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# *Canadian Trade Policies and the World Economy*

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*This is Volume 9 in the series of studies commissioned as part of the research program of the Royal Commission on the Economic Union and Development Prospects for Canada.*

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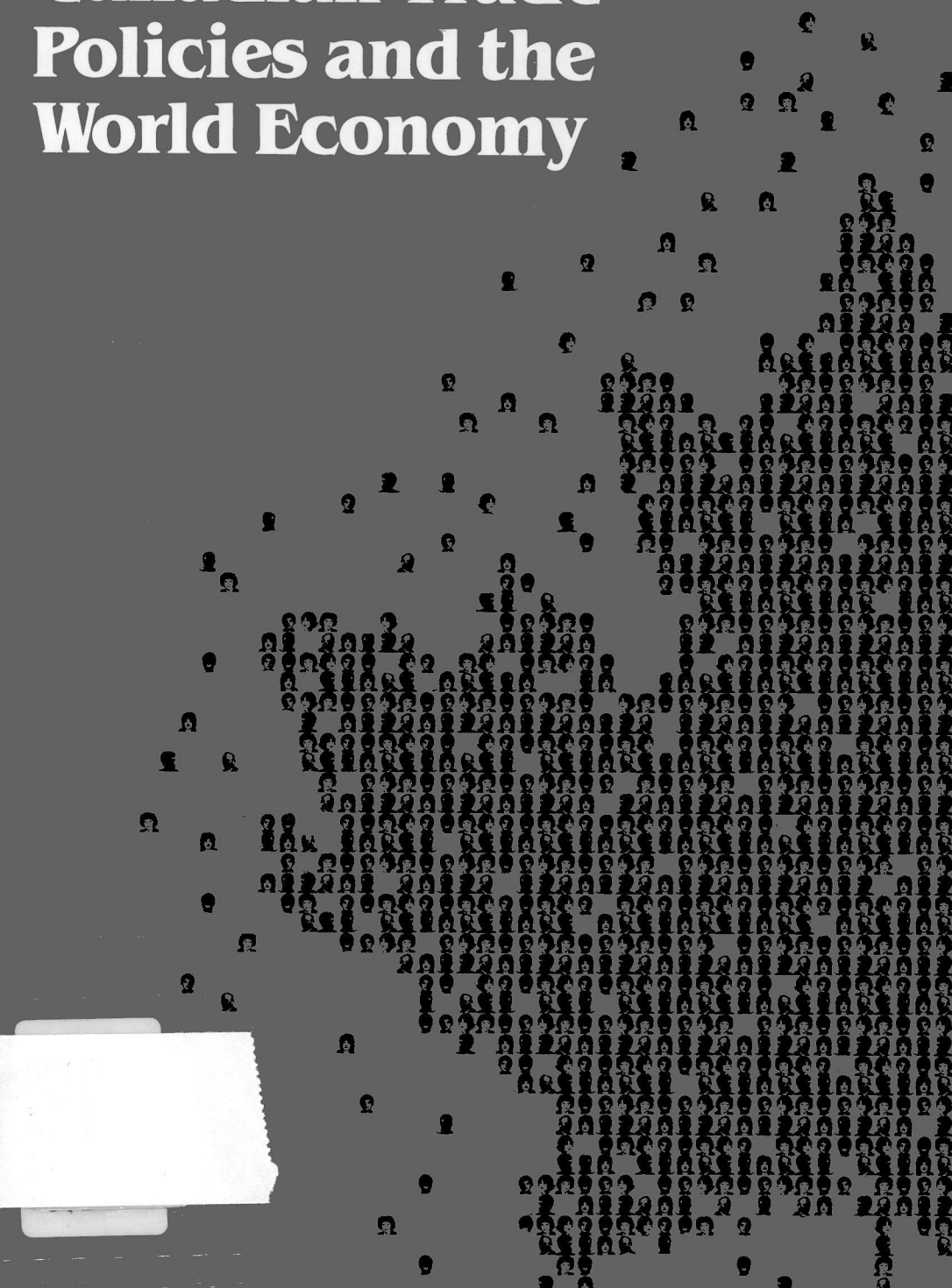


**JOHN WHALLEY**

**with Colleen Hamilton and Roderick Hill**

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*with* COLLEEN HAMILTON  
*and* RODERICK HILL

*Published by the University of Toronto Press in cooperation with  
the Royal Commission on the Economic Union and Development  
Prospects for Canada and the Canadian Government Publishing  
Centre, Supply and Services Canada*

University of Toronto Press  
Toronto Buffalo London

Grateful acknowledgment is made to the following for permission to reprint previously published and unpublished material: Ontario Economic Council; Organisation for European Cooperation and Development.

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Printed in Canada  
ISBN 0-8020-7521-8  
ISSN 0829-2396  
Cat. No. Z1-1983/1-41-9E

CANADIAN CATALOGUING IN PUBLICATION DATA

Whalley, John.  
Canadian trade policies and the world economy

*(The Collected research studies / Royal Commission on the Economic Union and Development Prospects for Canada,*

ISSN 0829-2396 ; 9  
Includes bibliographical references.  
ISBN 0-8020-7521-8

I. Canada — Commercial policy. 2. Foreign trade promotion — Canada. 3. Canada — Economic policy. I. Hamilton, Colleen. II. Hill, Roderick. III. Royal Commission on the Economic Union and Development Prospects for Canada. IV. Title. V. Series: The Collected research studies (Royal Commission on the Economic Union and Development Prospects for Canada) ; 9.

HF1479.W48 1985 382'.3'0971 C85-099112-9

PUBLISHING COORDINATION: Ampersand Communications Services Inc.  
COVER DESIGN: Will Rueter  
INTERIOR DESIGN: Brant Cowie/Artplus Limited



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When the members of the Rowell-Sirois Commission began their collective task in 1937, very little was known about the evolution of the Canadian economy. What was known, moreover, had not been extensively analyzed by the slender cadre of social scientists of the day.

When we set out upon our task nearly 50 years later, we enjoyed a substantial advantage over our predecessors; we had a wealth of information. We inherited the work of scholars at universities across Canada and we had the benefit of the work of experts from private research institutes and publicly sponsored organizations such as the Ontario Economic Council and the Economic Council of Canada. Although there were still important gaps, our problem was not a shortage of information; it was to interrelate and integrate — to synthesize — the results of much of the information we already had.

The mandate of this Commission is unusually broad. It encompasses many of the fundamental policy issues expected to confront the people of Canada and their governments for the next several decades. The nature of the mandate also identified, in advance, the subject matter for much of the research and suggested the scope of enquiry and the need for vigorous efforts to interrelate and integrate the research disciplines. The resulting research program, therefore, is particularly noteworthy in three respects: along with original research studies, it includes survey papers which synthesize work already done in specialized fields; it avoids duplication of work which, in the judgment of the Canadian research community, has already been well done; and, considered as a whole, it is the most thorough examination of the Canadian economic, political and legal systems ever undertaken by an independent agency.

The Commission's research program was carried out under the joint direction of three prominent and highly respected Canadian scholars: Dr. Ivan Bernier (*Law and Constitutional Issues*), Dr. Alan Cairns (*Politics and Institutions of Government*) and Dr. David C. Smith (*Economics*).

Dr. Ivan Bernier is Dean of the Faculty of Law at Laval University. Dr. Alan Cairns is former Head of the Department of Political Science at the University of British Columbia and, prior to joining the Commission, was William Lyon Mackenzie King Visiting Professor of Canadian Studies at Harvard University. Dr. David C. Smith, former Head of the Department of Economics at Queen's University in Kingston, is now Principal of that University. When Dr. Smith assumed his new responsibilities at Queen's in September, 1984, he was succeeded by Dr. Kenneth Norrie of the University of Alberta and John Sargent of the federal Department of Finance, who together acted as Co-directors of Research for the concluding phase of the Economics research program.

I am confident that the efforts of the Research Directors, research coordinators and authors whose work appears in this and other volumes, have provided the community of Canadian scholars and policy makers with a series of publications that will continue to be of value for many years to come. And I hope that the value of the research program to Canadian scholarship will be enhanced by the fact that Commission research is being made available to interested readers in both English and French.

I extend my personal thanks, and that of my fellow Commissioners, to the Research Directors and those immediately associated with them in the Commission's research program. I also want to thank the members of the many research advisory groups whose counsel contributed so substantially to this undertaking.

DONALD S. MACDONALD





At its most general level, the Royal Commission's research program has examined how the Canadian political economy can better adapt to change. As a basis of enquiry, this question reflects our belief that the future will always take us partly by surprise. Our political, legal and economic institutions should therefore be flexible enough to accommodate surprises and yet solid enough to ensure that they help us meet our future goals. This theme of an adaptive political economy led us to explore the interdependencies between political, legal and economic systems and drew our research efforts in an interdisciplinary direction.

The sheer magnitude of the research output (more than 280 separate studies in 72 volumes) as well as its disciplinary and ideological diversity have, however, made complete integration impossible and, we have concluded, undesirable. The research output as a whole brings varying perspectives and methodologies to the study of common problems and we therefore urge readers to look beyond their particular field of interest and to explore topics across disciplines.

The three research areas, — *Law and Constitutional Issues*, under Ivan Bernier; *Politics and Institutions of Government*, under Alan Cairns; and *Economics*, under David C. Smith (co-directed with Kenneth Norrie and John Sargent for the concluding phase of the research program) — were further divided into 19 sections headed by research coordinators.

The area *Law and Constitutional Issues* has been organized into five major sections headed by the research coordinators identified below.

- Law, Society and the Economy — *Ivan Bernier and Andrée Lajoie*
- The International Legal Environment — *John J. Quinn*
- The Canadian Economic Union — *Mark Krasnick*

- Harmonization of Laws in Canada — *Ronald C.C. Cuming*
- Institutional and Constitutional Arrangements — *Clare F. Beckton and A. Wayne MacKay*

Since law in its numerous manifestations is the most fundamental means of implementing state policy, it was necessary to investigate how and when law could be mobilized most effectively to address the problems raised by the Commission's mandate. Adopting a broad perspective, researchers examined Canada's legal system from the standpoint of how law evolves as a result of social, economic and political changes and how, in turn, law brings about changes in our social, economic and political conduct.

Within *Politics and Institutions of Government*, research has been organized into seven major sections.

- Canada and the International Political Economy — *Denis Stairs and Gilbert Winham*
- State and Society in the Modern Era — *Keith Banting*
- Constitutionalism, Citizenship and Society — *Alan Cairns and Cynthia Williams*
- The Politics of Canadian Federalism — *Richard Simeon*
- Representative Institutions — *Peter Aucoin*
- The Politics of Economic Policy — *G. Bruce Doern*
- Industrial Policy — *André Blais*

This area examines a number of developments which have led Canadians to question their ability to govern themselves wisely and effectively. Many of these developments are not unique to Canada and a number of comparative studies canvass and assess how others have coped with similar problems. Within the context of the Canadian heritage of parliamentary government, federalism, a mixed economy, and a bilingual and multicultural society, the research also explores ways of rearranging the relationships of power and influence among institutions to restore and enhance the fundamental democratic principles of representativeness, responsiveness and accountability.

*Economics* research was organized into seven major sections.

- Macroeconomics — *John Sargent*
- Federalism and the Economic Union — *Kenneth Norrie*
- Industrial Structure — *Donald G. McFetridge*
- International Trade — *John Whalley*
- Income Distribution and Economic Security — *François Vaillancourt*
- Labour Markets and Labour Relations — *Craig Riddell*
- Economic Ideas and Social Issues — *David Laidler*

Economics research examines the allocation of Canada's human and other resources, the ways in which institutions and policies affect this allocation, and the distribution of the gains from their use. It also

considers the nature of economic development, the forces that shape our regional and industrial structure, and our economic interdependence with other countries. The thrust of the research in economics is to increase our comprehension of what determines our economic potential and how instruments of economic policy may move us closer to our future goals.

One section from each of the three research areas — The Canadian Economic Union, The Politics of Canadian Federalism, and Federalism and the Economic Union — have been blended into one unified research effort. Consequently, the volumes on Federalism and the Economic Union as well as the volume on The North are the results of an interdisciplinary research effort.

We owe a special debt to the research coordinators. Not only did they organize, assemble and analyze the many research studies and combine their major findings in overviews, but they also made substantial contributions to the Final Report. We wish to thank them for their performance, often under heavy pressure.

Unfortunately, space does not permit us to thank all members of the Commission staff individually. However, we are particularly grateful to the Chairman, The Hon. Donald S. Macdonald; the Commission's Executive Director, J. Gerald Godsoe; and the Director of Policy, Alan Nymark, all of whom were closely involved with the Research Program and played key roles in the contribution of Research to the Final Report. We wish to express our appreciation to the Commission's Administrative Advisor, Harry Stewart, for his guidance and advice, and to the Director of Publishing, Ed Matheson, who managed the research publication process. A special thanks to Jamie Benidickson, Policy Coordinator and Special Assistant to the Chairman, who played a valuable liaison role between Research and the Chairman and Commissioners. We are also grateful to our office administrator, Donna Stebbing, and to our secretarial staff, Monique Carpentier, Barbara Cowtan, Tina DeLuca, Françoise Guilbault and Marilyn Sheldon.

Finally, a well deserved thank you to our closest assistants: Jacques J.M. Shore, *Law and Constitutional Issues*; Cynthia Williams and her successor Karen Jackson, *Politics and Institutions of Government*; and I. Lilla Connidis, *Economics*. We appreciate not only their individual contribution to each research area, but also their cooperative contribution to the research program and the Commission.

IVAN BERNIER  
ALAN CAIRNS  
DAVID C. SMITH

## ACKNOWLEDGMENTS

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I am grateful to Harvey Bale, Clarence Barber, Vic Clarke, Lilla Connidis, John Curtis, Bill Diebold, Ted English, Gerry Helleiner, Michael Hart, John Jackson, Hon. Donald Macdonald, Sandy Moroz, Alan Nymark, Jack Quinn, Ed Safarian, Warren Schwartz, Frank Stone and Ron Wonnacott for helpful comments on an earlier draft. Louise Adamson and Ruth Crow gave valuable assistance in editing the text. The word processing unit of the Royal Commission handled typing and revisions with patience and skill.

JOHN WHALLEY



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## Introduction

Canada is a relatively small, open economy with a large amount of foreign trade relative to its gross national product. The majority of that trade — over 70 percent — is with the United States. Policies that either limit or encourage foreign trade are therefore more important for Canada than for many other countries.

Trade policies in Canada have deep historical roots, perhaps deeper than for most other areas of economic policy, since Confederation itself was partly a reaction to the termination by the United States of an earlier reciprocal trade treaty. The protectionist stance subsequently adopted in the National Policy of 1879 has largely remained at the centre of Canada's international trade strategy in the years following.

Since the end of the Second World War, however, the protectionist stance of earlier years has been modified. This has occurred not because the National Policy itself has formally been repudiated, but because Canada has negotiated multilateral tariff reductions and codes regulating foreign trade with other countries under the General Agreement on Tariffs and Trade (GATT). Although this process began in the mid-1930s with our bilateral agreements with the United States, the pace has quickened in the postwar years, first with the signing of the GATT in 1947 and subsequently through seven rounds of negotiations. Active support for and participation in the GATT has been the main plank of Canadian trade policy in the postwar years.

However, despite the frequent arguments of economists that on balance Canada harms its interests by using protection, reducing Canada's own protection has largely been viewed in wider public debate only as a necessary price to be paid for the increased access Canadian exporters have gained to foreign markets. This reduced protection has nonetheless increased the penetration of Canadian markets by foreign suppliers,

both those in Canada's major trading partners and those in lower-cost developing countries. And this trend has made Canadians nervous about the threats to jobs posed both directly by import growth and indirectly by the rapid technological changes underlying it.

Despite these developments, until relatively recently the view in Canada has often seemed to be that although important, trade policy is perhaps one of the areas of Canadian economic policy least worth discussing. The outcome of GATT negotiations has largely determined the rules under which Canadian trade takes place, and many believe that as a relatively small nation, Canada cannot realistically hope to have much influence over events. Canada can promote its interests in the detailed negotiations but cannot seriously affect the main drift of developments, which have been seen as determined by the United States, the European Community and — to an increasing extent — Japan. Although policies affecting trade with the United States have rightly been seen as crucial to Canadian interests, the assumption underlying policy making has been that the best avenue through which to pursue Canadian objectives in this area is multilateral negotiation in the GATT. This view was supported by *A Review of Canadian Trade Policy*, published in 1983 by the Department of External Affairs.

However, pressures for a re-examination of this approach to trade policy making are now surfacing from a number of different quarters. In both the Canadian and the international trade policy community, there is widespread concern about whether global trade policy making can continue to rely as heavily on the GATT as it has in the past three decades. In the view of many, international efforts under the GATT, although clearly beneficial both to Canada and to the wider international community, have not been wholly successful in some areas. One is in making headway in significantly limiting the use of such non-tariff measures as quantitative restrictions, voluntary export restraint agreements, orderly marketing agreements, and domestic subsidies. Indeed, many of the current frustrations in the United States, Japan, and Europe with one another's trade policies have their origins in the use of these non-tariff measures. These measures are not satisfactorily covered by the GATT, and the proportion of world trade adversely affected by these arrangements (and thus not lowered by negotiated GATT codes) seems to be growing.

In addition, as a relatively small country, Canada is especially vulnerable to the use of contingent protection (safeguards measures and countervailing and anti-dumping duties) by its larger trading partners, and the uses of this type of protection have not been fully addressed by the GATT. The erection of trade barriers against Canada as safeguards measures or through countervailing duties is especially problematic because of the large adjustment costs Canada faces if market access for Canadian exports is impaired for any length of time. A strengthened

safeguards code did not result from the Tokyo Round even though Canada tried hard to secure such an agreement, and the inability of the GATT to deal satisfactorily with this and other issues of contingent protection remains a major concern. Indeed, some have even cautioned that the attempts made thus far in the GATT to deal with these issues have given international legitimacy to a series of questionable trade practices and that further attempts to negotiate codes on these matters within the GATT could produce even more widespread use of these practices.

Further dissatisfaction with the GATT has come from the developing countries, which see their interests as largely excluded from GATT negotiations. These countries view the GATT as a rich man's club that concentrates on reducing only that protection which affects trade between developed countries but leaves largely unaffected the protection applicable to much of the exports of developing countries. To redress what they see as a structural imbalance in the global trading system, many developing countries would like to see more discrimination in their favour in trade policies but they do not see this as a likely outcome of future GATT negotiations.

Because of these and other concerns, even if a new negotiating round is initiated, some have queried how much further progress toward global trade liberalization can occur under the GATT unless its framework is changed. Institutional change involving the GATT itself is therefore on some people's agenda for trade policy reform.

In the academic community, Canada's trade links with the United States have come under considerable scrutiny. A particularly influential study by Wonnacott and Wonnacott (1967) claimed that large benefits would accrue to Canada were it to enter a bilateral free trade arrangement with the United States. A more recent study by Harris (1984) has also shown large gains to Canada from a more liberal trading order, with most of the benefits occurring through increased trade with the United States. Results of both of these studies have been widely cited as suggesting that in a bilateral free trade arrangement large benefits would accrue to Canada (perhaps in the region of 10 percent of GNP) from being able to exploit economies of scale more fully through increased access to a larger market, and further benefits would arise from the rationalization of Canadian industry.

Although these studies have by no means won unanimous approval in the academic community, they have contributed significantly to the growing pressure for a closer re-examination of Canada's trade policies and to a more direct focus on Canada's bilateral relationship with the United States. Concerns about national sovereignty are acknowledged by these authors, but the thrust of their argument is that if Canada continues to avoid direct negotiation of improved access to U.S. markets on a bilateral basis because of reservations about sovereignty, Canadians must be aware that significant costs are involved.

The security of Canada's access to U.S. markets is another major area of concern. In recent years, Canadians have agonized over countervailing duty cases on such products as softwood lumber that, if successful, would have restricted market access for Canadian exports. Similarly, Canada has faced the threat of safeguards measures through quotas on steel and copper in U.S. markets that would have imposed large adjustment costs on Canada and restricted access to U.S. markets. Improving the security of access to U.S. markets is therefore a dominant theme in other calls for a free trade arrangement between Canada and the United States.

Concerns about the direction of Canada's trade policies have also been fueled by other policy debates on which trade issues impinge. Canada's domestic policies in the past few years, particularly those toward energy and inward foreign investment, have provoked strong reactions abroad. These reactions have raised the issue of how far Canada should go in modifying its domestic policies to offset threats of trade policy retaliation by other countries. In addition, rapid growth in the Pacific Rim countries has led to unease in Canada and other developed countries about competition from cheap imports and threats to job security. Some have suggested that Canada needs to maintain its trade barriers to protect itself from these developments. Furthermore, regional differences in Canada are increasingly seen as making national consensus on trade and other international economic policy issues at best elusive, at worst impossible.

Trade also has links to other international aspects of Canadian policy making. Canada's trade policies tend to be more restrictive toward developing countries than toward other countries, primarily because developing countries export products, such as textiles, that cause Canada major adjustment problems. But the conflicts with Canada's commitment to fostering the development process in these countries is a dilemma. A relatively open immigration policy has traditionally been supported on the grounds that new immigrants help to transfer new technology and ideas to Canada. But if these benefits can be achieved through trade, this argument is weakened and other aspects of immigration policy need to be re-evaluated. Links between trade and exchange rates are another set of issues. Some see the U.S. dollar as currently significantly overvalued, adding to protectionist pressures in the United States, and suggest that reform of the international financial system has to be considered alongside trade liberalization.

## **Issues Addressed in the Research Program**

Canada's place in a changing world and its role in the global trading system have provided the focus of the Commission's research program in economics on trade policy matters. Under this program we commis-



sioned ten studies and held six research symposia. The studies, summaries of the symposia and a selection of papers presented at the symposia make up volumes 10 through 14 of the Commission's research series. Research on related topics was also undertaken by the Commission's research groups in institutions and law.

In designing our research program we have been mindful of both previous work on the issues and constraints on our time and coverage. Two especially important and detailed examinations of Canadian trade policy have been undertaken in recent years, the first by the Standing Senate Committee on Foreign Affairs (1978, 1982) under Senator van Roggen (hereafter referred to as the van Roggen report), the second by the Department of External Affairs (1983) (hereafter referred to as the External Affairs review). These studies provided the basis for some of our own research. Because of the comprehensive discussion of trade prospects for individual industries and sectors in the External Affairs review and the representations made by industry and other groups in the Commission's hearings, we consciously kept the focus of our research on broader issues and focussed on the longer term.

For convenience, our research program has been grouped around three main themes: Canada's place in the world; Canada's links with the United States, and the domestic implications of Canada's trade, investment, and other policies. This grouping provides organizing themes for the papers making up volumes 10, 11 and 12 of the Commission's research series. Volume 13 is a monograph by Richard Harris which examines the theoretical framework of Canada's trade policies. Volume 14 consists of a long study by Bruce Wilkinson on trade prospects in Canada's natural resource industries and a shorter paper by Anthony Scott on Canada's water export policy.

Canada's trade policies encompass many objectives and involve a range of instruments. The need to secure access to foreign export markets requires an overall foreign policy strategy in which achieving trade objectives through negotiation and diplomacy plays a key role. The management of Canada's protective policies clearly reflects the desire to achieve the benefits of trade, but regional issues and the threats to particular industries from rapid market penetration by low-cost suppliers also come into play. Thus Canada's trade policies are not made in a vacuum, divorced from wider policy objectives and the ebb and flow of domestic economic and political pressures. These trade policies reflect the interplay among a number of interacting and competing concerns.

### *The Long-Run Benefits of Lowered Canadian Protection*

Economists frequently make the argument that in the long run, a small economy makes itself worse off by using trade barriers to protect its industries. Protection tends to lower the volume of trade both by reducing imports and by encouraging the use of resources in industries that

substitute for imports rather than in those that produce exports. Domestic consumers have to pay higher prices for both imports and domestic products produced behind the protective barrier. Protectionist trade policies are also often cited as one reason why Canadian industries are relatively less efficient than those in some of Canada's trading partners.

Does this theoretical model really apply to Canada? Some have argued that protection is necessary to develop a secure national market, which is needed to fuel Canada's development. It is also often suggested that protection has encouraged foreign firms to invest in Canada and that without this protection they would merely have serviced the Canadian market from abroad. Lowered Canadian protection is frequently portrayed as leading to an outflow of foreign firms, loss of jobs, and reduced productivity and growth.

The response of those economists convinced of the virtues of free trade has been to argue that Canada's paramount need is for security of access to a larger market and that appropriate policies to encourage foreign investment should be decided independently of trade policies (through tax policies, for example). These economists argue that protection inevitably imposes costs on consumers and that if other effects of trade protection are desired, such as a stimulus to capital inflows, they can be achieved through better means.

How are these arguments to be evaluated and what are the orders of magnitude involved? How much does protection cost Canadian consumers in the long run? What would the impact be on Canadian industries if Canada unilaterally lowered or removed its protection? Would Canadian manufacturing activity have to be reduced, as is frequently claimed, or are there grounds for arguing that the opposite may happen?

### *Adaptation Versus Insulation*

A related topic of debate affecting Canada's trade policies has been whether Canada should use protection to insulate its economy from developments abroad or should allow the economy to adapt and exploit opportunities abroad. Unemployment concentrated in particular regions or industries and linked to import penetration presents a special dilemma for trade policy makers. Compassion suggests helping those affected, but propping up ailing industries or regions is an expensive course of action that imposes costs on other Canadians.

What are the options? Should Canadian policy makers seek to facilitate change by resisting pressures for new protection and slowly removing the protection now in place, giving adjustment assistance to those affected, or should they instead use protection to offset pressures from abroad that lead to dislocation in the domestic economy? Should protection of existing industries such as the textile industry from low-cost foreign competition be continued, on the grounds that short-run adjustment costs outweigh the long-term benefits from freer trade, or should

policies aim instead at facilitating adjustment of labour and other resources out of these industries? How large are the short-run costs associated with adjusting to changes caused by other external events? If an active adjustment assistance program is sought, how should it be designed? Should assistance go to workers or to firms? Should it be provided for a long time or only for short periods to encourage speedy adjustment?

### *The Balance Between Multilateralism and Bilateralism*

During the postwar period Canada has relied heavily on the multilateral approach to international trade policy negotiations pursued under the GATT. Canada was one of the original GATT signatories in 1947 and has actively participated in the seven negotiating rounds held since then. This approach to trade policy has been supported by successive governments. As a smaller country, Canada clearly gains from the resulting increased access to export markets abroad and from a global order based on rules, transparency of trading practices, and non-discrimination.

However, the GATT has changed over time. Its agreements now cover well over 100 countries, both increasing the complexity and slowing the pace of negotiations. While the early GATT rounds were successful in negotiating reductions in tariffs, subsequent rounds, although helpful, have generally been less successful at dealing with the various non-tariff measures that impede Canadian exports in foreign markets. Since 70 percent of Canada's trade is with the United States, does it still make sense to rely so heavily on a multilateral approach to trade policy? The issue is whether bilateral options that are complementary to Canada's use of the multilateral approach should also be explored.

Supporters of the bilateral approach frequently observe that many smaller countries already participate in regional trade groupings, such as the European Community, the European Free Trade Association, the Latin American Free Trade Area, the Caribbean Common Market and the Association of South-East Asian Nations. Canada, however, does not. The growth in regional trade arrangements in the postwar years has taken place despite the GATT and has given many countries more secure access to markets in neighbouring countries than they would have had if they, like Canada, had relied primarily on the multilateral approach.

Should Canada also seek regional trade arrangements through bilateral negotiations with the United States? These arrangements clearly need not and should not exclude Canada's continued involvement in and commitment to the GATT, but they would offer Canada additional room to manoeuvre. The arguments in favour of pursuing bilateral negotiations are that they offer the opportunity to move farther and faster toward both increasing access to Canada's most important export markets and making that access more secure against the use of contingent protection (such as safeguard actions and countervailing duties) aimed at

other countries but nonetheless affecting Canada. The arguments against regional arrangements are that they can divert Canada's trade flows, potentially compromise wider foreign policy objectives, and may impair the ability to negotiate multilaterally. An important benefit from the GATT is the discipline multilateral agreements place on all Canada's trading partners, and there is concern that this discipline may be weakened if Canada enters new bilateral agreements. Indeed, the strongest argument is that any aggressive bilateral or regional initiative on Canada's part could serve to undermine the GATT and eventually harm Canadian interests, especially if there were a strong reaction in Japan, the European Community or both to bilateral negotiations between Canada and the United States.

Nonetheless, the fact remains that Canada is one of the few major developed countries with neither a large internal market nor duty-free access to other large markets. All of Canada's other trade partners among developed countries except the United States and Japan, which have their own large internal markets, have entered free-trade arrangements with neighbouring countries. In addition, it is far from clear that bilateral initiatives undermine multilateral negotiations. The formation of new regional trade groups can accelerate the multilateral process, as some claim happened in the early 1960s following the formation of the European Community.

### *Links with the United States*

Those in favour of actively pursuing the bilateral approach to secure improved market access usually suggest exploring closer links with the United States, since it is Canada's largest export market. Advocates of such a policy base their arguments on both estimates of large gains from improved access to U.S. markets and the security value that improved assurance of access would bring.

But others have questioned whether the gains from free trade with the United States are as large as some studies suggest, and ask what the long-term dangers actually are if Canada's access remains insecure. If there are large potential gains from a formal trade agreement with the United States, Canadians would seem to be forgoing a significant improvement in their living standards by not more actively seeking such an arrangement. But if the gains are not large, it becomes important to assess what factors these studies have missed.

It is also important to clarify exactly what free trade with the United States means in a world of managed trade and complex non-tariff measures. How can these factors be controlled to Canada's satisfaction within the bilateral relationship? Should free trade include capital flows, technology, data, and other service flows? Should a free trade arrangement be broad, covering all sectors and products, or should some

sectors be excluded? Can it be achieved by building on existing proposals for sectoral free trade, or is a new initiative required?

What would the United States ask of Canada in such an arrangement, and how can any possible impairment of national sovereignty be evaluated?

Do these concerns provide a rationale for not pursuing such an arrangement even if such gains are significant and the risks of interruption of access are acknowledged?

### *The Implications of Growing Protection Elsewhere*

A widespread view is that both protection and preferential trade arrangements among groups of countries are on the rise globally and that the trade policy arrangements of the postwar years will not continue in the decades ahead. It is clearly important to Canadian policy makers to know whether protection and trade preferences have in fact increased, as many claim, and how strong the pressures for increased protection are likely to be in the future, particularly in the United States. It is also important to know whether they are growing at such a pace that Canada risks serious harm by not aligning with a regional country grouping, or whether it should instead be even more cautious about such arrangements.

There has been much talk lately in the United States of using the threat of reciprocal trade measures against Japan and other countries to gain increased market access for U.S. exports. These measures would be used where the United States assesses that its exports are being treated unfairly by another country compared to the treatment it gives to imports from that country. This would be a departure from previous U.S. trade policy and reflects a growing mood of international assertiveness characterizing U.S. foreign policy in general. Some U.S. trade policy advisors see such actions as justifiable attempts to "level the international playing field."

To the extent that U.S. measures aimed at Japan or other countries hurt Canada, it seems clear that Canada would be better off negotiating secure access to U.S. markets through a regional trade arrangement before such measures are taken. On the other hand, if reciprocal trade measures in the United States are carefully targetted against these countries, Canada may gain from its preferential position in U.S. markets even in the absence of such an agreement. It would gain further if these countries targetted retaliatory actions against the United States. Put simply, aligning itself with one participant in a trade war can make Canada part of the target for other protagonists, but not aligning itself may make Canada subject to attack from both sides.

### *Canadian Interests in the GATT*

In spite of the difficulties currently confronting the GATT framework of regulation over protectionist policies and their influence on world trade, there are nonetheless important Canadian interests to be pursued within this multilateral approach. Over the postwar years, Canada has gained substantially from both the GATT itself and the various multilateral negotiating rounds organized by the GATT. It has gained increased access to larger foreign markets and benefited from the more widespread application of international rules and order over the international trading system. This is true even though GATT trade liberalization has tended to concentrate on trade in manufactures, in which Canada is a net importer, and this may not have been as advantageous to Canada as more general reductions in trade barriers covering all trade.

How Canada has fared in the most recent Kennedy and Tokyo rounds under the GATT and what this outcome suggests for any future rounds are important questions in assessing its future actions in the multilateral theatre. In a new round, how should Canada approach unfinished business from the Tokyo Round, such as the issue of a strengthened safeguards code for which Canada argued strongly? How might Canadian interests be affected by new initiatives on such issues as service trade or agricultural subsidies? If, as some suggest, the new round is a "Round of the South" as developed countries try to bring developing countries more fully into the GATT process, what initiatives should Canada support, and how might Canada fare?

### *Non-Tariff Measures*

It is now widely agreed that among developed countries at least, the most important trade policies are no longer tariffs but non-tariff measures, such as quotas, voluntary export restraints, and government regulations of various kinds that hinder trade. The proportion of world trade that takes place under arrangements conducted outside GATT rules (such as voluntary export restraints or state trading) seems to be growing, and the GATT has not proved as successful as some would have liked as a vehicle for limiting their use.

Is it true, as is often alleged, that nations other than Canada use these trade policy instruments more extensively than Canada does and, if so, what are the implications? How can Canada manage both its bilateral and multilateral trading relationships if non-tariff measures are on the increase and are difficult to control? What are the reasons for the growth in the use of non-tariff measures? Is there any link to the multilateral reductions of tariffs resulting from negotiated agreements under the GATT? If so, what is implied for Canada's approach to future negotiations in the GATT?

### *Export Promotion and Industrial Strategy*

In recent years, many countries have increased their use of subsidies to promote exports. This is often alleged to be one of the principal reasons for Japan's success in foreign trade. Should Canada also develop more fully a policy of export promotion? Some argue that rapid technological change and the tendency for the efficient scale of production to increase over time require such a policy as part of a Canadian industrial strategy.

There are problems, however. Deciding which products to promote is easy with hindsight but difficult *ex ante*. It is often hard to satisfactorily limit commitments of tax money to minimize losses of public funds. And if such a policy is introduced, there are issues of design. Should support concentrate on promoting industries, firms, projects, or products? How can policies be structured to avoid the risk of countervailing duties by Canada's trading partners? How efficiently and successfully do Canada's existing export promotion policies achieve the objectives set for them?

### *Regional Dimensions of Canada's Trade Policies*

Regional interests enter trade policy debates, like most policy matters in Canada, in ways that are confusing and often little understood. It is often claimed that Ontario and Quebec gain from the federal tariff at the expense of the Western and Atlantic provinces, which are forced to pay more for manufactured products produced in Central Canada and sold to them behind a tariff wall. Quebec supposedly gains from textile quotas, Ontario from the Canada-U.S. Automotive Products Trade Agreement (better known as the Auto Pact), and Western Canada from some features of Canada's agricultural protection. Are these frequently voiced perceptions accurate?

Identifying gainers and losers simply as provinces is not a simple matter, because of increased inter-provincial migration. In addition, many of the regional impacts at issue are more localized than is implied by the usual distinction between heartland and hinterland provinces. For instance, when Ontario buys textiles from Quebec, the prices are affected by import quotas on textiles in just the same way as for the West and the Atlantic provinces.

Irrespective of how the regional impacts of Canadian trade policies are evaluated, Canada's diversity makes a truly national consensus on trade policy a difficult and perhaps even unattainable goal. But how does Canada formulate its trade policy in such circumstances? Should the provinces be given more or less authority in trade policy matters? Has federal-provincial consultation been adequate in the past and how can the process of consensus-building, so crucial to securing Canada's interests in international negotiations, continue? Indeed, how can a federal government negotiate trade policy abroad if provincial governments are not bound by agreements into which it enters? And can Canada's



national trade policy objectives be reached when provinces erect barriers that affect interprovincial trade and capital flows and labour mobility?

