REACHING OUTWARD

TWENTY-FOURTH ANNUAL REVIEW

ECONOMIC COUNCIL OF CANADA 1987

Reaching Outward

Reaching Outward

Economic Council of Canada
Twenty-Fourth Annual Review
1987

Available in Canada through

Associated Bookstores
and other booksellers

or by mail from

Canadian Government Publishing Centre
Supply and Services Canada
Ottawa, Canada K1A 0S9

Catalogue No. EC21-1/1987E — Canada: $6.95
ISBN 0-660-12620-6 — Other Countries: $8.35

Price subject to change without notice

Ce rapport est également disponible en français sous le titre : *Un pari stratégique*.

Contents

This document reflects the views of the Members of the Economic Council of Canada. However, comments by D. Cohen, K. Kaplansky and D. Bellemare, and R. Koskie appear after Chapter 5.

Members of the Economic Council of Canada

JUDITH MAXWELL, Chairman
CAROLINE PESTIEAU, Director
HARVEY LAZAR, Director

MILLER H. AYRE
President and Chief Executive Officer
Ayre's Limited
St. John's, Newfoundland

DIANE BELLEMARE
Professor
Department of Economics
Université du Québec à Montréal
Montréal

JALYNN H. BENNETT
Corporate Development Vice President
The Manufacturers Life Insurance Company
Toronto

JACQUES BOUGIE
President
Alcan Extrusions
Scarborough

MARTIN I. CHERNIN
Secretary-Treasurer
Pearl Realty Company Limited
Sydney, N.S.

DIAN COHEN
President
Cohen Couture Associates
Montréal

PIERRE FORTIN
Professor
Department of Economics
Université Laval
Québec

ALIX GRANGER
Vice President
Pemberton, Houston, Willoughby, Inc.
Vancouver

YVES GUÉRARD
President
Le Groupe Sobeco
Montréal

CHAVIVA HOSEK*
Partner
Gordon Capital Corporation
Past President
National Action Committee on the Status of Women
Toronto

CHESTER A. JOHNSON
Chairman and Chief Executive Officer
Western Pulp Inc.
Vancouver

KALMEN KAPLANSKY
Former Director
Canadian Branch Office
International Labour Organization
Ottawa

GEORGE A. KEY
Businessman
Summerside, P.E.I.

RAYMOND KOSKIE
Koskie & Minsky
Barristers and Solicitors
Toronto

* Ms. Hosek temporarily withdrew from the Economic Council for the period July 31 to September 10, 1987; thus she has not been associated with the content of the *Twenty-Fourth Annual Review*.

Foreword

The purpose of the Annual Review is to reflect upon the key developments influencing the performance of the economy, to consider the opportunities and challenges that lie ahead over the medium to long term, and, as required in the *Economic Council of Canada Act*, "to compare [these] prospects with the potentialities for growth in the economy." Today, as we approach the deadline for negotiating a potentially historic trade-liberalization agreement between Canada and the United States, these matters take on new meaning.

Canada has traditionally depended upon international trade and foreign investment for much of its prosperity. In recent years, the exposure to international economic developments has been enhanced by the growing integration of world markets for goods, services, and financial capital. Investors are making decisions on the basis of global comparisons, and savings portfolios are becoming increasingly diversified. The well-being of Canadians is thereby inexorably linked to international markets.

The world economy is now struggling to cope with the legacy of a period marked by oil shocks, double-digit inflation, a sizable recession, and a slump in commodity prices. That legacy includes serious imbalances in currency alignments and in world trade and indebtedness. Because part of this imbalance is due to the remarkable vitality of newly industrializing nations around the Pacific Rim and elsewhere, fears have been expressed about the competitive survival of many traditional domestic industries. Increasingly, in one country after another, governments are being asked to raise protective barriers against foreign competition. Against this background, Canada has entered into the new *Uruguay Round* of negotiations at the General Agreement on Tariffs and Trade and has also undertaken bilateral negotiations with the United States.

Last year, the Council commenced work on the implications for Canada of lower multilateral and bilateral trade barriers. In *Changing Times* (October 1986), we reported our overall projections for the economy under three alternative possibilities: protectionism with retaliation; the mutual removal of Canada-U.S. trade barriers; and the removal of the trade barriers, accompanied by stipulated productivity gains in manufacturing resulting from access to, and competition within, the wider North American market. Almost immediately we were asked by officials at both levels of governments and by community and industry representatives to elaborate on our findings in terms of specific regions, industries, and occupations. Over the past year, our researchers have probed more deeply. Their quantitative results, originally presented in an authored Discussion Paper No. 331, are described here, along with the results of additional work on labour market impacts. As well, the Council has views on the potential impact that increasingly protectionist trade legislation in the United States could have on Canada's unique systems of regional, social, and cultural support.

Any projections of the Canadian economy must have, as a starting point, a set of assumptions and an analytical framework. That framework is grounded in past patterns of behaviour. For purposes of modeling, these relationships are transposed into a set of mathematical equations, suitably tested for their consistency. Simulations are then run, based on certain key assumptions about the international and domestic economies and the policies of various governments. How closely the model's projections will resemble the ensuing reality will depend on the internal structure of the model and on whether the unfolding of events coincides with the key assumptions employed. We have great confidence in the internal structure of the forecasting models that we have used; but it would be folly to expect that all of our assumptions about the future will be accurate.

These caveats notwithstanding, most members of the Council have confidence that the numerical projections in this Review accurately reflect the direction and the relative size of the impacts of the hypothetical trade agreement examined. They also recognize that there is more at stake in the current trade negotiations than industrial competition. What we are witnessing is an effort to redefine North American trade and economic relations. Whatever the outcome of the bilateral and multilateral trade discussions, Canadian managers and workers face a lot of adaptation. We are confident that they have the knowledge and ability to reach outward in order to compete successfully in the broader world arena. And the Economic Council of Canada will do its best to continue to provide informed analysis of the trade-policy environment that is now unfolding.

Judith Maxwell
Chairman

Reaching Outward

READER'S NOTE

The reader should note that various conventional symbols similar to those used by Statistics Canada have been used in the tables:

..	figures not available
...	figures not appropriate or not applicable
--	amount too small to be expressed
–	nil or zero
e	estimated figures
x	data confidential, to meet the secrecy requirements of the *Statistics Act*.

Details may not add up to totals because of rounding.

1 A Global View

Canada is in its fifth year of growth since the ravages of the 1981-82 recession. In the intervening period, Canadians have become more affected than ever by business, financial, and government decisions taken outside their borders. Each year the volume of world output and of world trade increases, and each day billions of dollars are transmitted electronically between countries, in response to myriad commercial opportunities. Savings from many parts of the world are attracted to Canada, just as Canadian savings are seeking profitable ventures abroad.

Canada has been greatly enriched by the growth of world commerce, as have other industrialized countries. Yet, ironically, the freer the interchange of commerce between nations, the more exposed each nation and its citizens become to the practices and policies of others. This has brought new challenges and tensions, as governments have sought to pursue both their national and international ambitions. Greater economic integration and interdependence inevitably create pressures for the normalization or harmonization of laws governing commercial transactions, just as they call for greater monetary and fiscal coordination among the major western governments. Yet each nation is accustomed to its own way of doing things, and each government must recognize that its primary obligations are to its own electorate. Thus, even among the leading western nations, the achievement of international coordination is difficult at the best of times. Today huge imbalances of foreign trade and investment flows make the task even more difficult, yet even more necessary. Canadians will need to take these global perspectives into account if they are to respond successfully to the competitive challenges that will arise in the years ahead.

The New Realities

In reviewing the course of history, one is struck by the patterns of rise and demise of individual nations' wealth and influence. Examples include the dominance of Spain in the days of sailing, discovery, and colonization; that of the United Kingdom in the nineteenth century; and that of the United States in the twentieth century. The prospects are that Japan and the Pacific Rim – and, possibly, a revitalized and integrated European Economic Community – could become the leading engines of growth in the twenty-first century.[1] This shifting pattern of leadership occurs because countries – by domestic initiative, technological breakthroughs, resource discoveries, or war – take a quantum leap over others in productivity performance and real per-capita incomes. Subsequently, a process of catch-up and convergence occurs as trailing nations adopt, or improve upon, many of the leader's technologies.[2] This quickens their rate of structural change without their having to experience some of the manpower or capital shortages that confront the leader. Eventually, the leader's gradual loss of pre-eminence gives rise to inward-looking protectionist sentiments. Loss in the share of world trade is accompanied by charges of "unfair competition" and the advocacy of trade measures to force reciprocal access to foreign markets.

Such was the case, for example, in the United Kingdom in the late 1800s with the rise of such organizations as the National Fair Trade League and the Reciprocity Free Trade Association. Such is also the case with the present trade bill (H.R.3) passed by the U.S. House of Representatives and the alternative bill (S.490) recently adopted by the U.S. Senate.[3]

The parallel also holds with regard to shares of world output and trade. During the four decades prior to the First World War, Britain's share of world industrial production fell by half; her share of world manufactured exports, by one-quarter. Since 1950 the U.S. share of world GDP has dropped by half from 40 to less than 22 per cent; and its share of world trade has declined by more than one-third – from 17 to 11 per cent. In both periods, the pace of economic growth in the leading country fell behind that of its major competitors.[4]

There is, it can be argued, a strong correlation between the "diminished giant" syndrome and the tensions that now surround the U.S. foreign political and economic agenda. In a world in which the growth of knowledge and scientific expertise is progressing almost exponentially, the productivity levels of most of the industrialized and industrializing nations have been converging; and the dominance of the United States in terms of per-capita wealth and income has diminished though not disappeared.

