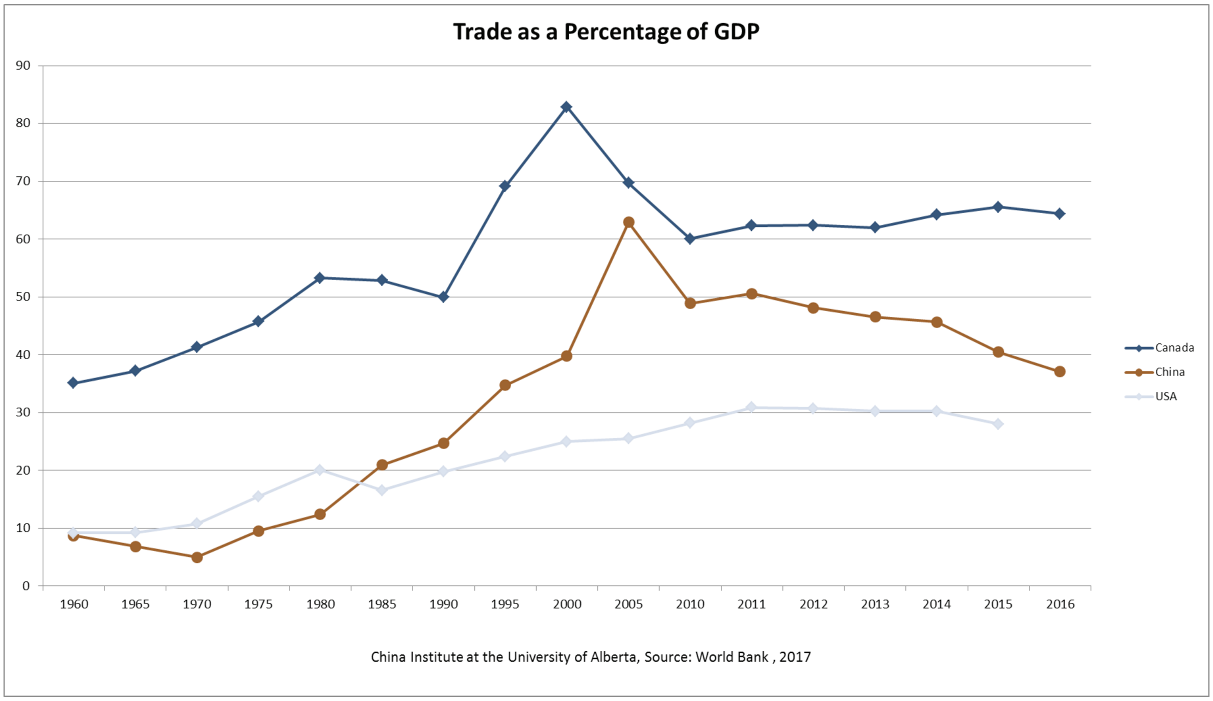
5 A positive sign is that several pre-negotiation consultations with Canadian stakeholders have taken place already.

China offers great trading opportunity, only exceeded by the U.S. and possibly the EU. But China is evolving quickly, and if "stable" means static, the rapidly shifting China can hardly be termed stable. China is quickly moving towards superpower status, with a corresponding global reach. By comparison, Canada is a much more stable and much less dynamic economy, with a lower international political presence. This twin challenge of rapid change and scale on the Chinese side will continue to pose difficulties for its more moderately sized partner. China and the United States, especially in the face of a renewed European tendency towards fission, not fusion, appear destined to dominate our 21$^{st}$ century, and perhaps to contend for supremacy by the U.S. But no matter how strong China becomes, Canada is unlikely to pursue such a close embrace with it, as this would risk being perceived by the United States as a bilateral threat. Even an equally balanced relationship with China and the U.S. is probably a non-starter for Canada.

Thus, Canada must find a point of equilibrium where we can maximize economic benefits for our China relationship, without suffering serious damage to our trade, political and security relations with the U.S. This balance may or may not include a CCFTA; however, Canada is too dependent on trade and foreign investment to forgo the opportunity to expand economic relations with China.

# APPENDIX

## GRAPH A:



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