### *Financial Markets and Trade Policies*

When proposals to change Canada's trade policies are advanced, it is sometimes argued that the required macro adjustments in the economy will be severe. An area of special concern is that of exchange rate impacts. Will a unilateral removal of trade barriers increase imports and lead to a dollar depreciation? Does this analysis apply equally to the cases of multilateral and bilateral trade policy changes? Would a Canada-U.S. initiative on freer trade involve significant changes in Canada's exchange rate? To what extent can or should Canada pursue an independent exchange rate policy, and what policies would be needed to achieve specified exchange rate targets? If trade policy changed, how would Canadians benefit from attempts to stabilize the dollar at a pre-specified parity?

### *Foreign Ownership in Canada*

Foreign ownership of capital in Canada is large, especially in the manufacturing and resource industries. Even though Canada has been a net exporter of capital on a balance of payments basis in recent years, it remains a significant importer of capital when reinvestment in Canada by foreign capital owners is taken into account. There seems little doubt that the extent of foreign ownership in Canada has been declining in recent years, in part because it has become less attractive to foreign investment.

Does this large foreign ownership of capital imply special problems for Canada's trade and foreign investment policies? Has the past behaviour of foreign multinationals in Canada posed special problems? To what extent do the interests of foreign multinational enterprises run counter to Canada's national interest and to what extent do they coincide? How can the potential of these enterprises best be harnessed to the advantage of all Canadians? What policy changes could Canada institute to attract more foreign investment?

From the 1970s until very recently, the Foreign Investment Review Agency was the major instrument of control over foreign investment in Canada. Should Canada have controls over inward capital flows, and how stringent should these controls be? How severely do controls act as disincentives to inward investment? Do these effects undermine the objectives of both Canada's trade and other policies?

### *Policies Toward the Third World*

In recent decades, Canada has seen itself and been seen abroad as one of the more sympathetic among the developed nations to the problems of



the Third World. With limited strategic or military objectives and the heritage of both the Pearson tradition and Canada's leadership role in the Cancun summit, Canada has had an opportunity to show leadership and compassion for countries and regions that face especially difficult economic circumstances. Yet Canada's aid performance remains below the widely accepted target of 0.7 percent of GNP per year adopted by the United Nations Conference on Trade and Development (UNCTAD), and much of its aid has reduced impact because it is tied in various ways. In addition, Canada's trade policies toward the Third World have become more restrictive in recent years, especially in the area of textiles.

What initiatives can Canada realistically take to help these nations, and what is a sensible price to pay for such endeavours? Should such initiatives be localized to the trade and aid policies Canada pursues toward the Third World, or is there scope for Canadian initiatives on global questions affecting these countries? Can Canada ally itself with other developed countries to help Third World countries more effectively? For instance, should Canada encourage other lending nations to join in examining options on debt rescheduling that could improve conditions for Third World countries in the years ahead? Is there any potential for new trade groupings that might explore the community of interest Canada has with certain Third World countries on trade in resource products or on trade-related investment issues?

### *Immigration Policies and the Canadian Economy*

An important set of links between the Canadian economy and others are those that operate through flows of labour. Immigration policies have historically been a key concern in shaping a development strategy for Canada. In recent years, however, these policies have been little discussed and have grown increasingly restrictive, first under the influence of the 1974 green paper on immigration and more recently through measures adopted in 1982 as a short-term accommodation to recession-induced unemployment.

Some have suggested that relatively liberal immigration policies targeted toward highly skilled migrants is an effective way for Canada to share in the benefits of technological advance abroad. However, flows of technology or capital goods can achieve the same ends as international flows of labour. And if there are benefits of a larger market under a liberal immigration policy, these too can be captured through a more liberal trade policy regime.

What should be the objectives of Canadian immigration policies and what are the best ways to achieve them? Current projections based on present fertility trends and immigration levels suggest that after some years of slowing growth Canada's population will start to fall. How large should the population be and what immigration levels should be

chosen? Can a more liberal immigration policy help offset some of the less desirable effects of the aging of Canada's population?

All the questions presented in this introduction suggest the need for a thorough re-examination of Canada's current trade, foreign investment, and other policies that interact with the external environment. A more thorough discussion is needed than at any time since the debates on the National Policy in the late nineteenth century. The research program in economics on trade policy was designed to provide background information and analysis for the report of the Royal Commission; to contribute to a broader understanding of the political, economic, and historical contexts underlying trade policy; and to lay out the policy options available. This paper provides a summary of the results.



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## Canada's Trade Policies in Context

### Trade, Trade Policies, and Foreign Investment in Canada

A necessary preliminary to any discussion of Canada's trade policy options is a sense of its current trade situation and an appreciation of the main elements of policy at issue.

Canada's foreign trade by major commodity groups with the United States and with all trading partners in 1982 is reported in Table 1-1. In 1982, Canada was a net importer of manufactures, although not on the scale often claimed, and a net exporter of raw materials and resources. Furthermore, manufacturing exports exceeded exports of primary products, although trade in manufactures includes imports and exports of autos and parts with the United States under the Auto Pact. As is shown by Table 1-2, in recent years Canada has had a sizeable surplus on its merchandise trade which has in part financed its deficit on non-merchandise transactions, such as payments of interest and dividends abroad.

Canada's imports and exports by geographical area for 1982 are shown in Table 1-3, and data on the shares of Canada's trade with the United States over time are reported in Table 1-4.<sup>1</sup> The main feature of both tables is the dominance of the United States, which currently accounts for over 70 percent of Canadian trade on both the export and import sides.

The United States accounted for only a little over 50 percent of Canada's exports before the signing of the Canada-U.S. Auto Pact in 1965, and for an even lower proportion in the immediate postwar years. By the early 1970s, however, these trade shares had increased close to the present 70-percent range. In fact, the U.S. share of Canadian exports

TABLE 1-1 Canada's Foreign Trade by Major Commodity Group, 1982 (merchandise trade, Cdn\$ billion)

Commodity Group	Trade with U.S.			Trade with All Partners			Trade with U.S. as Percent of Total	
	Exports	%	Imports	Exports	%	Imports	Exports	Imports
Total	55.42	100.0	47.65	81.71	100.0	67.63	67.83	70.46
of which:								
Agricultural and food products	2.81	5.06	2.95	10.97	13.42	5.22	25.62	56.51
Raw materials	4.05	7.31	1.00	7.09	8.67	1.27	57.12	78.74
Ores & other minerals	1.42	2.55	1.16	4.55	5.57	1.57	31.21	73.89
Fuels	10.37	18.71	2.51	11.71	14.33	6.82	88.56	36.80
Non-ferrous metals	2.03	3.68	0.56	3.39	4.15	0.81	59.88	69.14
Iron and steel	1.34	2.42	0.70	2.00	2.45	1.36	67.00	51.48
Chemicals	3.29	5.94	3.53	4.86	5.94	4.84	67.70	72.93
Other semi-manufactures	5.26	9.49	1.51	6.69	8.18	2.06	78.63	73.30
Machinery for specialized industries	2.45	4.42	5.75	3.36	4.11	7.25	73.09	79.21
Office & telecommunications equipment	1.15	2.07	3.81	1.66	2.03	4.34	69.12	87.93
Motor vehicles	14.80	26.70	11.41	15.90	19.45	13.29	93.09	85.83
Other machinery and transport equipment	4.26	7.68	7.68	6.43	7.87	9.25	66.22	83.02
Household appliances	0.60	1.08	0.94	0.90	1.10	2.03	66.22	46.01
Textiles	0.15	0.26	0.76	0.35	0.43	1.41	41.38	53.98
Clothing	0.16	0.29	0.13	0.26	0.31	1.05	61.90	11.91
Other consumer goods	0.94	1.70	2.37	1.17	1.43	3.85	80.21	61.49

Sources: GATT, International Trade 1982-83, Table A.18, Geneva, 1983, Statistics Canada, *Trade of Canada Exports by Countries*, Table 2, March 1983, Statistics Canada, *Trade of Canada Imports by Countries*, Table 1, March 1983.

**TABLE 1-2 Canada's Balance of International Payments, Selected Years, 1950-83**

	1950	1960	1965	1970	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
						(millions of current dollars)								
Merchandise exports (adjusted)	3,139	5,392	8,745	16,921	32,591	33,511	37,995	44,210	52,511	65,582	77,086	84,480	84,577	91,268
Merchandise imports (adjusted)	3,132	5,540	8,627	13,869	30,902	33,962	36,607	41,473	49,129	61,157	68,293	77,112	66,239	73,227
Merchandise trade balance	+ 7	- 148	+ 118	+ 3,052	+ 1,689	- 451	+ 1,388	+ 2,737	+ 3,382	+ 4,425	+ 8,793	+ 7,368	+ 18,338	+ 18,041
Non-merchandise receipts	1,145	1,823	2,903	5,011	7,761	8,329	9,115	9,903	11,366	11,950	14,305	16,148	16,861	16,913
Non-merchandise payments	1,471	2,908	4,151	6,957	10,910	12,635	14,345	16,939	20,050	21,881	25,423	30,834	33,624	34,261
Deficit on non-merchandise transactions	- 326	- 1,085	- 1,248	- 1,946	- 3,149	- 4,306	- 5,230	- 7,036	- 8,684	- 9,931	- 11,118	- 14,686	- 16,763	- 17,348
Current Account Balance	- 319	- 1,233	- 1,130	+ 1,106	- 1,460	- 4,757	- 3,842	- 4,299	- 5,302	- 4,840	- 1,069	- 5,766	+ 3,017	+ 1,577

*Sources:* Statistics Canada, *The Canadian Balance of International Payments 1978*, Table 1, p. 10, Table 35, pp. 183-85, June 1980. Statistics Canada, *Quarterly Estimates of the Canadian Balance of International Payments, Fourth Quarter 1983*, Table 17, p. 82, April 1984.

TABLE 1-3 Canada's Foreign Trade by Geographical Area, 1982 (Merchandise trade, Cdn\$ billion)

	Imports	Percent of Total Imports	Exports	Percent of Total Exports
United States	48.19	71.25	56.05	68.60
Japan	3.58	5.29	4.47	5.47
European Community	5.79	8.57	7.35	8.99
Other developed countries	5.34	7.90	7.42	9.08
Developing countries	.39	.57	1.21	1.47
Latin America	2.34	3.46	2.20	2.70
Far East	2.00	2.96	3.01	3.69
Total	67.63	100.00	81.71	100.00

Sources: International Monetary Fund, *Direction of Trade Statistics, Yearbook 1983*, pp. 116-17. Statistics Canada, *Trade of Canada, Exports by Countries*, March 1983, Table 2, p. 11. Statistics Canada, *Trade of Canada, Imports by Countries*, March 1983, Table 1, p. 13.

**TABLE 1-4 Canadian Trade with the United States,  
Selected Years, 1961-84**

	Exports to the U.S.	Imports from the U.S.
	(% of total exports/imports)	
1984 <sup>a</sup>	75.7	72.6
1983	72.9	71.6
1982	68.2	70.5
1981	66.2	68.6
1980	63.3	70.2
1979	67.8	72.5
1978	70.3	70.7
1977	69.8	70.4
1976	67.3	68.8
1975	65.1	68.1
1974	66.0	67.4
1973	67.4	70.7
1972	69.3	69.0
1971	67.5	70.1
1966	60.5	71.5
1961	54.5	67.0

Sources: Bank of Canada, *Bank of Canada Review* (December 1984), Tables S136, S137.  
Royal Commission on the Economic Union and Development Prospects for  
Canada, *Historical Statistical Compendium*, 1985, Tables 6.17, 6.19.

a. First 10 months.

fell in the late 1970s and was closer to 60 percent than 70 percent by 1980. Data for the first 10 months of 1984, however, show a further recent growth in this share, with 75.7 percent of Canada's exports going to the United States. The Auto Pact is the major event that has elevated this trade share from already high levels in previous years. Some have gone so far as to suggest that Canada now might well be as fully integrated in its trade with the United States as is California with the other 49 U.S. states.

The relatively small share of trade with both the European Community and Japan, shown in Table 1-3, is also notable. Trade with developing countries is small, with imports from Latin America slightly larger than those from the Far East (excluding Japan). Interestingly, the growth in Canadian trade with the United States has taken place during a period when the third option (increased trade with Europe) has been a prime Canadian trade objective.

Average levels of Canadian tariff protection for groups of commodities as they were in 1976 and as they will be at the end of the Tokyo Round implementation period in 1987 are reported in Table 1-5. Currently, Canada has somewhat higher protection on average than other OECD countries. However, these tariffs are scheduled to be significantly reduced through the implementation of the Tokyo Round tariff cuts. By

**TABLE 1-5 Canadian Tariff Protection (nominal tariff rates by commodity)**

	1976	1987 <sup>a</sup> (projected)
Agriculture		
Meats and dairy products	4.8	4.1
Cereals	2.6	2.5
Other agricultural products <sup>b</sup>	3.2	2.6
Forestry and fisheries	.5	2.5
Mining		
Coal	0.0	0.0
Oil, natural gas	0.0	0.0
Metallic, non-metallic, and other	0.6	0.4
Manufacturing		
Non-durable goods: tea, sugar, coffee, spices, cocoa	8.4	7.8
Alcoholic drinks	6.7	3.9
Other foods <sup>c</sup>	5.0	3.7
Tobacco	20.5	19.2
Apparel and textile products	20.6	18.7
Paper, printing, publishing	9.5	4.9
Pharmaceuticals and toiletries	10.3	8.7
Other chemical and other allied products	7.9	6.9
Petroleum and coal products	8.8	6.7
Rubber and plastics	15.4	12.1
Durable Goods		
Lumber, wood, and furniture	10.4	7.2
Primary and fabricated metals, stone, glass	10.9	7.2
Machinery except electrical	6.5	4.6
Electrical machinery	13.9	6.8
Transport vehicles	10.0	6.6
Scientific and precision instruments	8.8	5.1
Miscellaneous manufacturing	7.6	5.6
Average tariff across all imports	9.5	6.8
Average tariff across imports from the United States	8.5	6.1

*Source:* J. Whalley, "Canadian Interests and the Tokyo Round Trade Agreements" (1980), based on an analysis of GATT data undertaken by the Special Trade Representative, U.S. government.

a. This corresponds to the end of the Tokyo Round implementation period.

b. Other agricultural products include fruits, vegetables, oil seeds, nuts, animal feed, crude animal and vegetable materials, silk, wool, cotton, jute and vegetable fibres.

c. Other foods include animal and vegetable oils and fats, miscellaneous foods, prepared fruit and vegetables, prepared cereals, beverages, prepared meat and fish.



1987, Canada's average tariffs on manufactures will be from 6 to 7 percent. By that time, the Tokyo Round cuts will also have generated comparable reductions in the tariffs of Canada's trading partners.

These tariff estimates must be interpreted with caution since they average duty-free and dutiable items and also provide estimates of nominal rather than effective levels of protection for factors of production employed in various Canadian industries. Many other factors, such as the implications of the valuation formulas used and the distinction between goods made in Canada and those made elsewhere (especially important for machinery), can also affect the degree of protection. It is generally agreed that effective levels of protection in Canada are higher than nominal levels (Wilkinson and Norrie, 1975) because of the low tariffs Canada applies to raw material imports. Unfortunately, there are no other recent studies of levels of effective protection in Canada that enable an assessment to be made of how these levels have changed with implementation of Tokyo Round tariff cuts.

The main features of Canada's non-tariff trade policies are summarized in Table 1-6. Generally speaking, these policies apply on a sector-by-sector basis. Restrictions on imports of textiles and clothing under the Multi-Fibre Arrangement provide substantial protection to the Canadian textile industry, which is heavily concentrated in Quebec. A similar effect operates through quotas on footwear. These restrictions have the effect of raising prices of textiles and clothing in Canada above world prices (inclusive of Canadian tariffs). Canada's main voluntary export restraints apply to imports of autos from Japan.

The Canada-U.S. Auto Pact of 1965 is Canada's most important sector-specific trade policy arrangement. The pact allows for duty-free trade in autos and parts between U.S. and Canadian manufacturers and has been responsible for much of the growth in Canada-U.S. trade in the past 20 years. The pact covers about 25 percent of Canada-U.S. trade and the Canadian portion is heavily concentrated in Ontario.

Agricultural protection operates primarily through supply management marketing boards that operate at both federal and provincial levels. The principal federal marketing boards cover chickens, eggs, and turkeys; the most important provincial marketing boards cover fluid milk. These boards set prices in Canada and protect farmers by controlling flows of imports into Canada, which in turn raises the costs of agricultural produce for consumers. In the case of eggs, for instance, a widely quoted estimate is that in British Columbia, prices are approximately 20 percent higher than in the United States as a result of these controls (Borcherding, 1980, p. 39). Further agricultural items, such as sugar, cheese, coffee, butter, and meat, are on a special import control list for supply management or other reasons.

Energy export policies are a further feature of the Canadian foreign trade regime since, in effect, they impose a set of export taxes on

**TABLE 1-6 Main Features of Canada's Non-Tariff Trade Policies**

*Export restraint agreements covering textiles, clothing, and related industries*

Bilateral export restraint agreements restrict imports of textiles and apparel from 18 countries, most of which are developing countries. These agreements have been negotiated for five-year periods in accordance with the Multi-Fibre Arrangement III, negotiated in 1981. Quotas also apply on imports of footwear, synthetics, and canvas.

*Voluntary export restraints*

The most significant voluntary export restraint covers imports of autos from Japan.

*The Auto Pact*

The Auto Pact of 1965 allows free access into the U.S. market for Canadian motor vehicles and original equipment parts as long as foreign content is less than 50 percent. There is free entry into the Canadian market for U.S. automotive products through bona fide manufacturers of motor vehicles. Under the agreement, these manufacturers must maintain minimum ratios of motor vehicle production to sales and an absolute value of Canadian value-added at least equal to that in the base year of the agreement. If these conditions are not met the Canadian government may impose penalties. In addition to the conditions of the official agreement, the manufacturers agreed in letters of undertaking to both a lump-sum and a sales-related increase of Canadian value-added in the production of motor vehicles and original equipment parts. No sanctions have been laid down against failure to comply with these growth requirements.

*Agricultural protection*

Under supply management programs, marketing boards (for chicken, turkey, eggs, and fluid milk) restrict imports through quotas or bans. Items placed on import control lists for supply management or other reasons include butter, cheese, coffee, sugar, and meat.

*Energy export policies*

Before approving exports of oil and natural gas, the National Energy Board requires that a determination be made of whether Canada has sufficient inventory to meet expected demand for 25 years. In addition, the NEB sets export prices.

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*Sources:* Department of External Affairs, *Summary of Canada's Bilateral Restraint Arrangements, Textiles and Clothing* (Ottawa, July 1983), and J. Whalley, *Regional Aspects of Confederation* (volume 68 of the Commission's research series).

exporters of energy products. In the case of oil, an explicit export tax reflects the difference between controlled prices in Canada and world market prices. These taxes act as a disincentive to oil exporters (Canada exports oil from western Canada to the western United States and imports oil into eastern Canada). Further distortions of Canadian trade occur through the implicit subsidy to energy-using industries, many of which are in central Canada. In the case of natural gas, approval for foreign sales must be obtained from the National Energy Board, which in turn requires that Canada's ability to meet future demand be ascertained. Recently, however, changes have been made in natural gas pricing to liberalize pricing and supply regulations.

Because of the importance of exports to Canada, the trade barriers Canadian exporters face abroad are an especially important part of the overall trade picture. These barriers are summarized in Table 1-7. Average tariff rates on trade with major trading partners are reported, along with an outline of the main non-tariff measures that Canada faces in its export markets. As can be seen, the average tariff rates that Canada faces in most of its markets in developed countries are lower than its own and are projected to decrease further by 1987 and to remain below Canada's.

These data also suggest that Canada already enjoys substantial preferential access to the U.S. market, partly because trade under the Auto Pact is duty-free and partly because a significant portion of Canadian exports to the United States are natural resources that either are duty-free or face low tariffs. However, there are still U.S. tariffs that adversely affect Canada, including tariffs on petrochemical products.

The non-tariff measures Canada faces in foreign markets are more difficult to summarize. In the United States, these barriers reflect mainly government procurement practices and administrative delays that can provide protection to U.S. producers. In the European Community, the Common Agricultural Policy is a major impediment to Canadian exporters, and quotas also apply to such items as pulp. Agricultural policies in Japan have a similar effect on Canadian exporters and Japan also uses a number of devices that make penetration of their market for manufactured products difficult. In Latin America and the developing countries generally, tariffs are considerably higher than in the developed world, as a result of the import substitution policies which are commonly used. These policies are often supplemented by a range of non-tariff measures, the most important of which are import licensing arrangements (quotas). As a result, markets in developing countries tend to be extremely difficult for exporters from Canada and other developed countries to penetrate.

In Table 1-8 data on foreign ownership and control in Canada are reported by industry. Significantly higher foreign ownership is indicated in resource and raw material industries than in manufacturing industries.

**TABLE 1-7 Tariff and Non-Tariff Measures Faced by Canada  
in Major Export Markets**

	Average across 1976	Tariff Rates All Imports 1987	Main Non-Tariff Measures
		(projected)	
United States			Buy-American laws; Surface Transportation Assistance Act (1978); FSC (formerly DISC); administrative delays with customs clearance; countervailing measures.
average on imports from the world	5.7	4.0	
average on imports from Canada	1.8	0.9	
European Community	6.7	4.8	Common Agricultural Policy; government procurement; environmental standards; administrative procedures; preferential access to other European countries.
Japan	7.9	7.0	Complex distribution system; quotas; technical barriers; industrial standards; government procurement; government involvement in developing industries; non-acceptance of Canadian test data; ministry of finance's control over foreign direct investment; discrimination against foreign freight carriers.
Latin America	n.a.	n.a.	Import licensing; foreign exchange controls; regional access preferences; import bans; demands for concessional project financing.
Other developing countries	n.a.	n.a.	Import licensing; quotas; import bans; regional preferences; bureaucratic slowness; lack of transparency in customs and documentation procedures; health standards; priority allocation of funds to essential imports.

*Sources:* After-tariff rates from unpublished data from U.S. Special Trade Representative, Washington, D.C., Department of External Affairs, *A Review of Canadian Trade Policy: A Background Document to Canadian Trade Policy for the 1980s* (Ottawa, 1983), Chapter 6, pp. 154-57.

**TABLE 1-8 Distribution of Ownership and Control  
in Canadian Non-financial Industries**

	Percentage of Capital Employed in Canada Owned by			Percentage of Capital Employed in Canada Controlled by		
	Canada	U.S.	Other Countries	Canada	U.S.	Other Countries
Manufacturing						
1974	48	43	9	43	43	14
1979	53	39	8	49	39	12
1982		n.a.		51	30	11
Petroleum and natural gas						
1974	43	45	12	25	59	16
1979	52	38	10	47	40	13
1982		n.a.		55	35	10
Mining and smelting						
1974	44	45	11	42	45	13
1979	51	36	13	49	37	14
1982		n.a.	57	31	12	

*Source:* Statistics Canada, *Canada's International Investment Position, 1979 and 1980* (67-202), Table XI, p. 32.

Foreign ownership as a percentage of the total Canadian capital stock has been declining in recent years, especially in the petroleum and natural gas industries.

Finally, in Table 1-9 Canada's foreign aid performance relative to that of other developed countries is reported. As can be seen, the current aid flow is less than 0.5 percent of GNP per year, significantly below the target of 0.7 percent of GNP adopted by UNCTAD. Canada's performance is significantly below that of such developed countries as Sweden and Holland, but above that of the United States, Japan and the United Kingdom. In addition, a large proportion of Canadian aid is tied to purchases from Canada; Canada seems one of the least generous of the OECD countries in terms of aid quality — that is, in terms of the degree to which aid is tied.<sup>2</sup>

## **Two Central Issues: Adaptation Versus Insulation and the Multilateralism-Bilateralism Balance**

In evaluations of directions for Canadian policies toward foreign investment, two central questions dominate discussion: protection versus free trade and the balance between multilateralism and bilateralism. The

**TABLE 1-9 Foreign Aid Provided by Canada and Other Developed Countries, as Percentage of GNP, Selected Years, 1970-82**

	1970	1975	1979	1980	1981	1982
Canada	0.41	0.54	0.48	0.43	0.43	0.42
Netherlands	0.61	0.75	0.98	1.03	1.08	1.08
Norway	0.32	0.66	0.93	0.85	0.82	0.99
Sweden	0.38	0.82	0.97	0.79	0.83	1.02
Denmark	0.38	0.58	0.77	0.74	0.73	0.77
France	0.66	0.62	0.60	0.64	0.73	0.75
Belgium	0.46	0.59	0.57	0.50	0.59	0.60
Germany	0.33	0.40	0.45	0.44	0.47	0.48
United Kingdom	0.39	0.39	0.52	0.35	0.43	0.37
Australia	0.62	0.65	0.53	0.48	0.41	0.57
Austria	0.07	0.21	0.19	0.23	0.48	0.53
New Zealand	0.23	0.52	0.33	0.33	0.29	0.28
Japan	0.23	0.23	0.27	0.32	0.28	0.29
Finland	0.06	0.18	0.22	0.22	0.28	0.30
Switzerland	0.15	0.19	0.21	0.24	0.24	0.25
United States	0.32	0.27	0.20	0.27	0.20	0.27
Italy	0.16	0.11	0.08	0.17	0.19	0.24
OPEC countries	1.18	2.92	1.88	1.84	1.50	1.22
Eastern Europe, U.S.S.R.	.15	0.11	0.13	0.15	0.14	0.14

*Source:* OECD, *Development Co-operation, 1983 Review* (Paris, 1983), p. 188.

former is concerned with the choice of trade policies for Canada and the latter with the best strategy to improve Canada's access to foreign export markets.

As far as Canada's protective barriers are concerned, the issue is the extent to which Canadian producers should be protected from forces and pressures arising externally. Economists have long preached the virtues of free trade, based on the argument that long-run gains accrue to Canada from specializing more heavily in producing goods in which it has a comparative advantage. There are, however, internal changes that would occur were Canada to move unilaterally toward free trade. Prices of imports would fall, but Canadian suppliers would also receive less for previously protected products. The issue is usually seen by economists as involving the wider national interest, as represented by Canadian consumers, versus narrower sectoral interests, as represented by both producers' groups and labour unions in protected Canadian industries. This is because in the short run, there would undoubtedly be dislocations caused by any changes in trade policies which would affect such groups. The issue is thus whether Canada is willing to adapt freely to changes in its external environment and seize the opportunities for long-

term gain, or whether some degree of insulation from these events is warranted because of concerns about short-run dislocations.

As far as barriers abroad are concerned, the main issue is the best choice of strategy in negotiating with foreign countries to improve both the scope and quality of market access for Canadian exports. Should Canada follow a multilateral strategy based on negotiating in the GATT, should it pursue a regional strategy focussed on those countries of greatest significance to Canada, most notably the United States, or should both options be pursued simultaneously?

Although the choice between bilateralism and multilateralism is often presented to Canadians as an either/or proposition, in fact it is clear that both strategies can be simultaneously pursued. De facto, Canada has done so in the postwar years, negotiating bilateral arrangements such as the Auto Pact with the United States while at the same time pursuing multilateral negotiations in the GATT. The issue is therefore the best balance to strike between these strategies.

### *Adaptation Versus Insulation*

The choice between unilateral free trade and protection is a classic question analyzed and re-analyzed by economists over many years. Since the days of Ricardo, most economists have argued in favour of free trade, especially for small economies with little influence over the terms at which they can trade on world markets. The doctrine of comparative advantage still dominates much of the thinking on international trade policy. Put simply, this doctrine argues that a country should export those commodities it can produce relatively cheaply compared to the rest of the world and use the proceeds to import goods produced at relatively lower cost elsewhere. The argument is that countries gain by specializing in the production of those commodities in which they have an advantage over other countries, measured in terms of the relative costs of production in each country across all tradable goods. Relative, or comparative, advantage is thus differentiated from absolute advantage. A country could produce all goods more cheaply than its trading partners but still benefit from international trade. The important point is, of course, the emphasis on comparative rather than absolute advantage as the determinant of trade flows.

The paper by James Markusen in *Canada-U.S. Free Trade*, volume 11 of the Commission's research series, explores the issue of how far this theoretical approach applies to Canadian trade. Markusen evaluates the ways in which Canada might gain from a free trade environment and the possible impacts on Canadian manufacturing industries. These impacts have long been topics of controversy among both economists and policy makers. An important aspect of this debate concerns the implications of scale economies in manufacturing. On the one hand, the larger market

resulting from free trade may allow Canadian firms to rationalize their production, resulting in lower prices for consumers, higher real wages or both. On the other hand, Canadian firms may not be able to rationalize their production quickly enough to meet the foreign competition. In this case, free trade could result in more plant closures, increased unemployment, and a general contraction of Canadian manufacturing.

Markusen stresses how free trade in the presence of scale economies can lead to gains to Canada in four distinct senses. (a) Free trade can lead to increased competition and reduced domestic monopoly power in manufacturing, leading to lower prices for Canadians. (b) Free trade may also rationalize production, eliminating production of some goods and expanding outputs of others, again leading to lower prices and costs. (c) The increased market due to free trade may also allow the introduction of new products, leading to gains from increased product diversity. (d) Increased market size may also permit firms to build more specialized plants, thereby rationalizing the number of products produced per plant.

However, there is no guarantee that the benefits accruing from free trade in the presence of scale economies in an abstract model will be realized in practice. The presence of non-competitive behaviour along with large-scale production unfortunately means that unfavourable outcomes cannot be theoretically ruled out. However, Markusen shows that imperfect competition will not interfere with the gains from free trade if production is rationalized — that is, if firms respond to free trade by increasing their output and lowering average cost or if the product in question is withdrawn and replaced by a lower cost import.

Markusen analyzes whether rationalization will accompany a move to free trade. A rationalization effect is more likely if a country is small relative to its major trading partners; if there is relatively free entry into manufacturing; if marginal (as opposed to average) production costs are not significantly higher in the country than abroad; and if the behaviour of foreign firms is competitive rather than collusive. Markusen's own judgment is that the Canadian manufacturing sector is likely to expand as a consequence of free trade.

The application of the doctrine of comparative advantage to Canadian trade policy has always been contentious. Over the years, there has been a strong aversion to an economy in which Canadians are largely “hewers of wood and drawers of water,” even though Canada's comparative advantage has traditionally been seen as lying in its resource industries. As a result, much of Canada's policy making has been devoted toward strengthening the industrial base in Canada even though comparative advantage suggests that this direction is inappropriate. There has also been discussion of engineering or changing Canada's comparative advantage by anticipating trends in new production methods and promoting particular export industries.



Identifying exactly where Canada's comparative advantage lies and how it is likely to change in the years ahead is an extremely difficult task. Even though Canada is a net exporter of primary products (agricultural products and resources) and a net importer of manufactures, these categories are both broad aggregates, and within each there are both exports and imports. Isolating where Canada's comparative advantage lies within these categories is not easy.

For example, Canada was a net exporter of oil in the years before the introduction of energy price controls and the National Energy Program, but became a net importer in the years 1975–81, and is currently a net exporter. It is possible to argue that the introduction of energy price controls had distorting effects that changed Canada's trade pattern from what would have been dictated by comparative advantage. Similar effects may have been produced by provincial taxes on logging. Alternatively, it is quite possible that changes in trade patterns over time may be due to underlying technological factors rather than policy variations. What has been observed in the data could well have occurred even if the policies at issue had not been used.

Because of these and other factors, economists tend to be cautious about their own ability to identify precisely those commodities in which any country has a comparative advantage. Economists do, however, frequently argue that where there are no large economies of scale and no distortions due to trade-restricting policies, freely competitive markets will produce trade patterns in which each country trades according to comparative advantage. Economists therefore tend to favour free trade as their preferred trade policy regime. However, economists are often skeptical about claims that areas of comparative advantage can be determined simply from data on trade flows (the so-called "revealed comparative advantage") because of the large number of potential distortions of trade patterns that can occur.

Despite this skepticism, considerable concern has been expressed that Canada's comparative advantage may be changing and that policy makers need to anticipate the implications of this change for Canada's other domestic policies rather than relying on market-selected comparative advantage to determine trade patterns. As a fraction of total exports, exports of key primary products (such as agricultural and forest products) have been falling over recent decades, while manufacturing exports have been increasing. A number of factors underlie these trends. A major growth in Canadian manufacturing exports followed the Auto Pact in 1965. In the forest products and agricultural areas, there has been additional international competition from suppliers in developing countries. These trends may continue as Canada's primary product exports face further increases in competition in export markets, along with cost increases from diminished availability of resources.

Do these trends in the global economy now require countries such as Canada to select and promote particular industries? One argument for such intervention is that the structure of production in major manufacturing industries requires large-scale operation and that first entrants usually establish a dominant market position. Those holding this view note the apparent successes of Japan and other countries in promoting and supporting particular industries that have become viable export industries.

The difficulty is in identifying the areas in which export potential exists. This problem is reflected in the on-going debate on the pros and cons of industrial policies in Canada and the problems involved in "picking winners." In addition, if Canada actively subsidizes selected industries it risks the introduction of countervailing duties by its trading partners. Furthermore, potentially large commitments of government funds may be involved. Richard Harris, in his commission monograph, *Trade, Industrial Policy and International Competition*, volume 13 of the research series, gives qualified support for such policies. Other economists have generally been more critical.

A further objection frequently made to arguments that Canadian trade policy follow a free trade approach consistent with a classical comparative advantage doctrine concerns adjustment costs — that is, costs stemming from disruptions and dislocations in Canada's industries and regions as Canada adjusts to a free trade regime. One version of this argument is that although there may be long-run benefits for Canada, there are simultaneously large adjustment costs associated with such a change. Put simply, if Canada could design a trade policy from scratch and ignore the current structure of the economy, a free trade posture might be desirable. However, because Canada has had a policy of protecting its manufacturing industry for some years, there are substantial adjustment costs involved in moving toward a free trade regime, particularly for such industries as textiles and smaller scale manufacturing industries in Quebec and other regions. Some industries might not be viable without continued protection, and some single-industry towns might shrink substantially or even disappear. The size of the possible adjustment costs from free trade, for example with the United States, becomes an extremely important consideration, to be balanced against the possible size of the long-run gains.

Another area where adjustment costs arise is in deciding how to deal with foreign competition from low-cost producers. It is often asserted in Canada that such competition is unfair and that domestic industries should be protected. Low-cost competition reflects low wages, low wages reflect unfair treatment of labour abroad, and therefore, so the argument goes, Canada should protect affected domestic industries.

According to the doctrine of comparative advantage, the reasons why foreign countries are able to produce commodities more cheaply than

Canada are irrelevant in deciding what policy is in the Canadian national interest. If commodities can be produced relatively more cheaply abroad, then it is in the national economic interest to allow these imports to enter with no protective barrier. The resources that would be used to produce these goods in Canada can be redeployed more effectively elsewhere, some of them in export industries. But, even so, the question of adjustment costs has to be considered.

Another dilemma is posed by concerns over rapid technical change abroad. The fear is that Canadians will permanently lose their jobs because of increased foreign competition. This issue is similar to the discussion above, in that it also involves a trade-off between short-run adjustment costs and the long-run dictates of comparative advantage. If technical change abroad results in cheaper production of some goods outside Canada, trade gives Canada an opportunity to share in these benefits. Canada's share of these gains will be larger with a free trade policy than under a protectionist policy. But equally, Canada has to be willing to make the necessary adjustments to realize these gains.

### *The Balance Between Multilateralism and Bilateralism*

The second of the key questions in Canadian trade policy involves the choice of strategies directed to securing access to major export markets — particularly choices involving multilateral and bilateral approaches. What combination of multilateral and bilateral strategies is likely to be the best guarantee of Canadian access to vital export markets abroad in the years ahead? Are these two approaches competitive with one another or complementary?

Since the formation of the GATT in 1947, Canada has been a staunch supporter of a multilateral global approach to the regulation of international trading arrangements. There is little doubt that the tariff reductions achieved in the GATT negotiations have significantly increased Canadian access to export markets abroad. The multilateral process tends to be especially valuable for smaller countries such as Canada, because they gain more than larger countries, relative to their own size, from access to export markets. As a smaller country, Canada clearly has a strong interest in a liberal international trading order based on clear rules and backed up by the discipline of multilateral agreements. Multilateralism within the GATT therefore might seem the appropriate trade policy approach for Canada to follow.