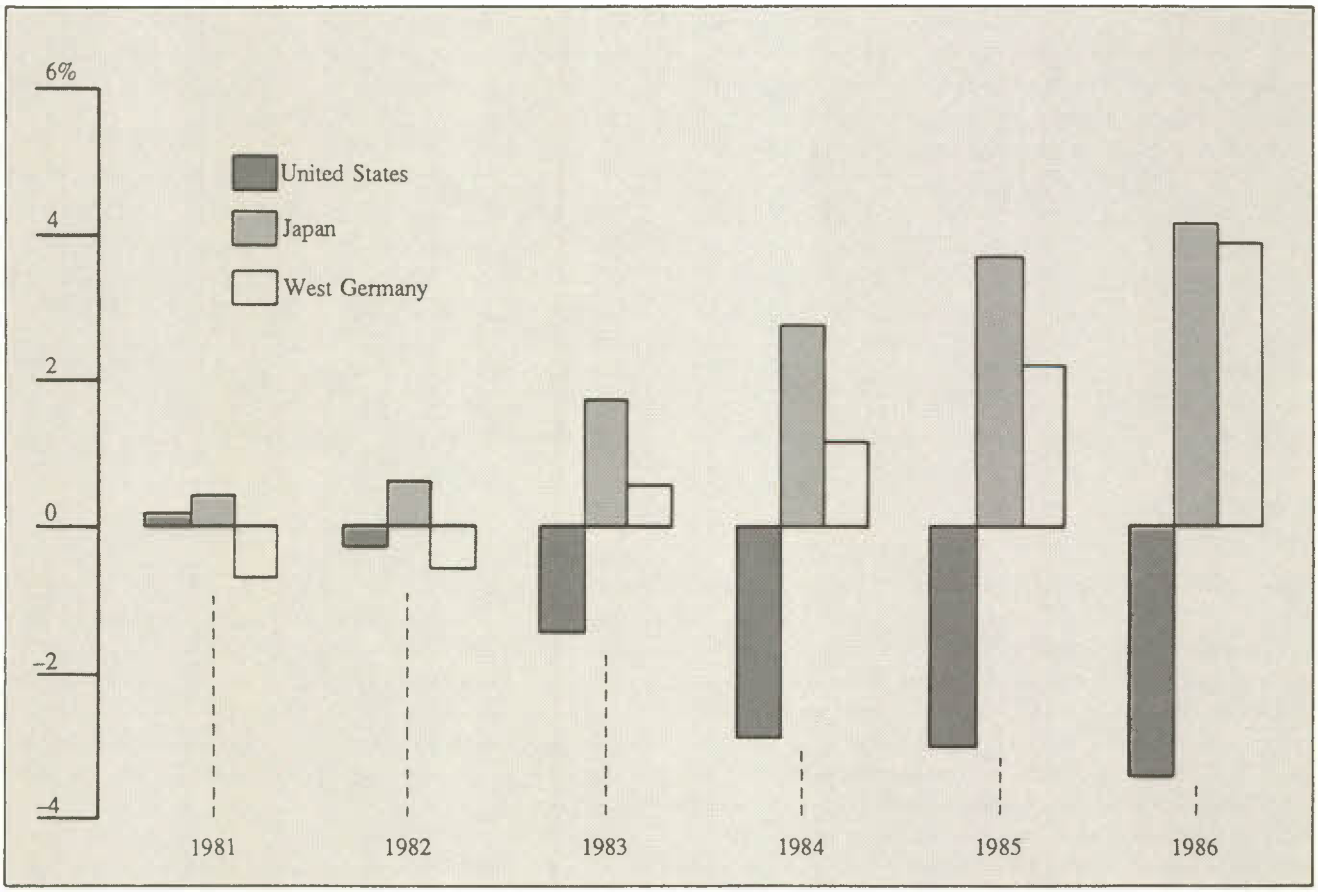
Equally there is ample evidence in Congress and throughout the United States of rising protectionist sentiments and disenchantment with the trading success and practices of other nations. Chart 1-1 shows the sharp divergence in current-account balances since 1981, as Japan and West Germany racked up big surpluses and the United States ran into deficit. This deficit reflects the deep penetration of imports into the U.S. market, which forced shutdowns and rationalization by many manufacturers who, quite naturally, complained to their Congressmen and Senators about unfair competition. The U.S. trade deficit has diminished since mid-1986, thanks to harsh cost-cutting by industry and to the depreciation of the U.S. dollar. Nonetheless, the deficit remains large, and the political pressure to block import competition has not lost its momentum.

While differences still exist between the views of the Administration and those of Congress, the growing rhetoric for "fair" trade, "reciprocal access to markets," and "level playing fields" augurs for increased use of countervailing, antidumping, and other voluntary or involuntary trade restrictions, or even the application of across-the-board import surcharges. Even now, voluntary restraint agreements – which, being bilaterally negotiated, violate Article 1 of the General Agreement on Tariffs and Trade (GATT) – apply to over 40 per cent of U.S. imports. Of course, many Americans would respond that their effective tariff rates are lower than those of most of their OECD competitors and that their nontariff barriers are far less pervasive or subtle than those found in Japan and Europe. And they are right. But the very size of the United States and the stridency of those who would subscribe to "fairer" as distinct from "freer" trade give cause for alarm.

The savings and investment circumstances of nations also show a distinct pattern during their various stages of development. Traditionally, countries in their early growth years have limited savings, so they draw upon foreign know-how and capital to finance imports of

Chart 1-1

Current-Account Balance as a Proportion of GDP, United States, Japan, and West Germany, 1981-86



SOURCE Wharton Econometrics.

machinery and equipment and to build the material and social infrastructure they require. This usually gives rise to trade deficits and growing debt obligations. As these countries mature and become viable in their own right, they frequently run trade surpluses with which to service or reduce their foreign indebtedness. Ultimately, with rising incomes and domestic savings, these nations – once industrialized and advanced – become net lenders, enjoying a net inflow of interest payments and running modest trade deficits that provide export earnings for other developing countries.

Such, for instance, is a reasonably apt description of the early period of British hegemony, when the United Kingdom invested heavily in the development of the United States, Canada, and other parts of the Empire. It also fittingly describes the postwar situation in this century, when the United States, through the Marshall Plan and related aid, helped to re-establish war-ravaged Europe and Japan. Subsequently there was considerable private and public U.S., European, and Japanese lending abroad. In many respects, this debt-cycle hypothesis lies behind the lending practices of the International Monetary Fund and the World Bank; and it was the model that guided the recycling of OPEC funds and western loans to South American, Asian, and African nations during the 1970s, when real world interest rates were low or negative.

But the United States no longer fits this prototype of the mature industrialized nation exporting capital to other developing or maturing economies. Although a great deal of U.S. direct and portfolio investment continues to find its way abroad, the bottom line is that the United States is now the world's largest debtor nation. It is also, paradoxically, a target for investment by countries with surplus savings, and a haven for the substantial capital flight from Latin American and other debtor nations. This debtor position of the United States is the direct result of domestic fiscal stimulation through large federal budgetary deficits, combined with relatively tight monetary constraints to curb inflation, which together raised real interest rates in that country to record highs. This led first to a seriously overvalued U.S. dollar (which discouraged exports and encouraged imports) and produced huge trade deficits in the United States, coinciding with equally large surpluses for Japan and most of western Europe. Clearly this imbalance was unsustainable.

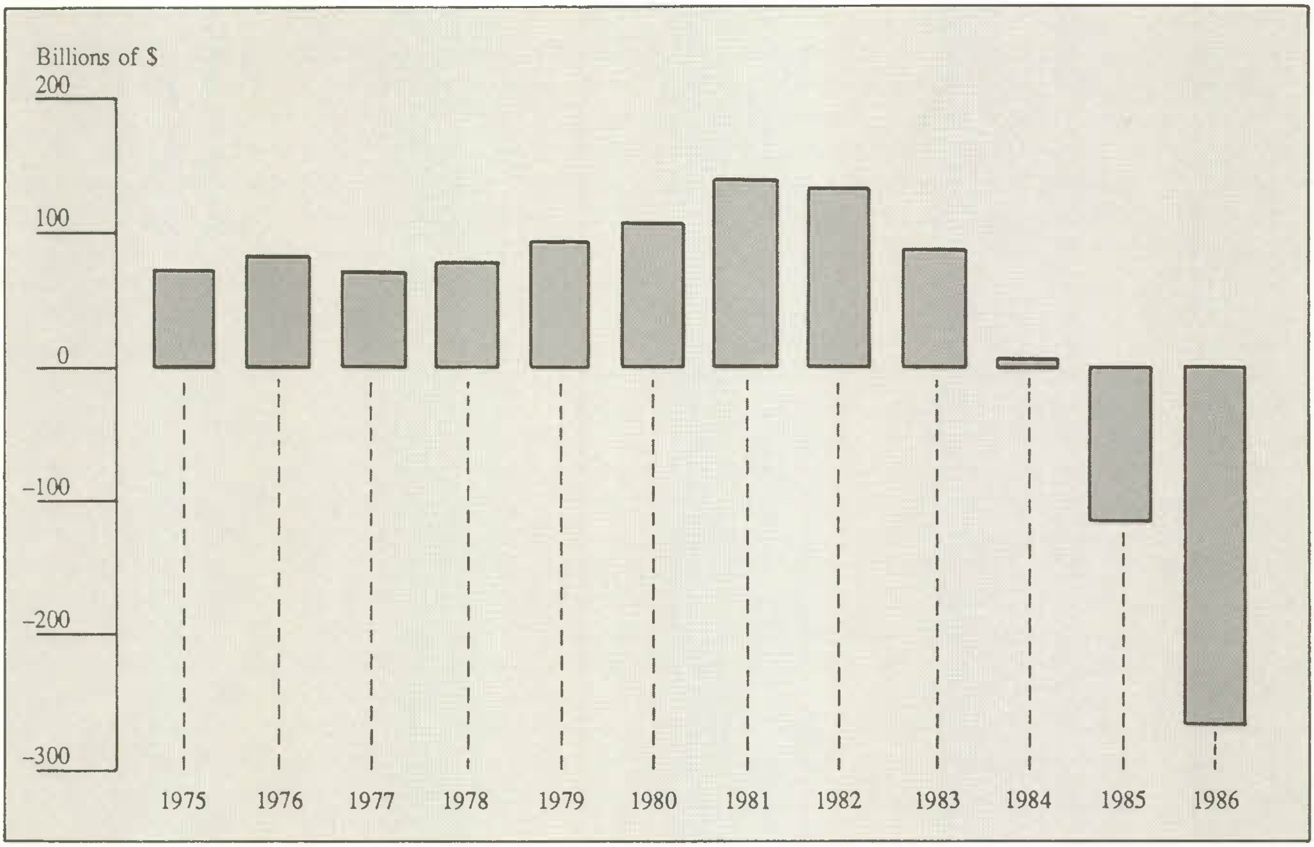
Commencing in 1985 and supported by government "jawboning" in meetings of the finance ministers of the major industrial countries – the Group of Five ("G-5") and the Group of Seven ("G-7") – the U.S. dollar has dropped by about 40 per cent against the Japanese yen and the main European currencies, and the trade deficit has begun to diminish. Still there are real questions as to whether the United States can reverse its trade flows by enough, or soon enough, to service adequately its rapidly rising foreign indebtedness. Net U.S. foreign debt amounted to an estimated $264 billion in 1986, compared with net assets of $141 billion in 1981 (Chart 1-2). By the early 1990s, net debt could well total $1 trillion – an amount equal to the total outstanding debt of all underdeveloped countries today. At today's interest rates, just to service that projected debt alone would require export surpluses in real terms of about $60 billion. Given this year's estimated trade deficit of about $140 billion, a swing in the balance of trade in the order of $200 billion would be needed in order to stop the rise in net debt outstanding.

Clearly, the United States has a formidable task ahead of it in seeking a shift of this magnitude in its trade balance. In the absence of substantial real growth in other OECD countries – in the order of at least 3 per cent per annum – which may in turn require strong growth initiatives by Japan and West Germany, the prospects of the United States rectifying its trade imbalance without resorting to protectionism are not especially strong. If such growth can be achieved, however – and to do so will require fiscal stimulus by the major surplus nations – it will be easier for the United States to accelerate its return to a better trade balance; in addition, the debtor countries in the developing world will be able to increase their revenues from exports and thus ease the burden of their debt load. Unfortunately, the current indications are that the major surplus nations – notably West Germany and Japan – are not, as yet, prepared to move far enough or fast enough to facilitate this adjustment process. In these circumstances, the breeding ground for protectionism in the United States is bound to grow.

There are actually three possible exits from the impasse. The first and most favourable for all trading nations is, as just suggested, the growth solution. Since U.S.-led growth shows signs of faltering, this requires the other major industrial countries to grow faster than the United States, thus creating a demand for U.S. exports and offering alternate markets for exporters who now sell to that country. This realignment of growth rates should be accompanied by a significant cut in the U.S. budget deficit so that the United States can rely more upon domestic saving and less upon capital inflows. U.S. officials have been pushing the first part of this option, pressuring Japan and West Germany to stimulate domestic growth through tax cuts and/or government spending increases – so far, to little avail. And, neither the U.S. Administration nor the Congress has been able to make much headway in significantly reducing the federal deficit.

Chart 1-2

International Investment Position, United States, 1975-86



SOURCE U.S. Department of Commerce.

The two other possible exits are considerably more destabilizing. One would consist of a further depreciation of the U.S. dollar, while the other would involve a resort to heightened protectionism, which could well run the risk of provoking a global recession.

Should the U.S. dollar be forced or encouraged to depreciate further, the effect would be to repudiate a percentage of that country's indebtedness to creditors abroad (since U.S. liabilities are mostly denominated in U.S. dollars). This, indeed, was what occurred in the early 1970s, when the United States was also importing capital to finance the Vietnam War and elected to let the price of gold float. In this context it is not surprising that foreign investors began acquiring more diversified portfolios, so that between 1977 and 1985 the share of U.S. dollars in identified official holdings of foreign exchange dropped from 80 to 65 per cent, while those denominated in German marks and Japanese yen increased commensurately.[5] A further "freefall" of the U.S. dollar would also be destabilizing in the sense that it would likely coincide with a speculative exodus of capital and with a resurgence of inflation and higher interest rates in the United States. This would increase the likelihood of another recession in that country.

The third option, which involves aggressive trade tactics and protectionist measures aimed at reducing the U.S. trade imbalance, together with a rise in interest rates to contain inflationary pressures, could be harmful to world trade and output growth. It could be potentially devastating for Third World countries – mainly Latin American countries. Interest payments on their debts are tied to U.S. interest rates, and they rely on export growth to finance the debt repayments. It "would force the debtor countries to choose between a sharp reduction in growth and a moratorium on interest payments [or] induce the debtors to form a cartel [to abrogate] the recent loan agreements."[6]

In short, the fate of many countries, including Canada, lies in the way the major industrial countries work out an exit from the impasse. Perhaps the most sanguine view, over the longer term, is that through a process of steady interaction with the other major western nations, along with progress in reducing the federal deficit, the United

States will avoid extreme protectionism and will allow the currency realignment of the past two years to exercise its gradual equilibrating effects on trade.

One reason that we do not write off the more favourable exit pattern is the latent strength and resiliency of the U.S. economy. For what can be observed is that the United States has been channeling significant amounts of foreign savings into the modernization of its industrial structure. Important aspects of these borrowings have been the issues of Eurobonds by U.S. corporations, the flow of European direct investment funds into the oil and gas and the manufacturing industries, and Japanese investments in U.S. government bonds and direct investments in trade and financial services.[7] The upshot will be a massive restructuring of U.S. industry, aimed at maintaining domestic and international competitiveness by drastically reducing the cost of production.[8] Indeed, according to the European Management Forum, the United States continues to lead the world in technology development.[9] Notwithstanding the current protectionist sentiments and the problems posed by future foreign debt-service payments, the "diminished giant" is far from abandoning its traditional dominating economic role on the international stage.

Nevertheless, we cannot ignore the warning signals. The seeds of protectionism and of slower growth have been sown; it will take wise economic management to avoid serious misadventures in the global economy over the next few years. In the process, Europe and Japan will have to pick up some of the slack in international economic growth that will follow from efforts by the U.S. government to curb its budget deficit.

Growing Internationalization

Canada has always been a trading nation, exposed to the ebb and flow of international demand and supply of goods. Over the past decade, this exposure has increased significantly as markets for goods and for capital have become unified into one integrated system. Today, corporations in almost all nations are making investment decisions on the basis of global cost comparisons and the prospects for international sourcing. As a result, trade now increasingly involves components as well as finished goods.

Comparative advantage in locating production facilities can now shift dramatically in response to both market and nonmarket initiatives. It can derive from research and development, leading-edge innovation, and very effective sales and marketing – such as, for instance, the Japanese have achieved with video cassette recorders. It can be shaped by resource discoveries that supplement a nation's stock of physical and human capital or by price shocks such as those initially generated by the OPEC cartel. It can be artificially created or maintained by government subsidies and other forms of protection; or, more often these days, it can be shaped, at least in the short run, by exchange-rate swings.

Exchange rates have become extremely volatile, driven less by trade (the traditional influence) and more by capital flows, at least in the short run. Part of the growing influence of capital flows has, of course, been associated with the widespread deregulation of complex domestic rules covering deposit-taking, insurance, and securities institutions, as well as with the growth – in North America, at least – of pension funds and other large pools of savings. Another part has been related to the sharp increase, at least until recently, in international commercial bank lending.

In contrast to the growing protectionism on the trade front, widespread liberalization has taken place in most of the world's major financial centres. With increased competition, sharply reduced costs of international transactions, and a quickening of the speed and volume of information flows, a wide range of new investment and savings options has opened up.[10]

The lack of world regulation of financial markets – combined, on occasion, with the herd instinct of speculators – evidently increases the risks for borrowers and lenders, and the potential instability of exchange rates. Indeed, one of the legacies of the period of high inflation and the recycling of OPEC funds has been the shift in financial markets to shorter-term maturities and to new instruments that were introduced as hedges against unforeseen risks but are often used for speculative purposes. Many large organizations have taken pains to diversify their portfolios considerably on a global basis and are thus far more concerned than before with international interest-rate differentials and exchange-rate movements.

The decision by the major industrial countries in the early 1970s to let exchange rates float was intended to give governments greater autonomy over monetary and fiscal policy. It now appears, however, that those floating rates set in train a number of unforeseen and undesirable effects. The first was that by moving from fixed to flexible exchange rates, a major domestic constraint to keep inflation rates down – or at least in line with those in the dominant (U.S.) economy – was removed. The second was that exchange rates were allowed to respond to concerns about the future course of inflation and to speculative and other pressures, and thus to get out of line with each nation's true competitive cost situation. Not surprisingly, with capital becoming highly mobile internationally, the upshot was rising inflation rates, misalignments of currencies, and speculative surges. The economic consequences of these developments have been described:

> ... massive payment imbalances, consequential international investment flows that bear no relationship to the real scarcity of capital, distortions to the optimal time pattern of consumption, unnecessary adjustment costs as resources are shifted back and forth between the tradable and nontradable sectors, the destruction of productive capacity, possible ratchet effects on inflation, and protectionist pressures.[11]

All of these problems have forced governments to acknowledge that autonomy over economic policy is clearly limited. Events in integrated markets know no borders. The 1985 Plaza Agreement of the major industrial countries marked a shift in thinking towards greater international monetary coordination and exchange-rate management. Specifically, proposals were advanced for the major countries to set exchange-rate targets consistent with domestic medium-term circumstances and goals. Participating countries would be expected to conduct macroeconomic policies so as to keep their exchange-rate fluctuations within 10 per cent of the target. More recently, at the 1986 Tokyo Summit, interest focused on the use of common "indicators" to help achieve greater policy harmonization. However, little progress was made over the following year in reaching agreement on an approach, and the subject was not even raised in the final communiqué of the 1987 Venice Summit. Whether this represents a weakening of resolve remains to be seen.

Nonetheless, whatever the outcome, several points are clear. First, the process of competition, deregulation, and financial innovation has blurred the separation of functions between the various financial intermediaries. Second, increased competition has prompted investors to shift frequently between substitute assets in response to interest-rate spreads at home and abroad. This has resulted in a narrowing of the spreads, and that, in turn, has diminished somewhat the ability of central banks to monitor and control the main monetary aggregates. The result has been a refocusing of central-bank policies from attempts to influence domestic interest rates, and particularly the spread between interest rates, to working through exchange rates in order to influence macroeconomic performance and competitiveness. While we do not necessarily share the pessimism in the following assessment of the recent G-5 and G-7 initiatives, the warning is clear:

> They will not succeed in stabilising exchange rates, unless they either turn back the clock by moving to constrain international capital flows, or agree, and so act, to give up a much greater degree of national autonomy for independent (monetary) policy.[12]

At a minimum, this means that the leading industrial nations must explore systematically the options that exist between the two extremes of fixed and floating exchange rates.

International Debt Management

Another area where coordination and action are required is in helping the less developed countries (LDCs) to work off their debt burdens in a way that will not destabilize the international financial system. The problem encompasses two groups of countries: the first comprises impoverished African countries, which have crushing debt burdens but which are too small to cause any significant disruption to their lenders (mainly governments and international agencies); the second is made up of countries (mainly Latin American) that owe very large amounts to commercial banks.

In 1982, the outstanding debt of the LDCs was reported at about US$740 billion. It reached close to US$900 billion in 1985 and, according to the World Bank, will exceed US$1 trillion at the end of 1987. Half of this debt is owed to banks. Latin American and Caribbean countries account for the largest proportion of Third World debt (43 per cent of the total). Within Latin America, about three-quarters of the total indebtedness is accounted for by Brazil, Mexico, Argentina, and Venezuela.

For both small and large debtor nations, the problem is similar. Developing countries cannot grow and develop without an inflow of capital. If a large portion of their export earnings is used to service their debt, this reduces the foreign-exchange earnings available to finance imports of necessities, components, or investment goods. The problem is compounded if heavy debt-service payments are accompanied by capital flight. This is the "Catch 22" of the LDCs. In the case of the African countries, policymakers must agree on a plan to forgive existing debt and examine very critically plans to get the economies growing again. (Five of those countries – Morocco, the Ivory Coast, Zaire, Zambia, and Mali – suffered declines in GNP of over 30 per cent between 1980 and 1985.) The amounts of money involved are small, so the obstacles here are technical and bureaucratic, aggravated by the lack of political clout of those desperately poor nations. In the broader context, the International Monetary Fund is now proposing to deal with the issue by tripling the funds available to low-income countries through its "structural adjustment facility" over the three years 1988 to 1991, and to lower interest rates on the debt of those countries. Canada has agreed to contribute, but this initiative is awaiting approval by the United States and Japan, among others.