However, Canada's situation is unique compared to other smaller countries. Seventy percent of its trade is with one large country, the United States. In addition, trade liberalization within the GATT has concentrated on trade in manufactures, and Canada is a net importer rather than a net exporter of manufactures. In many ways, Canada's

interests are similar to those of the developing countries, since they also export natural resources and raw materials.

Although Canada now has considerable access to the U.S. market, the guarantees of continued access are limited. The recent U.S. countervailing duty case on lumber, which was nearly successful, and the problems Canadian industry experienced due to U.S. global quotas on carbon steel (directed primarily at Brazil, Spain, Korea and other countries, but not at Canada) vividly illustrate this problem. Although the GATT rules played an important part in preventing a countervailing duty from being levied in the lumber case, Canada remains subject to the possibility of significant adjustment costs if its access is threatened again in this or other areas. Even if Canada obtains greater access abroad, the threat that its access may be impaired restricts the degree to which Canada is able to exploit the opportunities created. Canada's interest is clearly in a broad liberal global trading order covering all regions and all products on the basis of firm rules limiting the use of contingent protection. What combination of bilateral and multilateral negotiations would take Canada furthest in meeting that objective?

The multilateralism that has characterized global trade arrangements over the past decade has been very different from the multilateralism of the 1950s and 1960s. Because the GATT has grown in size, negotiations have become increasingly difficult to conduct. The lowest common denominator often seems to determine the outcome. Issues of concern to both Canada and its main trading partners have sometimes not been fully pursued because of Canada's inability to convince all parties to the negotiations of the value of its proposals. Negotiating simultaneously with 130 countries is quite a different matter from negotiating with the original 23 GATT members. Therefore some Canadians find regional trade arrangements — more specifically bilateral trade links with the United States negotiated outside but allowed within the GATT framework — an increasingly attractive supplement to multilateral efforts. This position is argued forcefully in the van Roggen report (1978, 1982).

Advocates of bilateral initiatives on Canada's part do not discount the multilateral approach, since multilateralism and bilateralism can coexist as separate planks of a global Canadian trade policy. These advocates argue, however, that under a multilateral system where non-tariff barriers are permitted and increasingly used, frustrations can occur in negotiating further reductions in trade barriers multilaterally. More progress may be possible down a bilateral route.

The question therefore becomes whether active pursuit of a bilateral trade arrangement could potentially damage Canada's ability to negotiate improved access multilaterally. If so, Canada might be made worse off by initiating negotiations with the United States as a supplement to its multilateral efforts.

Whether a small country could significantly undermine the GATT process at present by pursuing active bilateralism seems questionable. The argument, however, is that the larger countries and country groupings that determine global trade policies (in particular the European Community, the United States, and Japan) view one another's trade policies with growing alarm. The formation of the European Community in 1958 was a major departure from the multilateralism that had earlier characterized the GATT, because it created a geographically discriminatory trade arrangement. Any further move toward geographically discriminatory policies by one of the major global trading powers will not be welcomed by the others. Canadians who oppose bilateral arrangements argue that for precisely these reasons, the United States is likely to rebuff any initiative by Canada. Furthermore, if a bilateral arrangement were agreed to, it would raise the level of trade friction for both countries with Japan and the EC, leading to further fragmentation of global trade policies that could be harmful to Canada in the long run. These considerations, however, are highly speculative.

The formation of the European Community accelerated multilateral GATT negotiations in the 1960 Dillon Round because the United States needed a means of negotiating with the new, larger economic unit. A similar event could occur in the future were Canada to move more aggressively down the bilateral route and negotiate bilaterally with the United States. Indeed, it could be argued that Canada's influence over the eventual outcome of multilateral negotiations might be larger today if it had been involved earlier in a bilateral negotiation with a dominant trading power such as the United States, since Canada's bilateral arrangement might in part determine the agenda for a subsequent multilateral negotiation.

In addition, it may still be the case that Canada would gain from a joint bilateral/multilateral approach to trade policy even if its ability to negotiate multilaterally is impaired. A successful bilateral negotiation that GATT partners assess as consistent with the GATT would yield not only more secure access but also preferential access to U.S. markets. This is the type of access already achieved by Canada under the Auto Pact, which gives Canada access to the U.S. market that is denied to other competitors. Since 70 percent of Canada's trade is with the United States, the gains of developing that particular trading link may make bilateral negotiation desirable even if potential gains on the other 30 percent of Canada's trade are impaired.

These two issues are central to current discussions of Canada's trade policies and are returned to repeatedly in the sections that follow.

## **A Retrospect on Canadian Trade Policies**

Also central to an evaluation of Canada's options with regard to future trade policies is a sense of the historical context of its present trade policies. Alternative positions on various options available to present-day policy makers can often usefully be understood by first laying out both the winning and losing arguments made in previous policy debates. Table 1-10 outlines some of the events that have been central to trade policies since Confederation, and Table 1-11 summarizes some of the main events involving the GATT since 1947 that have been of special importance to Canada.

As has already been indicated, trade policy has been especially important in the historical development of Canada, since the origins of the nation itself lie partly in trade policy conflicts. Before Confederation, a reciprocal free trade treaty with the United States covering primary products was negotiated. The U.S. withdrawal from this treaty in 1866 was one of the factors leading to Confederation in 1867.

The debates on economic policy in the immediate post-Confederation period repeatedly stressed the advantages of participation in a large, secure market. In this period, a series of attempts were made to secure access to both British and U.S. markets through negotiated trade agreements. These attempts proved unsuccessful and in 1879 the National Policy was introduced, with tariffs as one of its major instruments. From the debates of the time, it is clear that protection was seen as a second-best policy compared to free trade with the United States. This view changed in the decades that followed.

The National Policy established that westward settlement would be encouraged by transportation subsidies. In turn, transportation development would promote market growth in the West and aid the process of nation-building. These markets were to be preferentially secured for producers in central Canada behind the protective barrier of the national tariff. High Canadian tariffs would also produce higher wages, which would reduce outward migration to the United States and encourage immigration from Europe.

The history of trade policy in Canada from the time of the National Policy onward has largely been one of redefined protectionism. In the early part of the twentieth century, tariff protection was modified to operate on three separate levels, with different tariffs for different trading partners. The United States and other countries that had not negotiated a special treaty with Canada were subject to the highest level, the General Tariff. Countries that had negotiated special treaties were subject to a lower level, and the lowest tariffs applied to goods from countries within the British Empire. This preferential treatment was not reciprocated until 1932, when the Commonwealth System of Preferences was established.

**TABLE 1-10 Evolution of Trade Policies in Canada**

1854	Reciprocity Treaty (Elgin-Marcy Treaty) concluded with the United States. Terms include free trade in primary products such as fish, lumber, grain, and coal. The treaty was to last ten years, at which time twelve months notice had to be given if either country wanted to be discontinued.
1866	United States withdraws from the Reciprocity Treaty.
1867	Canadian Confederation.
1868-97	Canadian tariff policy include a standing offer of reciprocity with the United States along the lines of the 1854 treaty.
1869	The Canadian minister of finance visits Washington, offering free or equal access to Canadian fisheries and canals and reciprocal free entry of certain manufactures in return for free entry of Canadian natural products to the United States. U.S. government not interested.
1870	Bill introduced in Canadian Parliament that would provide for a commercial union between Canada and the United States.
1871	Great Britain and United States conclude the Treaty of Washington to regulate the use of inshore fisheries and national waterways between Canada and the United States. Sir John A. Macdonald proposes renewal of 1854 treaty to compensate Canada for opening her fisheries and waterways. Americans refuse to negotiate on that basis.
1874	Liberal government sends an envoy to Washington to assist the British in drafting a treaty that includes a tariff-free list of natural resources and a substantial number of manufactured articles. U.S. Senate refuses to consider the draft treaty because the Canadians insisted on extending any free trade arrangements to include Great Britain.
1879	Macdonald's National Policy introduced, aimed at providing a secure national market for Canadian manufactures. Government support for westward settlement intended to strengthen this market, which in turn would be encouraged through the development of a national transportation system.
1891	Canadian government agrees to send a delegation to Washington to negotiate a trade agreement with the United States. Negotiations fail.
1896	Laurier proposes reciprocity with the United States but is turned down. He says, "There will be no more pilgrimages to Washington. We are turning our hopes to the Old Motherland."
1897	Fielding introduces the Dominion Tariff. This tariff increases many duties but contains separate tariffs toward the United States, allowing Canada to retaliate against the American Dingley tariff rates without raising the general level of tariffs in Canada. Tariff preferences toward the British go unreciprocated.
1907	Establishment of a triple-schedule tariff in Canada, with the United States subject to the highest tariffs.



**TABLE 1-10 (Cont'd)**

1909	Payne-Aldrich tariff on newsprint introduced in the United States, enabling the United States to impose maximum rates against countries that discriminate against the United States.
1910	Laurier is confronted by farmers in western Canada wanting reciprocity with the United States, especially in farm implements. United States charges that Canadian concessions to France in 1906 constituted discrimination against the United States, and that they would unwillingly have to enforce maximum rates of the Payne-Aldrich Act against Canada. U.S. delegation goes to Ottawa in March. Canada is ready to negotiate reciprocal trade concessions with the minimum tariff as a basis.
1911	<p>Agreement reached with the United States in January for free trade to be enacted by concurrent legislation. The agreement provides for free trade mostly in primary products and a small number of manufactured products, such as iron and steel sheets, and reciprocal tariff reductions on a wide range of other articles. Of particular significance is the duty-free access for Canadian newsprint to the United States. In the United States, Taft has much difficulty getting bill passed.</p> <p>In Canada, debate in Parliament forces Liberals to call a September election.</p> <p>During the election campaign, the Conservatives show strong imperialist sentiment. They stress that free trade with the United States would mean increased competition for Canadian farmers because of the earlier U.S. growing season; would jeopardize relations with Britain; and would risk importing U.S. economic difficulties such as unemployment. The Liberals stress the benefits of a larger market under free trade.</p> <p>Results: Laurier (Liberals) loses; Borden (Conservatives) wins; reciprocity defeated.</p>
1913	Prospects for free trade with U.S. undermined for extended period. Underwood tariff allows for duty free access of Canadian newsprint.
1921	United States introduces emergency tariffs.
1922	United States introduces Fordney-McCumber tariffs.
1930	Canada introduces higher tariffs. United States introduces Hawley-Smoot tariffs.
1932	Agreement at the Ottawa conference produces British Preferential Trading System — first instance of reciprocated Imperial Preference. United States increases revenue duties.
1933	“Buy America” Act implemented in the United States, providing a preference margin of 6 percent for a domestic bid over a foreign bid (including duties). Preference raised to 12 percent if the domestic bidder is a small business.
1934	United States introduces Reciprocal Trade Agreements Act (Roosevelt Good Neighbor Policy)



**TABLE 1-10 (Cont'd)**

1935	Canada-U.S. Bilateral Agreement. Canada grants United States most-favoured nation status and, in some products, tariff reductions below intermediate rates.
1937-38	In return for U.S. tariff reductions, Canada and Britain further reduce tariffs and remove some of their preferences. Canada and United States on MFN basis, but Canada maintains Commonwealth preferences.
1941	Hyde Park Declaration. Bilateral cooperation in the defence field agreed between Canada and the United States (Defence Production Sharing Agreement).
1942	Canada agrees in an exchange of notes with the United States to work toward a reduction in tariffs.
1943	Canada prepares to abolish preferences in the tariff schedule, provided the United States and United Kingdom are willing to make compensatory tariff reductions. Polls in Canada indicate strong support for free trade with United States reflecting strong internationalist sentiment during the war.
1945	Canada hopes United States will make "multilateral horizontal" tariff reductions (major across-the-board cuts). Congressional pressure opposes these cuts, only selective cuts possible. British continue to link willingness to remove Imperial Preferences to sweeping American tariff cuts. Congress does not agree.
1946	Canada raises its dollar to parity with American dollar. Consideration given to a reciprocity arrangement with the United States to strengthen Canada's dollar position and lessen dependence on European markets.
1947	Canadian dollar position regarded as serious. Canadian government declares itself willing to enter into a free trade agreement even if this necessitates a major readjustment and reorientation of Canada's international trade. Canadian government imposes "dollar-saving" restrictions the same day it signs the GATT.  GATT Treaty signed in October. Seven negotiating rounds under the GATT occur between 1947 and 1980 (see also Table 1-11).
1948	Canadian and American negotiators settle on the basis for a general trade agreement. Included are the immediate removal of all duties by both countries; the prohibition of all quantitative restrictions on imports after five years (with important exceptions on both sides); the inclusion of the right of both sides to impose absolute transitional quotas on certain products during the five-year period, and joint consultation on agricultural marketing. Prime Minister King pressed by advisers to move forward but flatly refuses, "I stressed strongly that regardless of what the economic facts might be, the issue would turn on union with the States and separation from Britain."

**TABLE 1-10 (Cont'd)**

1957	Rome Treaty establishes the European Community, comprising Belgium, Luxembourg, France, the Netherlands, the Federal Republic of Germany and Italy. Treaty signed in March, comes into force January 1, 1958.
1959	Stockholm Convention establishes the European Free Trade Association to come into force July 1, 1960. The area consists of Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom, with the purpose of establishing a free trade area through the gradual elimination of tariffs on industrial goods and the progressive reduction of import quotas.
1960	Montevideo Treaty establishes the Latin American Free Trade Association (LAFTA), comprising Brazil, Chile, Peru, Uruguay, Argentina, Mexico and Paraguay.
1961	Short Term Agreement on Cotton Textiles concluded, regulating trade in textiles through quotas for a transitional period to allow developed countries to adjust to competition from developing countries. Agreement subsequently renewed and expanded into Multi-Fibre Arrangement.
1964	Kennedy Round GATT Trade Negotiations begin in Geneva.
1965	Canada-U.S. Automobile Products Trade Agreement (Auto Pact) concluded, provides for conditional duty-free trade between Canada and the United States in original equipment, automotive parts, and accessories (except tires and tubes) and in all but specialized types of motor vehicles.
1967	Conclusion of Kennedy Round (see Table 1-11).
1968	Canada and the United States disagree over interpretation of the objectives of the Auto Pact and the retention of the Canadian safeguard conditions. This marks the beginning of continuing differences over the Auto Pact, generally resolved following bilateral negotiations.
1969-70	Increasing global integration and interdependence are factors causing both Canada and the United States to undertake major reviews of foreign policy approaches and positions.
1970	Canada adopts floating exchange rate regime. The Canadian dollar moves toward, and then above, parity with the U.S. dollar.
1971	The Nixon administration, in reaction to continuing U.S. balance-of-payments problems, takes the United States off the gold standard, devalues the U.S. dollar and imposes a surtax on imports (motor vehicles imported from Canada are exempted). Canada is unsuccessful in seeking exemption from surtax, the first time after the Second World War that Canada is not excluded from a major U.S. economic policy action.
	Domestic Investment Sales Corporation (DISC) introduced by the United States. Canada counters with a reduced corporate tax rate for manufacturing industry (manufacturing and processing incentive).

**TABLE 1-10 (Cont'd)**

1972	<p>The "special" economic relationship is officially ended by President Nixon in his address to the House of Commons. "It is time for Canadians and Americans to move beyond the sentimental rhetoric of the past. It is time for us to recognize that we have very separate identities; that we have significant differences, and that nobody's interests are furthered when these realities are obscured."</p> <p>Canada adopts an Import Surveillance Program designed to identify export-tied tax reductions abroad, such as offered under DISC.</p>
1973	The Foreign Investment Review Act in Canada establishes FIRA.
1974	U.S. Trade Act initiates Tokyo Round Trade Negotiations in the GATT. Includes a provision authorizing the president to negotiate bilateral free trade agreements with North American countries, and Mexico. The Trade Act signals a switch from trade policy as an instrument of overall U.S. foreign policy, to trade policy as an explicit instrument of U.S. economic self-interest.
1976	The Canadian dollar falls sharply against the U.S. dollar, resulting in a 25 percent devaluation by mid-1982.
1978	The Standing Senate Committee on Foreign Affairs (van Roggen Report) recommends that serious consideration be given to bilateral free trade with the United States.
1979	U.S. Trade Agreement Act concludes Tokyo Round Negotiations.
1983	<p>External Affairs issues a Review of Foreign Trade Policy and suggests that the government consider the advisability of sectoral free trade with the United States in urban transport equipment, textiles, agricultural equipment, and petrochemicals.</p> <p>Task Force on the Automobile Industry recommends content provisions apply to all autos sold in Canada.</p>
1983/84	Series of cases involving the possibility of countervailing duties and safeguards measures in the United States cause alarm in Canada. Softwood lumber, carbon, steel, copper, and pork are all threatened with trade restricting measures which would adversely affect Canadian access to U.S. markets.
1984	Generally positive reaction by the United States to the free trade initiative. Red meat and computer services added to the list of items for consideration.

*Sources:* D.C. Masters, *Reciprocity 1846-1911*, The Canadian Historical Association Booklets, No. 12 (Ottawa, 1969); Sperry Lea, *A Canada-U.S. Free Trade Arrangement: Survey of Possible Characteristics* (Washington, D.C., 1963); Department of External Affairs, *A Review of Canadian Trade Policy* (Ottawa, 1983); L. Ethan Ellis, *Reciprocity, 1911: A Study in Canadian-American Relations* (New Haven, 1939); J.H. Young, *Canadian Commercial Policy*, Royal Commission on Canada's Economic Prospects (Ottawa, 1957); Robert Cuff and J.L. Granatstein, "The Rise and Fall of Canadian-American Free Trade, 1947-48," *Canadian Historical Review* 58 (December, 1977).

**TABLE 1-11 Evolution of the GATT**

1947	General Agreement drawn up in Geneva in October 1947. This is seen as a trade agreement designed to record the results of a tariff conference that was to be the first of many conducted under the auspices of the International Trade Organization (ITO), and an extension of the U.S. initiatives in the Atlantic Charter and Mutual Aid Agreements. The main influences on this process were the earlier views of President Roosevelt and Cordell Hull on international cooperation to reduce trade barriers. U.S. position is that non-tariff barriers should be abolished and that all tariffs should be reduced through international negotiations. First round of negotiations is held in Geneva in April. These proceed on a product-by-product basis with all members of the Preparatory Committee (except the U.S.S.R.). The 23 GATT signatories make commitments to lower or bind approximately 45,000 tariff rates. They are Australia, Belgium, Brazil, Burma, Canada, Ceylon, Chile, China, Cuba, Czechoslovakia, France, India, Lebanon, Luxembourg, Netherlands, New Zealand, Norway, Pakistan, South Africa, Southern Rhodesia, United Kingdom, and the United States.
1948	In March, Havana Charter for establishment of the ITO to succeed GATT completed.
1949	Second GATT Round held at Annecy, France. Eleven countries participate and further tariff bindings result.
1950	The Truman administration decides not to seek Congressional approval of the ITO Charter. Charter considered a complicated document that allows too many trade restrictions as exceptions to stated free trade principles.
1951	Third GATT Round held in Torquay, England. The United Kingdom, Germany, Austria, Korea, Peru and Turkey join. Agreement to "rebind" concessions agreed to at Geneva and Annecy. When added to the new concessions negotiated at Torquay, more than 55,000 tariff rates covering a large part of world trade are stabilized until 1954. Rules adopted by the Contracting Parties for future negotiations stipulate that the binding of a low duty or of duty-free treatment is to be recognized as a concession equivalent in value to the substantial reduction of high tariffs, or the elimination of tariff preferences.
1956	Fourth GATT Round held in Geneva. Japan joins; the first time that all major non-communist developed countries participate.
1960-61	Fifth GATT Round (Dillon Round) held in Geneva. First part of round devoted to tariff adjustments brought about by the formation of the European Community. The remainder was devoted to normal negotiations.  Short-term Arrangement Regarding Trade in Cotton Textiles introduced — initially to last 12 months.

**TABLE 1-11 (Cont'd)**

1962	<p>U.S. Trade Expansion Act initiates Kennedy Round. President given authority to reduce tariffs by a maximum of 50 percent from rates existing on July 1, 1962. Proposed reductions are to be spread over a period of 5 years. Administration declares its intent to offer linear cuts on existing duties.</p> <p>Long Term Arrangement for Cotton Textiles to last 5 years — later extended until 1973.</p>
1964	<p>Sixth GATT Round (the Kennedy Round) begins in Geneva. Four major changes occur relative to earlier rounds. (1) Negotiations take place on a multilateral basis, with concept of general linear tariff reductions introduced. (2) Negotiations on certain non-tariff measures are included — principally anti-dumping codes and customs valuation procedures, particularly the American Selling Price. (3) Less developed countries are permitted to participate in negotiations on a less than fully reciprocal basis. (4) United States insists that negotiations guarantee acceptable conditions of access to world markets for agricultural products.</p>
1967	<p>Results of conclusion of Kennedy Round. (1) Duties reduced an average of 35 percent on 60,000 traded industrial products. (2) Major industrial countries lower duties on about 70 percent of the value of their dutiable imports in 1964; tariffs on almost two-thirds of these dutiable imports cut 50 percent or more. (3) Sectoral negotiations initiated in aluminum, chemicals, pulp and paper, steel, textiles and agriculture. (4) American Selling Price system eliminated in return for concessions on other non-tariff measures, especially the European automobile taxes based on horsepower. (5) New anti-dumping code requires determination of injury to be made only when authorities are satisfied that dumped imports are demonstrably the principal cause of injury.</p>
1970	<p>Agreement reached in UNCTAD for a Generalized System of Preferences allowing developed countries to extend preferential tariff rates to developing countries.</p>
1973	<p>Britain, Denmark and Ireland became full members of the European Community. The Seventh GATT Round (the Tokyo Round) is initiated with the following objectives. (1) Negotiations open to non-GATT member countries as well as GATT members. (2) Tariff negotiations based on linear, across-the-board reductions. (3) Non-tariff measures to receive particular attention. (4) Negotiations on trade in agricultural and tropical products to recognize problems particular to these sectors. (5) Developing countries to be accorded "special and more favourable treatment". (6) Some possibility of sectoral negotiations as a complementary technique.</p> <p>Multi-Fibre Arrangement enlarged coverage to include synthetics and woolsens.</p>
1974	<p>Canada implements General Preferential Tariff Scheme directed at Developing Countries.</p>
1978	<p>Multi-Fibre Arrangement II negotiated to last 5 years.</p>

**TABLE 1-11 (Cont'd)**

1979	Conclusion of the Tokyo Round. (1) Industrialized countries agree to reduce their duties on many thousands of products over an eight-year period beginning January 1, 1980. (2) Tariff concessions agreed to by Austria, Canada, the EC, Finland, Japan, New Zealand, Norway, Sweden, Switzerland and the United States. Reduce the level of all industrial tariffs by about one-third of their pre-Tokyo round levels. (3) Agreements reached on a range of non-tariff measure codes covering government procurement, standards, customs valuation and administration and other items.
1981	Multi-Fibre Arrangement III negotiated to last 5 years.
1982	GATT ministerial meeting in Geneva discusses trade issues. United States raises the issue of agricultural protection in European Community through common agricultural policy. GATT Work Program initiated.
1983	Possible content of a future multilateral trade negotiation raised at Williamsburg summit. No concrete proposals made. Concern over reciprocity proposals in the United States.
1984	U.S. State of the Union Message mentions the possibility of a new GATT Round. Major issues likely to be service trade issues, agricultural non-tariff measures, a new safeguards code and graduation proposals for less developed countries.

*Sources:* Fred Lazar, *The New Protectionism: Non Tariff Barriers and Their Effects on Canada* (Ottawa, 1981); Kenneth W. Dam, *The GATT: Law and International Economic Organization* (Chicago, 1970); Frank Stone, *Canada, The GATT and the International Trade System* (Montreal, 1984); GATT, *What GATT Is and What GATT Has Done* (Geneva, 1964); GATT, *GATT in Action* (Geneva, 1952).

In 1911, with the defeat of Laurier in the general election (where the Conservatives carried the day on a sentiment of "no truck or trade with the Yanks"), protectionist sentiment in the country was firmly established. Protectionist policies were henceforth regarded by successive governments as a political given that no politician seeking or trying to retain office should try to alter. This policy direction continued into the early 1930s, with the Commonwealth System of Preferences taken one stage farther at the 1932 Ottawa Conference.

The key events that were to shape Canadian trade policies in the postwar years were, however, taking place elsewhere, primarily in the United States. Under the pressures created by the Great Depression, protection everywhere in the world had been raised to much higher levels. The Roosevelt government became convinced that the Depression had been exacerbated by global protectionist trade policies, and therefore began its Good Neighbor Policy. The major element in this policy was a series of bilateral reciprocal trade arrangements, negotiated first with its major trading partners and then extended more widely

through the concept of most favoured nation status. Countries given this status benefited from tariff reductions the United States negotiated bilaterally with any nation. Canada was among the first to negotiate bilateral arrangements, and between 1935 and 1938, a series of agreements substantially reduced the levels of protection in both countries. These agreements marked a major change in Canadian policies from those of earlier years.

The bilateral agreements of the United States, Canada, and other countries during the interwar years set the stage for the emergence of the GATT after World War II. As part of the reconstruction of Europe, and with the Good Neighbor Policy still in place, the United States initiated a series of arrangements under the auspices of the United Nations, culminating in the GATT, drawn up in 1947. At the time, the GATT was seen as a temporary device intended only to record the outcome of a conference arranged to negotiate reductions in tariffs and eventually to be replaced by the more wide-ranging International Trade Organization (ITO). However, the United States was subsequently unwilling to ratify the ITO treaty, which was seen as a document containing too many compromises of basic free trade principles. From these beginnings, the GATT has subsequently expanded its coverage of both countries and trade policy issues through a series of multilateral negotiations that have largely defined global trade policies in the postwar world, certainly as far as trade in manufactures is concerned.

As a framework for regulating world trade, the GATT embodies a series of key principles. A central principle is non-discrimination, the idea that whatever concessions or obligations are negotiated under the GATT framework by one signatory are to be extended to all others. Related to this principle is the concept of national treatment — once commodities pass national borders and are behind trade barriers such as tariffs, they should be treated equally with domestically produced commodities. Equal treatment would rule out discriminatory sales taxes on imports for example. The GATT also seeks to achieve transparency in trade barriers, with a strong presumption that all trade barriers should eventually take the form of tariffs, which can then be negotiated down between the GATT signatories.

Although the principle of non-discrimination has been breached in the accords resulting from the recent Tokyo Round negotiations, progress has been achieved in GATT negotiations over the years. With the exception of trade within the European Community and European Free Trade Association, the geographically discriminatory trade policies of the prewar years (such as Commonwealth preferences) have become less prominent. Regional trade groupings (such as the EC and EFTA) have been accommodated in the GATT even though they run counter to its spirit and are widely seen as doing so. However, *de facto* discrimination has been possible in the GATT through the selection of commodity groups

or issues covered. Both the requirement of reciprocal negotiation and the leading role played by the North Atlantic economies have resulted in discriminatory effects against some countries, especially in the developing world.

A strong feature of the GATT as it has evolved has been its stress on multilateralism. The idea has been to replace the bilateral trade arrangements that characterized the prewar years by global agreements that aim to rationalize and coordinate the trade policies of all countries. As a result, discussions on trade policy issues within the GATT have been focussed on a series of multilateral negotiating rounds.

Seven GATT negotiating rounds guided by these principles have taken place since 1947, and Canada has fully participated in them. In the first five rounds (those preceding the Kennedy Round, which began in 1964), the reductions achieved in trade barriers were relatively modest. Tariff rates were bound and small reductions in tariffs were achieved. Trade liberalization during this period was also restricted by fixed exchange rates and the presence of exchange controls.

More important steps toward global trade liberalization were achieved under the Kennedy Round, from 1964 to 1967. In contrast to the limited product-by-product negotiations used in earlier rounds, a general-purpose-formula approach to tariff reductions was adopted. By and large, this was modelled on the 50-percent-linear-cut approach proposed in the round by the United States. Although there were many exceptions to the general-formula cut in the final agreement, the process of initially proposing general reductions and discussing exceptions only later significantly broadened the coverage of GATT negotiations. A new code on anti-dumping duties defined the conditions under which countries could impose duties on other countries dumping in their markets. During this period, there was also substantial pressure to give the developing countries preferential market access on a limited range of products through a system of nationally administered special preferences. These preferences were introduced in 1970.

Although in many ways the Kennedy Round was the pinnacle of achievement of the GATT, it also sowed the seeds of some later problems. The contingent protection incorporated in the original GATT treaty through the safeguards code and taken further in the Kennedy Round has been viewed by some observers as one of the main causes of the non-tariff measures that have been more prevalent since the 1970s. The Kennedy Round also involved an undertaking by the United States to eliminate the American Selling Price system (the use of national values, higher than the market price, in calculating tariffs of certain products), which was generating doubts about the significance of agreements entered into under the GATT. Lastly, problems with the procedures for enforcement and the settlement of disputes in the GATT that had been



present in earlier years became more evident as efforts were made to move forward from the Kennedy Round.

In the seventh and most recent round, the Tokyo Round, 99 member and non-member countries participated in negotiations on an across-the-board basis. Canada had been granted some exemptions in the Kennedy Round, but took part in the Tokyo Round negotiations on the same basis as the rest of the participants. Although Canada favoured sectoral negotiations as the best means to reduce tariffs and non-tariff measures, a broader formula approach prevailed. The results were an average weighted depth of tariff cut of close to 40 percent on Canadian exports to the United States, the EC, and Japan taken together. The average reduction in Canadian tariffs was comparable. However, in the areas of textiles, footwear, clothing, and ships, Canada made relatively small or no reduction in tariffs.

By 1987, when implementation of the agreement will be completed, well over 90 percent of Canadian exports will enter the United States at tariffs of 5 percent or less, and a significant percentage of exports will be duty free, including trade under the Auto Pact. The average Canadian tariff on dutiable industrial imports will be reduced to between 9 and 10 percent.

The Tokyo Round also included new codes on non-tariff measures affecting countervailing duties, customs valuation, and licensing practices. On the agricultural side, concessions covering over \$1 billion worth of Canadian exports were exchanged with Canada's major trading partners. Included were improved access for Canadian whiskey to the United States, the EC, and Japan. An important concession was also obtained for Canadian exports of aged cheddar cheese to the EC and the EC also granted Canada a sizeable tariff quota for high-quality beef. However, Canada was unsuccessful in achieving the strengthened safeguards code it sought.

Although the outcomes of these GATT negotiations have yielded major benefits to Canada, a number of recent developments have cast doubt on the prospects for comparable progress in the future. A particularly important development is the trend since the Kennedy Round for countries to settle trade policy disputes bilaterally, outside the GATT. Conflicts between the United States and Japan during the past decade, for example, have resulted in a series of voluntary export restraint agreements concluded outside the GATT framework. Similar voluntary export restraint agreements between Japan and the EC cover video cassette recorders, autos, light commercial vehicles, forklift trucks, motorcycles, television sets and tubes, machine tools, and quartz watches (around 38 percent of Japan's exports to the EC in 1983).<sup>3</sup> Differences between the EC and the United States over steel have produced a series of arrangements that have changed over time but have included orderly

marketing agreements, trigger price mechanisms, and quotas. Canada has not participated to the same degree as these larger trading powers in discussions on these arrangements because it is too small to be a major source of trade irritation for the larger world powers. However, the trend toward resorting to non-GATT agreements has made Canada more concerned about guarantees of access, because of the erosion of the GATT non-discrimination principle.

It is increasingly apparent to Canadians that during the postwar years, the rest of the world has not maintained the same allegiance to the spirit of the GATT that Canada has shown. Separate geographical trade arrangements now exist in many regions of the globe. Canada is alone among major OECD countries in not having secure access to a market of 100 million people or more. To some observers, it seems naive for Canada not to explore more actively bilateral and multilateral arrangements to achieve this end. In turn, the GATT is viewed by some Canadian trade policy practitioners as a source of both opportunity and frustration. They are concerned about the GATT's inability to make significant progress in restraining the growing use of non-tariff measures or to evolve a more adequate procedure for the settlement of disputes. At the same time, it is recognized that the GATT may still be the best hope for a truly multilateral approach to global trade liberalization. There is therefore widespread disagreement as to whether we are headed into a new round of GATT negotiations that will reinvigorate the GATT (for example, by dealing with important non-tariff measures and bringing developing countries into the liberalization process) or whether we are witnessing the beginning of the end of the GATT, with geographically discriminating policies and increasing recourse to settling trade disputes outside the GATT.

The major exception to Canada's postwar trade policy of reliance on the GATT to secure access to foreign markets was the negotiation of the Auto Pact in 1965. This arrangement provides for duty-free trade in auto equipment and parts between Canadian and U.S. manufacturers as well as a range of guarantees by the major car producers in Canada covering levels of production.

In both the United States and Canada the Auto Pact is considered to be especially beneficial for Canada, and within Canada it is viewed as mainly benefiting Ontario. Canadian producers have been able to use longer production runs and obtain better access to U.S. markets than would otherwise have been the case, and Canadian consumers have been able to buy autos at lower prices. It is widely believed that unique circumstances led the United States to agree to such an arrangement, and that agreements of the same form for other sectors are unlikely.

Other developments relevant to Canadian trade policies over the past two decades are also worth noting. In the early 1970s, the "third option" was developed, partly as a reaction to the perceived ending of the special

relationship with the United States as a result of U.S. unwillingness to exempt Canada from its 1971 protective trade measures (except for autos). Eventually, the third option was interpreted as meaning that Canada's trade with Europe was to be developed as a counterweight to trade with the United States. This has not happened, partly because only a small share of Canada's trade is with Europe compared to its trade with the United States, and partly because of both European and Canadian inability to develop trade policies favouring bilateral trade over that with other trading partners, because of the non-discrimination principles of the GATT. The third option also generated little support in the business community in Canada. In fact, because of the Auto Pact, Canada's trade share with the United States increased immediately before the adoption of the third option and has since remained at the higher level. In addition Canada's trade with Japan, other Pacific Rim countries, and Latin America has grown more than trade with Europe.

High growth rates in a number of the newly industrialized countries have been a further factor underlying Canada's trade strategy in recent years. The newly industrializing countries have generated major competitive challenges to Canadian industry both in domestic markets and in major export markets, such as the United States. Countries such as Malaysia, Taiwan, Hong Kong, Singapore, South Korea, and others have substantially increased their real incomes per capita over the past 15 to 20 years as their export activity has grown. This export activity has presented major difficulties for a number of Canadian industries, raising questions about whether and how Canada should negotiate trade policy changes with these countries.

Canada's arrangements generally with Third World countries have also been changing over the same period. For many years, Canada has been perceived abroad as a compassionate developed country that has used its resources to promote the interests of the Third World. The actual direction taken in Canada's trade and aid policies toward developing countries has been quite the opposite. Canada's current aid when calculated as a fraction of GNP falls substantially below that of a number of comparable Western nations such as Holland and Sweden. In addition, OECD data indicate that a significant portion of Canada's bilateral aid is tied rather than given in untied form. Canada's trade policies against developing countries have become increasingly restrictive, especially in textiles through the tightening of quotas under the Multi-Fibre Arrangement in 1976. Although these quotas were supposed to be subsequently liberalized, this liberalization has not happened to any significant degree.

Despite the events of the postwar years, Canadian perceptions on trade policy matters still seem largely based on the received wisdom of earlier years. It is still widely believed that Canada's heritage in trade policy generally favours protection as part of the on-going process of

nation-building, along with the recognition that a policy of protection must be balanced against the need to secure access to foreign export markets. Since 1947 Canada has relied mainly on the GATT to guarantee its access to export markets. Multilateral rather than bilateral arrangements have prevailed. Canada has still not developed a clear framework for trade policy toward the United States, toward rapidly growing nations and the Third World generally, and toward the promotion of particular industries behind a protective wall.