The obstacles in the way of a solution for the bigger countries with huge debts are much more complex. Despite the hopes engendered by the so-called "Baker Plan" put forth in 1985 by the U.S. Secretary of the Treasury – encompassing internal structural policies to promote growth and investment, more lending by the International Monetary Fund and the World Bank, and increased financing from private sources over a period of three years – little progress has been achieved.

To some extent the problem has actually grown worse, as the indebtedness of LDCs has risen not only in absolute terms but also in relation to gross national product. Brazil's ratio of debt to GNP rose to 51 per cent in 1985 from 34 per cent in 1982. In 1985 the ratio for Argentina was 80 per cent; and for Chile, 142 per cent. Had it not been for rescheduling agreements and for the decline in world interest rates, debt-service payments as a proportion of export receipts would have also risen. Indeed, the ratio did increase for Mexico and Argentina, and even for the countries where it declined, it remains at a high level (Table 1-1).

On the other hand, the situation of the lenders has improved. It is true that commercial banks are still heavily involved, but in the case of Canadian banks, for instance, while outstanding loans accounted for about 114 per cent of the equity of the six largest Canadian banks in 1983, they accounted for 82 per cent of equity in 1986.[13] The financing extended by U.S. banks to Latin American countries has declined even more. To compensate for this tightening of the private purse, the developing countries have had to trim their imports dramatically and to turn to official lenders. IMF loans to

Table 1-1

Debt Position of Selected Developing Countries, 1980, 1982, and 1985

		Total external debt				
					As a proportion of export earnings	
			As a proportion of GNP			
		Amount	Total debt	Interest only	Interest only	Interest plus amortization on long-term debt[1]
		(Billions of US$)	(Per cent)			
Brazil	1980	70.2	29.0	2.6	27.1	56.4
	1982	91.3	34.0	3.5	39.8	71.7
	1985	106.7	51.3	3.8	27.2	34.9
Mexico	1980	57.5	31.9	2.6	18.6	38.0
	1982	86.1	55.5	5.0	28.1	44.6
	1985	97.4	58.3	5.7	31.7	48.2
Venezuela	1980	29.6	50.2	2.1	5.5	13.3
	1982	31.8	48.0	2.5	8.1	16.0
	1985	32.1	66.0	2.8	8.2	12.9
Argentina	1980	27.2	51.1	1.6	7.5	17.7
	1982	43.6	79.9	2.4	13.5	23.9
	1985	48.4	79.9	5.7	33.6	41.7
Philippines	1980	17.5	49.6	1.7	7.2	13.9
	1982	24.3	61.9	2.4	11.6	24.4
	1985	26.2	80.6	3.0	12.2	19.5
Chile	1980	12.1	45.5	3.5	14.6	37.9
	1982	17.3	77.9	8.7	37.8	62.1
	1985	20.2	142.2	11.6	35.0	44.1

1 For Argentina and Venezuela, the figures pertain to the public debt only.
SOURCE World Bank, *World Debt Tables* (Washington, D.C., 1987).

those countries, which accounted for only 1.6 per cent of the total indebtedness in 1980, rose to 4.2 per cent in 1985.

Meanwhile, private financial markets themselves are slowly responding to the situation. A growing secondary market is developing for the debt of some of the larger Third World debtors. Use of the secondary market enables banks to increase the liquidity of their loans and, by various means (including debt-option equity swaps), to decrease their exposure to specific countries. The recent write-down by some banks of some of their Third World loans makes it easier for them to participate in this market, since the loans already written down would not represent too great a loss when traded at market prices. (These market prices range from over 62 per cent of face value for the Venezuelan debt to around 10 per cent for that of Peru. The price of Mexican debt has been just under 50 per cent.)[14] The secondary debt market, however small (US$5 billion in total volume in 1986), represents a positive response by private lenders and indicates that many banks are facing hard reality and valuing their loans at what they are worth.

The major problem in helping the "big" debtors among the LDCs to cope with their debt burden is lack of leadership. The international financial organizations (the IMF and the World Bank) have had only limited resources with which to extend additional credit. The mature creditor countries – Japan and West Germany – have not taken a leadership role, though there is growing pressure on Japan to do so. The United States is handicapped by its own burgeoning debt and by strong political resistance to any measures that would appear to bail out the commercial banks. The price of limited action to date has been a deterioration in the financial health of the debtor countries and a major constraint on the growth of world trade. With a renewed flow of credit, properly tied to commitments for domestic reform, these debtor countries could potentially be major importers once again – a source of demand that would be a welcome contribution to the growth option described earlier. Without a new flow of credit, the pressures of depressed growth and political instability will mount.

The Canadian Situation

Canada must obviously learn how to navigate in a world economy that is much more turbulent and fiercely competitive than in any previous period. One of the key objectives for economic policy is to make the economy resilient enough to withstand unfavourable shocks – low commodity prices or financial disturbances, for example. The recovery that followed the 1981-82 recession has been very unbalanced regionally, giving the appearance of there being "two Canadas" – a prospering urban concentration within the Montreal-Toronto-Windsor axis; and relatively depressed conditions elsewhere. But there are signs that the worst is over, and while the constraints on policy independence imposed by the increasing integration of markets must be recognized, Canadians are already turning their many advantages, as citizens of an informed and modern, outward-reaching nation, into opportunities.

We believe that Canada is well placed to search out the new markets of the world.

First, Canada has a demonstrated capacity to trade competitively with Japan, Europe, and the newly industrialized countries. Its multicultural society helps to forge trading and financial ties around the world and fosters a distinctly more outward orientation than that of our larger neighbour. In particular, as a relatively smaller nation, Canadians have been able to establish trading and related ties abroad, unhindered by the political baggage attached to the commercial relations of the United States and some European countries.

Second, the realignment of the Canadian dollar with respect to the yen and to the European currencies over the past year has already enabled us to expand our export opportunities in Japan and the European Economic Community.

Third, although too few Canadians realize it, we are ahead of most other countries in our use of basic technologies such as satellite communications, remote sensing, and optic-fibre networks. We therefore have the capacity to specialize and to make broader and more effective commercial use of these and other new technologies than do many of our competitors. At the moment, however, we lag behind in the use of robots, computers, and process technologies in the workplace, as we explained in a recent statement.[15]

Fourth, Canadian firms and institutions now attract capital flows from around the globe. These capital flows bring with them technologies and expertise that enhance competitiveness. At the same time, Canadian firms are themselves gaining experience as multinationals. Not only do we have a substantial trade surplus with the United States; we are also a net exporter of capital to that country.

Finally, we are a young and informed society. Among OECD countries, Canada has a larger share of young adults in full-time postsecondary educational courses than all but the United States. Industrially we are becoming increasingly diversified; Canadians are also showing a greater willingness to form their own businesses, and in recent years there has been an unprecedented surge of new, small enterprises in all parts of Canada.

The Need for Growth

Clearly, the industrialized and developing nations, together, need a period of sustained growth to restore confidence and financial stability. The developing countries and the United States alike require an environment in which they can expand their exports. The alternative is protectionism, leading to stagnation or worse. All of this calls for international cooperation in an increasingly interdependent world. While the proposals put forward by the G-5 or G-7 have, so far, resulted in broad statements of intentions, more substantive measures are required. Most important are understandings and actions that will help to restore healthy trade relations among the nations of the world without resort to increased trade restrictions.

As for Canada, one thing is clear. We cannot stand still. Too much is happening on the technological, financial, and trade fronts. We have much to gain if we exercise the ingenuity and knowledge that we have developed over the years. But first, Canadians must do more to improve the order in their own house. For the private sector, there is no choice but to gear up for productivity improvements by seeking out economies of scale, finding a suitable market niche, and adopting the newest technologies. As world markets become more competitive, initiatives of this kind will be required whether or not trade barriers with the United States are reduced. For policymakers, this is a time to get the fundamentals right in terms of tax reform, competition policy, and the reduction of barriers to savings, investment, and trade; mechanisms to coordinate economic policy among the major industrialized countries must also be developed. The Canadian authorities must strive to maintain the growth momentum and steadily address the issue of the federal debt.

In Chapter 2, we examine Canada's performance and the prospects for the medium term, taking into account the recent tax-reform proposals. Then in Chapter 3, we focus on one of the most important commercial-policy initiatives in Canada's history, analysing the consequences of a Canada-U.S. free-trade agreement for employment and output. In Chapter 4, we examine the growing pressure to harmonize policies across the Canada-U.S. border, paying special attention to subsidies, health care, unemployment insurance, and the cultural industries. Chapter 5 provides a summary and conclusions, and examines Canada's options should trade talks with the United States fail.

2 The Medium-Term Outlook

Canada's future economic prospects hinge, more than ever, on developments in the global economy. Substantial increases in the integration of world markets for commodities, manufactured goods, services, and capital mean that no matter how well we manage our affairs, fluctuations in our economic performance will be influenced substantially by external events. One important message of Chapter 1 is that we face an uncertain, even volatile, international situation. This volatility will certainly colour any assessment of economic prospects for the period 1987-91. Most importantly, it makes it vital for Canadian policymakers to focus on initiatives that will reduce Canada's vulnerability to unfavourable "shocks" from abroad.

The Council has traditionally put forward a "base case" that characterizes the medium-term outlook, bounded by an "optimistic case," where all goes well on the international scene, and by a "pessimistic case," where unfavourable trends emerge. Will the industrial countries find a way to coordinate economic choices and pursue a growth-oriented option? Or will their policy choices be destabilizing, provoking an economic slump or a resurgence of inflation and higher interest rates? We cannot answer these questions with certainty, but we find comfort in the fact that the Canadian economy has established a much more solid basis for economic growth over the past 12 months.

Canada and the Recovery

Central Canada is now enjoying an economic boom, triggered by, among other things, three favourable developments on the international scene: the fall in world oil prices in 1986; the decline in interest rates in 1986 and early 1987; and the realignment of exchange rates that began in early 1985 (Chart 2-1).

The drop in world oil prices and the decline in Canadian interest rates (made possible by recent substantial inflows of foreign capital, which also strengthened the Canadian dollar vis-à-vis the U.S. dollar) have left Canadians with more disposable income. This, in turn, has supported continued strength in consumer spending and, more recently, has led to a strong upswing in new home construction. These price and interest-rate developments have also reinforced the revival in business confidence, as indicated by the vigorous growth in machinery and equipment investment that has taken place during the past three years.

The exchange-rate realignment – and, in particular, developments in the markets for the U.S. dollar, the yen, and the mark vis-à-vis the Canadian dollar – has helped to improve net exports in two ways. First, it has made Canadian products more competitive in Europe and Asia, thus spurring exports to those markets. Second, it has also generated some strong gains in industrial production in the United States, resulting in increased demand in that country for Canadian industrial materials.