These and other issues clearly present challenges to the basic premises on which Canada's trade policies rest. How these issues are resolved will have major implications for Canadians in the years ahead.

## **A Retrospect on Policies Toward Foreign Investment**

Trade and investment flows are closely related. Over the years, protective barriers have caused foreign firms to invest in Canada in order to service the Canadian market from within rather than from outside. These inward capital flows, while aiding in Canada's development, have caused concern over the extent to which control over Canada's economic fortunes resides abroad.

Policies controlling inward foreign investment in Canada are quite recent. Although there was general concern in the late 1950s about the high degree of foreign control of Canadian industry, a number of specific problems with U.S.-controlled firms in particular sparked policy debate. During this time, there was an upsurge of discussion of possible conflicts between the activities of foreign-controlled corporations and the Canadian national interest, culminating in a series of influential reports on foreign investment in Canada. This debate laid the foundations for the policies of the 1970s and especially the control of inward foreign investment through the Foreign Investment Review Agency (FIRA), recently renamed Investment Canada. These developments are summarized in Table 1-12.

From its inception to the recent changes, FIRA was one of the more controversial elements of Canadian economic policy, causing disquiet abroad, particularly in the United States. A number of Canadians argued that FIRA was not in the national interest since it discouraged inward foreign investment and denied benefits to the Canadian economy from increased capital flows. These arguments were given added weight by those who noted that to the extent that foreign countries, including the United States, subsidize foreign investment abroad through their tax systems (such as through the foreign tax credit), discouraging inward investment means forgoing the further potential benefits of a larger tax base.

Related concerns focussed on whether or not FIRA proved an inefficient instrument for achieving the objective of ensuring Canadian benefits

**TABLE 1-12 Canadian Investment Policy and FIRA**

1962	Passage of the Corporations and Labour Unions Returns Act (CALURA)—in large part the result of the Gordon Royal Commission. Its objective is to help determine the extent and nature of foreign investment in Canada. It requires all Canadian corporations with assets and revenues above a minimum level to file detailed annual reports on their operations, assets, and breakdown of Canadian and foreign ownership
1966	Canadian government issues non-binding "Guidelines of Good Corporate Citizenship." Other government initiatives include intervention to prevent the sale to foreign buyers of Canadian businesses such as Traders Group, Denison Mines, and Home Oil.
1968	Watkins Report on Foreign Ownership and the Structure of Canadian Industry is published. It emphasizes general problems of foreign investment rather than specific issues arising out of particular investments. It also argues that the most important issue is national independence — the capacity of the government of Canada to implement decisions in the national interest. While it accepts that foreign investment provides significant benefits to Canada by contributing to a high standard of living, it argues that this benefit must be weighed against the costs of such investment in terms of inefficiencies introduced into Canadian industries and the hindering of the capacity of the Canadian economy to generate growth. The report recommends that an agency be established to monitor operations and investments of foreign corporations in Canada, and suggests that the government explore the option of requiring foreign investors to guarantee greater benefits to Canada.
1969–70	Wahn Report (Standing Committee on External Affairs and National Defence) is published. This endorses the conclusions of the Watkins Report but goes further. It concludes that it is time to indicate clearly that "it is the general policy of the Canadian government that all companies operating in Canada shall, over a reasonable period of time and with due regard to varying circumstances, including availability of Canadian capital, permit at least 51 percent of their voting shares to be owned by Canadian Citizens." It also calls for majority Canadian representation on all corporate boards of directors, and recommends a "Canadian Ownership Law" to establish a "Canadian Ownership and Control Bureau" under the direction of a minister. The function of the proposed bureau would be to perform many of the advisory and research functions referred to in the Watkins Report, but the Wahn Report also suggests that the bureau have screening and decision-making powers.
1972	The Gray Report on Foreign Direct Investment in Canada recommends a screening process for foreign investment in Canada. The process is to rely on five central features: cost-benefit analysis; use of a case-by-case basis; a bargaining or negotiating process; a framework of policy guidance; and selectivity (i.e. concentrate on major transactions).
1973	The Foreign Investment Review Act establishes the Foreign Investment Review Agency (FIRA) with several key features. The Minister responsible for FIRA is to advise the Cabinet, which is to make

**TABLE 1-12 (Cont'd)**

	the decisions on whether to approve or block individual foreign investments in Canada. The Foreign Investment Review Bill provides a general statement of "the factors to be taken into account," but factors contained in the statute are not significantly different from the statutory guidance given most regulatory authorities. The review process is to entail screening of all takeovers, all new investments and all expansion by foreign companies into "unrelated" businesses. The act specifies the threshold level for a review as assets under \$250,000 and annual revenues under \$3,000,000. This is aimed at limiting reviewable cases to those of "economic significance." The statute also imposes a test that reviewable investment must be or is likely to be "of significant benefit to Canada." This is to be the sole test of whether a reviewable investment should be allowed or rejected, and by law must be applied to every case.
1980	The Government announces its intention to amend the Foreign Investment Review Act "to provide for performance reviews of how large foreign firms are meeting the test of bringing substantial benefits to Canada . . . [and] to ensure that major acquisition proposals by foreign companies will be publicized prior to a government decision on their acceptability." The announcement is in part due to the controversy with the United States over the National Energy Program.
1982	Reference on local procurement and export content features of FIRA to the GATT by the United States — subsequently partially upheld and modifications made by Canada.
1984	New government renames FIRA Investment Canada and declares its intention to revise rules governing inward capital flows.

*Source:* Information in this table draws heavily on Richard Schultz, Frank Swedlove, and Katherine Swinton, *The Cabinet as a Regulatory Body: The Case of the Foreign Investment Review Act* (Ottawa, 1980).

from foreign investment. The effects of the screening mechanisms used by FIRA have not been fully studied, and relatively little appears to be known about the ways in which the criteria translated into concrete rulings.

Complaints from the United States about FIRA have recently resulted in a the establishment of a GATT panel to rule on the local procurement and export content provisions of FIRA rulings. A negative ruling by the panel on the local content issue forced Canada to make some modifications.

In addition, the pattern of Canada's foreign investment position has been changing through the 1970s. Since 1975, on a balance-of-payments basis, direct investments abroad exceeded those made in Canada by foreigners. Although reinvestment of undistributed profits by foreign-based companies restores Canada's position as a net recipient of foreign

investment, it has clearly been investing more abroad than in previous years. Canada's claims on income generated abroad have been growing, and its interest in exploring the possibility of using the GATT rules to regulate international investment flows has correspondingly changed.

Thus, like Canada's trade policies, policies directed toward foreign investment are in a state of flux. The restrictive policies toward inward capital flows, in place until recently, reflect the heritage of thinking from the 1960s. Support for these policies has weakened, in part because they are seen to have discouraged new inward investment flows. In turn, Canada's interest in the establishment of a set of international rules governing foreign investment has increased because of Canada's growing foreign investment abroad.



## Canada's Access to Foreign Export Markets

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### Trade Links with the United States

Canada's trade policies toward the United States have been and remain central to its foreign policy and to Confederation itself. For this reason, the Commission's research program in trade policy has given special attention to this topic. Many of the key issues were discussed in a symposium on Canada-U.S. trade and a symposium on Canada and the global trading system, which included a major section on the sectoral free trade initiative. A number of symposium papers appear in *Canada-U.S. Free Trade*, volume 11 of the Commission's research series. The volume also contains a recent paper by Ronald Wonnacott, originally prepared for the Business Council on National issues, which is highly relevant to the Commission's work on this topic. Recent modelling work on Canada's trade options by Richard Harris is summarized in a monograph *Trade, Industrial Policy and International Competition*, which is volume 13 of the series. The Canada-U.S. issue also surfaces repeatedly in the other studies in this series and in research undertaken by other groups within the Commission.

Most discussion of Canada's trade links with the United States focusses on the possibility of bilateral negotiation of some form of free trade arrangement covering most or all of Canada-U.S. trade. Proposals for free trade arrangements take many forms, but three central elements appear: (a) elimination of tariffs on both sides of the border toward each other's exports, perhaps phased in over a number of years; (b) a series of codes designed to limit the use of non-tariff measures against each other's exports, similar to GATT codes covering government procurement practices; (c) codes to impose more discipline on either the use or the impacts of contingent protection measures (safeguards measures,



countervailing and anti-dumping duties) on each other's exports. Canada's tariffs are higher than U.S. tariffs but non-tariff measures and especially contingent protection cause more problems for Canada than for the United States. Therefore, the view in Canada seems to be that it is in the national interest to have a free trade arrangement that goes substantially beyond just tariff reductions. In addition, to be compatible with Canada's GATT obligations, any agreement has to cover "substantially all trade" between the two countries (currently interpreted as over 80 percent of trade). A broad-ranging rather than narrow, sector-specific agreement is therefore what most advocates have in mind.

Advocates of bilateral free trade are careful to stress that they do not see such a free trade arrangement as leading in any way to either wider economic integration or political integration, as has happened in Europe. There, a staged approach to a wide-ranging economic integration has been consciously planned, moving from a free trade area (elimination of tariffs) to a customs union (elimination of tariffs with a common external tariff against third countries) to eventually harmonized tax and monetary policies. This wider economic integration in Europe is also seen as a way of politically unifying Europe, especially in the foreign policy sphere. In discussion in Canada, advocates of free trade see a quite different approach — namely, to maximize economic gains from free trade but to minimize any of the pressures toward a wider economic or political integration. Their intention is to advance only to free trade with no further steps toward a customs union or harmonized domestic policies. This arrangement is similar to Sweden's relationship with the European Community. The example of Sweden supports the view that such an arrangement does not inevitably lead to further integration.

### ***Arguments for a Bilateral Free Trade Arrangement***

Two arguments are usually made in favour of negotiating a bilateral arrangement to reduce or remove trade barriers to cross-border flows of goods between Canada and the United States. These arguments appear strongly in all the Commission's research on this issue.

First is the argument that in economic terms, Canada could gain significantly from increased access to the larger U.S. market. Increased export opportunities would allow Canadian firms to expand production and realize benefits from greater economies of scale and rationalized production methods. The pressure of increased competition with U.S. firms would compel Canada's manufacturing industries to become more efficient.

Second is the argument that Canada's access to the U.S. market would become more secure. The risk of loss of access through U.S. imposition of countervailing duties or safeguards measures will remain a

problem unless Canada can limit the use of such contingent protection through a formal agreement.

The arguments concerned with benefits from increased access are often associated with the work of Wonnacott and Wonnacott (1967) and are further supported through the work of Harris (1984), summarized in *Canada-U.S. Free Trade*, volume 11 of the Commission's research series. In their work in the 1960s, the Wonnacotts based their calculation of the gains to Canada from Canada-U.S. free trade on the assumption that productivity in protected Canadian manufacturing industries would rise by the amount of the Canadian protection removed and that scale economies in Canada would yield further gains as the larger U.S. market was more fully penetrated by Canadian suppliers. The Wonnacotts estimate the gains to Canada from bilateral free trade to be around 10 percent of GNP, with a 4 to 4.5 percent gain coming from the removal of Canadian protection and the balance from the removal of U.S. barriers to Canadian exports. Harris estimates the gains to Canada from multilateral free trade to be 8 to 10 percent of GNP on the basis of data from the mid-1970s, with most of these gains realized under a bilateral Canada-U.S. free trade arrangement. In more recent work, summarized in a Royal Commission symposium, Cox and Harris estimate the gains to Canada from bilateral free trade with the United States to exceed those obtained by the United States under multilateral free trade, because although trade with the United States represents only 70 percent of Canada's trade, the preferential access to U.S. markets under bilateral free trade more than compensates for this limitation.

In studies by Harris and the Wonnacotts, it is the improved Canadian access to the larger U.S. market that generates these large benefits, since a large market allows Canada to exploit economies of scale. As a result, the length of production runs in Canada increases as Canadian industry is rationalized. Some trade diversion takes place as barriers between the two countries are lowered, since third countries that were previously the lowest-cost sources of supply are displaced by the partner country in the free trade arrangement. However, the dominance of the United States as Canada's largest trading partner means that the trade diversion effects are small, given the difference in size between the two countries. The net effect of the free trade arrangement is large and positive for Canada. Harris's recent estimates have attracted considerable attention partly because they are approximately consistent with those in the earlier studies by the Wonnacotts and because the estimates have been produced from a tightly specified model with strong theoretical underpinnings.

As both Harris and others (such as Whalley, 1984) have emphasized, the Harris results are dependent on the assumptions and parameter values used in the model. One issue with the specification of his model concerns the trade barriers Canada currently faces in U.S. markets.

Because of limitations on data sources available to him, Harris used data that do not fully incorporate the substantial preferences Canada already has in U.S. markets. As is noted in Table 1-7, the average tariff on imports from Canada is approximately one-fifth of the average tariff on all imports, and the more important quantitative restrictions in the United States, such as voluntary export restraints on autos and quotas on textiles and clothing under the MFA, do not apply to Canada.

Another issue in these calculations is the specification of the scale economy parameters. The extent of scale economies in Canadian manufacturing remains an issue. In Harris's model, the gains from multilateral free trade without scale economies are less than 2 percent of GNP. In addition, the model does not include the impacts of future Tokyo Round tariff reductions. Delaying the introduction of a free trade arrangement from the 1970s to the 1980s, when barriers are lower, will give smaller gains than those implied by data for the mid-1970s. These estimates may, however, be downward biased to the extent that they do not include the socially wasteful transport costs associated with the extra interregional trade created by Canadian trade barriers (see the paper by Melvin included in *Canada-U.S. Free Trade*). In addition, gains from free trade in energy are excluded.

The size of gains to Canada under a free trade arrangement with the United States depends crucially on the potential in Canadian industry for exploiting economies of scale (that is, increasing the scale of operations, leading to lower per-unit costs). The potential that exists here depends not only on the significance of scale economies in production, but also on the degree to which trade restrictions and market imperfections in Canada prevent them from being realized. In industries where there are non-competitive elements, the removal of Canadian trade barriers can allow economies of scale to be exploited through a rationalization of production because increased competitive pressures from free trade would force a more efficient allocation of resources both within and between sectors. As cheaper imports put pressure on higher-cost Canadian producers, firms would be induced to rationalize production and reduce costs. In industries without these non-competitive elements, these effects may not occur.

At a more detailed level, it is important to know which industries would gain or lose as a result of a bilateral free trade arrangement with the United States, since the removal of Canadian and U.S. barriers has offsetting effects. The Harris model indicates a substantial expansion of Canadian manufacturing, with the trade balance moving into a significant surplus position. Capital-intensive industries facing trade barriers in the United States, such as resource-processing industries, would expand. Labour-intensive industries would tend to contract, although the competitive pressures producing this effect would not be so great under bilateral free trade since these industries are also protected in the

United States. Significant intersectoral shifts in employment within manufacturing also seem likely.

The second set of arguments currently being advanced in Canada in favour of negotiating a Canada–U.S. free trade arrangement focusses on the security value to Canada of removing threats of contingent protection in the United States, particularly safeguard measures and countervail. These measures create substantial risks for Canadian firms attempting to penetrate the U.S. market, since their market access remains insecure without a wider system of guarantees.

The argument here is that the access Canada currently enjoys in U.S. markets remains uncertain and, if interrupted, could result in substantial adjustment costs. Several years ago, the application of countervail by the United States against tires produced in Atlantic Canada under a regional development grant caused great concern in Canada.<sup>4</sup> Because of this case, it became apparent that the risk of countervail in the United States would constrain future regional policy actions of the Canadian government, and possibly policy actions in other areas. Over the past two years, there have been even more dramatic illustrations of this same problem. A countervail case brought by the U.S. softwood lumber industry based on the way stumpage fees are calculated in Canada was nearly successful and would have caused severe damage to Canada's lumber industry. In the case of steel, the possible introduction of global quotas by the United States as a safeguard measure to prevent market penetration by Brazil, South Korea, and other developing countries looked at one stage as if it would have major repercussions on Canada's steel industry, even though Canada was not the intended target for these measures. Thus, advocates of a Canada–U.S. free trade arrangement who focus on this argument stress the need to preserve and guarantee the access Canada now has, as well as the gains to Canada from further reductions in trade barriers in the United States.

Finally, adding to these arguments are concerns over recent proposals in the United States suggesting a policy of "aggressive reciprocity." Although these are proposals rather than firm policies, a move in this direction could see the United States raising its levels of protection if it perceives other countries to have higher barriers than its own. Since Canada has higher tariffs than the United States on many items, it could be adversely affected. A free trade arrangement with the United States could prevent any adverse consequences for Canada from such a policy.

### ***Arguments Against a Free Trade Arrangement***

The dominant argument against a free trade arrangement with the United States has long been the issue of Canada's ability to maintain its sovereignty, but other reservations — such as the possible impacts on the multilateral trading system, the risk of a capital outflow from

Canada, and, more generally, the size of adjustment costs — have also been raised.

The national sovereignty question centres on two issues. First, what constraints on domestic policy would Canada have to accept to reach an agreement on bilateral free trade? Regional development assistance is an example of a set of trade-distorting domestic policies that may have to be restricted. Elements of the National Energy Program and the Foreign Investment Review Act that have annoyed the United States in the past, as well as other government restrictions on U.S. investment in Canada, would likely be raised in negotiations.

Second, once an arrangement had been entered, could the United States use the threat of abrogation to pressure Canada into complying with U.S. foreign policy objectives, changing internal domestic policies on which a consensus had been established in Canada, or gaining guarantees of access to Canada's resources? These concerns are based on the argument that most of the economic benefits of a Canada-U.S. free trade arrangement would go to Canada, whereas the benefits to the United States would be largely political.

Although the benefits of access to a market of 23 million people would be significant for the United States, they are in all probability smaller than the benefits to Canada of improved and more secure access to the larger U.S. market. This raises the issue of what the United States would want in such an arrangement. Table 2-1 is a partial list of issues the United States might raise in negotiations with Canada.

Issues surrounding the sovereignty question have been taken up in the Commission's research program in Politics and Institutions of Government and will only be briefly sketched here. Several different scenarios can be identified. One is that a free trade arrangement would not threaten Canada's sovereignty because the main reason the United States may respond favourably to any negotiations would be simply to preserve the political status quo, with a friendly neighbor along its 3000-mile northern border. Another is that the main U.S. objective is to secure some form of guarantee of access to Canada's resources and eventually to the water resources of the Great Lakes. Yet another is that establishing a free trade arrangement will set in motion a political dynamic of inevitable integration and eventually cultural absorption by the United States.

These issues are exceptionally difficult to quantify or even formulate in analytical terms. As yet, no one has been able to cite a historical precedent or set out in a fully convincing way how the momentum toward integration becomes irreversible. Examples such as Sweden's arrangement with the European Community suggest that integration can be limited to a free trade area, and other examples such as the Latin American Free Trade Association suggest that even the initial free trade arrangement may falter over time. The possible impacts on sovereignty are so speculative that it can even be argued that Canada's sovereignty

**TABLE 2-1 U.S.–Canada Bilateral Trade Issues Listed by the U.S. Special Trade Representative's Office**

**Foreign Investment Review Agency (FIRA)** *Background:* FIRA was established in 1973 to increase Canadian control over foreign investment. The law included local sourcing and export performance requirements specifying when foreign-owned firms must purchase Canadian goods and/or export a specific share of their Canadian production. GATT panel, pursuant to GATT Article XXIII:2, ruled that with respect to local sourcing requirements the Canadian Government actions were inconsistent with Canada's GATT commitments. The panel concluded that Canada's export performance requirements are not inconsistent with GATT. *Current Status:* Adoption of Panel Report by GATT and Council in February 1984.

**Border Broadcasting** *Background:* In 1976, Canada adopted a tax provision denying Canadian enterprises tax deductions for the cost of advertising in foreign media when the advertising is directed primarily at Canadians. The main targets have been advertisements placed on U.S. television stations broadcasting into Canada. *Current Status:* Several years of bilateral consultations failed to provide a compromise solution. Proposed legislation to enact a mirror provision in U.S. tax law has been introduced in Congress.

**Trucking** *Background:* Deregulation of the U.S. trucking industry created an imbalance in competitive opportunities for U.S. motor carriers in Mexico and Canada. The Bus Regulatory Reform Act of 1982 contained a section which imposed a moratorium on grants of new operating authority to Mexican and Canadian motor carriers. President Reagan partially lifted the moratorium as it applied to Canada in September 1982. *Current Status:* Exchange of letters between United States and Canada outlined bilateral understanding on international trucking and led to presidential determination that fair and equitable treatment has been gained for U.S. trucking interests. Canada–U.S. Motor Carrier Consultative Group established, and working groups on data, taxation and vehicle registration formed after group's first meeting.

**Pharmaceutical Patent Policy** *Background:* Canadian Patent Law provides that any Canadian pharmaceutical company may request the Canadian Commissioner of Patents to provide a compulsory licence for foreign pharmaceutical patents, with the payment of only a nominal royalty of 4 percent. The U.S. Government has expressed its concerns over this law on a number of occasions, and in May 1983, the Canadian Government announced its intention to revise the law. *Current Status:* Consultations are underway with the Canadian Government on modification of legislation.

**Wine** *Background:* In October 1981, the Liquor Control Board of Ontario announced an "Ontario Wine Assistance Program" that included changes in mark-ups and special handling charges which effectively increased the price for most imported wines. Wines produced in Ontario were exempt from the special handling charge. The United States argued that this measure violated Canada's commitment made in the multinational negotiations not to increase the differential in a mark-up between domestic and imported wine except as might be justified by normal commercial considerations. *Current Status:* On July 1, 1983, the special handling charge was removed from North American wines and on August 15, 1983, on all other imported wine. A reference (minimum) pricing system was also established.

*Source:* Annual Report of the President of the United States on the Trade Agreements Program (Washington, D.C., 1983), Table 14.

(defined as the freedom to take independent action) would be enhanced under a free trade arrangement. One reason is that the threat of counter-vail in the United States in the absence of a free trade arrangement can constrain Canada's domestic policies more than a negotiated bilateral accommodation on countervailing duties. Despite these considerations, however, the Canadian public is rightly concerned about the sovereignty issue, which lies at the heart of debates on Canada-U.S. free trade.

The adjustment costs of entering a free trade arrangement with the United States are also a major concern, especially when the potential threat of abrogation by the United States is considered. It is generally agreed that although Canada might receive proportionately more of the total benefits accruing from a free trade arrangement, it would also face larger adjustment costs. The geographical concentration of Canada's manufacturing industries intensifies the adjustment problem. The industries likely to face the greatest adjustment costs are largely concentrated in central Canada. Some labour-intensive industries, hit by both higher real wages and import competition from the United States, would disappear. According to Harris, in the long run, at least 6 to 7 percent of the total Canadian labour force would have to shift among industries if a free trade arrangement were concluded with the United States.

However, the evidence on the size of adjustment costs from such trade policy changes remains limited. With previous trade liberalization episodes elsewhere, such as the Kennedy Round and the formation of the EC and EFTA, adjustment costs from liberalized trade policies have been estimated to be small. Cline et al. (1978) examined the possible adjustment costs that could occur with the different tariff-cutting formulae being considered in the Tokyo Round. Their estimate for Canada showed the gains from trade liberalization outweighing adjustment costs by a ratio of 62 to 1. If these estimates are accepted, the orders of magnitude by which they would need to be revised to make free trade an unattractive proposition seem so large as to make such an outcome implausible.

There is also widespread agreement from the advocates of Canada-U.S. free trade that an adjustment assistance program would be needed as part of a free trade arrangement both to assist factors of production leaving declining industries and to promote rapid absorption of these factors into expanding sectors. A bilateral Canada-U.S. agreement would have to recognize the proportionately larger adjustment costs that Canada would face and permit adjustment assistance in Canada.

Another concern with a free trade arrangement is the size of adjustments involving foreign investment. According to the Harris model, a net inflow of capital from abroad would occur under multilateral free trade as capital-intensive Canadian industries rationalize their production methods. A similar effect could well occur under a bilateral Canada-U.S. free trade arrangement. However, some have argued that U.S.



firms that have been induced to enter Canada to produce behind the barrier of protection would have no incentive to remain and would relocate to the United States. This effect would be at least partially offset by the increased incentive for other firms to locate in Canada and export to the United States because of the removal of U.S. trade barriers. These issues are taken up in the paper by David Burgess in *Canada-U.S. Free Trade*.

A further concern is that a move toward economic integration with the United States would change the long-run variability of Canadian GNP per capita. This change would occur if U.S. business cycles had an even greater impact on Canada than they currently have. However, there is uncertainty in the research community about whether U.S. fluctuations in aggregate activity are greater than those that Canada would otherwise experience.

The effect of a Canada-U.S. free trade arrangement on the multilateral trading system is another concern. Both Canada and the United States might hesitate to enter such an arrangement if it could seriously weaken the present multilateral global trading system. The consequences could be more serious for the United States than for Canada, since a larger fraction of its trade is with the rest of the world. At present, the United States seems to be willing generally to deal bilaterally with smaller countries on trade issues. This willingness has been evident in the negotiations over free trade arrangements with Caribbean countries and Israel. Frustrations over trade conflicts with the European Community and Japan may be one reason why the United States is much more willing than formerly to negotiate bilaterally. Another reason may be the possibility that such negotiations can help accelerate multilateral negotiations.

### ***The Form of a Canada-U.S. Trade Arrangement***

As was emphasized in the research symposium on Canada-U.S. free trade, besides debating the pros and cons of the issue, it is important to consider more concretely how such an arrangement might work. Canada-U.S. free trade could take different forms: sectoral free trade restricted to certain products, a free trade area covering all or substantially all trade between the two countries; or a customs union involving a free trade arrangement between Canada and the United States along with common trade barriers against third countries. A free trade arrangement could be the result of a treaty ratified by the U.S. Congress or an executive order. Generally, most commentators in Canada strongly favour a treaty since it becomes more difficult for the United States to subsequently withdraw. It could be a closed-ended arrangement that other countries could not enter, or it could be open for third parties such as Mexico to join at a later date.



The recent discussion of the possibility of sectoral free trade with the United States was initiated by the review of trade policy released by the Department of External Affairs in 1983. This review suggested considering free trade with the United States in textiles, petrochemicals, urban transit equipment, and agricultural machinery. This sectoral approach has advantages. It largely restricts the adjustment problems to the sectors that are the subject of any resulting negotiation. In addition, as a substantial amount of Canada's trade with the United States will be essentially duty free by the end of the Tokyo Round implementation period, negotiations on a sectoral basis could focus on those remaining areas with high tariffs or non-tariff measures of particular importance to Canada.

However, a sectoral arrangement also has serious drawbacks. It would be difficult to deal with the crucial issues of contingent protection through such an agreement, since these issues are not localized to particular sectors. The scope for trading off benefits in one sector against those given to the United States in another sector is severely constrained. In addition, sectoral free trade would fail to cover substantially all the trade between the two countries, as Article XXIV of the GATT requires for such an arrangement. A GATT waiver would almost certainly be required by the other GATT contracting parties, and at present this would probably be refused.

Further disadvantages include the incentives for lobbying for exemptions by various groups once such a possibility is allowed. There is also the possibility of increased distortions in some sectors, such as textiles, where producers might demand lower quotas on imports from third countries if imports from the partner country increase.

In contrast, a broader customs union or free trade area has the advantage of removing most of the customs procedures between the two countries, helping to reduce customs-related non-tariff measures involving administration and valuation, and enabling uses of contingent protection to be limited. The requirement that trade policies toward third countries be harmonized in a customs union suggests that a free trade area might be a more realistic option. It is widely believed that harmonization of Canadian and U.S. trade policies would really amount to having Canada's trade policy set in Washington. A free trade area offers the benefits of improved access to the large U.S. market with less policy intervention from outside through harmonized policies.

The disadvantage of a free trade area compared to a customs union is that to prevent imports being made into the lower tariff country and re-exported to the higher-tariff country, imports must be accompanied by a certificate of origin. However, experience in EFTA and elsewhere suggests that certificate-of-origin problems have not proven burdensome.

To allow for a smooth adjustment process at the start of a free trade arrangement, the tariff elimination portion could be phased in over a

number of years. One option would be for tariffs to be reduced by one percentage point per year in both countries until eliminated. Thus, higher tariffs would be eliminated over a longer period than low tariffs. This process would leave Canada's more heavily protected industries with some protection for a few years after tariffs for their competitors in the United States have disappeared. This could give these Canadian industries security for their Canadian operations while they make needed changes in their production and marketing methods to take advantage of the opportunities in U.S. markets.

Issues arising with non-tariff measures in any Canada-U.S. free trade arrangement would also have to be dealt with, presumably by rules agreed upon to restrict or eliminate them. In the case of safeguards measures, one possibility would be for both countries to exempt each other when they apply such measures where the partner country is not the major source of supply and is not the source of market disruption.<sup>5</sup> This procedure would have removed the threat to Canada when global steel quotas were considered in the United States. In the case of counter-vailing duties, a harmonized definition of subsidies could limit the applications of such duties to Canadian suppliers, and a tightened definition of injury could be explored.

In addition, a procedure for settling disputes would undoubtedly have to be developed. One suggestion is that a joint Canada-U.S. commission be established to oversee all aspects of any free trade arrangement, although such a body would probably only make non-binding recommendations to the two national governments. The issue of abrogation would also need careful consideration. One option might be to allow abrogation with five years notice or to allow dissolution of the agreement only by mutual consent.

In the final analysis the most decisive issue might be whether the United States would have a serious interest in such an agreement. Compared to Canada, the United States would experience relatively small gains from a free trade arrangement. The size of the market to which U.S. firms would have access would increase somewhat and there would be gains to the United States, but not on the scale of those expected in Canada. However, there might be political gains for the United States from a smoothly working arrangement and possibly significant economic gains if the alternative is for Canada to follow a more protectionist and nationalistic route.

Many years ago, the British Empire and the Commonwealth were seen as the alternative to strong links with the United States. With the end of the Empire and the demise of the Commonwealth as a major economic force, this alternative no longer exists. In recent times, the alternative to developing Canada's bilateral trade links with the United States has been seen as the GATT. Increasingly, however, it is argued that the GATT may have yielded most of its potential gains. In some circles, it

is now viewed as yet another ineffective global organization involving an ever-increasing number of countries. Perhaps the key question for Canadian trade policy makers in considering closer trade links with the United States is where else Canada can turn to develop its export markets. This ultimately may be the inescapable and compelling argument in favour of a bilateral arrangement to achieve freer trade and secure access to U.S. markets while also continuing multilateral trade negotiations.

## **Other Bilateral Trade Policy Options**

Over the years, there has been frequent discussion of the merits of seeking to diversify Canada's foreign trade by more actively promoting trade with countries other than the United States. This thinking lay behind the "third option," the attempt in the 1970s to promote trade with Europe, and has surfaced more recently in suggestions that Canada explore a free trade arrangement with Japan.

The option of a Canada-Japan free trade area is analyzed by Ronald Wonnacott in a short paper published in *Canada and the Multilateral Trading System*, volume 10 of the research series. Considering the volume of Canada's trade with Japan and the apparent superiority of Japanese technology, it might seem in the Canadian interest to pursue such a free trade arrangement. According to Wonnacott, however, this is unlikely. While conceding there could be benefits to Canada, he argues that the gains would be limited by high transportation costs and other considerations. Free trade would probably not affect resource exports significantly because Japanese barriers against such goods are already low. For political reasons, there is not much prospect that Japan would lower protection in the agricultural sector. There would be limited prospects for increased exports of industrial goods because Japanese invisible non-tariff measures would probably remain under a negotiated free trade agreement. Therefore, Wonnacott does not see any major across-the-board gain in Canadian exports to Japan under Canada-Japan free trade.

By eliminating Canadian barriers against Japanese goods, Canada could benefit from increased industrial imports in areas where Japan is Canada's lowest cost source of supply. However, this change would necessitate adjustments by Canadian firms and workers as industrial employment is displaced by imports. Wonnacott points out that it is unnecessary to engage in a free trade arrangement to enjoy increased access to Japanese technology since technology can readily transfer across tariff-ridden borders. In his opinion, the performance of the Japanese themselves is proof of this proposition.

As outlined by Wonnacott, the costs of Canadian-Japanese free trade appear to outweigh the benefits. If Canada were to buy goods from Japan

under a free trade arrangement rather than from a lower cost source of supply, such as the United States, the trade diversion cost to Canada could be substantial. Present trade patterns indicate that other countries are frequently lower cost sources of supply than Japan. Currently about 95 percent of Canada's imports come from countries other than Japan, although Canada does use discriminatory import barriers against Japan that bias this figure.

In Wonnacott's view, the most decisive argument against Canada-Japan free trade is that such an arrangement would disturb Canada's existing trade arrangements with the United States. A negative U.S. reaction to the resulting trade diversion would be likely. Any U.S. retaliation against Canadian exports would be extremely costly for Canada. Wonnacott further notes that U.S. hostility would also be directed at Japan. Therefore there is virtually no chance that Japan would accept a proposal to engage in a free trade arrangement with Canada.

Wonnacott would favour negotiating a free trade arrangement with both Japan and the United States, if that is possible. In the event that the United States and Japan do not wish to freely trade with each other, Canada would benefit even more from a bilateral free trade arrangement with each since it would then have preferential access to both markets.

Wonnacott also outlines the characteristics Canada should look for in assessing potential free trade partners. A country should be wealthy and able to absorb a wide range of Canada's resources and manufactured goods. It should be a least-cost source for a large portion of Canada's imports. It should be geographically close so that gains from trade are not dissipated in transport costs. Finally, it should be a country which already trades heavily with Canada. The United States of course fits this description far better than Japan. Put another way, the dominance of the United States in Canada's trade makes trade relations with the United States central in deciding on an appropriate trade policy for Canada.

A similar argument also applies to the possibility of bilateral free trade with Europe. Such an arrangement makes sense as a complement to initiatives that improve Canada's access to U.S. markets, but not as a substitute for a Canada-U.S. arrangement. Although the third option of the 1970s was not promoted as free trade with Europe, but rather as increased trade, Wonnacott's criteria suggest that this orientation to Canadian trade policies would be less productive than a bilateral free trade initiative with the United States.

## **Canadian Interests and the GATT**

Canada has always been a strong supporter of the GATT and issues concerning the GATT are central to an evaluation of the options for Canada's trade policies in the decades ahead. These issues were taken

up in a research symposium on the GATT and Canadian interests and are further discussed in the commissioned paper by John Curtis in *Canada and the Multilateral Trading System*, volume 10 of this series.

### ***The Main Features of the GATT***

The General Agreement as it stands today consists of 38 articles divided into four parts. Part IV, comprising Articles XXXVI–XXXVIII, was added in 1965 to deal with the interests of the developing countries. As of February 1984, 89 countries are members of the GATT and 30 countries maintain a de facto application of GATT rules. Among the most significant non-participants are the Soviet Union, China, Mexico, Venezuela, and most OPEC countries.

The two main principles embodied in the General Agreement are trade on the basis of non-discrimination (the most-favoured-nation principle) and equal treatment for domestic products and imports from all countries once tariffs have been paid. This second principle implies that tariffs should be the only means of protection for domestic industries except under carefully defined and controlled circumstances. Institutionally, the GATT has relied on a consultative process to lead to negotiations on tariff reductions on the basis of mutual advantage. Disciplinary measures are not initiated automatically if a member country violates a GATT code. Instead, the injured country has the right to withdraw equivalent concessions or take retaliatory measures upon approval by member countries. A process of consultation and conciliation in the event of a dispute is strongly emphasized.

Canada has participated actively in the seven GATT negotiating rounds held to achieve multilateral reductions in trade barriers since 1947. The more recent Kennedy and Tokyo rounds have been of particular importance because of their wide coverage and broad impact on Canada's trade.

### ***The Kennedy Round, 1964–67***

The Kennedy Round was the first time that tariff negotiations were undertaken in the GATT on an across-the-board basis, in contrast to the product-by-product and sectoral approaches of earlier rounds. Canada was granted special status by the other participants in the negotiating round because it was agreed that linear cuts by Canada would lead to relatively large tariff reductions on price-sensitive imports of manufactures, while price-insensitive exports would receive only modest duty cuts in export markets.