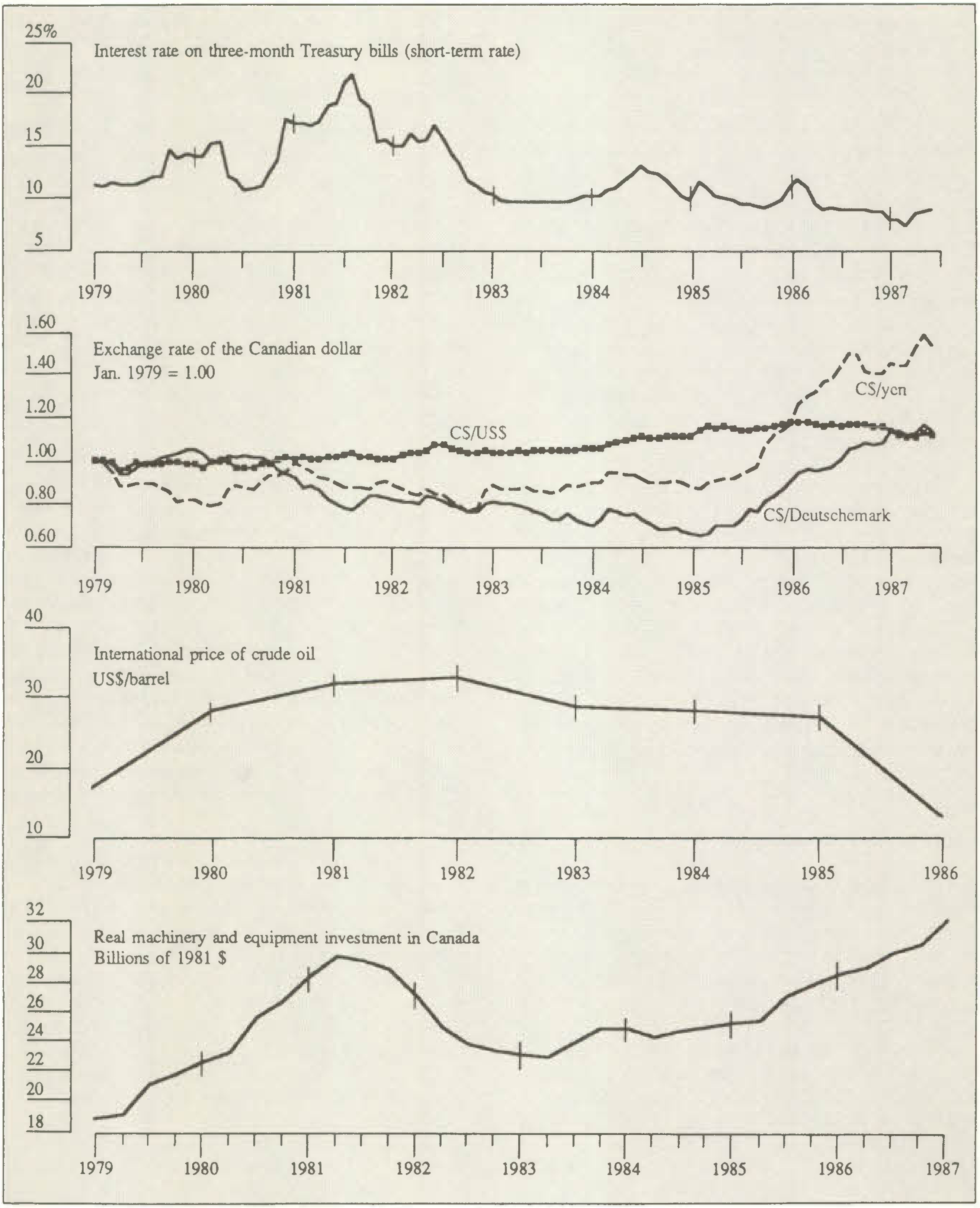
The net result of this prosperity has been a sharp drop in the unemployment rate in the industrial centres of southern Ontario and southern Quebec, as well as a decline in the personal saving rate, as Canadians have become more confident about the future. In addition, government revenues (especially in Ontario) have increased in response to higher income and sales. At the same time, the trade surplus has diminished, as consumers and businesses have increased their imports. All in all, it is fair to say that strong economic growth has been working its magic: some of the damage done by the 1981-82 recession in terms of higher unemployment rates and government deficits has been repaired. In fact, Canada's growth rate of over 3 per cent in 1986 was the highest among the member countries of the Group of Seven (G-7).

That magic, which favoured central Canada, has been slow to work its way through to the other provinces or, for that matter, to the northern regions of Quebec and Ontario. These areas are still dragging the anchor of low commodity prices. The prices of three commodities – food, metals, and crude oil – have fallen dramatically since the early 1980s (Charts 2-1 and 2-2). All three showed encouraging signs of bottoming-out in the summer of 1986, but the recovery to date in food and metals is certainly not strong enough to restore incomes in the resource-producing regions of Canada.

The recovery in oil prices over the past 12 months is more encouraging, however. Higher prices, combined with the changes in tax policy introduced by the federal and provincial governments during the past year, have improved the cash flow to oil producers considerably

Chart 2-1

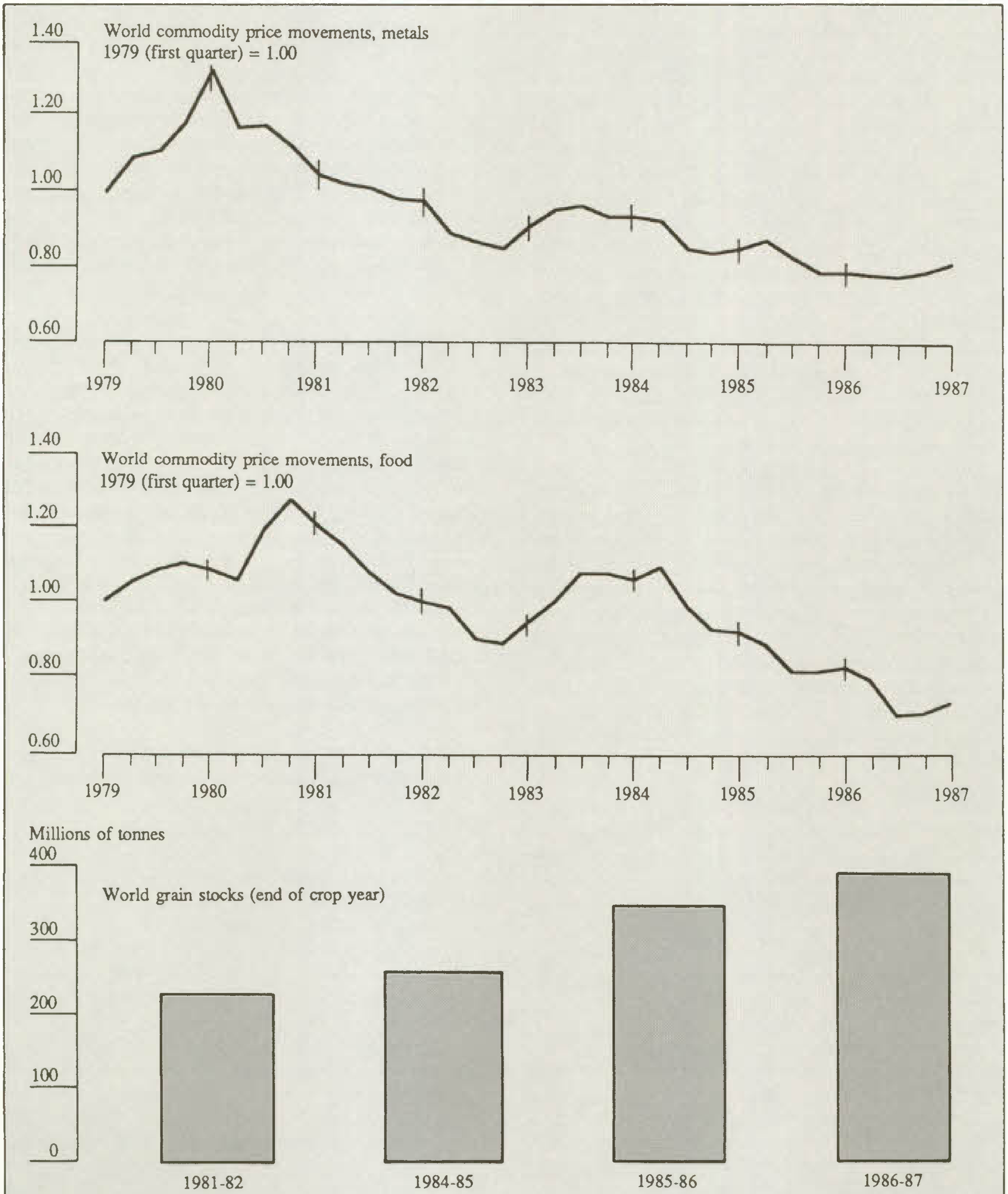
Factors Contributing to Canada's Current Economic Performance, 1979-87



SOURCE Estimates by the Economic Council of Canada.

Chart 2-2

Commodity Prices and Grain Stocks, 1979-87



SOURCE Estimates by the Economic Council of Canada.

since the abyss of mid-1986. Even though gas producers are still plagued by low prices and weak demand, there has been a notable revival in economic activity in Calgary (real estate prices are rising again, for example). A pick-up in exploration and development activity is now under way, but it is still a far cry from the buoyant days of megaprojects and frontier activity, when the resource sector was a stimulus to growth for the whole Canadian economy.

A revival in the oil sector will help Alberta and Saskatchewan, and perhaps Nova Scotia, Newfoundland, and British Columbia – provinces where the aftermath of the recession has dragged on for far too long. But true recovery in the West must await a recovery in agriculture, especially in Saskatchewan. Here, the prospects are not as favourable. As for the northern parts of central and western Canada, future prosperity hinges on rising metal prices. And for the Gaspé peninsula and parts of the Atlantic provinces, the future will be shaped not so much by the price of fish, which is currently booming, but by the availability of adequate stocks.

The immediate price outlook is mixed. At the time of writing, oil prices were firming after showing signs of weakening, and much will depend on how successful OPEC members are in holding to their agreed production quotas. Wheat prices in 1987-88 will likely average about $170 per tonne; and feed barley, around $70 per tonne, down from 1986-87 levels. And while some progress is being made in reducing Canada's stocks of wheat and coarse grain, world grain stocks remain very large. As for raw materials and metal prices, 1988 is likely to see some modest strengthening of the recovery that commenced this year.

World grain markets are clogged with excess supply, and governments may require years to unravel the excessive subsidies that created those surpluses in the first place. With production incentives far too high for current world market conditions, the cost of farm-price subsidies has increased dramatically in many countries. The mirror image of this, of course, is the difference between the prices received by farmers and the prices paid by consumers, which has widened dramatically.

In metal markets, Canadian producers are adjusting slowly to changing patterns of demand for industrial materials. For example, for some uses copper is being replaced by fibre optics, and steel by plastic or by lighter metals. They are also competing with new low-cost suppliers in developing countries. Most mines that are still operating in Canada can break even at current prices, but investment in new capacity will have to wait until the current ore bodies have been depleted. In short, we cannot bank on an early favourable turn in food or metal markets to correct the economic problems of both western and eastern Canada.

Repairing the Damage

What, then, is the state of the Canadian economy and the status of economic policy? What, if anything, can be done to reduce the damage done to the economy by weak commodity prices or to overcome the continuing ravages caused by the upsurge of inflation during the 1970s and 1980s and by the recession of 1981-82? Three problems deserve special attention – regional disparities in growth and unemployment, government debt burdens, and productivity growth.

Unemployment rates are still much too high, especially in the resource-producing regions of the country (Table 2-1). Unemployment in Ontario dropped to 6.0 per cent in July 1987 – a level lower than in 1979, before the recession hit. In Quebec, the unemployment situation is also much better than it was at the depth of the recession, but not all the damage has been repaired as yet. In contrast, unemployment rates in the Atlantic provinces and in the western provinces are still well above their 1979 levels. This disparity in regional unemployment rates is a direct reflection of the slump in commodity prices described earlier. And because these prices are determined in international markets, governments have been forced to apply band-aids through financial assistance. The only alternative would be longer-range strategies for economic diversification.

One side effect of the ongoing slump in economic activity in both the western and eastern provinces has been the emergence of relentless demands on the federal government to spend more or to tax less in order to support the incomes of those who live in the depressed regions. At the same time, the lack of a sustained growth dividend from productivity has meant a weak expansion in the federal tax base in the corporate sector. And persistent deficits have led to a steady buildup of debt that must be serviced with dollars that could otherwise be used to finance more-substantive national programs.

The result is that the federal government's fiscal position is still tenuous despite several years of rigorous spending restraint, which reduced federal outlays from 23.5 per cent of GDP in 1984 to 22.3 per cent in 1986. The federal deficit as a proportion of GDP in 1986 was therefore 4.9 per cent – considerably higher than the 3.4 per cent reported in 1979. The federal Minister of Finance is committed to reducing the deficit substantially, but that objective has proved difficult to achieve. Indeed,

Table 2-1

Unemployment, Productivity, and the Federal Deficit, Canada, 1979-87

	1979	1982	1986	July 1987
		(Per cent)		
Unemployment rate				
Newfoundland	15.2	16.8	20.0	17.5
Prince Edward Island	11.2	12.9	13.4	13.0
Nova Scotia	10.1	13.1	13.4	11.5
New Brunswick	11.1	14.0	14.4	13.5
Quebec	9.5	13.8	11.0	11.0
Ontario	6.5	9.9	7.0	6.0
Manitoba	5.4	8.4	7.7	7.1
Saskatchewan	4.1	6.2	7.6	7.7
Alberta	3.9	7.9	9.9	9.9
British Columbia	7.6	12.2	12.5	12.4
Canada	7.4	11.1	9.6	9.1
Change in productivity (output per employed person)	–0.2	0.0	0.5	...
Federal deficit as a proportion of GDP	–3.4	–5.4	–4.9	...
Interest on the public debt				
As a proportion of GDP	2.9	4.5	5.2	...
As a proportion of federal expenditure	15.6	19.6	23.2	...

SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

in the minister's last two economic statements – the February 1987 Budget and the June 1987 White Paper on Tax Reform – it was necessary to undertake measures to speed up tax collections in order to stay on the fiscal track.

As far as productivity is concerned, the aggregate rate of growth improved from 1983 to 1985 but has since faltered (Chart 2-3). Such gains can be achieved more easily if the economy is growing and business is investing. We shall show in Chapter 3, however, that while many Canadian firms in the primary and service sectors are no less productive than their U.S. counterparts, the manufacturing sector as a whole lags far behind that of the United States. The gap in manufacturing is of deep concern, because that sector is becoming increasingly exposed to international competition. Manufacturing firms are therefore under immense pressure to modernize plant, equipment, and management systems in order to compete effectively in both domestic and foreign markets.

The Policy Constraints

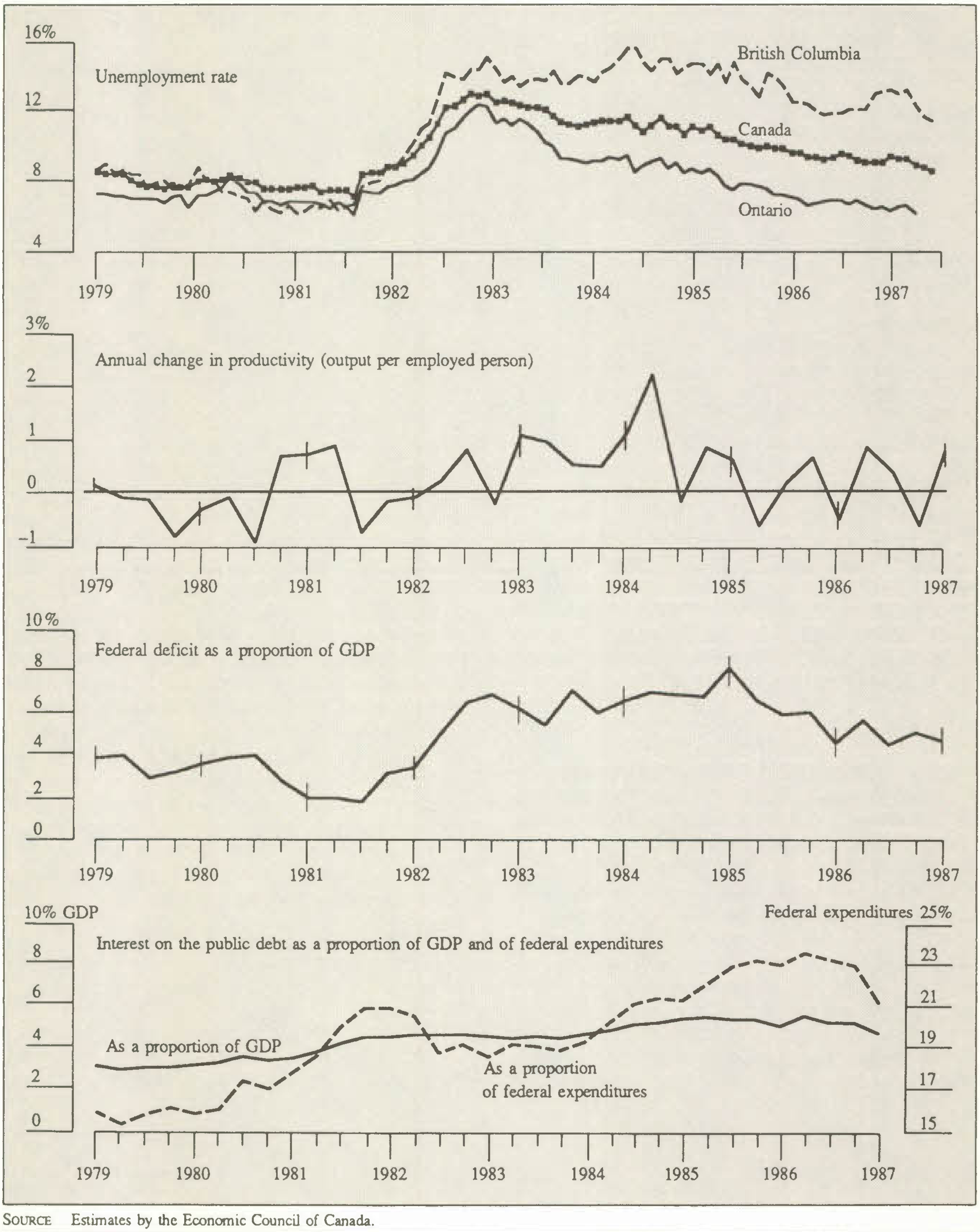
Fiscal policy will be under considerable stress as long as the regional imbalances continue. The federal government will be the target of demands for continuing support from grain farmers and other groups. Our projections indicate, however, that even under the base-case assumptions of continued economic expansion and rigorous spending restraint until 1990, the government will barely be able to keep to the fiscal track. Moreover, federal finances will remain vulnerable to any slowdown in growth abroad, as is shown in our pessimistic case. In a slow-growth or no-growth environment, the Minister of Finance can only offer support to one group in society by taking funds from others. It goes without saying that this is a difficult policy to sustain.

As far as monetary policy is concerned, the Bank of Canada has never focused exclusively on the domestic economy. It has always used monetary policy to act as a buffer against international pressures on the exchange rate. As early as 1982, the Bank recognized the changes that were occurring in international financial markets and the growing variety of financial instruments by adopting a more eclectic approach in interpreting trends in the money supply. More emphasis is now being put on exchange-rate developments – particularly with respect to the Canada/U.S. rate. To cite the Governor of the Bank:

> I am often asked why the Bank pays so much attention to the exchange value of the Canadian

Chart 2-3

Problem Areas in Canada's Recent Performance, 1979-87



SOURCE Estimates by the Economic Council of Canada.

> currency. The answer is simple. Domestic price stability is the primary contribution that monetary policy can make to good economic performance. And the most important single price in the Canadian economy is the price of the Canadian dollar.[1]

The Bank of Canada will face a difficult dilemma over the next several years because there is no mechanism to fine-tune monetary policy for the different regions. The divergent economic performance within Canada's regions, described earlier, means that there could be the risk of overheating inflation in central Canada while the rest of the country is still struggling to get out of the recession. At this stage, there is no evidence of substantial overheating, but it will certainly be necessary to keep a watchful eye on the situation in southern Ontario and southern Quebec. The prices of goods and services produced in Canada are currently rising at a rate of about 4 per cent (based on the GDP deflator at factor prices). Price indexes have picked up some momentum in recent months, but this is a reflection of the increase in world oil prices and of exchange-rate realignments.

The Base Case

What can Canadians expect from the economy as they move towards the 1990s? We have already emphasized that the future will be dominated by conditions in foreign markets, such as those related to commodity prices (especially oil prices), and by the anticipated path for real growth, inflation, financial conditions, and so on, of our major trading partners. Two other areas of major structural changes will be federal tax reform and trade policy.

As far as tax reform is concerned, we include the impact of Stage One changes in the base case.[2] We have not included Stage Two changes because we regard those adjustments as too uncertain. Furthermore, because of the uncertain content of a free-trade agreement with the United States, the trading pattern with that country in the base case remains unadjusted for the effects of a U.S. bilateral trade agreement or for any changes in U.S. trade legislation. Chapter 3 provides a detailed discussion of the potential industrial and regional effects in Canada of a trade accord with the United States.