It is usually argued that Canada emerged as a major gainer from the Kennedy Round in the 1960s because of the increased access it gained for exports. In the long run, further gains accrued from the reductions in

Canada's own protection. During the round, Canadian tariffs were cut on \$1.4 billion of imports from the United States, almost half of them by more than 25 percent. The United States in turn cut tariffs on \$1.25 billion of imports from Canada, but its cuts were deeper. Canada also accepted the revised anti-dumping code that emerged from the negotiations.<sup>6</sup>

### *The Tokyo Round, 1973-79<sup>7</sup>*

The stated aims of the Tokyo Round were to expand and liberalize world trade; to secure additional benefits from international trade for developing countries; and to reduce or eliminate non-tariff measures, or at least to mitigate their trade-restricting or trade-distorting effects and bring such measures under more effective international discipline. Agriculture was also to be specially treated.

By the end of the negotiations, the industrialized countries had agreed to reduce tariffs by an average of 34 percent, with cuts to be implemented over an eight-year period ending in 1987. The average level of these tariffs should be in the range of 5 to 6 percent by that date. Agreements were also reached on an improved legal framework for the conduct of world trade and on various non-tariff measures, including subsidies and countervailing duties, technical barriers to trade, government procurement, customs valuation, import licensing procedures, and a revision of the 1967 GATT anti-dumping code.

The Agreement on Subsidies and Countervailing Duties ensures for the first time the uniform application of GATT rules on subsidies and countervailing duties by all signatories. Before applying countervailing duties, signatories are required to demonstrate that a domestic industry has suffered material injury caused by subsidized imports from another member country.

Discussions also took place on a legal framework for the conduct of world trade. Five issues make up the work program of the Framework Group that was established. The first is more favourable treatment for developing countries, leading to gradual fuller participation in the GATT. The main provisions of this issue are proposed modification to the most-favoured-nation principle (the enabling clause) to allow contracting parties to grant differential and more favourable treatment to developing countries. The second covers safeguards actions for balance-of-payments purposes. Third, improvements to GATT mechanisms for the settlement of disputes were agreed to and ways to achieve these improvements are under discussion. Fourth, it was agreed that less developed countries may modify or withdraw concessions to achieve development objectives, with details to be discussed in the Framework Group. Finally, export restriction provisions in the GATT are to be

reviewed in the broader context of world trade, with particular focus on the trade and financial needs of the developing countries.

In the government procurement area, an agreement was worked out that applies to any procurement contract with a value of SDR 150,000 or more including incidental services. (SDRs are Special Drawing Rights in the International Monetary Fund, used by the IMF and many countries as a unit of account. As of February 1985, SDR 150,000 was equivalent to Cdn\$195,000.) Signatories agreed to give national treatment to all suppliers and not to discriminate between foreign and domestic suppliers. The agreement does not apply to regional or local entities, and covers purchases of a civilian character. Developing countries are not required to grant reciprocity on either products or entities covered, and are permitted to grant preferential treatment in regional or international arrangements.

The customs valuation agreement aims to establish a uniform and neutral system for valuing imports, to prevent the use of arbitrary or fictitious customs values. Canada agreed to implement the code by January 1, 1985, provided it could revise upward tariff rates where adoption of the new system would result in a significant decrease in the level of protection afforded domestic producers under the existing system.

Under the agreement on technical barriers to trade, signatories agreed to administer their regulations according to international standards, including testing and certification requirements, to minimize unnecessary restrictive effects on imported goods. This agreement, however, applies only to national governments. The agreement on import licensing procedures stipulates that licensing rules will have to be published promptly. Forms and procedures are to be as simple as possible. An applicant who is refused has the right to explanation and appeal.

Under a separate agreement on civil aircraft, signatories agreed to eliminate all tariffs and equivalent charges applied to imports of these products and repairs by January 1, 1980. Included are civil aircraft, civil aircraft engines, ground flight simulators, and all other parts and components, whether original, replacement, repair, or conversion equipment. This agreement resulted from negotiations between Canada, the EC, the United States, Japan and Sweden. Furthermore, the agreement on technical barriers to trade is to apply to certification requirements and operating and maintenance procedures.

An International Dairy Arrangement was also concluded, intended to expand and liberalize trade in dairy products without causing undue fluctuations in supply and prices. The products discussed include milk, cream, butter, cheese, curd, and casein. Canada did not sign the protocol relating to milk products.

Finally, in the agreement on Article VI of the GATT (anti-dumping), changes were made to bring the article into line with the new code on



subsidies and countervailing duties. A determination of material injury must be made and must involve an objective examination of the volume of dumped goods and their effect on domestic prices and producers.

### ***A Future GATT Round<sup>8</sup>***

Canada's approach to the GATT in the years ahead depends to some extent on the possible content of (and chances for success in) a future negotiating round, and a judgment on how Canada has fared in previous rounds. Whether a future round will or will not be initiated in the next few years is currently an active subject of speculation. The U.S. administration has stated its interest in pursuing such negotiations, but as yet negotiating authority has not been granted by Congress. The Europeans are more cautious since the issues they see being raised, such as agricultural protection and trade in services, are not perceived as areas in which they would benefit from a reduction in trade barriers. Unfinished business from the Tokyo Round and the contents of the Work Program agreed upon at the conclusion of the 1982 GATT ministerial meeting are generally acknowledged to make up the agenda of a possible future round.

**Safeguards** The issue of safeguards, left over from the last round of negotiations, is of major concern to Canada. Revision of the present safeguards code was discussed during the Toyko Round, but agreement could not be reached because the European Community wished to apply the code on a selective basis. One proposal is that those countries agreeing to the new code should be able to apply it among themselves, but there is no consensus on this issue and it is clear that a new agreement is some way away. Canada was a strong proponent of a strengthened safeguards code in the last round, and it can be expected to support inclusion of further negotiations on this issue.

**Government procurement** Also of great significance to Canada is government procurement (rules stipulating when governments may or may not give preference to domestic over foreign suppliers when awarding contracts). There are a number of sectors where Canadian industry is internationally competitive but government procurement practices abroad effectively limit the size of foreign export markets. Telecommunications, power generation and transmission, and surface transportation equipment are all examples of Canadian industries that would gain from an expansion in the government procurement code agreed to in the Tokyo Round. The heart of the issue is that lower level jurisdictions (provinces, states in the United States and government enterprises) are not bound by the present procurement code. A strengthened code would



improve Canada's access abroad but the negotiations would directly involve matters now under provincial jurisdiction.

**Subsidies and countervailing duties** A further concern to Canada is the increased use of subsidies abroad, especially in the agricultural and manufacturing sectors. Negotiations on this issue would be linked to the need to examine the risks of using subsidies as a form of protection. Inclusion of a strengthened code on subsidies and countervailing duties would almost certainly be seen as beneficial to Canada, although Canada would want to preserve its ability to use regional subsidies.

**Services** The question of trade in services, which the United States raised in the November 1982 ministerial meeting, will almost certainly be included in any future round. At present there is no framework of rules that regulates international trade in services on a basis similar to that covering trade in goods. At this stage, it is not clear how Canadian interests might be affected by such a code.

**Agriculture** The close relationship between domestic agricultural policies and border controls on agricultural flows has meant that relatively less progress has been made during previous GATT rounds in liberalizing trade in agriculture than in liberalizing trade in industrial products. However, agricultural trade issues (and especially the Common Agricultural Policy of the EC) are high on the agenda. From a Canadian perspective, obtaining greater discipline through the GATT over trade barriers affecting agricultural products is an important objective.

**Natural resource products** Sectors that Canada would like to see discussed in a future GATT round include fisheries, non-ferrous metals and forest products. Canada successfully pressed for the inclusion of fisheries in the GATT Work Program, with the objective of achieving a degree of multilateral discipline, and lower tariffs and non-tariff measures for fisheries products. The results of the Tokyo Round were disappointing for Canada because a number of fisheries products continue to face high tariffs and a range of non-tariff measures, especially in the European Community. Canada would also like improved market access for Canadian petrochemical exports.

**Quantitative restrictions and non-tariff measures** The GATT 1982 Ministerial Declaration established a group to review quantitative restrictions that do not conform to GATT rules and to seek liberalization of other restrictions and non-tariff measures. This is a broad ranging set of issues, but concrete steps in this direction could be of significant benefit to Canada.

**High technology** The United States has been trying to initiate a work program on trade in high technology although this was not included in the 1982 Ministerial Declaration. Such a work program is likely to appear on the agenda for possible future GATT negotiations, but how Canadian interests are affected remains unclear.

**Developing countries** Canada, along with other developed countries, has expressed an interest in seeing developing countries participate more fully in the GATT and in exploring ways in which this participation might be accomplished. The 1982 ministerial meeting included a number of issues of particular interest to the developing countries in the Work Program, such as improved access for tropical products, liberalization of trade in textiles and clothing, structural adjustment, and strengthening the implementation of Part IV of the GATT, which covers the developing countries.

**The settlement of disputes** Concerns that might be discussed in a future round include the composition of panels, the provision of legal advice by the GATT Secretariat, the degree of emphasis on conciliation (as opposed to adjudication), the handling of disputed panel findings, and the degree of commitment of contracting parties to take action in response to unfavourable findings and recommendations. Strengthening these procedures has always been a Canadian objective, and further discussion of these issues would probably be in the Canadian interest.

**Trade-related investment issues and counterfeit goods measures** Although the U.S. proposal to discuss ways of controlling the use of trade-related investment measures was rejected at the 1982 ministerial meeting, the proposal continues to be of interest to the United States and will almost certainly reappear in any future negotiations. The United States has also developed a draft code on commercial counterfeiting, and hopes to see more progress on this issue in a future round.

### ***The Future of the GATT***

Despite Canada's gains from previous GATT negotiations, it is widely agreed that the GATT has its share of problems and some observers believe they are growing. Perhaps the most significant issues involve non-tariff measures and the proliferation of voluntary export restraints and other arrangements concluded outside the GATT. The GATT was originally meant to deal primarily with tariffs. Other trade measures are more difficult to monitor and identify, since they are often inseparable from a nation's domestic policies. Those non-tariff measures dealt with in Part II of the GATT, such as quantitative restrictions, import licens-

ing, and safeguards arrangements, were intended to be used only as temporary measures confined to specific purposes and circumstances, not as the more permanent elements of trade policy they have become. Bringing these trade arrangements more fully under international discipline through negotiated multilateral arrangements is therefore the prime challenge the GATT faces.

Related are difficulties with the procedures for the settlement of disputes in the GATT. Member countries are committed to consult bilaterally in the event of a dispute, and if bilateral consultations are unsuccessful the parties can request a panel review. This informal procedure worked well in the past, but lately problems have arisen, including the absence of sound monitoring, compliance and enforcement methods; increased use of protective measures not covered in GATT rules; and non-adherence by contracting parties to the panel recommendations. In addition, countries have been willing to accept demands for voluntary export restraints on their exports rather than relying on GATT procedures for the settlement of disputes to deal with their trade problems. A further contributing factor is the cumbersome size of the GATT. In contrast to the original GATT membership of 23, a total of 99 countries participated in the recent Tokyo Round negotiations, which took six years to complete.

A further area where the GATT has failed to make as much progress as many — including many Canadians — would have liked concerns the trade interests of the less developed countries. They have to accept the results of negotiations among the developed countries and then apply the results to their needs, which are often quite different from those of the industrialized countries. In addition, less developed countries do not have much power to influence GATT negotiations in their favour. A further problem is how to deal with countries with centrally planned economies within the framework of an institution based on the principles of free enterprise.

Despite Canada's strong support of the GATT in previous years, it is not clear whether trade policy makers in the future will be able to rely on the GATT as heavily as in previous decades. The GATT contains Canada's main trade agreements with most of its trade partners, including the United States, and continues to provide a forum for on-going consultations with other trading partners, but the problems that have become more evident in recent years have made some cautious about advocating a continuation of past policies.

In considering Canada's future approach to the GATT, the key questions are how Canada should use the GATT framework to further its interests and how it should blend its obligations under and negotiations in the GATT with any bilateral initiatives it may take. One judgment call concerns the degree to which Canada can benefit from the multilateral framework by using its influence with small and middle-sized countries

and aligning itself as necessary either with or against major trading powers. A related consideration is the lack of negotiating leverage Canada would have as a smaller country trading with larger countries if it did not participate actively in the GATT.

### *Canada's Future Policy Stance Toward the GATT*

Canada's policy stance toward the GATT in the years ahead could be based on any of a number of different approaches. One approach would be based on the perception that although the GATT has become less effective since the 1970s, Canada has been a major gainer from the global multilateral framework, and should pursue a more active role in reinvigorating the GATT. Canada would become an active participant in a new GATT round and would seek to promote and preserve existing multilateralism. Any bilateral initiatives on Canada's part would be downplayed on the grounds they could impair its ability to follow a policy of active multilateralism.

A second approach would be for Canada to maintain its participation in the GATT but actively pursue complementary bilateral options. The view underlying this approach is that because of Canada's relatively small size compared to the United States, Japan, and the EC, it does not have as strong an influence on the broad direction of the GATT negotiations. Certainly Canada has been successful in advancing its national interests within the GATT, but the larger powers have determined the broad parameters of negotiating rounds. Furthermore, because of the multilateral negotiating framework, Canada has to make its arrangements with its largest trading partner, the United States, through a complex multilateral framework, when in fact many issues would more appropriately be taken up bilaterally. Many countries have moved toward regional trading arrangements, such as the European Community, the European Free Trade Association and the Caribbean Basin Initiative between Caribbean countries and the United States. This approach supports the pursuit of bilateral negotiations with the United States, but on the understanding that they need not necessarily weaken or fragment the GATT and that any bilateral arrangement would complement Canada's continued commitment to the multilateral GATT framework.

A third approach would be to question whether the GATT has now reached an impasse as an institutional framework and whether Canada should actively seek institutional reform. Over the years, there have been many suggestions for alternative regional groupings in global trade arrangements, such as a multi-tiered GATT system. Such a super-GATT might involve a smaller group of countries more actively interested in a truly liberal world trading system. In turn, such a group of countries might be more willing than the full GATT membership to accept pro-

posals made by middle-sized countries such as Canada. The non-discrimination principle of the present GATT system would disappear under such an arrangement, but the benefits to Canada from a more active though smaller super-GATT could more than offset any resulting losses.

Exactly how Canada's trade interests have been furthered through the GATT and how they may be affected in any future GATT round remain a subject for debate. The perception is strongly entrenched in Canada that the GATT has served Canada well by allowing increased access to export markets and providing for discipline in world trade. Can significant further access be obtained through this route? What are the alternatives for Canadian trade policy? These are crucial questions in deciding how Canada should approach its participation in the GATT in the years ahead.

## **Canadian Trade Policies and Non-Tariff Measures**

A central feature of the current trade policy environment within which Canada operates is the widespread use of non-tariff measures to regulate international trade. The use of these measures greatly complicates multilateral negotiations in the GATT and raises the question of how Canada should conduct trade policy in light of the increased use of these instruments. These issues were taken up in a symposium, summarized in volume 10 of the research series, and are discussed in the commissioned paper by John Curtis in the same volume. Symposium papers by Moroz and Morici on the use of non-tariff measures in Canada and the United States appear in volume 11.

### ***Non-Tariff Measures at Home and Abroad***<sup>9</sup>

Non-tariff measures are practices other than tariffs that affect trade and can change the volume, commodity composition, and direction of international trade flows. Frequently these measures are explicitly adopted to protect domestic industries, but in some cases they are a side effect of domestic policies. Examples are regulations designed to protect the health and safety of consumers, which can have the (usually unintended) effect of distorting trade.

In the mid-1970s the GATT decided to adopt the term *non-tariff measures* to describe these policies, rather than the more commonly used term *non-tariff barriers*, because not all of the policies involved produce barriers as such. Table 2-2 lists the major practices classified by the GATT as non-tariff measures.

Since the major Canadian export market is the United States, it is U.S. trade barriers that usually attract major attention from Canadians. Among these are buy-American laws and regulations such as the Surface Transportation Assistance Act, which requires that federal funds spent on transportation equipment be used to buy products from domestic

**TABLE 2-2 Major Classification Headings in the GATT Inventory of Non-Tariff Measures**

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Part I	Government Participation in Trade and Restrictive Practices Tolerated by Governments
A	Subsidies, export subsidies, competitive subsidization
B	Countervailing duties
C	Government procurement
D	Restrictive practices tolerated by governments
E	State-trading, government monopoly practices, etc.
Part II	Customs and Administrative Entry Procedures
A	Anti-dumping duties
B	Valuation
C	Custom classifications
D	Consular formalities and documentation
E	Samples
F	Rules of origin
G	Custom formalities
Part III	Technical Barriers to Trade
A	General
B	Technical regulations and standards
C	Testing and certification arrangements
Part IV	Specific Limitations
A	Quantitative restrictions and import licensing
B	Embargoes and other restrictions of similar effect
C	Screen-time quotas and other mixing regulations
D	Exchange control
E	Discrimination resulting from bilateral agreements
F	Discriminatory sourcing
G	"Voluntary" export restraints and export restrictions
H	Measures to regulate domestic prices
I	Tariff quotas
J	Export taxes
K	Requirements concerning marking, labelling, and packaging
L	Other
Part V	Charges on Imports
A	Prior import deposits
B	Surcharges, port taxes, statistical taxes, etc.
C	Discriminatory film taxes, use taxes, etc.
D	Discriminatory credit restrictions
E	Subsidies
F	Emergency action

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*Source:* Unpublished GATT documentation.

producers; the Domestic International Sales Corporation and its successor the Foreign Sales Corporation, which provides an export subsidy through the tax system; the excessive legalization of American trade policy, with the legal system being used as a way of harassing importers who attempt to penetrate the domestic market; and the use of countervailing, contingency, and support measures.

In the European Community, another major Canadian export market, the key barriers result from preferential access granted to certain countries such as the EFTA countries; the Common Agricultural Policy, which provides agricultural subsidies that impact on Canada's agricultural exports; standards and other administrative procedures; and government procurement practices.

In Japan, a whole range of policies operate, including quantitative restrictions subject to variations, inconsistencies, and complexities of various kinds; quotas; technical barriers and standards; the non-acceptance of Canadian test data; rigorous customs enforcement with no appeals procedure; government procurement practices; government subsidies and research grants in key developing industries; and the ministry of finance's control over foreign freight carriers in access to Japanese facilities. In addition, prohibitions, restrictions, or changes are frequently added to regulations affecting foreign countries.

It is often asserted that Canada uses fewer non-tariff measures than its trading partners, that it is the lone Boy Scout in a discreetly protectionist world. This view can be questioned, however, since Canada uses a range of non-tariff measures similar to those of other countries, both to provide protection for various industries and to promote its industrial and regional development. Foreign countries dealing with Canada frequently produce a list of non-tariff measures they assert Canada uses. In Canada, these barriers are usually perceived to be the coincidental effects of purely domestic economic policies. The two most important non-tariff issues recently raised by the United States are rules governing entry of foreign investment into Canada and a number of features of the National Energy Program. There was, for example, a complaint by the United States on the local sourcing features applicable in FIRA rulings, which was upheld by a GATT panel.

In addition, such issues as subsidies, pricing policies of provincial liquor boards, supply management practices of both federal and provincial marketing boards, government procurement practices at both the federal and provincial levels, and provincial laws regarding export restrictions on minerals have attracted the attention of foreign governments. Other issues raised have included bilingual labelling requirements on mass-produced goods (which the United States has raised as a non-tariff measure) and the implications of metrication.<sup>10</sup>

## *Are Non-Tariff Measures on the Increase?*

It is sometimes asserted that non-tariff measures are on the increase and have been used by some countries to offset the effects of reductions in tariffs in GATT negotiating rounds. According to this view of the world, countries are seen as participating in GATT rounds to reduce tariffs — both their partners' and their own — while simultaneously offsetting the consequences by using other instruments that achieve the same protective effect. However, non-tariff measures are often inefficient instruments for achieving their objectives, and in some cases they have an even more restrictive effect than the tariffs they are intended to replace. Therefore, some observers attach a high priority to moving beyond the trade liberalization that has been achieved thus far in the GATT to focus more fully on non-tariff measures.

In contrast, others argue that non-tariff measures have simply become more visible as tariff barriers have declined in the postwar years. Their inclusion in the 1947 General Agreement is proof that they were present earlier and are now just more apparent. This is the so-called waterline hypothesis.

Peter Morici, in a paper presented at the Commission's symposium on non-tariff barriers and published in volume 11 of this series, argues that as tariff reductions were being negotiated in the 1960s and 1970s, the industrialized countries were developing a system of managed trade and protection through subsidies for certain mature industries. He notes that during this period, two trends of protection emerged among the advanced industrial countries. Selective protection in the form of orderly marketing arrangements, voluntary export restraints, and market-sharing agreements between these countries was used to manage unemployment in mature industries caused by imports from the newly industrialized countries and Japan. Further protection through domestic production and employment subsidies as well as export incentives emerged because of the increased competition between the advanced industrial countries in technology-intensive industries.

The growth of this form of protection is evident from Table 2-3. Selective protection began with the Short Term Agreement on cotton textiles in 1961, originally intended to be in place for only 12 months, but subsequently extended into two long-term agreements through the 1960s and into the early 1970s. By the mid-1970s, the Multi-Fibre Arrangement controlled trade in textiles, and agreements in steel and autos were beginning. By the 1980s the agreements in autos had spread further, and footwear had entered the picture, along with agreements on consumer electronics and motorcycles. Canada's participation in this emerging system of selective protection has not been as active as the other countries listed in the table, primarily because the impacts of import







penetration from the developing world have not been as severe. However, the trend toward increasing selective intervention is clear.

Table 2-4 is a recent list of restrictive trade measures on manufactured goods in major developed countries. Many of these measures are relatively recent, but the growth in coverage is notable, as is the relatively small number of such measures in use in Canada. The relatively lighter use of these instruments by Canada is also confirmed by Table 2-5, which shows the share of imports of manufactures covered by the trade restrictions used by the United States, the EC, Canada, and Japan.

A further view on non-tariff barriers was presented in notes prepared for the symposium on non-tariff barriers by Jan Tumlrir of the GATT Secretariat. He categorized non-tariff barriers in order of decreasing importance as quantitative restrictions, subsidies, anti-dumping codes, product standards, customs valuation procedures, and government procurement. In his view, all measures following quantitative restrictions are annoyances rather than significant trade barriers. However, Tumlrir also cited estimates suggesting that the proportion of world trade conducted outside the system of GATT rules (in defiance of its rules or in a non-liberal manner) is now approaching one-half.

According to Tumlrir, quantitative restrictions are at the heart of problems the global trading system faces, and the GATT has been unable to effectively deal with these restrictions even though their use is explicitly rejected in the GATT. In spite of the attempts to deal with non-tariff measures, restrictions are conspicuous by their absence from any of the GATT codes that have been negotiated.

### *Non-Tariff Measures and the GATT*

It was originally the intent of the GATT that all non-tariff measures would be abolished as soon as balance-of-payments difficulties permitted and that all protection would eventually take the form of negotiable customs duties. However, although the various GATT rounds have discussed NTMs, they have not been eliminated but instead have grown in use.

It was not until the Kennedy Round that NTMs were first subjected to serious scrutiny and negotiation. Measures selected for attention included government procurement, valuation procedures for imports, administration of technical regulations, internal regulation, and quantitative restrictions. Negotiations for the most part did not progress beyond the agreement to establish negotiating groups on these matters. Exceptions included modification of the American Selling Price system, which was combined with tariff concessions in the settlement reached in the chemical sector, and the agreement on a code of behaviour covering anti-dumping practices.<sup>11</sup>

During the Tokyo Round, agreement was reached for codes of conduct covering industrial standards and certification procedures, government

**TABLE 2-4 Restrictive Trade Actions on Manufactured Goods in Canada, the United States, EEC, Japan (in effect in 1983)**

<b>Canada</b>	
Automobiles	VER
Textiles and apparel	Quotas (MFA)
Leather footwear	VER/OMA
Non-leather footwear	Quota
<b>United States</b>	
Textiles and apparel	Bilateral quotas (MFA)
Porcelain-on-steel cookware	Safeguard
CB radio transceivers	Safeguard
Footwear (non-rubber)	OMA
High carbon ferrochromium (F.C. over 8% carbon)	Safeguard
Colour TV assemblies	Safeguard
Lag bolts, nuts, screws of iron or steel	Safeguard
Specialty (stainless and alloy) steel	OMA/Bilateral quotas
Automobiles	VER
Certain steel products	VER
Motorcycles	Safeguard
Specialty steel	Safeguard
<b>European Community</b>	
Textiles and apparel	Bilateral quotas (MFA)
B/W television receivers	OMA/VER
Jute products	OMA/VER
Tunny for industrial purposes	Other
Phosphate fertilizers	Renewed surveillance
Steel (iron and steel, excluding ferroalloys)	VER
Steel (Korea)	Other
Motorcycles	Other
Colour TV	VER (at 1982 levels)
Colour TV tubes	Quota
Numerically controlled machine tools	VER
Quartz watches	VER
VTRs	Quota reduction
Light commercial vehicles	VER
Automobiles	VER
Motorcycles	VER
Forklift trucks	VER
<b>France</b>	
Industrial chemicals: synthetic organic dyestuffs	Global quota
Tiles	Bilateral quota
Ferroalloys	Discretionary licensing
Radio, T.V., communication equipment	Bilateral quota/Discretionary licensing
Consumer goods: umbrellas, toys	Quota/Import licensing
Automobiles	VER
VTRs	Import via Poitiers only
Tableware	Other

**TABLE 2-4 (Cont'd)**

<b>Italy</b>	
Footwear (Japan)	Bilateral quota
Film (chemicals, nec)	Bilateral quota
Tires and tubes	Bilateral quota
Pottery, china	Bilateral quota
Tiles	Bilateral quota
Cutlery, tools	Bilateral quota
Engines: internal combustion, piston	Bilateral quota
Radio, TV communications equipment	Bilateral quota
Motorcycles, bicycles	Bilateral quota
Raw silk	Safeguard
Automobiles	VER
<b>United Kingdom</b>	
Radio, TV communications equipment:	
Transistorized radio and TV receivers	State trading
B/W TV	Quotas
Yarn of synthetic fibre	Safeguard
Footwear (Korea, Taiwan, Poland)	OMA/VER
Flatware (Korea)	OMA/VER
Automobiles	VER
VTR	Other
Tableware	Other
<b>West Germany</b>	
Flatware (Korea)	OMA/VER
Automobiles	VER
<b>Benelux</b>	
Flatware (Korea)	OMA/VER
Automobiles	VER
<b>Japan</b>	
Sheep and goat leather	Discretionary licensing
Leather footwear	Discretionary licensing
Automobiles	Discretionary licensing
Telecommunications equipment	Discretionary licensing
Pharmaceuticals	Discretionary licensing

*Source: Annual Report of the President of the United States on the Trade Agreements Program (Washington, D.C., 1983), pp. 121-22.*

*Notes:* The list of trade-restrictive actions in Japan does not include Japanese restrictive trade practices that do not fit into the categories under consideration.

VER – Voluntary export restraints.

OMA – Orderly marketing arrangements.

**TABLE 2-5 Restrictions on Manufacturing Imports in Canada, the United States, the European Community, and Japan  
(Restricted Trade as a Share of Total Imports of Manufactures)**

	United States	% of 1980 Imports	European Community	% of 1980 Imports	Canada	% of 1980 Imports	Japan	% of 1980 Imports
1980	Restrictions already in effect	6.40	Restrictions already in effect	10.80	Restrictions already in effect	1.20	Restrictions already in effect	7.20
<b>Additional Restrictions Introduced after 1980</b>								
1981	Automobiles	6.20	Steel (Korea) Tape recorders (UK/Japan) Automobiles (Germany, Belgium/Japan)	1.40	Leather, footwear	0.27		—
1982	Certain carbon steel products (EC)	0.81	Motorcycles (France/Japan) VTRs (France/Japan)	0.18	Non-leather footwear	0.26		—
1983	Motorcycles	0.30	Colour TV tubes VTRs (numerically controlled machine tools) Quartz watches Motorcycles Forklift trucks	2.50		—		—

*Source: Annual Report of the President of the United States on the Trade Agreements Program (Washington, D.C., 1983), p. 123.*

procurement policies, government valuation practices, and import licensing. A new code relating to subsidies and countervailing duties was also adopted. A new safeguards code aimed at greater discipline and transparency over measures providing for emergency action against sudden surges of imports of particular products was not achieved, largely because the European Community wanted the right to take selective action.<sup>12</sup>

The experience with non-tariff measures under the GATT has therefore been somewhat mixed. Important non-tariff measures remain outside the coverage of GATT agreements, and where a substantive attempt was made to deal with one of the major issues, namely safeguards, it was not possible to reach any further agreement. As far as Canada is concerned, this experience with negotiating non-tariff measures in the GATT is viewed by some as not very encouraging. Realistically, however, there may also be few alternative institutional mechanisms available for negotiating restrictions on their use.

### *Conducting Trade Policy in Light of Non-Tariff Measures*

In conducting trade policy, Canada therefore has to recognize the presence of non-tariff measures. This poses a series of perplexing choices for Canada. If it is true that non-tariff measures have increased as tariffs have been reduced, then it is questionable that trade liberalization under the GATT has really helped to increase Canada's access to foreign markets, and the potential benefits from future GATT negotiations should be viewed with skepticism. On the other hand, if the waterline hypothesis is correct, then the multilateral framework has served Canada well. In this case, Canada should renew its commitment to the GATT in order to achieve reductions in non-tariff measures and further improve its access to foreign markets.

These issues, of course, play a part in determining the balance between a bilateral and a multilateral focus in Canada's trade policies. A further consideration is that non-tariff measures are far more complex, more difficult to negotiate, and more difficult to define than tariff barriers. It will therefore be extremely difficult to deal with these measures on a multilateral basis through the GATT. Since the non-tariff measures that are most important to Canada are those used by its major trading partners (the United States, the EC, and Japan), a major move on the non-tariff measure issues may well argue for an increased bilateral rather than multilateral focus to Canada's trade policies.

A complicating issue is that some non-tariff measures by Canada's trade partners actually help Canada. Canada can benefit from increased access to its export markets if discriminatory trade barriers are used against third countries. An example would be U.S. trade barriers against imports from Japan. Therefore, a multilateral code on particular non-

tariff measures covering all markets abroad might not always be in the Canadian interest.

Also complicating these issues are the questions of measurement and data. The list of non-tariff measures currently compiled by the GATT is extraordinarily long and obtaining estimates of their severity is a daunting task. There is no general agreement about whether non-tariff measures have become more or less severe over time or indeed about what impact these trade barriers actually have on world trade. There is even evidence suggesting that non-tariff measures such as the MFA may in fact work in favour of the countries against which the restrictions are aimed.

How should Canadians approach trade policy in light of these considerations? Three options can be distinguished.

### *The GATT Option*

It is generally agreed that the GATT is an important institutional framework through which to control NTMs, but that there are difficulties in trying to negotiate reductions in these measures. It is difficult to reach a consensus among members about which barriers to negotiate on. There is no common set of measurements on which negotiators can base their offers. There are problems with the most-favoured-nation principle, since many countries wish to use selectivity in their non-tariff measures.

Different approaches have been suggested to deal with the NTM problem within the GATT. One is a general multilateral approach with dispute resolution through GATT panels. Another is a barrier-by-barrier approach with rules of behaviour for NTMs not covered by the GATT. A further step might be to negotiate a withdrawal of the Protocol of Provisional Application that permitted exemptions for existing NTMs at the time the GATT was signed, to make the GATT rules on non-tariff measures into more firmly binding international obligations.

Clearly, a set of rules covering non-tariff measures needs to facilitate the multilateral reduction of existing trade distortions and to limit the introduction of further barriers. There is also a need for a strong monitoring system and enforcement procedure. It is generally agreed that an adjustment assistance code is also needed before any significant reductions in non-tariff measures on an international scale can be taken further. Some have also suggested that the GATT Secretariat should play a stronger role in providing data and analysis for negotiations and in performing surveillance duties and initiating actions in the event of non-compliance with the codes.

### *The Bilateral Option*

Pursuit of a bilateral option or even a series of bilateral options would involve an attempt to negotiate bilateral arrangements with major trading partners independently of the framework of the GATT. It is often



alleged that U.S. actions involving non-tariff barriers are directed against third parties and are not intended to affect Canadian trade adversely. Although this may be true, there are also non-tariff issues in the United States that are of direct interest to Canada, such as the Surface Transportation Assistance Act. It is questionable, however, whether Canada could exert enough influence to change U.S. non-tariff measures, especially if any changes had to be administered on a most-favoured-nation basis.

### *The Unilateral Option*

A final option is for Canada to control its own NTMs unilaterally. Some argue that in the case of small countries such as Canada, the major losers from non-tariff barriers — and for tariffs as well — are the ones imposing these barriers. In this view, non-tariff measures are seen as a reflection of internal political pressures for protection of narrow producer interests, as distinct from the national interest. To the extent that this is so, the unilateral option may be a desirable route for Canadians to follow. The drawback is that unilateral action does not help to improve and secure access to export markets.

## **Export Promotion and Industrial Policies as Vehicles for Access**

In addition to attempts to negotiate increased and secure market access for exports through agreements with trading partners, much recent attention in Canada has been devoted to export promotion policies. Exports can be promoted by either granting general subsidies to exports or exporting firms or by targetting government assistance toward particular firms, products, or industries which appear to have particularly strong export potential. The latter approach is often thought of as an integral part of an industrial policy, reflecting the focus of such policies on promoting particular industries. These issues are addressed in two papers prepared for the Commission: an evaluation of Canada's export promotion programs by André Raynauld which appears in volume 12, and a monograph by Richard Harris on industrial policy and its links to trade policies which is volume 13 of the series.

### *Canada's Export Promotion Program*

Canada's export promotion policies primarily reflect the activities of the Export Development Corporation (EDC). This corporation was established in 1969 and replaced the earlier Export Credit Insurance Corporation. EDC's activities consist mainly of insurance programs and loan financing. EDC loans (export credits) cover many products, including industrial equipment, nuclear energy products, shipbuilding and com-

munications equipment. Under its insurance programs, EDC insures against commercial and political risks for up to 90 percent of the value of exports. Unlike similar policies in countries such as Japan and France, Canadian programs are not mandatory. It is up to the exporter to decide which risks to insure and with which country to trade. (Less than 1 percent of exports to the United States are insured by the EDC). Insurable risks may be commercial, such as a purchaser's refusal to pay for goods received, or political, such as a blockage of funds or cancellation of imports due to war or revolution.

Raynault estimates the premium paid on the value of insured exports at 0.4 percent in the 1970s, 0.445 percent in 1980, and 0.721 percent in 1982. Compared with the practices of most other industrialized countries (or even the total size of Canadian exports), the volume of EDC insurance is modest, due to both the high level of trade with the United States and the high percentage of intra-firm trade.

The EDC also extends credits under its loan programs to foreign purchasers of products with 60-percent Canadian content. These credits can be as large as 85 percent of the value of the exports. They can be medium or long term, and have a set price for the term of the loan.

An especially important type of long-term financing in which the EDC engages is the opening of lines of credit as framework agreements with foreign countries. These agreements inform Canadian firms that credit is available and that certain countries are willing to conduct business with Canada. In 1982, 28 lines of credit were established with 16 countries. The establishment of these lines of credit followed the announcement by the federal government in 1981 that it would invest \$300 million per year for three years in "crédit-mixte," or parallel credit operations to counterbalance similar subsidies offered by other governments.

However, it is important to keep in mind that despite the existence of the EDC, it is the commercial banks that play the key role in financing Canada's exports. Ninety-nine percent of Canadian foreign trade relies on short-term financing, which is the main area in which the banks operate. Since 1980, the banks' participation in EDC loans through loan sharing has steadily decreased. The banks usually take shorter term loans at a floating interest rate, whereas EDC takes longer term, fixed-rate loans.