As for monetary policy, we expect a mild tightening in response to higher domestic and external rates of inflation during the period 1987-89. Short-term interest rates are expected to increase, and money-supply growth rates are expected to decline.

World oil prices are assumed to remain around US$19.50 per barrel until late 1988. By 1991 the price of a barrel of crude is expected to average more than US$21.00. We do not expect a strong recovery in general commodity prices (including those for grain and metals), although we believe the bottom of the cycle in commodity prices has been reached.

We anticipate real growth in the U.S. economy to average about 2.5 per cent for the period 1987-91. This includes one year (1990) in which real growth drops below 1 per cent. The timing of a U.S. growth pause in 1990 coincides with the views of leading U.S. forecasters, but it also involves a judgment call. For this reason, we examine two alternative cases – one in which real growth averages 2.2 per cent per year, with a U.S. growth pause in 1988; the other in which no slowdown occurs until after 1991. In the latter case, real growth in the United States averages 3.5 per cent per year. Appendix A contains the details of what we expect by way of domestic fiscal, monetary, and energy developments, as well as our judgment about future developments in the world economy, including those in the United States.

Using these assumptions as a framework, our base case calls for the continuation of a steady pattern of growth for Canada as a whole until 1989, with continuing wide disparities in regional growth rates.

This raises the question of whether or not we will enter the 1990s from a position of strength, with the damage from the previous recession in good repair. Will deficits, the unemployment rate, and productivity performance be such that we can cope fiscally when the current economic cycle turns down? Our current assessment suggests that by the end of the decade, Canada will still have some distance to go before unemployment rates, deficits, and productivity trends enable it to deal from a position of strength. In summary, the base-case viewpoint is as follows (Table 2-2):

- Real growth is expected to average 2.8 per cent during the period 1987-91; 1988 will likely be a bit stronger, with growth at 3 per cent, while 1989 and 1990 are anticipated to be years of below-average economic performance, reflecting (among other things) a weakening of the external sector and a tail-off in the investment cycle.

- The recovery in oil prices, the expectation of a small inflation bubble in the United States, the continued tightening of labour markets, a bottoming-out of commodity prices, below-average productivity performance, and some upward pressure in the growth of nominal wages – all of these factors are expected to lead to an inflation rate that will average just below 5 per cent for the period 1987-91, peaking at 5.9 per cent in 1989.

Table 2-2

Selected Economic Indicators, Canada, 1987-91 (Base-Case Projection)

	1987	1988	1989	1990	1991	Average 1987-91
			(Per cent)			
Change in:						
Real GDP	3.2	3.0	2.3	2.0	3.5	2.8
Consumer price index	4.3	5.2	5.9	5.2	3.7	4.9
Labour force	2.0	2.4	1.6	1.2	1.8	1.8
Employment	2.6	3.1	2.0	1.0	2.0	2.1
Productivity (output per person-hour)	1.5	0.2	0.8	1.0	2.2	1.1
Real wage rate	-1.3	-0.3	0.8	1.4	1.6	0.4
Nominal wage rate	3.0	4.9	6.7	6.6	5.4	5.3
Level of:						
Unemployment rate	9.1	8.5	8.2	8.3	8.2	8.5
Participation rate[1]	66.2	67.1	67.5	67.6	68.2	67.3
As a proportion of GDP:						
Real investment	20.9	21.0	21.2	21.2	21.6	21.2
Government surplus or deficit						
Federal	-4.1	-3.4	-3.4	-3.1	-2.1	-3.2
All other levels	-0.5	-0.2	-0.1	-0.2	-0.2	-0.2
Balance of international payments						
Current account	-2.2	-2.5	-2.5	-1.7	-2.0	-2.2
Merchandise account	1.7	1.3	1.1	1.7	1.2	1.4
Nonmerchandise account[2]	-0.8	-0.8	-0.8	-0.7	-0.7	-0.8

1 Labour force as a proportion of the population aged 15 and over.
2 Excludes net income services.
SOURCE Estimates by the Economic Council of Canada, August 1987.

• Employment growth in 1987 and 1988 should be strong, following the pattern of real growth. During the period 1988-90, when real growth weakens, employment growth will probably slip below 2 per cent per year.

• Productivity growth (output per person) is expected to advance at an annual rate slightly above 1 per cent. We expect performance to be strong in 1987 and to strengthen again as the economy recovers from the 1990 growth pause. A poorer performance during the intervening years will contribute to upward pressure on unit labour costs, adding to inflationary strains in 1988-90.

• After a long drought, growth in real wages is expected to recover during the period 1989-91. Nominal wage growth will average about 5.3 per cent, being above the 6 per cent mark during the years 1989-90.

• Unemployment rates will trend downward to a range just above 8 per cent by the end of the decade, averaging 8.5 per cent for the period 1987-91. This downward trend will be interrupted by a period of slow growth in 1990, after which a strong recovery will again nudge the unemployment rate downward.

• Investment is expected to be one of the engines of growth during the period 1987-91. The origin of this strength will be in the current surge of new housing construction, sustained growth in machinery and equipment purchases, and a pickup in spending in the energy sector.

• No substantial improvement in the ratio of the federal deficit to GDP is expected to occur before 1991, even though we assume a continuation of rigorous spending restraints, with expenditures as a proportion of GDP dropping from 22.3 per cent in 1986 to 20.2 per cent in 1991. The deficit/GDP ratio is expected to decline from 4.1 per cent in 1987 to 3.4 per cent in 1989. A strong performance after the growth pause will finally push it down further to 2.1 per cent in 1991. Thus, even with a determined effort to control spending, the deficit will remain a serious issue until the end of the decade. And if there are unforeseen expenditure increases or revenue shortfalls, little or no improvement can be expected.

• Canada's balance of international payments on current account will remain in deficit throughout the projection period. A weakening of external demand, a bubbling-up of domestic inflationary pressures relative to external market conditions, and a weak auto market will contribute to the deterioration in 1987-89.

The Performance Band

How sensitive is our view of future economic performance to the key changes that may occur on the economic scene? How vulnerable are the deficit and the unemployment rate to a different set of economic circumstances? What would be the result if such factors as economic performance in the United States, investment and savings decisions in Canada's private sector, global market conditions with respect to interest rates and exchange rates, and supply-side factors related to growth in productivity were to develop differently than in the base case? The Council believes it is important to ask "what if" questions in order to determine Canada's ability to cope if and when economic circumstances are not as favourable as they are today – or, for that matter, if and when they are *more* favourable than they are today. At the same time, looking at alternative economic developments enables us to estimate the expected outcome on both the optimistic and the pessimistic side (Table 2-3). Such estimates are helpful in forming a public-policy strategy.

The Optimistic Case

Our base-case view of the performance of the U.S. economy over the next five years provides for continuation of the current expansion through 1990, at which time a growth pause is expected to occur. There are, however, alternative viewpoints. What if the expansion of the U.S. economy continues at a much stronger pace than we have assumed in the base case, with no pause in growth in 1990? Although this scenario is less likely, given the current developments south of the border, assessing its impact would illustrate the benefits to Canada of the continuation of a strong North American economy.

Examining the impact of external developments will lead to a more realistic assessment if they are combined with comparable changes in key domestic areas. For example, a continuation of the expansion of the U.S. economy at a strong pace – combined with increased growth in Canadian domestic investment spending, lower domestic interest rates, higher domestic wage growth, increased growth in consumer spending (and, conversely, lower saving rates), more favourable productivity growth, and a stronger Canadian dollar – would not be an unrealistic outcome. Such optimism would also illustrate the level of domestic real performance needed to repair the damage that still remains as a result of the 1981-82 downturn without the aid of new federal policy initiatives.

For example, in the optimistic case both the unemployment rate and the government deficit as a proportion of GDP show modest improvement (Table 2-4). Unemployment rates dip below 8 per cent in 1989, while the federal deficit falls to just under 1 per cent of GDP by 1991. Other areas also show improvement. For example, the ratio of the federal debt to GDP begins to decline in 1988, and the volume of personal savings expands even though saving rates are lower, with increments being applied to the formation of productive capital in the business sector rather than to the financing of government deficits. Although annual domestic inflation rates peak at just below 7 per cent, favourable productivity trends keep a lid on these price pressures. One negative outcome in the optimistic scenario is that the current-account deficit increases significantly – exceeding 3 per cent of GDP throughout much of the period to 1991. This is a reflection of the strong tendency of imports to rise when both consumption and investment are growing rapidly.

The Pessimistic Case

Several factors suggest that a weaker growth pattern in the next 12 to 18 months cannot be ruled out. The huge trade and government deficits in the United States, uncertainty in international financial markets, the unsettled position of the U.S. dollar vis-à-vis the yen and the mark, and the possibility that the Federal Reserve Board might react strongly to the anticipated upward drift in inflation rates – all of these factors could lead to much less favourable conditions in the world economy. This could have a substantial negative impact on Canada. We have therefore tested a pessimistic case where the assumed growth pause actually takes place in 1988.

A 1988 growth pause would reduce increases in investment spending, in wage rates, and in consumer spending (thus leading to higher saving rates). It would also reduce improvements in productivity. In fact, during the years 1988-90 this pessimistic case is weak enough to

Table 2-3

Key Components of Alternative Environments, United States and Canada, 1987-91

	1987	1988	1989	1990	1991	Average 1987-91
			(Per cent)			
United States						
Change in:						
Real GDP						
High-growth scenario	3.0	5.2	4.3	2.2	2.8	3.5
Base case	2.4	3.0	2.1	0.5	4.9	2.6
Low-growth scenario	1.8	0.4	3.0	2.4	3.4	2.2
Real consumer expenditures on autos						
High-growth scenario	–5.3	3.2	–2.0	–0.8	0.8	–0.8
Base case	–5.1	3.6	–2.4	–3.0	8.2	0.3
Low-growth scenario	–9.9	–2.7	6.1	1.6	3.9	–0.2
Level of:						
Short-term interest rate						
High-growth scenario	5.9	6.7	8.1	8.4	8.1	7.4
Base case	6.7	7.5	8.6	7.2	6.9	7.4
Low-growth scenario	6.6	8.0	7.9	8.1	7.9	7.7
Canada						
Nonresidential investment as a proportion of GDP:						
High-growth scenario	11.4	12.3	13.3	13.6	13.7	12.9
Base case	11.4	12.1	12.6	12.5	12.3	12.2
Low-growth scenario	11.4	12.0	12.3	12.0	12.0	11.9
Level of:						
Short-term interest rate[1]						
High-growth scenario	7.7	8.1	9.1	8.9	9.0	8.6
Base case	8.3	9.3	10.2	9.2	8.8	9.2
Low-growth scenario	8.9	11.4	12.4	12.1	11.0	11.2
Personal saving rate						
High-growth scenario	9.3	8.8	9.0	9.0	8.4	8.9
Base case	9.5	9.5	9.7	9.6	8.9	9.4
Low-growth scenario	9.7	10.4	11.2	11.4	11.0	10.7
Change in:						
Nominal wage rate						
High-growth scenario	3.4	6.6	9.6	9.7	8.3	7.5
Base case	3.0	4.9	6.7	6.6	5.4	5.3
Low-growth scenario	2.6	2.8	3.7	3.4	2.8	3.1
Private nonfarm productivity						
High-growth scenario	1.9	1.4	1.4	1.8	2.7	1.8
Base case	1.5	0.2	0.8	1.0	2.2	1.1
Low-growth scenario	1.2	–0.6	0.8	1.0	1.8	0.8
				(US$)		
Exchange rate of the Canadian dollar:						
High-growth scenario	0.752	0.750	0.746	0.742	0.741	0.746
Base case	0.749	0.745	0.740	0.738	0.735	0.741
Low-growth scenario	0.749	0.746	0.748	0.744	0.738	0.745

1 90-day commercial paper rate.
SOURCE Estimates by the Economic Council of Canada, August 1987.