### ***The Costs and Benefits of Export Promotion Policies***

Canada uses a similar percentage of public resources to finance exports as other industrialized countries. At the federal level, in addition to EDC export financing programs, the Wheat Board offers short-and medium-term credit to developing countries. Several provinces also operate export financing programs within the broader activities of their Crown corporations. Most of this financing is directed toward developing coun-

tries. Raynauld estimates that in 1980 approximately \$2.3 billion was paid to less developed countries in export credits, more than twice the total credits granted by EDC.

The financial cost of export promotion policies is the difference between benefits (the return on capital invested by EDC) and costs (the cost of borrowing capital). Raynauld estimates that in 1982, the net return on export promotion loan activities was 5.2 percent lower than the cost of capital investment (meaning that export loans were subsidized by just over 5 percent).

However, the economic cost of these policies is a different matter. It involves calculating a weighted average of the gross-of-tax rate of return on the private investment displaced by export financing, the net-of-tax rate of return on domestic private savings, and the net-of-tax rate of return paid to foreign investors. Raynauld estimates that in 1982, the national cost of EDC loans was between \$443 million and \$318 million, depending on the assumptions used.

Evaluating the benefits of EDC activities is difficult for several reasons, since a range of benefits have been claimed. The primary objective of EDC activity is to promote Canadian exports. However, it is difficult to evaluate its contribution to that objective, since it does not follow that an export order insured or financed by EDC would not have been obtained without EDC's help. Typically, however, the foreign importer and the Canadian supplier both benefit, the division between them depending on demand and supply elasticities. The cost of the subsidy is borne by the Canadian taxpayer.

Another rationale sometimes given for EDC activity is that it provides services on a commercial basis that the private sector would otherwise not supply. Although it is true that 80 to 90 percent of EDC insurance activities are short term (less than two years) and cover a market segment not fully covered by the financial sector, it can be argued that the existence of EDC has deterred private firms from entering this segment of the insurance market.

Another benefit sometimes claimed is that EDC programs contribute to employment. Raynauld evaluates the empirical evidence in support of this claim as disappointing, and concluded that employment and balance-of-payment effects of EDC financing are negligible. He also argues that there are more appropriate policy instruments available to achieve these objectives, such as general monetary and fiscal policies.

Since approximately 60 percent of the insurance and 70 percent of EDC credit cover countries other than the United States or Europe, market diversification is another benefit sometimes claimed. Raynauld argues, however, that diversification per se is not a sensible objective for Canada's trade policies. Indeed, initiatives that follow such a direction can create new distortions and risks rather than reduce them.

Neither does Raynauld support the argument that government intervention through export assistance can compensate for tariffs or other barriers abroad. Whether or not Canada subsidizes its exports, the barriers abroad are there and are a national cost to Canada. In Raynauld's view, the solution is not to subsidize exports, but rather to seek to eliminate the tariffs and other foreign barriers that Canada's exports face.

Where foreign governments subsidize their exporters, it may seem only fair for Canada to help its own suppliers compete. However, as Raynauld points out, Canada still has to pay for its programs and there is the further danger of an escalation of subsidies, increasing the costs to the taxpayer still further.

Another benefit sometimes claimed for Canada's export promotion policies is that they can favour small and medium-sized businesses and provide for balanced regional development. Raynauld considers these objectives to be inappropriate for the EDC. In his view, small and medium-sized businesses are generally not as well equipped for overseas export activities as large firms and should not be encouraged to run excessive risks by distorting their activities through EDC financing. As for regional development, Raynauld argues that there are better methods of achieving these objectives.

Thus, although the EDC promotes the growth of exports and encourages a diversity of financial services to exporters, Raynauld argues that this is achieved at a net cost to the Canadian taxpayer of about \$500 million in 1982. He suggests that the EDC remove itself from short- and middle-term global insurance, but remain the main participant in a mixed system of reinsurance and as a last-recourse insurer. He recommends that direct credit and contract negotiation be turned over to financial institutions but that the EDC continue to offer facilities for rediscounting bank loans and even guarantees if necessary. He also suggests that EDC maintain its role as a negotiator of framework agreements with foreign countries.

### ***Industrial Policy and Trade***

The broader links between trade policy and industrial policy are addressed in Harris's monograph, which examines how an active industrial policy can coexist with an outward-looking trade policy and what the implications are for Canada's export policies.

Harris outlines in some detail the basis for his position in favour of an industrial policy for Canada. He questions the traditional perception that Canadians should be "hewers of wood and drawers of water" if trade is conducted according to traditional comparative advantage, and concludes that traditional comparative advantage, although perfectly

adequate to explain trade in primary products, is inadequate to explain trade in manufactured products.

In his view, the major implication of recognizing this deficiency is that the traditional emphasis on primary products as the source of Canadian comparative advantage and manufacturing as the sector at a comparative disadvantage is in error. To Harris, manufacturing is more properly viewed as an industry with no factor abundant base. He argues that the connections between manufacturing and resources should not be determined by reference to differences in factor use in the two sectors. In his view, trade in manufactures is more properly viewed within the context of the overall structure of world markets and, in particular, those variables determining competition in global markets. He sees an entry barriers approach to market structure as the most adequate theoretical structure for the analysis of Canadian trade in manufactured goods.

Using this line of argument, Harris advocates a multi-pronged approach to both Canadian trade policies and their links to industrial policy. He considers industrial policy to be synonymous with trade policy for a small country such as Canada. In his judgment, it is paramount that Canada pursue free trade with the United States both in goods and in cross-border investment. He also sees targetting (picking winners and losers) as desirable and considers it a necessity for Canada because of the small market size of the Canadian economy, its large geographic size, the large size of modern corporations within concentrated industrial markets, and the dynamics of individual firm development. He asserts that good economic intelligence will help in identifying industries that are potential winners.

Harris also suggests that Canada seriously consider free trade with the United States in energy, minerals, and forest products. This arrangement would guarantee an export market for those energy products, such as natural gas and hydroelectricity, where the United States is the only natural market. In addition, Harris suggests that offering to guarantee the United States long-term supplies of energy would give Canada bargaining leverage in obtaining increased access to U.S. industrial markets.

Harris points out that it is imperative for an industrial policy to focus also on the adjustment problems in those industries that are losers because of the changing international division of labour. These policies would take the form of offering compensation, mobility grants and job retraining, as well as helping firms in affected industries to rationalize and restructure. Harris notes that job retraining will have to be targetted at certain occupations. He sees training in microelectronics as useful and feels that education generally should place greater emphasis on science and engineering.

Harris also asserts that industrial development in Canada would be helped by raising the share of GNP devoted to industrial research and by implementing policies that focus on the development of small and medium-sized firms and help them to overcome export barriers. He feels that an industrial policy should address the problem of competition facing large-scale basic industries such as autos, rubber, and other traditional manufacturing industries. In Harris's view, plant automation offers the possibility that in the longer term, some of these industries may be made competitive in their present North American location. Therefore, he sees premature plant automation, encouraged through specific subsidy programs, as one policy response that may be warranted.

Harris feels there is a need for an active industrial policy in Canada, along with pursuit of a freer trade posture and a positive adjustment policy.

### *The Debate on Industrial Policy*

Despite Harris's endorsement of an industrial policy for Canada as part of an outward-looking trade strategy, the arguments in favour of an industrial policy are not as strongly endorsed by other economists. In fact, as is well known, there has been an active debate on industrial policy in Canada over the past few years, with advocacy from the Science Council of Canada (Britton and Gilmour, 1978) and reaction from economists such as Wonnacott (1980) and Watson (1983). A number of issues have been raised in this debate that go beyond the discussion of industrial policy in the Harris monograph but are nonetheless relevant to formulating a Canadian trade policy and are therefore raised here. The material presented here draws on these contributions.

Industrial policy is a term that means different things to different people. It denotes the discretionary use of policies for the purpose of changing the industrial structure from that determined by market forces. To some, the essence of such policies is the establishment of a general environment that allows successful industries to emerge more easily. To others, industrial policies focus on the promotion of particular industries or products (that is, on picking winners). Strong growth performance in Japan, allegedly due to the judicious use of industrial policies, has also been used by some as a strong argument for similar policies to be adopted in Canada.

Much of the criticism of industrial policies from economists has focussed on the issue of picking winners. Despite Harris's advocacy of improved economic intelligence as a basis for picking winners more successfully than in the past, it is not clear that in practice this is easy to do. Many would say that over the years, the government has been unable to translate this (laudable) general principle into specific, concrete

action. Moreover, political pressures often make it difficult for governments to admit failure, and can result in continued investment in losing enterprises.

Picking winners is often viewed as the key to Japan's success, but this view overlooks a number of other contributing factors. Japan has, for instance, had a higher savings rate, lower taxes on the return to assets, and a smaller share of GNP in the public sector than in North American or European countries.

It is important to remember that governments have at times picked spectacular losers, such as the Concorde in the United Kingdom. Just as Japanese experience may support picking winners, experience in economies that have had lower growth rates than Canada (such as the United Kingdom or New Zealand) suggests the opposite.

Generally, economists tend to be skeptical of the wisdom and feasibility of government attempts to pick winners, whether in terms of firms, industries, or products. The question economists repeatedly raise is why the competitive market cannot be relied upon to pick winners. Economists usually see a strong pro-competitive policy rather than an industrial policy per se, as an integral part of an outward-looking trade strategy, since they see this as encouraging efficiency and removing anti-rationalization effects due to market collusion.

There are, however, other issues underlying the industrial policy debate and its relation to trade policy. One is whether providing research and development subsidies to promote new product development really helps export performance. Such policies can be counterproductive if they crowd out privately financed R&D. Although externalities from R&D may justify some degree of subsidization, it seems important to find a more efficient subsidy method than Canada has used in the past. Tax concessions rather than grants might help ensure that marketability of the subsidized product enters into R&D decisions in a more coherent way. This policy choice could also reduce the risk that trading partners would use countervailing duties to counteract the export effects of Canadian R&D subsidies.

Another possible component of an industrial policy would be procurement policies favouring Canadian-made products by all three levels of government, especially in the high-technology area. However, such a policy would involve some problems. If it were followed, Canada would find it hard to make the case for strengthening international codes on non-tariff measures, such as those covering government procurement. In addition, discriminatory policies of this form impose additional costs on Canadians through the higher taxes required to pay for the preference policies.

Industrial policy advocates also suggest that technology should be imported by independent Canadian firms in arm's length licensing agreements, not by foreign subsidiaries. Although this policy tends to reduce



the degree of foreign ownership in the economy, it can also be disadvantageous insofar as it slows the transmission of new technology to Canada.

A further claim sometimes made by industrial policy advocates is that mergers of existing Canadian firms should be encouraged in order to strengthen the ability of Canadian firms to compete internationally. Allowing (as opposed to forcing) such mergers may indeed be desirable since this can mean realizing the gains from scale economies and rationalization usually associated with trade liberalization. It does not follow, however, that merger policy is a substitute for more liberal trade policies, since the full benefits to Canadian industry from larger scale production and increased competition require reductions in foreign trade barriers.

## The Service Trade Issue

Although there are several trade issues that would be part of either future bilateral or multilateral trade negotiations, one that has received special attention in the Commission's research program is the trade-in-services issue. This attention partly reflects the efforts of the United States to include service trade on the agenda of a future GATT round. The importance of services to the Canadian economy has, however, also motivated the attention given to this issue.

The term *trade in services* refers to a range of non-merchandise international transactions, such as banking, insurance, transborder data flows, freight and shipping, and travel. U.S. efforts to include the trade-in-services issue on the agenda for a future GATT round are based on the assessment that the United States has a comparative advantage in the provision of these items. Services, including those provided by government, now account for about two-thirds of U.S. GNP and an even larger portion of U.S. employment. In the past two decades, over 80 percent of job growth in the United States has taken place in the service industries.<sup>13</sup> The relative immunity of service industries to downturns in economic activity has been evident in the most recent recession. While manufacturing employment declined by 2.8 million from 1979 through December 1982, service employment increased by 2.2 million.<sup>14</sup> Services are exported through multinational companies and generate manufactured exports, and the liberalization of trade in services is seen as essential to an improvement in U.S. trade performance.

However, despite the importance of the service sector in the U.S. economy, Canada's trade with both the United States and other countries remains concentrated in goods. In 1981, Canada exported \$84.1 billion in goods but only \$14.9 billion in services (and only \$11.7 billion in tradeable services such as travel, freight and shipping). In the same year, imports amounted to \$77.5 billion in goods and \$29.7 billion in services



(\$14.8 billion in tradeable services). Canada's ratio of exports to production in goods in 1977 was 28 percent, almost four times greater than the 7.5 percent figure for services. Import penetration in Canada for goods was 29 percent in 1979, also more than four times greater than import penetration in services.<sup>15</sup> In addition, Canada's deficit in services trade has been growing; the service deficit was 2.5 percent of GNP in 1971 and 4.5 percent in 1981. This deterioration can be traced to Canada's growing deficit in terms of interest, dividend and other investment income paid abroad.<sup>16</sup>

Canadian and U.S. interests differ on this issue. The United States sees major export potential in services on a global scale, while Canada sees itself as an exporter of goods with perhaps less to gain. However, Canada's banking industry has shown considerable interest in the idea of free trade in services for much the same reason that other potential exporters have been attracted to free trade in goods — namely, the chance to penetrate much larger foreign markets. A clear Canadian position on the trade-in-services issue remains to be fully worked out.

### *Applying the GATT to Trade in Services*

One key issue with trade in services is whether, if the GATT framework is to be used to negotiate a multilateral agreement, existing GATT principles can be applied to services. Although the United States strongly favours an attempt, there is no consensus on whether this extension will be easy to accomplish or is even desirable.

In a study commissioned for the recent federal Task Force on Trade in Services, Clark (1982) concluded that most GATT procedures and practices should apply to trade in services and that it will be difficult to reduce barriers to trade in services unless principles and practices similar to those already in the GATT are applied.

However, Rodney Grey takes a different view in his commission paper, published in volume 10 in the research series. In his opinion, the GATT is in considerable disarray as a set of rules and is not working effectively for trade in goods. He suggests that a number of key provisions (Articles VI, XII, and XIX, for example) have evolved into rules that regulate the use of restrictive trade actions by governments and, if transferred to trade in services, would merely provide authority for new restrictive actions such as anti-dumping devices, countervailing duties, and restrictions to safeguard the balance of payments. Further, if broad rules were negotiated by the European Community and the United States and imposed on other countries, such as Canada, they would probably not take account of Canadian interests.

Grey emphasizes that although there may well be costly restrictions covering trade in services, other restrictions on trade in goods are perhaps of greater importance, even to the United States. He cited as

examples restrictions on agriculture, textiles and clothing, steel and autos, as well as the need to improve market access for exports of goods from developing countries. Grey's concern is that too strong a focus on trade in services in either a bilateral or a multilateral negotiation may divert attention from other more important trade issues.

In Grey's judgment, the central issue arising with trade in services is the international movement of information: data processing, transmission across borders, and complex computer programming. He feels that if the transborder data flow issue is tackled, a major portion of the trade-related services issue will have been addressed.

A further contentious issue in extending GATT principles to trade in services is that of national treatment. This is the GATT principle under which foreign goods are to be treated in the same manner as domestic goods after they cross the frontier. The GATT provides for protection at the border through tariffs, after which there should be no further discrimination in the treatment of imports compared to domestic goods. For most services, however, the frontier is irrelevant since the service transaction takes place directly with the recipient in his own country. Thus, if this principle were applied to services, it is not clear how a country could protect its services or how negotiation on the level of protection could proceed.

Other contentious issues involve the right of establishment and the right of access by foreign labour to provide services. Canada would probably be unwilling to unconditionally surrender control over the right of establishment for foreign inward direct investment, or to automatically grant entry to all individuals supplying services to Canadians.

### *Alternative Approaches to the Trade-in-Services Issue*

The assumption in Canada seems to be that any bilateral or multilateral negotiation on trade in services would require a catalogue of negotiable measures (such as rights of establishment) applied by various countries on a sector-by-sector basis. It would also be important to detail the current import regime for particular services in the countries involved.

Beyond this, various approaches could be taken to establishing a services trade agreement. These approaches have recently been looked at in a U.S. government study on service trade which suggested developing single-sector agreements open to all interested parties and tailored to the regulatory and other particularities of each sector. Since it would be difficult to maintain a consistent approach across all sectors and countries, bilateral sectoral agreements might be the easiest to negotiate, but there is the danger that restrictions against third countries might result, especially if market-sharing arrangements were included.

Another option explored in the study was bilateral agreements covering a larger number of sectors. Such agreements could incorporate an

exchange of concessions or benefits across a variety of service sectors and could incorporate general principles such as national treatment and transparency. In these bilateral agreements, the concept of most-favoured-nation treatment would presumably be abandoned in favour of preferential systems based on reciprocal arrangements.

A number of difficulties will inevitably arise in any negotiation on services. There is a lack of adequate and detailed statistical information on the basis of which countries can negotiate. Since services are intangibles, many of the administrative procedures for regulating trade in goods do not apply (for example, valuation). There are also difficulties inherent in the different national approaches to regulation. There are provisions in Canada's Bank Act, for instance, that prohibit cross-border data flows.

Despite all these problems, however, there is little doubt that if there is a further GATT round, trade in services will in all probability be on the agenda. It follows that Canadian interests in these issues will almost certainly need to be more fully explored in the years ahead.



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## Issues in Designing Canada's Import Policies

Import and export policies are inextricably linked, in the same way that imports and exports are linked through trade. Canada exports to pay for imports. Policies put in place because of imports affect the exports of others, who may retaliate with policies that affect Canada's exports. Despite the difficulties of separating trade policy into import and export policies, the research program has used an organizational division between those trade policy issues that primarily affect Canada's access to foreign export markets and those that directly affect Canada's domestic economy through protectionist measures. This section describes the results of the research on the latter.

### Adjustment Assistance Policies

Key to Canada's trade policies are the accompanying set of domestic policies that facilitate adjustments between industries and regions in Canada as external pressures on the economy change. Without adjustment policies, the pressures for protection will clearly be larger, and there are further issues of whether it is both equitable to compensate those affected by external change and efficient to help them adjust.

On-going structural adjustment is a fact of life in any economy. Firms enter and exit from industries, jobs appear and disappear, and investment flows toward industries offering the highest expected returns. In an open economy like Canada's, pressures for adjustment arise from both internal and external sources, the latter including changes in prices of imports and exports and changes in trade policies by Canada and by its trading partners.

The adjustment aspects of trade policy making were taken up in a Commission symposium on adjustment and trade policy. A summary of

the symposium is included in *Domestic Policies and the International Economic Environment*, volume 12 of the research series, along with expanded versions of symposium papers presented by John Baldwin and Paul Gorecki, David Richardson, Michael Trebilcock, Matthew Robertson and Alex Grey, and the Department of Regional Industrial Expansion. The central issue in this symposium was how public policy should respond to all the external pressures for change and, indeed, whether it should respond at all. If the domestic economy is insulated from changes abroad, both the status quo and the incomes of those factors of production that would be adversely affected by change are preserved, and adjustment policies are not needed. However, if one recognizes the costs of preserving the status quo, the question becomes how to design policies that facilitate adjustments rather than resist pressures for change.

The view that prevailed at the symposium was that whether there is a need for adjustment policies as part of an import policy depends on how well markets are seen to be working, since in an economy with smoothly functioning labour and capital markets, adjustment policies can be rationalized only in terms of compensating those affected by change. Since these individuals may be better off than those financing the compensation scheme through taxes, extensive adjustment assistance could mean a move toward more inequality. However, in an economy characterized by regionally concentrated unemployment, poor information flows, or low mobility between labour markets, adjustment policies can be more easily justified.

A related issue is how adjustment policies should be designed, assuming they are viewed as desirable. Should programs be targetted at specific groups, regions or communities, or should they be more general in scope? Should they be directed to firms or to workers? Is the source of adjustment pressures important in determining whether assistance is warranted? Finally, how can programs be designed to promote rather than retard adjustment?

### *The Sources of Pressure for Structural Adjustment*

In the past, the most important structural adjustment problems in Canada have generally not been due to changes in either foreign or domestic trade policies. Typically, other external shocks have been more important — oil price increases and the government's response to them; volatile export and import prices, especially in the 1970s; and the increasing importance of the newly industrializing countries in world trade. Changes in the domestic economy due to shifts in demand and productivity trends are even more important than these external shocks. Evidence presented in the symposium on adjustment suggested that in a sample of 13 Canadian industries that have experienced substantial

import penetration in the past 15 years, changes in domestic demand and productivity are the most important factors influencing employment changes, even though in many cases exports and imports had a significant effect.

However, even if trade policy changes have been less important than other sources of pressure for structural adjustment in the past, future trade policy changes may well cause significant adjustment problems, especially for industries such as clothing and textiles that are now heavily protected. Furthermore there is evidence that past trade policy changes have caused changes in Canada's industrial structure. Empirical work by Baldwin and Gorecki presented to the symposium indicated that lower tariffs in Canada lead to increases in plant scale, relative to comparable U.S. plants, in industries with a small number of firms protected by high tariffs. Lower tariffs have also increased the length of production runs in manufacturing. Tariffs also affect Canadian productivity relative to that in the United States through their effect on product diversity and relative plant scale, as well as the increased market size made possible by trade liberalization. Baldwin and Gorecki also found that relative productivity is greater the larger the Canadian market, measured by the number of plants of minimum efficient scale it can accommodate.

### ***Adjustment Policies: Their Design and Their Effects***

Government responses to adjustment problems can follow several alternative approaches. Policies may promote adjustment but may also involve temporary protection to allow for orderly and less painful adjustment. Adjustment assistance can be targetted at firms or workers (or both). Programs can be made available to all or they can be more narrowly targetted. However, the danger is that if the policies retard adjustment, the industry and its workers may remain dependent on the adjustment policies, which in turn may grow into permanent protection.

Many economists cite imperfect information, uncertainty, and incomplete factor mobility as sources of rigidities that can justify adjustment assistance programs. Several participants in the symposium cited wage rigidities in the labour market as the major problem area. Labour market externalities are specifically mentioned in Trebilcock's symposium paper as being important in cases where failing firms are forced to lay off workers in a particular region where unemployment is already high. As he puts it, "Subsidized employment maintenance with a failing firm may sometimes be less costly than firm failure, and indeed less costly than alternative forms of employment maintenance or social relief."<sup>17</sup>

Capital market imperfections are usually given less weight than other market imperfections in justifications for adjustment assistance. Ade-

quate access to capital markets to finance the human and physical capital investments needed for adjustment is sometimes cited as a possible reason for adjustment assistance. However, in examining the treatment of Canadian companies that have experienced difficulties unrelated to trade problems, Trebilcock did not find a convincing rationale for providing public funds for bridging finance. If firms are indeed viable, capital markets should be able to provide them with sufficient funds to continue operation. There is, however, a potential problem with the bankruptcy process in cases where liquidation of a firm's assets may fail to take fully into account the firm's long-run social value as an on-going productive unit.

The major design issues with adjustment policies are whether they should be primarily directed at firms or at workers, whether general or categorical adjustment policies are preferable, and, if categorical policies are chosen, whether they should be directed at all structurally displaced workers or only at trade-displaced workers.

Government can direct adjustment policies toward firms, assisting them in adjusting their productive capacity and letting labour adjust freely; or it can target adjustment assistance to the work force, letting firms adjust freely. It can also pursue an intermediate course. Several participants in the symposium argued that adjustment policies should be directed at workers, since capital owners are better able to adjust on their own because they have access to national and international capital markets and are likely to have better information concerning prospects for change and alternative employment opportunities for their resources in other industries. Put another way, the view was that it would be unwise to go to great lengths to preserve failing firms *per se* rather than helping workers adjust.

This issue of targetting also arises in choosing between general and categorical adjustment policies. General programs are desirable inasmuch as they avoid the introduction of specific distortions. Adjustment policies that assist rationalization within industries can also be important because it is such an important part of the adjustment process. Narrowly targetted policies are generally more difficult to design. Identifying losing industries is easier than identifying losing firms, since the rankings of firms within an industry are constantly changing.

Much of the evidence on the impacts of trade-related adjustment policies is based on American experience with the Trade Adjustment Assistance Program (TAA), discussed by David Richardson in his symposium paper. Under this program, adjustment support was made available to workers through additional unemployment benefits after ordinary payments expired, along with job-search and relocation allowances. The original TAA consisted of income support specifically aimed at trade-displaced workers, but over time the definition of trade-displaced changed. During the initial 1962–73 period, eligibility was

severely restricted and expenditures were small. From 1974–80, expenditures rose as eligibility criteria were eased. When rules were retightened in 1981, expenditures fell again. The duration of unemployment was affected by TAA because of the extended length of time for which benefits could be claimed. Generally, what seems to have occurred with trade-displaced workers was a series of unemployment spells beginning with a trade shock. The length of the first unemployment spell seems to have increased with the size of the benefit, but the correlation between compensation and total length of unemployment spells is low.

Experience with TAA in the United States has been widely read as suggesting that the program has been unsuccessful in facilitating adjustment. The chief drawback in the 1974–81 period was apparently that the program was not targetted narrowly enough, so that many workers received assistance when they were only on temporary layoff or a reduced work week.

Target efficiency has also been an issue with Canadian worker-related adjustment programs. For the most part, Canada has used more general policy instruments than the United States, such as Unemployment Insurance and training and mobility programs, although there have been some specific adjustment policies directed toward trade-related adjustment problems. The symposium paper by Matthew Robertson and Alex Grey indicated that in 1982–83 the Labour Adjustment Benefits Program provided \$9.3 million of preretirement benefits in selected trade-impacted industries (textiles, clothing, footwear, and tanning). The design of this program reflected the belief that older workers require assistance since, once unemployed, few are able to find new jobs.

The Industry and Labour Adjustment Program (ILAP) is another program that until recently provided adjustment assistance; its functions have now been taken over by the Industrial and Regional Development Program (IRDP). This program was focussed on 12 designated communities, chosen on the basis of the severity of unemployment, not the source of the adjustment problem (such as trade policy changes). The program consisted of enriched labour market programs such as training and mobility assistance, job-creation measures, and portable wage subsidies for older workers.

In evaluating the effectiveness of these labour adjustment programs, it is difficult to separate the structural or permanent dislocations to which these programs are directed, from the wider cyclical effects. The effectiveness of ILAP was limited because it was introduced in 1981, at the beginning of a recession. Robertson and Grey indicate that of the estimated \$97.2 million spent on ILAP in 1981–83, \$52.3 million was spent on job-creation measures, \$37.6 million on training, and much smaller amounts on mobility assistance, wage subsidies, and manpower con-



sulting services. Take-up of adjustment assistance was small and was mainly for short-term job creation.

An examination of the re-employment profiles of laid-off workers in industries falling under these programs indicated that about 65 percent return to the same employer in their next employment spell. This figure compares to the 40-percent average for all industries. The main reason seems to be limited opportunities for alternative employment in communities heavily dependent on import-competing industries (such as textiles, clothing, footwear, and tanning) but the data also suggest that these programs have been relatively ineffective in facilitating adjustments between industries.

Several participants in the symposium argued that pressures for structural adjustment in the 1980s will continue, especially as moves toward negotiated trade arrangements cover an increasing number of industries. Canada and many other countries are also faced with the problem of how to minimize the social costs of reallocating resources out of declining industries. Although in theory new employment opportunities should arise automatically because of market forces, in practice these reactions take time and pressures for adjustment assistance will continue as long as changes in trade policy are contemplated. Pressures can be eased somewhat by well-timed actions — for example, timing tariff cuts to coincide with periods in which the exchange rate is low, or with an upswing in the business cycle. In addition, if trade liberalization is limited to certain sectors, adjustment problems may be confined and policies better focussed.

However, the main argument for trade-related adjustment assistance remains the concentration of the effects of potential trade policy changes on certain sectors and the fact that the use of such assistance reduces pressure for protection and allows trade liberalization to proceed. The arguments for general structural adjustment policies rely on the existence of market rigidities and imperfections, most of which are not specific to trade-related disturbances.

To some, adjustment policies remain the key to future trade liberalization initiatives since without such policies, the political opposition from contracting industries and trade-impacted workers would thwart such attempts. In the United States, it is now frequently suggested that dissatisfaction with the way trade-related adjustment assistance worked in the 1960s and 1970s makes further trade liberalization more difficult to achieve. If this experience has any message for Canada, it would seem to be that a bilateral free trade initiative with the United States or a further round of multilateral trade liberalization under the GATT can only generate wide popular support if it is accompanied by a series of credible adjustment assistance policies.

## **Financial Markets, Exchange Rates, and Protection**

A recurrent issue in debates on Canada's trade policies concerns the links between protection and exchange rates. Put simply, will a lowering of Canada's trade barriers and the resulting increase in imports put pressure on the Canadian dollar, causing a depreciation in the exchange rate? Whether unilateral, bilateral, or multilateral trade agreements are involved, the issue is whether changes in the behaviour of financial markets make a reduction in Canada's protection more or less desirable as Canada moves toward freer trade. What kinds of exchange rate effects need to be taken into account? Would one form of exchange rate policy make a reduction in Canada's trade barriers more attractive than another?

These issues were explored in a Commission research symposium on exchange rates, financial markets, and trade liberalization. A symposium summary is included in volume 12 in the research series, along with the papers presented at the symposium by John Williamson, David Richardson, and David Longworth.

### ***The Misalignment of Exchange Rates and Protectionist Pressures***

In an open economy such as Canada, the exchange rate between the domestic currency and that of the country's trading partners is the relative price of different mediums of exchange. When the exchange rate changes, the terms at which real transactions take place between countries may also change. Persistent exchange rate misalignments and high volatility can therefore affect trade flows and ultimately alter resource allocation within economies. Persistent high exchange rates make it difficult for domestic firms to export and to compete with imports in the domestic market.

Many commentators cite the current high value of the U.S. dollar — due in part to large U.S. deficits and high U.S. interest rates, which generate capital inflows into the United States — as a significant factor generating protectionist pressure in the United States. Comparable pressures in Canada due to any misalignment do not seem important but could become so if the exchange rate were misaligned upward.

Misalignment is usually defined as a persistent departure of the exchange rate from its long-run equilibrium value. The long-run equilibrium value is difficult to determine but is usually thought of as the fundamental equilibrium value — the average, trade-weighted, real exchange rate at which a country generates a current account surplus or deficit sufficient to offset net capital flows.

Among researchers in this field there is substantial disagreement about whether or not misalignment can actually occur. Some see foreign

exchange markets as always in equilibrium, with short-term swings in exchange rates caused by volatility in interest rates, expectations, and other variables. Others argue that exchange markets can remain in fundamental disequilibrium for significant periods of time — that is, misalignment can occur. This issue is part of the wider debates between those macroeconomists who believe that disequilibrium can occur in all kinds of markets (including labour markets) for significant periods of time because of institutional rigidities and other factors, and those who discount this possibility. The former are often termed Keynesians, while the latter belong to the classical school of macroeconomists whose influence has been growing in recent years.

An exchange rate misalignment can be thought of as equivalent to a uniform temporary export tax and import subsidy. The issue is how temporary the misalignment is and what effects, if any, it causes. If there are significant adjustment costs involved in changing trade flows and reallocating resources within economies, exchange rate changes perceived as temporary will generally have little real effect. However, if misalignments persist for significant periods of time or are incorrectly perceived as permanent, then deviations of the exchange rate from its long-run level will have real effects.

Irrationality in financial markets was cited by several symposium participants as a possible contributing factor to misalignment of exchange rates, but to the extent that it exists at all, it seems empirically of secondary importance. There are many possible forms this irrationality might take. Exchange rates may, for instance, be affected by myopic or inappropriate expectations about the future. The behaviour of the Canadian dollar during the 1975–76 period was cited by some symposium participants as evidence of exchange market irrationality.

Prolonged undervaluation and prolonged overvaluation of a currency can both have a range of undesirable effects. Undervaluation will attract resources into tradeable goods sectors even though the volume of production cannot be economically sustained in the long run. Overvaluation causes the opposite effect. In both cases, adjustment costs are involved in moving resources between sectors in ways that the long-run equilibrium exchange rate may not justify. Further significant adjustment costs can arise from changes in trade policies induced through lobbying by workers and firms temporarily suffering under the adverse effects of an exchange rate misalignment.

If as a result of currency misalignment, either new protectionist or export promotion programs are adopted, it may be difficult to remove them when the misalignment disappears. Examples of past experience with temporary import surcharges adopted for balance-of-payments reasons do exist, but it is difficult to credibly guarantee the temporariness of trade policy changes made in the name of currency misalignments. If temporary protection does indeed become permanent,

then what began as a temporary distortion (the misalignment) has been converted into a permanent one (the new trade barriers).

A related problem is that new trade policies are very much a second-best alternative to offset the effects of misalignment. It is difficult to devise a non-distorting set of subsidies on exports and taxes on imports. Furthermore, as the domestic currency would probably be misaligned with respect to several different currencies and by different amounts, it may be necessary to attempt to discriminate among trade flows involving different countries, which violates the non-discrimination principle of the GATT. It is even possible that the changes in trade flows induced by the trade policy changes could drive the exchange rate even farther from its long-run equilibrium level.

Many claim that recent currency misalignments are a source of major pressures for protection. In his symposium paper, John Williamson suggests that misalignments between major currency blocs in mid-1983 could have been as large as 25 percent. In his view, the Canadian dollar seemed close to its fundamental equilibrium value. However, this is on a trade-weighted basis, and since he sees the currencies of Canada's trading partners as fundamentally misaligned, this would imply that the Canadian dollar was overvalued by roughly 5 percent against the Japanese yen and by 16 percent against European Monetary System currencies and undervalued by about 8 percent against the U.S. dollar. Another participant, however, felt that the bilateral rate against the U.S. dollar was about right. That would leave the Canadian dollar somewhat overvalued in trade-weighted terms.

To believers in misalignment, Canada, like most economies, is likely to suffer some of the costs outlined above. There may also be further costs if Canada faces restrictive trade policies in the export markets of its trading partners because of the pressures created by misalignment. According to the misalignment school, much of the recent trade friction between the United States, Japan, and Western Europe has been due to exchange rate pressures.

There was fairly broad agreement among symposium participants about the causes of current exchange rate problems. Although some were willing to give market irrationalities some role, an inappropriate U.S. monetary and fiscal policy mix was cited as the primary cause. This mix of loose fiscal policy and tight monetary policy was viewed as unsustainable in the long run. Capital inflows into the United States, currently running at about \$100 billion per year, are required to finance the large federal government deficit. One cannot predict how long the misalignment will last or when it will eventually reverse itself. The longer the misalignment persists, the greater the danger that the United States will turn to protectionism as a solution to what is essentially a macroeconomic problem. Many believe that the longer currency misalignment persists, the larger the adjustment will eventually be in the other

direction as asset portfolios realign. In the meantime, however, if U.S. budget deficits turn out to be a long-term feature, misalignment could persist and pressures on U.S. trade policies could continue for some time.

### ***Misalignment and Intervention in Foreign Exchange Markets***

Symposium participants also discussed whether central banks, including the Canadian monetary authorities, should intervene in the foreign exchange market in the presence of exchange rate misalignment, and if so, what form such intervention should take. The alternatives are unsterilized, partly sterilized, or completely sterilized intervention. Unsterilized intervention, the open market purchase or sale of official reserve assets, is also a form of domestic monetary policy since the domestic money supply is altered. Sterilized intervention differs from unsterilized intervention in that the effects on the domestic money supply are sterilized by open market purchases or sales of domestic securities. In this case, the net result is to change the shares of domestic- and foreign-currency-denominated assets in investor portfolios. Partial sterilization does not entirely eliminate the effects on the domestic money supply.

Unsterilized intervention would be a credible action to demonstrate that stable exchange rates are indeed a goal of monetary policy. If the government's policy targets are credible, unsterilized intervention can be effective since private capital movements themselves will stabilize the exchange rate. If the target is not credible, then official reserves will be inadequate to cope with cross-boundary portfolio reallocations, and intervention will not succeed. However, whether central banks would use monetary policy to affect exchange rates would probably depend on many other factors — the current state of inflationary expectations, the degree of labour market slackness and capacity utilization, the effects of intervention on other nominal targets of monetary policy, uncertainty over the value of the long-run real exchange rate, and the extent of the misalignment.

Sterilized intervention is generally regarded as a weaker tool than unsterilized intervention. The effectiveness of sterilized intervention depends on the degree of substitutability between assets denominated in different currencies. If substitution is costly, a change in the relative supplies of these assets will change relative asset prices, including exchange rates. There is evidence in support of the effectiveness of sterilized intervention as a short-run exchange rate smoothing device, indicating that it can be useful if misalignment can be caused by market irrationalities. Empirical evidence indicates that in the longer run, asset substitutability is a close to perfect tool.

Whether attempts to correct perceived currency misalignments would be successful remains an open question in the minds of many researchers. There are formidable difficulties in estimating the long-run equilibrium real exchange rate and thus the extent of a misalignment. There are also unresolved issues as far as the empirical evidence is concerned. Real interest rate differentials between countries in some cases cannot explain the large misalignments that apparently exist, and it is unclear what fraction of a misalignment may be due to market irrationality.

There seems, however, to be general agreement that there is little Canada can do on its own about these effects, especially if the Canadian real effective exchange rate is approximately at its long-run equilibrium level.

### ***Trade Liberalization and Exchange Rate Policies***

In considering the consequences of any potential change in Canada's trade policies, policy makers in Canada, as in other countries, need to assess whether there are any possible problems created by induced changes in the exchange rate. What is the appropriate stance of monetary policy in the post-liberalization adjustment period? Are fixed or flexible exchange rate regimes the best accompaniment to trade liberalization?

In the case of unilateral free trade, if the trade liberalization involved is a reduction in both tariffs and export subsidies, then changes in exchange rates and reductions in these trade barriers have similar effects. If exchange rates are fixed, the effect of removing tariffs and export subsidies is equivalent to the effect of a depreciation in the exchange rate. Under flexible rates, the removal of these trade policies is exactly offset by a depreciation in the exchange rate. External balance is maintained and all other variables, including the trade flows involved, are unaffected.

For the more conventional case of a unilateral reduction only in Canada's tariffs (or in its non-tariff barriers), if the exchange rate is fixed, the removal of trade barriers will cause the prices of imported goods, and thus the general price level, to decline. Demand for imports will rise and the trade account balance will deteriorate. This generates losses of reserves, and the Bank of Canada can either maintain its initial stock of foreign exchange reserves or let it decline. If the Bank decides to maintain reserves stocks, by selling enough domestic securities to raise domestic interest rates (relative to rates elsewhere) and producing a capital account surplus to match the current account deficit, the initial fall in the price level will reduce nominal money demand, resulting in an excess supply of money. During the adjustment period, this excess supply would be eliminated as the money supply falls while the Bank

maintains its reserves. In the long run, the gap between domestic and foreign real interest rates will also be eliminated (except for any risk premia involved). The new equilibrium will have a lower price level, a lower money stock, and a value of the capital account of the balance of payments equal to the negative of the current account. The real adjustments usually stressed by trade policy analysts will have taken place as resources are reallocated away from the import-competing sector to the export and non-traded goods sectors, but there are no further implications for Canada's trade policies from these monetary factors.

With a flexible exchange rate, as with a fixed exchange rate, the initial effect of unilateral free trade will be a fall in import prices, bringing down the general price level and causing an excess supply of money. The trade balance will also deteriorate. In this case, however, the currency will depreciate and import prices will rise, as will prices of all other goods, to restore money market equilibrium. Again, domestic interest rates rise so that the capital account balance matches the deterioration of the trade account. The long-run equilibrium will be the same as that with a fixed rate, but with a higher price level. The same real adjustments will occur as before.

Although there may be no long-run implications of trade liberalization for behaviour by the monetary authorities, a consensus from the symposium seemed to be that in the event of a unilateral trade liberalization, the Bank of Canada might feel compelled to adopt policies to achieve what it saw as a desirable path for the exchange rate. The Bank may decide to neither fix the exchange rate, permitting the money stock to fall, nor fix the money stock, permitting the exchange rate to depreciate. This response, a linear combination of the extreme fixed and flexible cases, would lead to an outcome for the exchange rate and price level between the two outcomes discussed above.

In the case of a bilateral trade initiative, it is not clear a priori whether the equilibrium real exchange rate would rise or fall. With unilateral free trade and an unchanged money stock, removal of domestic trade barriers tends to lower the exchange rate, but with bilateral liberalization, the removal of the foreign country's barriers will tend to have an offsetting effect. This uncertainty about the direction of the exchange rate movement would also be true in the more complicated case of multilateral trade liberalization.

Symposium participants also agreed that in the long run, there is no reason to believe that the bilateral Canada-U.S. exchange rate would be unstable in a free trade arrangement, provided monetary authorities in both Canada and the United States react in a predictable manner. Trade liberalization would simply raise or lower the exchange rate according to the relative differences generated in trade flows.

In the short run, the question is whether overshooting or short-run instability in exchange rates might accompany a change in trade pol-



icies. Those who do not believe in overshooting see a relatively smooth transition of the exchange rate to the new equilibrium. However, if the reallocations required in the economy as a result of the policy change are sluggish, the exchange rate could overshoot in the short run. After a trade policy change, there will also be considerable uncertainty about what new equilibrium relative prices should be, and in the presence of this uncertainty, even a predictable monetary policy might not lead to a smooth adjustment to the new equilibrium.

If the adjustment period contains what seem to the Bank of Canada to be overly large movements in the exchange rate, the Bank could intervene to smooth out these changes. It would have the choice between sterilized and unsterilized intervention. Sterilized intervention could have some effect as a short-run exchange rate smoothing device, but unsterilized intervention would be needed if the Bank wanted to counteract a prolonged movement of the exchange rate away from what seemed a reasonable long-run path. It would seem from the symposium that the Bank of Canada does not have a fixed view about what the exchange rate response to a trade policy change should be, recognizing that the desire for more stable exchange rate behaviour must be offset by the risk of stabilizing the rate at an arbitrary level.

Because of the adjustments required between industries and firms, unemployment would be likely to rise during the adjustment period following a trade liberalization, but it is not clear that monetary factors could either increase or reduce this unemployment beyond that caused directly by the trade policy changes. Since any increased unemployment is a real effect and is transitory, stimulative monetary policies would merely result in an increased rate of inflation and a depreciation of the nominal exchange rate.

## **The Regional Dimensions of Canada's Trade Policies**

A further feature of both past and current trade policy debates in Canada is the extent to which regional issues intrude. People have become more aware of the regional gains and losses from national trade policies over the years, and their perceptions in turn have influenced trade policy decisions. The regional impact of the tariff has been a source of regional grievance ever since the early years of Confederation and has been a complicating factor in negotiating reductions in tariffs. Reductions in protection have been generally resisted by central Canada and applauded in the West. Since central Canada (Quebec and Ontario) exports manufactures to the West and Atlantic Canada behind a tariff wall at gross-of-tariff prices, the net regional effect of Canadian protection is usually seen as generating real income gains for central Canada at the expense of the eastern and western provinces.



These considerations have complicated the posture that Canada has adopted in trade negotiations in the GATT. Canada's trading partners have frequently complained that the provinces are not signatories of the GATT accords and are therefore not bound by codes entered into by the federal government. This has been an especially difficult problem in the case of codes covering government procurement policies.

A further feature is that as Canada's trade policies have grown in complexity, the regional impacts of the various non-tariff elements of Canada's trade policies have also entered the debate. Protection of the textile industry under the Multi-Fibre Arrangement substantially benefits Quebec. The Auto Pact benefits an industry which is heavily concentrated in Ontario. On the other hand, Canada's trade policies toward energy penalize western provinces since, implicitly at least, they have to pay export taxes.

These issues are discussed in a Commission study by Ronald Shearer, published in *Canada-U.S. Free Trade*, volume 11 of the research series. Because of the strong links to the economic union component of the Commission's research, regional issues were also addressed in a research symposium. A symposium summary and papers presented at the symposium by James Melvin and Thorald Warley also appear in volume 11.

Shearer's paper outlines the relationships between regionalism and international trade policy. To Shearer, economic regionalism in Canada is more than a state of mind nourished by a folklore of real or imagined historical wrongs. Economic regionalism also reflects the physical diversity among regions, the nature of economic activity, performance and potential. Some domestic policies have intentional regional effects. In other cases, these effects are a by-product of broader national objectives. The sense of regional grievance associated with the impacts of tariff policies in Canada has, of course, been especially strong.

To illustrate the importance of the interaction between federal and provincial policies and their impacts on trade, Shearer examines the cases of agriculture, energy, and timber. Policies toward the agricultural sector reflect a long tradition of complex federal and provincial government intervention as a means of protecting the domestic market. Shearer questions whether moves toward freer trade in agriculture should involve only federal policies or whether the dismantling of provincial agricultural marketing and transportation subsidy programs should also be included. Warley also discusses regional dimensions of trade in agriculture in his paper.

The energy sector is also subject to a complex mix of federal and provincial government policies. Canada's petroleum pricing policies involve interregional transfers that compound the effects normally attributed to its international trade policies. Shearer argues that probably the energy sector could not be included in a formal free trade

arrangement since it is outside federal government jurisdiction. Timber is another case where there is substantial provincial government intervention, with corresponding impacts on international trade flows.

Shearer also surveys the literature on the regional impact of trade policies in Canada. The traditional view has been that beneficial effects of Canada's protection are felt in the industrial heartland provinces, as trade barriers raise the price of manufactured goods relative to natural resources, while the costs are borne in the resource-based western and Atlantic provinces where manufactured goods must be purchased from central Canada or other countries at gross-of-tariff prices.

In Shearer's view, the direct effects of Canada's trade policies on resource-based regions consist of restricted consumption of imports, with a resulting direct loss of consumer well-being; restricted resource-based exports, causing a loss of real income; expansion of protected manufacturing activity within the region, with loss of national efficiency through a misallocation of resources; and transfers from consumers and producers within the region to producers of protected products in industrial regions (and, to a lesser extent, to the federal government in import taxes).

It is the interregional transfer effect that Shearer considers of overwhelming importance. Even though he concludes that the true costs of restrictive international trade policies to the West and Atlantic Canada are not known with any certainty, a general indication of their impacts is reported by Dauphin (1978), who estimates that a move to unilateral free trade would raise real income by 3.8 percent in British Columbia, 3.9 to 4.8 percent in the Prairies, and 4.4 to 4.5 percent in Atlantic Canada, while incomes in Ontario and Quebec would not be much affected. On the other hand, studies such as those by Wonnacott and Wonnacott (1967) and Harris's Commission monograph suggest that substantial gains from multilateral or bilateral free trade would also accrue to the industrial heartland provinces because of rationalization effects within Canadian manufacturing industry.

Shearer also examines the literature on interregional economic adjustment, which he classifies under two schools of thought, referred to as the cumulative causation model and the market adjustment model. The cumulative causation model focusses on the interaction between social, cultural, and economic forces, including the development of attitudes and behaviour patterns of workers, businessmen, and government. Even though the model is primarily used to explain underdevelopment in Atlantic Canada, it can also be applied to performance in western provinces. It is sometimes argued, for instance, that peripheral regions are exploited by industrial heartland provinces since peripheral regions serve as markets for manufactured goods, sources of raw materials and a location for unemployed workers.

The market adjustment model is based on a more traditional comparative advantage view of international trade. Its basic thesis is that regions with relatively abundant supplies of labour specialize in producing labour-intensive products and regions with relatively abundant natural resources specialize in producing resource-intensive products. In Shearer's view free trade under this model is a rent-maximizing strategy for immobile labour and natural resources.

Even though the evidence suggests that resource-based regions could benefit significantly from either bilateral or unilateral free trade, Shearer feels that the traditional political barriers to free trade are of major importance. Taking into consideration that a national consensus implies agreement among provincial governments and that some provincial governments are involved in industrial policies affected by international trade policies, he is pessimistic about a national consensus on free trade.

All of these features make the evaluation of the regional dimension of Canada's trade policies that much more difficult. However, a few central themes that emerge from recent literature on these issues were emphasized in the symposium. One theme emphasized in the paper by James Melvin, is that to the extent that the national protection artificially stimulates interprovincial trade, protection can result in socially wasteful transportation costs along east-west transportation routes in contrast to cheaper north-south transport of goods between Canada and the United States. Transportation costs are relevant to other regional issues, since many other policies in Canada seek to promote east-west trade through nation-building policies at the expense of north-south trade.

Another issue is how the regional impacts of tariffs and other policies change when interprovincial factor mobility effects are taken into account. The traditional analysis of the interprovincial effects of Canada's trade policies is based on an implicit model in which factors of production are interprovincially immobile. If factors of production leave regions that lose from trade policy changes, the redistributive effect across provinces may be largely offset by factor mobility. In addition, immobile factors within provinces which are affected by trade policy changes may be owned by out-of-province residents or foreigners, further complicating the assessment of the interregional effects of trade policies.



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## **The Wider Aspects of Canada's Links with the Global Economy**

In addition to the need to improve the scope and security of Canada's access to foreign export markets and the domestic impact of Canada's own protective policies, there are a range of other issues that arise from Canada's interaction with the global economy. These issues include ways to formulate trade policies in light of the changing world environment, policies toward and links with the developing world, policies toward inward foreign investment, and our immigration policies (which have been growing increasingly restrictive in recent years). These issues are taken up in commissioned research papers that appear in volumes 10 to 14 of the research series.

### **Canadian Trade Policies in a Changing World**

Beyond the question of trade links with the United States and Canada's participation in the GATT, a further feature of Canada's current trade environment is the changing world environment and the ebb and flow of trade policies pursued elsewhere as they affect Canada. These issues surfaced in a number of the commissioned papers, including those by John Curtis and Gerald Helleiner, and were taken up in a Commission research symposium on Canada and the global trading system. The symposium summary, commissioned papers and a number of symposium papers are included in volume 10.

Recent trade policy developments of significance to Canada are clearly apparent in both the developed and the developing world. In the developed world, increasing reliance on measures concluded outside the GATT and other pressures on the multilateral trading system have produced heightened concerns in the past few years that a major break with the non-discriminatory policies of the past may be imminent. These, in

turn, have their own dangers and opportunities for Canada. Trade restrictions appear to be increasing in the developing world as domestic policy reactions to these countries' debt problems become more apparent. This has made developing country markets even more difficult to penetrate than in the past.

### *Developments in the United States*

In the past 25 years, the proportion of U.S. GNP representing foreign trade has approximately doubled, and the United States has become a more open, trade-dependent economy. This change has directly affected the way Congress deals with trade policy issues. Trade issues were formerly discussed almost exclusively at the subcommittee level, but are now more frequently debated on the floor of the Congress by pro-trade and anti-trade members concerned about the impact on income, jobs, and other matters.

Congress has sought to strengthen its constitutional rights over trade policy. Recently, there have been a series of proposals in the Congress for reciprocity legislation covering trade policy, which in some circles have been labelled "aggressive reciprocity" (Cline, 1983 and Wonnacott, 1984). The object of these proposals is to create a bargaining device that will force foreign countries to reduce their levels of protection to those of the United States. This is to be achieved either by requiring U.S. protection to be set at levels equal to those prevailing abroad (based on U.S. determination of the level of protection that prevails) or, in weaker versions of aggressive reciprocity, by giving the president the power to impose protection at these levels. These proposals are justified in the United States by the perceived need to "level the playing field" in trade policy.

Most of these proposals are targetted against Japan and, to a lesser extent, the European Community, but if enacted they would undoubtedly have major implications for Canada. If reciprocal measures of the type proposed actually are taken, they would undoubtedly put the United States in violation of its GATT obligations, creating enormous strains on the GATT system. Some seriously question whether the GATT in its present form could survive such a development.

Under the Danforth Bill, one of the milder reciprocity measures, the president would be given authority to use retaliatory measures but their use would not be made a requirement.<sup>18</sup> Additional features of the bill involve presidential authority to retaliate against unfair restrictions imposed on U.S. investments abroad, and provide for specific negotiating objectives with respect to international trade in services, investment, and high technology products. Under the bill, the president would be required to make annual assessments of trade policy abroad in

significant areas of interest to the United States, to develop a more active policy stance and promote U.S. international interests.

Further measures under consideration in the United States include export incentives to counteract unfair export subsidization elsewhere that displaces U.S. jobs. Proposals here include expanding low-interest export loans, providing tax breaks for manufactured exports, increasing subsidies for agricultural exports, and modifying the Foreign Corrupt Practices Act of 1977 to allow payments to officials of foreign governments (as permitted under local law), as well as payments aimed at expediting or securing the performance of routine official action.

Increased protection of domestic industry has also been discussed under the buy American provisions of the Surface Transportation Assistance Act of 1982. In late 1983, proposals were made to reduce the costs, complexity, and duration of countervail and anti-dumping cases. A coalition of import-sensitive industries in the United States, for instance, actively supports trade law changes that will make it easier for U.S. industries to get relief from foreign protection.

Although the U.S. system frequently produces motions and discussions of this sort that are never enacted into law, these developments are nonetheless indicative of a fundamental change in attitude toward trade policy matters in the United States. The Good Neighbor Policies of the Roosevelt era have been replaced by a mood of determination and resolve to deal more aggressively with the outside world in both trade and other foreign policy areas.

### ***The Implications of Aggressive Reciprocity in the United States***

The implication of moves by the United States toward aggressive reciprocity have been discussed by Wonnacott (1984) who sees major implications both for the global trading system and for Canada. Although it is possible that aggressive reciprocity might be a liberalizing device, it could also increase U.S. protection and reduce trade and collective welfare, as well as increasing global protection. Bilateral U.S. protective measures aimed at specific partners would run counter to the non-discrimination principle of the GATT. The detrimental effects to the GATT system of a trade conflict between two or more of the world's major trading partners are potentially large and would impact directly on Canada.

However, if a U.S. policy of aggressive reciprocity was not directed specifically at Canada and if it succeeded in persuading the target country to lower its barriers without having to use its threat, Canada would gain improved access to the same market. Other benefits would accrue if U.S. purchases were diverted from the target country to Canada. Canada could also benefit if reciprocity were to replace current

non-discriminatory safeguard actions in the United States that can produce adverse impacts on Canada even if unintentional. Canada would lose, however, from the resulting world trade disruption, and lowered real incomes in the United States and the target country would imply reduced demand for Canada's exports.

Different scenarios would come into play if Canada were the target of U.S. reciprocity actions. The gains or losses to Canada if it chose to comply and abandoned the offending policies would depend on whether these policies had been benefiting Canada to start with. However, such actions would undoubtedly be considered a serious infringement of Canadian sovereignty by the United States.

If the United States attempted to partially replace the GATT by monitoring the world trading system itself through aggressive reciprocity, the Canadian problem of loss of sovereignty could become even more serious. Canada's domestic policies that are viewed with concern in the United States (such as energy, foreign investment policies and regional and industrial subsidy programs) would be monitored not by a GATT panel, but directly by the U.S. administration.

If Canada were to ignore the U.S. threat and the United States implemented new trade restrictions, results could be even more damaging. And if Canada were to retaliate, Canadian terms of trade would further deteriorate and reduced export demand would mean loss of opportunities to exploit economies of scale. Other effects would include losses in production and consumption due to increased Canadian trade barriers, as well as a more restricted variety of products available to Canadian consumers.

To some, the prospect of a more assertive United States, more willing to use its muscle in trade policy disputes with its allies, suggests even more forcefully the importance of negotiating a bilateral free trade arrangement with the United States so that Canada will not become a target of U.S. reciprocity trade actions a few years down the line. A bilateral arrangement would cover existing protection in Canada, which could then not become the target of subsequent U.S. actions. Others, however, are more cautious, arguing that allying Canada too closely to the United States is a mistake since Canada becomes a target, along with the United States, for similar Japanese and European actions. Under this line of argument, Canada is viewed as better off keeping out of a reciprocal trade war among the European Community, the United States, and Japan and seeking to gain improved access to all three markets.

## ***The Implications of Trade Policy Developments Outside the United States***

There are also pressures outside the United States for an end to the non-discrimination in trade policy that has characterized the postwar world. Selectivity was very much the theme of the European position in the Tokyo Round on both safeguards and other issues, suggesting that further breaks with the trade policies of the past may occur in Europe in the future.

A further set of developments involves the rapid growth of the developing countries around the Pacific Rim, particularly Taiwan, Hong Kong, South Korea, Malaysia, Singapore, and the Philippines. In recent years, penetration of the Canadian market by low-cost imports from this region has grown substantially, as indicated in Table 4-1. Although the base for this growth is still small, these developments pose perplexing choices. A no-protection policy toward these imports could involve substantial domestic adjustments. On the other hand, protection against them clearly denies a substantial gain to the Canadian economy and especially to Canadian consumers, who are unable to buy these imports at lower prices. Such a policy also runs counter to the Canadian interest in furthering advancement in the developing world. In addition, Canada currently has a trade surplus with most of these countries, and preserving its access to these growing markets is important.

The impact of these external developments on Canada are potentially serious but also full of hidden opportunities. If Canada's major trading partners take reciprocal action aimed at other trading partners, this could have major beneficial effects for Canada. However, if such legislation is not applied selectively, Canada could be adversely affected. In the past year there have been general instances of trade policy developments elsewhere rebounding on Canada. Examples are threatened U.S. global quotas on steel and selective actions by the EC against Canadian news-

**TABLE 4-1 Canadian Import Penetration by Less Developed Countries, Position in 1978, Growth 1978-81**

	<b>Canada's Imports From LDCs as a Proportion of Domestic Consumption in 1978</b>	<b>% Change in value of LDC Imports 1978-81</b>
All manufactured goods	1.2	80
Textiles	2.6	54
Apparel	10.4	53
Other Consumer goods <sup>a</sup>	2.7	92

*Source: Annual Report of the President of the United States on the Trade Agreements Program (Washington, D.C., 1983), p. 125.*

a. Includes footwear, sporting goods, luggage, toys, umbrellas.



print as part of EC free trade policies with Scandinavian countries. Canada clearly has to negotiate a steady course through these developments, and basic issues of strategy need to be more fully worked through. In a changing world that is increasingly fragmenting into regional arrangements where discriminatory trade policies become the order of the day, Canada can lose access to major export markets even where this is not the deliberate intent of the policies adopted by its trading partners.

## **Canada and the Less Developed Countries**

Canada has always played a special role in global affairs through its interaction with the developing world. As a middle-level power with no territorial or military ambitions, Canada has always been viewed by developing countries as having a genuine interest in helping the development process in these regions. This vision of Canada reflects its history of quiet but active diplomacy and willingness to discuss and help with problems of the developing world without recourse to the authoritarianism that characterized the colonial years. This approach has been reflected in recent years in Canada's active participation in the on-going debates on North-South issues.

However, this view is not supported by Canada's performance in the two main spheres of policy that more directly affect the developing world — aid and trade policies. Canada's aid as a fraction of GNP has been falling since 1975, as shown in Table 1-9, and its ranking as an aid donor among the developed countries is surprisingly low — tenth among major nations in terms of percentage of GNP donated. Not only has this performance been poor, but a large fraction of Canada's bilateral aid is tied to purchases from Canadian sources,<sup>19</sup> further reducing the real value of this aid to developing nations.

In the trade area Canada's policies toward the developing world centre on the Multi-Fibre Arrangement (MFA) and Canada's application of the Generalized System of Preferences (GSP). The current (third) Multi-Fibre Arrangement is the latest in a series of agreements between developed and developing countries governing international trade in textiles and clothing. Under these agreements, dating from the 1960s, countries in the developing world agree to accept bilaterally negotiated quota restrictions on their exports of textiles and clothing to the developed world.

Like most developed countries, Canada has participated in this set of arrangements but has tended to make the application of its quotas more restrictive over time. Although initially less restrictive than in other developed countries, over time Canada has tightened quotas as much as the EC and Japan. An especially significant increase occurred in 1976, when quotas were tightened following the imposition of global quotas

under the GATT. Thus, as far as the developing countries are concerned, Canada's application of the MFA does little to help them. They are denied free access to Canada's markets for textiles, and voluntary export restraints covering developing country exports of clothing and apparel further tightened Canada's protective stance.

Canada's application of the general system of preferences reflects the same trend. This system was introduced in the early 1970s as a result of multilateral discussions in UNCTAD and was subsequently given a waiver under the GATT. This system allowed developed countries to give special tariff preferences to products from the developing world. The aim was to introduce a type of positive discrimination in favour of those developing countries exporting products not competitive with commodities produced by developed economies. The application of the GSP has been left to individual developed countries, and in Canada only a relatively small percentage of the imports from developing countries enter duty free under these arrangements.<sup>20</sup>

In the years ahead, the developing countries, particularly the faster growing countries of the Asia/Pacific region, offer potentially great opportunities to Canada through the growth in their markets. Canada's reputation in these countries as a promoter of the interests of the Third World is therefore directly linked to Canada's trade interests.

Canadians are also becoming more aware of the community of interest Canada has with much of the developing world. Canada is one of the few developed economies that is heavily dependent on exports of resources and raw materials, the same exports that characterize trade for much of the Third World. Canada and developing countries therefore jointly gain from arrangements that give increased market access to developed country markets for these products. This also suggests, however, that further positive discrimination in favour of developing countries by the developed world in general could be harmful to Canada, since they are often the major competition for Canada's resource industries in export markets.

### *North-South Trade*

In a paper prepared for the Commission on these issues, included in volume 10, Gerald Helleiner examines Canada's relations with developing countries in the broader context of the global North-South relationship. He highlights the growing role of the South — the developing countries — in the functioning of the global economy. Even excluding the oil exporters, they account for a larger market for Western European manufactured exports than the United States and Japan combined. In addition, the developing countries are more important to U.S. manufacturers than either Europe or Japan. The developing countries' ability to service external debt is widely recognized as crucial to the stability of

the international financial system. The North has a number of interests in the South, ranging from the elimination of persistent poverty to realizing the potential for increasing their own income through trade. The North also has concerns over the global population growth rate and possible environmental pollution. Hand in hand goes an interest in international political and economic order.

In Helleiner's view, commercial relationships dominate North-South relations. This is why the developing countries have sought reforms in the areas of trade and international finance. The failure in 1977 to negotiate an arrangement among the OECD, major OPEC countries, and the developing countries after the year-long Conference on International Economic Cooperation illustrates only too well how little reform efforts have accomplished.

As Helleiner points out, three UN conferences on trade and development have yielded few results, and the Common Fund for commodities has yet to be ratified by a sufficient number of countries to begin its work. Although tariffs on manufactured goods have been reduced through GATT rounds, these cuts have been smallest on products of greatest importance to the developing countries — items such as unskilled-labour-intensive manufactures and processed raw materials. Moreover, as tariffs have been reduced, non-tariff measures such as import quotas, orderly marketing arrangements, and voluntary export restraints have increasingly been implemented in a discriminatory manner against the developing countries.

### *The Debt Crisis*

A further crucial issue with potentially serious consequences for Canada is the debt situation in the developing countries. Helleiner attributes the developing countries' present economic difficulties in general and their problems in servicing their external debt in particular largely to the severe global recession of 1981 to 1983, combined with a deterioration in their terms of trade and high interest rates. Sharp cutbacks in commercial bank lending, only partially offset by the International Monetary Fund and other sources, have intensified these difficulties.

Helleiner's view is that if these problems are due mainly to illiquidity, the recent outburst of debt rescheduling and restructuring is a viable solution to the problem. However, if these balance of payments difficulties reflect permanent changes, restraint and restructuring are the only solution. Consequently, contingency arrangements have been developed, as in the case of commercial banks setting aside loss reserves. Other options include lengthening maturities, easing interest rates, and softening austerity measures.

Even with adequate contingency planning, however, defaults on developing country debt could seriously disrupt the global financial

system and imperil growth in the developed world. The debt crisis of the developing countries thus serves to emphasize the degree to which economic policies in the North and financial and trade policies toward the Third World are linked.

### *Canada's Policies Toward Developing Countries*

As Helleiner notes, a smaller share of Canada's trade is accounted for by trade with the developing countries than is true of other developed countries. In 1982, the developing countries supplied 11.9 percent of Canada's imports, and received 9.8 percent of Canada's exports. The developing countries' market share of total Canadian manufactures consumption amounted to only 2 percent in 1980.

Although the Canadian General Preferential Tariff was introduced in 1974 to allow for duties of two-thirds the MFN Rate or the Commonwealth Preferential Rate on developing country imports (whichever is lower), items of most interest to these countries, such as textiles, footwear, and some electronics, are ineligible. Under the Multi-Fibre Arrangement, recently extended until 1986, Canada has restraints on 15 textile products and 16 types of apparel entering from 18 countries. Thirteen of these were developing countries, and the remainder were centrally planned Eastern European countries. Comprehensive agreements, however, are only in place for Hong Kong, China, Korea, and Taiwan. Additional licensing requirements involve consultations on export authorizations of another 27 clothing and textile products. Complementary to these policies are quotas on footwear imports.

Helleiner also summarizes Canadian trade policies on primary commodities. In his view, Canada has tended to consider price stabilization schemes only on a case-by-case, commodity-by-commodity basis. Canada saw fit to join other importing countries in discussions of international agreements on cocoa, coffee, tin, sugar, and natural rubber, in efforts to hold down stabilized price ranges and tighten supply guarantees, but has shown little interest in producers' associations for copper and iron ore. It may be argued, however, that these arrangements seldom worked well and are discriminatory by their very nature.

Even though it has been a major Canadian objective to reduce tariff escalation on primary-processing products, Heilleiner points out that Canada maintains its own substantial tariff escalation on tropical primary products, even including some forest products. In his view, the recent discussions on a Canada-U.S. sectoral free trade arrangement should be conducted in the context of the broader multilateral trading system. He sees a clear need for careful analysis of the implications of trade diversion and the effects on the developing countries from the resulting trade discrimination.

## ***Aid Policies***

Helleiner portrays the Canadian record as particularly weak with respect to the quality of its aid. In 1982, 64.8 percent of total Canadian aid was tied to Canadian procurement, the second highest ratio in the OECD.<sup>21</sup> In fact, Canada leads all others in imposing tying restrictions upon its contributions to multilateral aid. Although a significant portion of Canada's multilateral program is food aid and should perhaps not be included in the calculation because Canada is one of the few major food grain exporters, taking food aid out still leaves a major component as tied.

With regard to the Canadian International Development Agency, Helleiner feels that the time has come for a major review of its objectives and practices. At the very least, he suggests that commercially oriented aid should be operated from development-related objectives. Additional suggestions to enhance Canada's contribution to overseas development include greater flexibility, a larger field staff with reasonable decision-making authority, and longer time horizons and budgeting commitments.

In Helleiner's view, a large degree of mutual interest exists between Canada and the developing world. This mutual interest includes stabilization of commodity prices; a slowdown in the escalation of protection for primary processing activities; and attention to international technology markets, trade in services, and other possible codes regulating trade and investment. He also sees common interests in the way the developing countries have approached issues of transnational corporate activity and restrictive business practices at the international level. In general, Helleiner stresses the mutual interest of the developing countries and the smaller and more trade-dependent developed countries, such as Canada, in the smooth functioning of the international trade and payments system.

Helleiner stresses the importance to the developing world of conducting trade on a multilateral, non-discriminatory basis. He also emphasizes the potential for the middle powers, including some of the developing countries, to influence events in this direction in the absence of major-power leadership.

## **Foreign Investment in Canada**

A further area of linkage to the global economy arises from the large degree of foreign ownership in Canadian industries occurring as a result of inward investment flows. In the recent decades, economic nationalism in Canada has exerted a powerful influence on Canada's policies in foreign investment, particularly in the area of controls over foreign ownership. Motivated in large part by the arguments made in the

Watkins and Gray reports (Canada, Privy Council Office 1968 and 1972, respectively) in the past two decades, Canada has introduced a series of policies whose objective is to increase Canadian ownership of Canadian industry. Through the Foreign Investment Review Agency (FIRA) to the National Energy Program (NEP), policy makers have accepted the objective of increasing the degree of both Canadian ownership and control over capital employed in Canada. Though FIRA has recently been renamed Investment Canada, it is to some extent the detail rather than the policy objectives that have been changed.<sup>22</sup>

Links also exist between Canada's trade policies and the size of the foreign presence in Canada. These links are very much at issue in any trade negotiations Canada may enter on either a bilateral or multilateral basis. If Canada's protective policies have encouraged foreign firms to invest in Canada to service the Canadian market from within rather than from outside, a reduction in protection may cause a major capital outflow as foreign firms leave.

Academic economists, however, have frequently stressed the substantial national costs involved with policies that impose controls on foreign investment inflows. Even if only a monitoring and approval procedure is used, a discouragement factor operates, along with the loss of opportunities for Canadians to take advantage of access to foreign capital.

In turn, the policies that have been used to pursue these objectives have not always involved the most efficient instruments. As a set of policies designed to control foreign ownership, FIRA has had the effect of discouraging inward foreign investment because of the monitoring and screening procedures involved. The foreign ownership features of the National Energy Program have been pursued through discriminatory ownership provisions of incentive grants, the Canadian Ownership Service Charge, and other provisions, and similar issues arise.

These issues are addressed in the Commission study by Edward Safarian, included in volume 12 of the research series, in which the various government policies used to control both inward foreign direct investment and foreign-owned multinational enterprises are described and their main effects evaluated. Volume 12 also contains a paper by David Burgess prepared for the symposium on exchange rates and financial markets, discussing the links between inward investment flows and Canada's trade policies.

### ***Multinational Enterprises and the World Economy***

Most foreign direct investment (FDI) takes place through multinationals and is concentrated in the major developed countries. In the 1970s, OECD member countries accounted for about 95 percent of recorded flows of FDI. The U.S. share of the total outward flows from the 13 major OECD economies fell sharply from 61 percent in the early 1960s to 29

percent and 22 percent in the late 1970s and early 1980s, while shares for West Germany, the Netherlands, Japan, and Canada rose. On the other hand, the U.S. share of the total flow of inward direct investment rose from 3 percent to 27 percent to 41 percent in the same period, making it the largest recipient of foreign investment.

Canada's traditional position as a major recipient of foreign direct investment has also changed in the past two decades. Canada's share of the OECD's inward investment flows fell from 16 percent to a negative figure between the early 1960s and the early 1980s. For the past decade, outward flows have significantly exceeded inward flows on a balance of payments basis. These data are, however, a little deceptive because re-investments of retained earnings by foreign-owned and Canadian-owned multinationals are not included. However, the value of Canadian-owned assets abroad is now about 54 percent of that owned by foreigners in Canada, compared with about 25 percent in the early 1970s, and is heavily concentrated in the United States.

Despite these trends, foreign ownership of capital in Canadian industry remains high by international standards, even though there was a considerable decline in the 1970s. In 1981, companies whose equity was controlled abroad accounted for 50 percent of capital in Canadian manufacturing, 44 percent in petroleum and natural gas, 46 percent in mining and smelting, and 6 percent in all industry outside agriculture and finance. The United States accounted for about 80 percent of the foreign direct investment in Canada.

By comparison, among comparable economies (such as Australia, Belgium, or Ireland), few have as much as 40 percent of their manufacturing capital in companies owned by non-residents. Among larger economies, Italy, France, West Germany, and the United Kingdom have between 20 percent and 30 percent; Sweden and Norway, 10 percent; the United States and Japan, approximately 5 percent.

In addition, as measured by the foreign content of inputs used by the 382 largest industrial multinationals in Canada, intra-firm trade increased in the 1970s. Importing firms related by ownership to exporting firms accounted for approximately one-half of imports from the United States in 1977, including petroleum imports and trade under the Canada-U.S. Auto Pact. In a range of other Canadian industries, more than half of U.S. imports are intra-firm.

### ***The Behaviour of Multinationals and the Canadian Economy***

Safarian also discusses how the process of internalization through intra-firm trade can explain why a firm operates abroad through subsidiaries rather than more directly by exporting. Studies have shown that market potential plays a major role in decisions about where to locate. Size and growth of the national market and the attempt to maintain market share



are further factors, as are the availability and cost of labour and raw materials. Significant public policy variables include the general attitude toward foreign investment, the degree of political stability, and the presence of exchange controls or financial restrictions. When evaluating the roles of foreign direct investment and multinationals, Safarian also stresses that it is often difficult to distinguish them from other determinants of economic activity. Moreover, the evidence Safarian examined suggests that industrial policies in Canada and abroad are more important than foreign ownership in explaining negative aspects of the structure of Canadian industry.

An important Canadian concern about the activities of multinationals has been the potential effects on national sovereignty. Issues with U.S.-based multinationals include the U.S. Trading with the Enemy Act, the application of antitrust guidelines to corporations abroad, and U.S. restrictions on the export of gas pipeline technology to the U.S.S.R. via subsidiaries and licences. However, countries other than the United States, such as West Germany, have comparably stringent laws.

Another concern often expressed is that the gains from multinational operations may accrue largely to the foreign firm and that continued reliance on multinationals may lead to a Canadian industrial structure that is more favourable to foreign countries than to Canada. Canadians have always been concerned when important corporate decisions are made outside their own country, some arguing that it is more difficult for the government to control foreign multinationals than to control domestic firms, because foreign firms can use the threat of leaving the country to offset government pressures.

Most studies of effects of multinationals on the Canadian economy, however, conclude that the net effects are positive. Particularly important is the tax revenue gain to Canada, which Jenkins (1979) estimates at between 1.5 percent and 2.5 percent of GNP for the period between 1965 and 1974.

### ***Trade Liberalization and Investment Flows***

A further issue that has frequently been raised in debates over foreign ownership in Canada concerns the effects of either unilateral or bilateral free trade on flows of foreign direct investment into Canada. It has long been believed that much of the foreign investment currently in Canada represents the response of foreign firms to the high tariff barriers that have characterized Canadian commercial policy since the days of the National Policy in the nineteenth century. Under this view, trade and foreign investment are substitutes. Foreign firms have the choice of supplying the Canadian market by exports from their home country or establishing branch plants in Canada. The higher the tariff barriers, the more attractive is the branch plant option. Hence the removal of tariff or



non-tariff barriers in Canada would result in the removal of the branch plants and foreign firms, which could then supply the Canadian market with expanded production abroad. These issues are discussed in the paper by David Burgess in volume 11, based on his presentation to the Commission symposium on exchange rates, financial markets, and trade liberalization.

Perhaps the first question to ask about the effects of any trade policy changes on foreign investment is whether or not decisions about trade policy should be based on these effects. During the symposium, it was argued that these should not be decisive factors in designing Canada's trade policies, since higher per capita real incomes would result from freer trade irrespective of whether foreign investment flows expand or contract as a result. The tariff is an inefficient policy instrument for the purpose of attracting additional foreign direct investment when compared with a subsidy policy. It is not in the national interest to control such investment indirectly by manipulating Canada's trade barriers.

The impacts on capital flows of both unilateral free trade and bilateral free trade with the United States were also considered at the symposium. In the unilateral free trade case, the feeling was that there might well be a considerable outflow of foreign investment. The critical factor in this case is the continued existence of foreign trade barriers. Significant economies of scale within the plant then become an argument for complete plant closures in Canada and the supplying of the Canadian market by exports from other countries.

However, the case of bilateral free trade with the United States involves a range of further complicating factors, and one cannot say *a priori* whether foreign investment will increase or decrease. Firms must consider the degree of security of access any trade agreement would offer them before deciding to expand production in Canada. The size of the Canadian market relative to the minimum efficient scale of plant and the size of possible economies of scale are also important considerations. In the most extreme case, if a plant could serve the entire North American market, it would have to rely on exporting 90 percent of its output if it located in Canada and only 10 percent if it located in the United States. Guaranteed access to the U.S. market thus becomes critically important. If this concern is met, Canada could become a more attractive location for foreign firms seeking to serve a North American market. This would also apply to Canadian firms currently investing in the United States, and, therefore, increased Canadian investment in Canada could potentially displace some foreign investment in Canada.

Another concern is how foreign-owned subsidiaries would react to trade policy changes. A worst-case scenario would be one in which there are widespread plant shut-downs and consequently increases in imports of manufactured goods. A sell-off of assets by U.S. subsidiaries would result in a fall in asset prices in Canada, but this would permit Canadians

to buy these assets at a lower price. A large capital outflow and a large trade deficit would put downward pressure on the exchange rate, also inhibiting further capital outflows and favouring production in Canada. Equilibrium would therefore be restored through a combination of exchange rate depreciation and adjustment in the manufacturing wage level to induce firms to remain in Canada. In the longer run, as plant rationalization takes place and economies of scale are realized, both real wages and real rates of return in manufacturing would be expected to rise. The Canadian manufacturing sector would therefore survive, but in a more specialized, leaner, and healthier form.

The tendency toward a wholesale exodus of foreign firms in the event of a move toward freer trade is also generally seen as unlikely. The more likely event is exit for those subsidiaries that have developed no special strengths and derive no particular advantage from their Canadian location beyond the protection of the tariff. Disinvestment in such cases may even be beneficial. Those firms likely to remain would be the better managed ones that have developed special expertise in certain areas. Increasingly, these subsidiaries are already moving toward world product mandates.

A further concern is how small and medium-sized Canadian firms would fare under freer trade. The risks they would face seem significant, since many lack experience in export markets and would have to compete with American-owned subsidiaries with access to their parent companies' financial resources and marketing facilities. Some Canadian firms could even be taken over or merged with U.S. firms to speed the acquisition of such facilities.

On balance, it is difficult to say whether foreign investment would increase or decrease under a bilateral free trade arrangement. Additional investment flows from third countries may well tilt the balance toward Canada's becoming a larger net importer of foreign capital, but these conclusions are at best approximate. However, in the longer run, domestic savings would rise because of the real income gains from the trade liberalization, allowing Canadians to own more of their own resources and perhaps be able to rely to a lesser extent on foreign funding than has historically been the case.

### ***Policy Instruments Used in Canada to Control Foreign Investment***

A range of instruments has been used to control or influence multinationals in Canada, the most important being the Foreign Investment Review Agency. These include economic performance requirements, for which FIRA has been the major instrument. In addition, there are federal and provincial requirements that a majority of the directors of a business be resident Canadians and authorizing differential treatment of firms

after establishment in Canada. The exploration and development grants under the National Energy Program are the most important example of these. There are also sectors where foreign investment is either prohibited or limited, such as communications, newspapers, banking, uranium, mining, airlines, and other transportation industries. Other features include a lower rate of federal tax for Canadian-owned small business that is not available to foreign-owned firms, and grants for mineral exploration in northern federal territories and for advertising in Ontario.

FIRA's control over foreign investment has been exercised through a review of each application for investment, to assess whether significant benefits accrue to Canada as defined by a prescribed set of criteria. During 1983, the agency's operations were substantially changed to simplify and speed up its procedures. In the process, the rate of rejection of proposals has fallen from the 10 to 12 percent range for new business and acquisitions in the period 1980–82 to about 5 percent more recently.

However, as Wonnacott (1982) has pointed out, as an instrument of control over foreign investment, FIRA is inferior to a discriminatory tax on foreign investment. Although it imposes a quantitative restriction on foreign investment, it sells no rights of access and the Canadian treasury collects no revenue from the restrictions FIRA imposes, as it would if a tax were used instead to limit foreign investment. FIRA can extract concessions from foreign firms to provide benefits to the Canadian economy — such as undertaking more R&D in Canada or shifting purchases from foreign sources to Canadian suppliers — but the value of these benefits is hard to quantify. FIRA is therefore perhaps best understood as a vehicle through which Canadians surrender tax revenues in exchange for these other benefits.

Although these benefits may be substantial in some cases, in other cases they may be exaggerated. In fact, some FIRA decisions may even be counter-productive, such as FIRA regulations on entry into industries that may have reduced competition.

Alternatives to the nationally oriented ownership policies pursued through FIRA include granting subsidies to nationally owned firms and taxing foreign firms more heavily to capture any rents that accrue. However, Canada's changing position as a less attractive host country for inward direct investment and an increasingly important home country for foreign direct investment suggests that Canada's interests in this set of issues will change in the years ahead as it focusses not only on the control of inward investment but also on ways controls in other countries impede Canada's ability to invest abroad. This suggests that Canada may have more interest in pursuing trade-related investment issues within the GATT and other foreign investment issues in the OECD than seemed likely a few years ago.

## **Immigration Policies and the Canadian Economy**

Immigration policies have been an important influence in shaping modern Canadian society. Canada's links with the external environment through flows of labour have perhaps been as important as its links through flows of goods and capital. As a comparatively recently settled country, Canada has relied extensively on immigration in certain periods to promote faster economic development than purely domestic labour force growth would permit. The so-called Wheat Boom Period, from 1896 to the start of World War I, and the heavy immigration of the 1950s are the most prominent examples.

Since Confederation, the general stance of Canadian immigration policy has been expansionary. Indeed, one of the objectives of the National Policy was to enlarge the size of the Canadian population, in part to provide a more secure domestic market for Canadian producers. The volume and composition of immigration have varied over the years in response to economic, political, and social conditions in Canada and in the sending countries. Emigration too has been an important variable.

The volume of migration and the skills and tangible assets migrants have brought to Canada have had a significant effect on both income levels and the distribution of income in Canada. The volume and composition of immigration has also had important effects on the distribution of income between labour and the owners of capital and resources, the age and sex structure of the population, labour force participation rates, domestic savings rates and many other variables.

### ***The Goals of Immigration Policies***

In a study on immigration policy and Canadian economic growth published in volume 12 of the Commission's research series, William Marr and Michael Percy examined the economic consequences of Canadian immigration policies, particularly their effects on per capita income, and the effect of immigration on national welfare levels.

They noted that immigration policy has several goals, some of which conflict and involve trade-offs. Demographic objectives involve choices that the government might take concerning the size, rate of growth, and structure of the Canadian population. Social or humanitarian objectives emphasize family reunification and the admission of refugees. Economic objectives are general; according to the 1978 Immigration Act, they involve fostering "the development of a strong and viable economy and the prosperity of all regions of Canada." Under the act, three classes of immigrants are specified: the refugee class, the family class and the independent (or "economic") class of migrants, which includes "selected" workers (that is, workers selected according to labour market criteria), sponsored relatives, entrepreneurs, and the self-employed.

Although the 1966 white paper on immigration took the position that immigration had made a major contribution to the national objectives of maintaining a high rate of population and economic growth, a different position was taken in the government's green paper just eight years later. It argued that the benefits of high rates of population growth were dubious on a number of grounds.

Recently, Canadian immigration policy has become more restrictive. In the independent class, with the exception of entrepreneurs and the self-employed, only those with pre-arranged employment approved by a Canadian employment centre are eligible for entry. This policy change has resulted in a sharp decrease in the numbers admitted under this category relative to former years.

Marr and Percy review the arguments advanced in the past about whether or not immigration improves national welfare. One argument claims that a larger domestic population permits more economies of scale in production. They point out that trade liberalization is a much simpler and more effective way of capturing these benefits. They reached a similar conclusion about the claim that the pace of technological change and income per capita is linked to the rate of population growth. As long as there are other, larger countries with more rapid population growth rates, Canada can obtain these benefits through leasing these countries' technologies or purchasing capital goods that embody the innovations. Marr and Percy see trade in technology, capital equipment, or both, as an alternative to immigration in capturing benefits from technical progress abroad.

The possibility of economies of scale in the provision of social overhead capital may be more compelling, but the empirical importance of this effect is questionable. With the exception of national defence, most of the goods and services at issue are subject to congestion costs, that is, the benefits an individual receives falls as more individuals share them.

The skills migrants bring with them represent a possible gain because the costs of child-rearing, education, and training for these individuals are borne by the sending country. These costs are not insignificant, especially in the case of developing countries, which have become an increasingly important source of immigrants in recent years.

### ***Labour Market Targetting and the Design of Immigration Policy***

An enduring aspect of Canada's immigration policies has been the effort to link the number and occupational composition of migrants to conditions in domestic labour markets. Before May 1982, labour market analyses and forecasts based on unemployment and vacancy rates were used to estimate demand in almost 500 occupational categories. This

occupational rating was then used in assessing the application of a prospective immigrant.

However, this procedure involved a number of difficulties. Subjective judgment played a significant role in determining the ratings, and although the methods used should ideally have been forward looking, they relied on data showing the state of the labour market in the past. In addition, if an occupational category was opened during any period, there was no way to control the numbers that could enter under that category.

Recent research has shown that workers admitted to specific employment do not experience lower unemployment than other immigrants. Therefore, although attempts are currently being made to develop a better forecasting system, experience with past attempts raises the fundamental issue of whether this class of immigrants should be targeted to specific jobs at all or whether greater flexibility is preferable. Relatively young, well-qualified, highly educated applicants may be better suited to a flexible system than applicants chosen more on the basis of narrower occupational characteristics.

Although gains to Canadians still occur with an occupationally selective system, following this course also runs the risk of becoming more dependent upon immigration for certain types of skilled workers. Canadians may then find that certain occupations become difficult to enter as training and apprenticeship programs become scarce if employers can rely on trained immigrants. The system may also have effects on the wage structure. According to Marr and Percy, policy makers in Canada may not have fully considered the possible consequences.

### *Immigration and Demographic Trends*

Immigration policy also has demographic objectives. The current Immigration Act requires the minister to report to Parliament the manner in which demographic considerations have been taken into account in determining planned immigration levels. The current projection is that with constant fertility of about 1.7 children per woman throughout her childbearing years and net immigration of approximately 50,000 per year, the Canadian population will reach 27 to 28 million people by the end of the century. If current fertility rates and net immigration rates continue after the year 2000, the population will peak at about 29 million around 2020 and then slowly begin to decline.<sup>23</sup>

If one takes a very long-run view and considers the levels at which the population will eventually stabilize, given assumptions about fertility and net immigration, then current fertility rates (about 1.75) and net immigration (about 50,000 per year) would leave Canada after about two hundred years with a stable population slightly above 10 million. To maintain the current level of about 25 million with the current fertility

rate, net immigration would have to roughly double to about 100,000 per year. This gives some indication of the importance of immigration levels in determining the size of the population in the long run. Of course, the fertility rate is an even more important variable in such calculations, and historically it has shown substantial variability. At the moment, fertility rates across the developed world, including Canada, are at low levels, and one cannot tell whether or not this will remain the case for a long time to come.

Marr and Percy suggest that a demographic objective should be a goal of immigration policy only insofar as the per capita income of original residents is expected to increase as a result. In their view, at the present time, reasonable criteria do not exist to permit defining the optimal levels or growth rates for a population.

The age structure of the population also provides a related but somewhat different demographic objective toward which immigration policy could be directed. The present aging of the population and the projected eventual decrease in the relative size of the labour force will leave an increased tax burden on the economically active population to fund public pensions and social services. Population projections suggest that higher immigration levels can make a contribution to increasing the size of the labour force and reducing the proportion of the total population over 65 years of age. If this were to be attempted, immigration policy would not become expansionary until the dependency ratio ceased its decline, which projections quoted by Marr and Percy place at around the year 2011.

### ***International Dimensions of Canada's Immigration Policies***

In addition to purely domestic concerns over real income per capita, it is also worth noting that the removal of all restrictions on migration throughout the world could lead to significant global gains. Although this possibility is politically unfeasible, economists have long recognized the flow of goods across borders to be a substitute for the flow of people and capital. Changes in barriers on international flows of goods therefore have to be considered alongside changes in restrictions on immigration. Through multilateral trade liberalization, per capita incomes in all countries would be improved. Thus, if a further objective of Canada's immigration policies is to relieve in some small way the population pressures in the developing world and raise real incomes, it is important to remember that this same objective could be achieved by adopting less restrictive trade policies toward these nations.





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## Concluding Remarks

This discussion of the implications for Canada of its links to the global economy has focussed heavily on its present and potential trade relations with other countries, both bilaterally and through the GATT. Other major issues include the domestic consequences of Canada's import policies, Canada's interests in the developing world, international factor flows, and foreign ownership in the Canadian economy.

The challenge of the decades ahead is to select appropriate policies that both protect Canadian interests and are oriented toward both a global trading order and a wider international set of arrangements beneficial to Canada. The position often taken in Canadian debates on these questions is that as a relatively small country, Canada has little or no role to play in these matters because of its inability to influence events to any significant degree. However, the history of the global economy since the 1940s suggests that this is not the case. Middle-level powers do have the ability to initiate changes in direction, particularly in periods where the global order is under pressure. The challenge is to initiate a set of policies designed to both promote Canada's national interests and to achieve a global order more beneficial to all countries, including both the developed and the developing world.

The choices ahead are complex. Canadians may be able to agree that on the export side the objective is to gain increased and secure access to major export markets, but choosing the appropriate instruments to meet this objective is more difficult. Canadians have to decide how to manoeuvre within the GATT. If it initiates changes in trade policy with the United States, ideally they should not fundamentally disturb the balance of global arrangements. They must be acceptable to the United States and must not compromise Canadian sovereignty. Canadians also have to facilitate the domestic adjustments that will inevitably accompany any



further reductions in Canada's trade barriers. Determining objectives and then selecting the instruments to achieve them must be kept squarely in mind as two different elements of policy making in these areas.

Perhaps the dominant feature emerging from the economics research program is the key role played by the United States in deciding on all these issues and the implications of this for Canada's policies. In both the research papers and the symposiums, the point has repeatedly been emphasized that over 70 percent of Canada's trade is with the United States, and that Canada neglects this feature of its environment at its peril. The dominance of the United States suggests that Canada should concentrate heavily on this link in developing its trading arrangements.

If there is a new policy direction emerging from this research, one might term it balanced multilateralism — an adherence to and acceptance of the GATT as vital to Canada's interests in a multilateral trading system, but not to the point of excluding other trade policy avenues. Canada's participation in the GATT should not prevent more active pursuit of its national interest through bilateral initiatives with the United States and even other major trading partners, such as Japan and the European community.

The pressures for additional protection and the dangers inherent in such a policy move were clearly recognized by all who participated in the research program, and the potential costs of any additional protection were very clearly labelled. Smaller countries generally have more to lose from their own protection than larger countries. An important plank of Canadian policies in the years ahead would therefore seem to be to resist domestic pressures for additional protection as firmly as possible, while recognizing the adjustment costs imposed on those affected by any policy change. A somewhat more accommodative policy stance toward active adjustment assistance, along with less accommodation of protectionist pressures, is widely agreed to be helpful in facilitating the changes in the Canadian economy necessary to adapt to a more open trade policy.

## **Postscript, July 1985**

This paper was delivered to the Commission for publication at the end of December 1984. Since that date there have been several important developments on the trade policy front which are not reflected in the text. In early 1985, the Department of External Affairs published a discussion paper on Canada's trade policy options which raised the issue of closer trade links with the United States. This was followed by a meeting in March 1985 in Quebec between Prime Minister Mulroney and President Reagan which resulted in a joint Declaration on Trade.

Generally through the spring and summer of 1985 Canada-U.S. trade has been discussed in Canada under a variety of headings — freer trade with the U.S., free trade with the U.S., a comprehensive free trade agreement with the United States. Such discussion has expanded in Canada but does not seem to have generated a corresponding debate in the United States. On the contrary, the focus of U.S. trade policy discussion has, if anything, been fair trade rather than free trade. In the late spring, trade issues with Japan were a major topic of debate in the United States. Since then sector issues with Canada have become increasingly important. Countering duties on hogs, salt, codfish and raspberries, have been invoked. Pressures from the U.S. lumber industry for countervailing duties against Canadian softwood lumber, and from the steel industry for inclusion of Canada in the system of voluntary export restraints in the U.S. are currently strong and a major problem for many Canadians.

On the multilateral front progress toward a future multilateral trade negotiation under the GATT continues, somewhat in fits and starts. The expected communiqué from the spring Bonn summit did not emerge, mainly, it seems, because of French insistence that trade in agriculture (and implicitly the Common Agricultural Policy in the European Community) not be on the agenda for a GATT round. However a series of summer meetings will address the range of issues covering what a future round might contain.

The fundamental trade policy issues that Canadians face in the years ahead are, however, largely unchanged. Our most important export market remains the United States, and our need for secure access is clear. On the other hand, the benefits to middle powers such as Canada from strong multilateral discipline over trade measures are equally clear, as are the wider social concerns over adjustment costs from changed trade policies and the intermingling of trade policy, sovereignty concerns, and external relations. Balancing the bilateral and multilateral focus in our trade policies remains a central issue today, as it was when this paper was written.

## Appendix

### Royal Commission Studies Referred to in the Text

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#### Commissioned papers published in the research series

Curtis, John M. "Which Way: Canadian Trade Policy in a Changing World Economy." In volume 10, *Canada and the Multilateral Trading System*.

Grey, Rodney de C. "The Service Industries: A Note of Caution about the Proposal to Negotiate Rules about Traded Services." In volume 10, *Canada and the Multilateral Trading System*.

Harris, Richard G. *Trade, Industrial Policy and International Competition*, volume 13.

Harris, Richard G. "Summary of a Project on the General Equilibrium Evaluation of Canadian Trade Policy." In volume 11, *Canada–United States Free Trade*.

Helleiner, Gerald K. "Underutilized Potential: Canada's Economic Relations with Developing Countries." In volume 10, *Canada and the Multilateral Trading System*.

Markusen, James R. "Canadian Gains from Trade in the Presence of Scale Economies and Imperfect Competition." In volume 11, *Canada–United States Free Trade*.

Marr, William L., and Michael B. Percy. "Immigration Policy and Canadian Economic Growth." In volume 12, *Domestic Policies and the International Economic Environment*.

Raynauld, André. "Insuring and Financing Exports in Canada." In volume 12, *Domestic Policies and the International Economic Environment*.

Safarian, A.E. "Government Control of Foreign Business Investment." In volume 12, *Domestic Policies and the International Economic Environment*.

Shearer, Ronald A. "Regionalism and International Trade Policy." In volume 11, *Canada — United States Free Trade*.

Whalley, John. *Regional Aspects of Confederation*. Volume 68.

Wilkinson, B. "Canada's Resource Industries: A Survey." In volume 14, *Canada's Resource Industries*.

Wonnacott, Ronald J. "Notes from an Address on the Proposal for a Canada–Japan Free Trade Area." In volume 10, *Canada and the Multilateral Trading System*.

#### Papers presented at Commission research symposia

Ahearn, Raymond J., and Alfred Reifman. "The Future of U.S. Trade Policy." Paper prepared for the Symposium on Canada and the Future of

the Global Trading System. Ottawa, July 24, 1984. Published in volume 11, *Canada-United States Free Trade*.

Aho, C. Michael, "What Changes Are Needed at the International Level for Improving Trade Relations?" Paper prepared for the Symposium on Canada and the Future of the Global Trading System. Ottawa, July 24, 1984. Published in volume 10, *Canada and the Multilateral Trading System*.

Baldwin, John and Paul Gorecki. "The Relationship Between Trade and Tariff Patterns and the Efficiency of the Canadian Manufacturing Sector in the 1970s: A Summary." Paper prepared for the Symposium on Domestic Adjustment to Trade Policy Changes and External Shocks. Ottawa, January 27, 1984. Published in volume 11, *Canada-United States Free Trade*.

Bale, Harvey E., Jr. "Canadian/United States Sectoral Negotiations: An Overview." Paper prepared for the Symposium on Canada and the Future of the Global Trading System. Ottawa, July 24, 1984.

Beigie, Carl. "The Automotive Sector." Paper prepared for the Symposium on Issues in Canada-U.S. Free Trade. Ottawa, October 1983.

Biggs, Margaret. "The Developing Countries in the International Trading System." Paper prepared for the Symposium on Canada and the Future of the Global Trading System. Ottawa, July 24, 1984. Published in volume 10, *Canada and the Multilateral Trading System*.

Boyer, Russell. "Trade Liberalization and the Exchange Rate: The Applicability of the 'Textbook Model' to Canada's Policy Options." Paper prepared for the Symposium on Exchange Rates, Financial Markets and Trade Liberalization. Ottawa, February 10, 1984.

Burgess, David, "The Impact of Trade Liberalization on Foreign Direct Investment Flows." Paper prepared for the Symposium on Exchange Rates, Financial Markets and Trade Liberalization. Ottawa, February 10, 1984. Published in volume 11, *Canada-United States Free Trade*.

Canada, Department of External Affairs. "Issues for GATT in the 1980s." Paper prepared for the Symposium on the GATT and Canadian Interests. Ottawa, December 2, 1983 (presented by John Weekes).

Canada, Department of Regional Industrial Expansion. "Experience in Canada with Adjustment Policies." Paper prepared for the Symposium on Domestic Adjustment to Trade Policy Changes and External Shocks. Ottawa, January 27, 1984 (presented by R. Harley McGee). Published in volume 12, *Domestic Policies and the International Economic Environment*.

Carter, Colin. "Issues in Canada-U.S. Free Trade in Agriculture." Paper prepared for the Symposium on Issues in Canada-U.S. Free Trade. Ottawa, October 1983.

Chambers, F.J. "Notes for a Presentation to the Research Symposium on Regional Interests in National Trade Policy." Ottawa, May 22, 1984.

- Clark, M.G. "Comments prepared for the Research Symposium on Regional Interests in National Trade Policy." Ottawa, May 22, 1984.
- Cox, David, and Richard G. Harris. "A Quantitative Assessment of the Economic Impact on Canada of Sectoral Free Trade with the United States." Paper prepared for the Symposium on Canada and the Future of the Global Trading System. Ottawa, July 24, 1984.
- Curtis, John M. "Thoughts on Improving the GATT Including a Future Multilateral Trade Negotiation." Paper prepared for the Symposium on Canada and the Future of the Global Trading System. Ottawa, July 24, 1984.
- Diebold, William, Jr. "Cartelization and Managed Trade: The Problem of Quantitative Restrictions." Paper prepared for the Symposium on Canada and the Future of the Global Trading System. Ottawa, July 24, 1984. Published in volume 10, *Canada and the Multilateral Trading System*.
- Earl, John. "U.S.-Canada Free Trade: A View from the East." Paper prepared for the Symposium on Issues in Canada-U.S. Free Trade. Ottawa, October 1983. Published in volume 11, *Canada-United States Free Trade*.
- Eastman, H.C. "Canadian Interest in a Free Trade Arrangement with the United States." Paper prepared for the Symposium on Issues in Canada-U.S. Free Trade. Ottawa, October 1983.
- Haessel, Walter. "Issues in Canada-U.S. Energy Trade." Paper prepared for the Symposium on Issues in Canada-U.S. Free Trade. Ottawa, October 1983.
- Hamilton, Colleen, and John Whalley. "Canada and the Future of the Global Trading System: Summary of the Proceedings of a Research Symposium." Ottawa, October 1984. Published in volume 10, *Canada and the Multilateral Trading System*.
- Hamilton, Colleen and John Whalley. "The GATT and Canadian Interests: Summary of the Proceedings of a Research Symposium." Ottawa, January 1984. Published in volume 10, *Canada and the Multilateral Trading System*.
- Hamilton, Colleen, and John Whalley. "Non-Tariff Barriers and Canadian Trade Policy: Summary of the Proceedings of a Research Symposium." Ottawa, January, 1984. Published in volume 10, *Canada and the Multilateral Trading System*.
- Hamilton, Colleen and John Whalley. "Regional Considerations and Canadian Trade Policies: Summary of the Proceedings of a Research Symposium." Ottawa, August 1984. Published in volume 11, *Canada-United States Free Trade*.
- Hamilton, Colleen and John Whalley. "U.S. Trade Policies and Canadian Interests: Summary of the Proceedings of a Research Symposium." Ottawa, 1984. Published in volume 11, *Canada-United States Free Trade*.

Harris, Richard G. "Some Observations on Trade and Adjustment Policies in Canada." Paper prepared for the Symposium on Domestic Adjustment to Trade Policy Changes and External Shocks. Ottawa, January 27, 1984.

Harris, Richard G. "A Canada-U.S. Free Trade Arrangement: Some Observations." Paper prepared for the Symposium on Issues in Canada-U.S. Free Trade. Ottawa, October 1983.

Hill, Roderick. "Domestic Adjustment to Trade Policy Changes and External Shocks: Summary of the Proceedings of a Research Symposium." Ottawa, March 1984. Published in volume 12, *Domestic Policies and the International Economic Environment*.

Hill, Roderick. "Exchange Rates, Financial Markets and Trade Liberalization: Summary of The Proceedings of a Research Symposium." Ottawa, July 1984. Published in volume 12, *Domestic Policies and the International Economic Environment*.

Hill, Roderick and John Whalley. "Summary of the Proceedings of a Research Symposium on a Possible Canada-U.S. Free Trade Arrangement." Ottawa, December 1983.

Hufbauer, Gary C. "U.S. Receptivity to Bilateralism in Canadian-American Economic Relations." Paper prepared for the Symposium on Canada and the Future of the Global Trading System. Ottawa, July 24, 1984.

Longworth, David. "Some Exchange Rate Policy Considerations When Trade Is Liberalized." Paper prepared for the Symposium on Exchange Rates, Financial Markets and Trade Liberalization. Ottawa, February 10, 1984. Published in volume 12, *Domestic Policies and the International Economic Environment*.

Lazar, Fred. "Reservations Concerning a Free Trade Arrangement with the U.S." Paper prepared for the Symposium on Issues in Canada-U.S. Free Trade. Ottawa, October 1983.

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Melvin, James. "The Regional Impact of Tariffs." Paper prepared for the Symposium on Regional Interests in National Trade Policy. Ottawa, May 22, 1984. Published in volume 11, *Canada-United States Free Trade*.

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Parkin, Michael. "Monetary Policy and Trade Liberalization." Paper prepared for the Symposium on Exchange Rates, Financial Markets and Trade Liberalization. Ottawa, February 10, 1984.

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Robertson, Matthew, and Alex Grey. "Trade-Related Worker Adjustment Policies: The Canadian Experience." Paper prepared for the Symposium on Domestic Adjustment to Trade Policy Changes and External Shocks. Ottawa, January 27, 1984. Published in volume 12, *Domestic Policies and the International Economic Environment*.

Salembier, Gerry. "Structural Adjustment Requirements, Rigidities and Policy Responses." Paper prepared for the Symposium on Domestic Adjustment to Trade Policy Changes and External Shocks. Ottawa, January 27, 1984.

Shearer, R.A. "Canada-U.S. Free Trade: A Western Perspective." Paper prepared for the Symposium on Issues in Canada-U.S. Free Trade. Ottawa, October 1983.

Stone, Frank. "Canada and the General Agreement on Tariffs and Trade." Paper prepared for the Symposium on the GATT and Canadian Interests. Ottawa, December 2, 1983.

Trebilcock, Michael. "The Political Economy of Business Bail-outs in Canada." Paper prepared for the Symposium on Domestic Adjustment to Trade Policy Changes and External Shocks. Ottawa, January 27, 1984. Published in volume 12, *Domestic Policies and the International Economic Environment*.

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## Notes

1. The European Community and Japanese tariffs apply to c.i.f. values (transport values including carriage, insurance and freight), while U.S. and Canadian tariffs apply to f.o.b. values (import values free on board, i.e., excluding transportation charges). For the same tariff rate, the degree of protection provided by EC and Japanese tariffs is higher.
2. Data reported in the OECD *Development Assistance Committee, Development Co-operation, 1983 Review*, Table D3, p. 197 indicate that the fraction of tied aid given by Canada in 1982 was 64.8 percent. Only Austria was higher at 76.7 percent. The United States has 31.5 percent tied aid, Sweden 13.3 percent, the United Kingdom 42.1 percent. The majority of our bilateral aid is tied, while most of our multilateral aid is untied. Data in Table E1, p. 199 from the same source also indicate that only a relatively small part of bilateral aid is food aid, so that even if this is removed from the tied aid portion, performance remains poor.
3. *The Economist* (December 22, 1984), p. 87.
4. In 1973, the United States Treasury ruled that exemptions from municipal tax, aid from Industrial Estates Limited in Nova Scotia, and federal regional grants to the Michelin Tire Company represented an export subsidy. A countervailing duty of 6 percent was levied, which after adjustments amounted to 2–3 percent.
5. The Canada–U.S. Safeguards Agreement was signed in February 1984. The agreement provides for advance notice of at least 30 days before restrictions are imposed, more regular consultations, and a declaration that short-term tariff relief is preferable to quantitative restraints. Certain compensation provisions are also included.
6. Preeg (1970), pp. 187–88.
7. Information in this section draws heavily on Canada, Department of External Affairs, (Ottawa, 1983a), Section II, pp. 8–9.
8. Information in this section draws heavily on "Issues for GATT in the 1980s" presented by John Weekes, Department of External Affairs, for the December 2, 1983 Commission symposium, "The GATT and Canadian Interests," summarized in volume 10 of the Commission's research series.
9. Information in this section draws heavily from Canada, Department of External Affairs, Section VI, pp. 154–57.
10. Canada, Senate, (1978), Vol. II, p. 146.
11. Evans (1971), (Mass., 1971), pp. 258–60.
12. Baldwin, (1979), p. 3.
13. United States, Office of the United States Trade Representative (1983a), p. 177.
14. *Ibid.*, p. 24.
15. The source for the above figures is Canada, Privy Council (Ottawa, 1982a), p. 15.
16. *Ibid.*
17. Michael Trebilcock, "The Political Economy of Business Bail-outs in Canada," published in volume 12 of the Commission's research studies.
18. Information in the preceding three paragraphs draws heavily from Ahearn and Reifman (1984), and Baldwin (1984).
19. See OECD, *Development Co-operation*, Table D.3, p. 197 and p. 238. Canada's fraction of tied aid is reported there as 64.8 percent. The majority of Canada's bilateral aid (around 2/3 of Canada's total aid) is tied. Even if food aid is taken out of the calculation, the fraction of aid that is tied is still high. Food aid from 1979 to 1981 accounted for only 6.1 percent of total Canadian aid (*ibid.*, Table E1, p. 199).
20. Unpublished data made available by External Affairs indicate that Canadian imports from all General Preferential Tariff (GPT) beneficiaries were \$6.9 billion in 1982. Of these imports, \$2.3 billion were dutiable imports, of which \$1.3 billion were eligible for GPT treatment; \$0.9 billion of imports actually entered at GPT rates, and of these imports, \$0.4 billion received a GPT of zero.
21. See 19, above.

22. The recent proposal to replace the Foreign Investment Review Act with the Investment Canada Act seeks to encourage investment in Canada by both Canadians and non-Canadians to contribute to economic growth and employment. The important changes are that review will no longer take place for new investments from abroad, acquisitions by non-residents of Canadian companies with assets under \$5 million, or indirect acquisitions (of parent companies outside Canada) under \$50 million. However, Investment Canada must be notified and review will take place regardless of size in all cases that involve culturally sensitive sectors. Acquisitions will be allowed if they are likely to be of "net benefit" to Canada, a change from the present wording which refers to "significant benefit." The Minister of Regional Industrial Expansion, rather than the cabinet as at present, will be authorized to make decisions. Since larger acquisitions and all foreign investment in culturally sensitive sectors will continue to be reviewed, the list of factors taken into account in such reviews remains largely unchanged. Safarian (1985) estimated that one-tenth of the number of transactions and two-thirds of the value of transactions subject to review under present procedures will be subject to review under the new act.
23. See Canada, Department of Employment and Immigration (1983), pp. 2, 8.

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ECONOMICS  
International Trade

# Canadian Trade Policies and the World Economy

JOHN WHALLEY with COLLEEN HAMILTON and RODERICK HILL

This is the first of six volumes dealing with **International Trade** (see list in back of book), included in the Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada.

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JOHN WHALLEY is Professor in the Department of Economics, University of Western Ontario, London. As well as being a co-author of this volume, he is research coordinator for the section on **International Trade**.

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University of Toronto Press



Royal Commission on the  
Economic Union and  
Development Prospects  
for Canada

ISBN 0-8020-7251-8