Table 2-4

Performance Band for Major Economic Indicators, Canada, 1987-91

	1987	1988	1989	1990	1991	Average 1987-91
			(Per cent)			
Change in:						
Real GDP						
High-growth scenario	3.3	3.9	2.8	2.1	3.3	3.1
Base case	3.2	3.0	2.3	2.0	3.5	2.8
Low-growth scenario	3.1	2.4	1.8	2.0	3.5	2.6
GDP deflator						
High-growth scenario	4.3	5.3	6.5	6.1	6.2	5.7
Base case	4.2	4.5	5.3	4.9	4.8	4.7
Low-growth scenario	3.9	3.3	4.3	3.6	3.7	3.8
Real-domestic-product deflator						
High-growth scenario	3.7	4.4	5.9	6.2	5.5	5.1
Base case	3.7	4.2	5.3	5.4	4.3	4.6
Low-growth scenario	3.6	3.7	4.7	4.3	3.6	4.0
Consumer price index						
High-growth scenario	4.3	5.2	6.6	6.0	5.0	5.4
Base case	4.3	5.2	5.9	5.2	3.7	4.9
Low-growth scenario	4.2	4.8	5.4	4.4	3.6	4.5
Employment						
High-growth scenario	2.5	3.3	2.4	1.0	1.7	2.2
Base case	2.6	3.1	2.0	1.0	2.0	2.1
Low-growth scenario	2.6	2.7	1.1	0.7	1.8	1.8
Level of:						
Unemployment rate						
High-growth scenario	9.1	8.4	7.9	8.1	8.1	8.3
Base case	9.1	8.5	8.2	8.3	8.2	8.5
Low-growth scenario	9.1	8.7	8.6	8.9	8.8	8.8
As a proportion of GDP:						
Federal deficit						
High-growth scenario	–3.9	–2.6	–2.2	–1.7	–0.9	–2.3
Base case	–4.1	–3.4	–3.4	–3.1	–2.1	–3.2
Low-growth scenario	–4.2	–4.5	–5.1	–5.2	–4.6	–4.7
Federal debt						
High-growth scenario	42.2	41.5	40.3	39.2	36.9	40.0
Base case	42.3	42.9	43.2	43.6	42.6	42.9
Low-growth scenario	42.5	44.5	46.7	49.4	50.8	46.8
Current-account balance						
High-growth scenario	–2.3	–3.1	–3.4	–2.8	–3.2	–3.0
Base case	–2.2	–2.5	–2.5	–1.7	–2.0	–2.2
Low-growth scenario	–2.1	–1.8	–0.9	0.5	0.5	–0.8

SOURCE Estimates by the Economic Council of Canada, August 1987.

cause new damage to deficits and unemployment rates, which in turn makes it difficult to get the economy moving again. Growth rates would average just a little over 2 per cent during that period.

In short, the optimistic case – which is plausible, but not highly probable, in our view – would be very favourable for Canada. The right combination of saving, investment, wage, and productivity trends and developments in financial markets, along with a strong U.S. growth path, would go a long way towards solving the problems of unemployment and deficits even without another sharp upswing in commodity prices. The bad news is that a less favourable combination of events could just as easily spell big trouble for Canada. In the pessimistic case, the recent improvements in the unemployment rate and the federal deficit would actually be reversed. By 1990 the government deficit as a proportion of GDP would not have improved at all, and the unemployment rate would have moved back to nearly 9 per cent (about its current level). Furthermore, many ominous signs, including an increase in the debt/GDP ratio, would intensify.

Tax Reform and Economic Growth

It is natural to ask whether tax reform will strengthen or weaken real growth. Many Canadians feel that past arrangements have been an obstacle to economic growth because tax incentives – and not genuine economic incentives – have influenced decisions made in the private sector. This, along with the issue of fairness, is one of the more important reasons for the major changes proposed by the Minister of Finance in the White Paper on Tax Reform.

In the base-case projection we have taken into account the proposed changes to the personal and corporate tax system. We have also incorporated the Stage One changes affecting the federal sales tax. With tax reform, of course, it is the long-run impacts on both savings and investment that are important. These cannot be modeled in the time horizon of the projections discussed in this chapter, but we have examined the long-run effects using other models developed in the course of our work on taxation. We found that the Stage One changes, together with those anticipated in Stage Two – in our simulations we limited the federal revenues raised by a national sales tax to those

Table 2-5

Projected Effects[1] of Income Tax Reform on Key Economic Indicators, Canada, 1988-91

	1988	1989	1990	1991
		(Millions of 1981 $)		
Real GDP				
– Level	1,072	2,608	2,512	2,017
		(Per cent)		
– Percentage	0.3	0.4	–0.0	–0.1
Consumer price index	0.2	0.2	0.2	0.2
		(Thousands)		
Housing starts	2	8	9	11
Labour force	9	41	60	54
Employment	15	62	89	81
		(Per cent)		
Unemployment rate	–0.0	–0.2	–0.3	–0.2
		(Thousands of $)		
Personal income	942	3,343	5,080	5,742
Corporate profits	435	827	183	44
		(Per cent)		
Personal saving rate	0.1	0.3	0.2	0.2
Ratio of nonresidential business investment to GDP	0.1	0.1	0.1	0.1
		(Millions of $)		
Federal budget balance	160	–969	619	1,307
Current-account balance	–1,058	–2,220	–2,233	–2,149

1 Expressed as deviations from the base case.
SOURCE Estimates by the Economic Council of Canada, August 1987.

derived from the current manufacturers' sales tax, which it replaces – will tend to improve the long-run growth in the economy for two reasons. The lower personal tax rates will increase the work effort, and the move towards neutrality in effective tax rates will make the allocation of capital more efficient.

Those effects occur in a longer time frame. But what about the short- to medium-run impacts? We look at these, using the same methods employed to develop the optimistic and pessimistic cases discussed in the previous section. In the current context, we ask the question: "What if tax reform were not part of the policy environment during the next five years?", and then we compare what transpires with the base-case results. The analysis takes into account the Stage One changes in personal and corporate taxation and those pertaining to the federal sales tax. This makes it possible to assess the impact of these proposals in the short run and the medium run with respect to major national economic indicators.

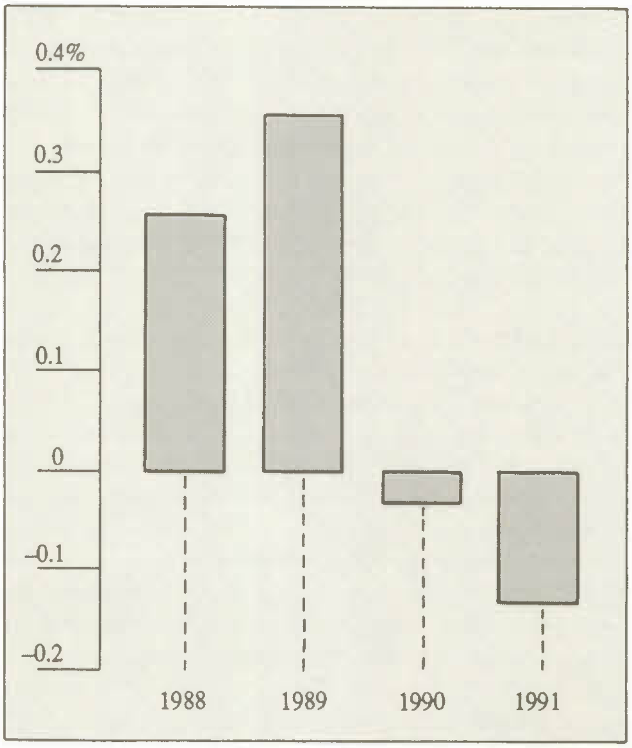
Although the reform package is slated to take effect on January 1, 1988, the withholding schedules related to the new tax brackets and tax rates for personal taxes do not take effect until July 1 of that year. Thus employers may withhold too much tax in 1988 for a large number of Canadian taxpayers. This will lead to the payment of substantial refunds during the first half of 1989. This cycle of overwithholding and refunds will have a substantial impact on the disposable income of consumers during the first and second year of tax reform.

In addition, the base broadening and rate restructuring that occur in Stage One associated with the federal sales tax are expected to produce a temporary acceleration in the rate of inflation. If wage earners regard this increment in inflation rates as truly temporary, however, then it should have little impact on future inflation rates via wage bargaining.

With these special considerations in mind, we find that tax reform would add about $1 billion to real GDP in 1988 and about $2.6 billion in 1989 (Table 2-5). Thereafter (1990-91), the positive impact of tax reform would subside. The initial upsurge in growth rates during the first two years and the subsequent return to the growth rates of the base case are partly explained by the considerations outlined previously. The timing of the withholding/refund cycle and the net reduction in the taxation on personal income would produce an upsurge in consumer spending, which would boost growth rates in both 1988 and 1989 (Chart 2-4). Thereafter, the effects of the reform would level off.

Chart 2-4

Projected Impact of Tax Reform on Real GDP Growth, Canada, 1988-91



SOURCE Estimates by the Economic Council of Canada, July 1987.

By 1991, these income effects in the early phase of tax reform could create as many as 80,000 additional jobs. But because many of the newly employed would come from outside the current labour force, the unemployment rate would only drop by about two-tenths of 1 per cent. In addition, the federal deficit would shrink by more than $1 billion, and additional deficit-reduction activity would occur at the provincial and local levels. Tax reform would increase inflation by about two-tenths of 1 per cent after the fourth year. This upward pressure would stem from a stronger economy and from increases in federal sales taxes on such items as telecommunications and cable services. The longer-run effects on investment incentives would not materialize before the end of our time horizon.

Conclusion

We emphasized in Chapter 1 that the medium-term economic outlook is plagued by uncertainties, depending, to a great extent, on the way the industrial countries work out the current imbalances in trade and capital flows. We have mapped out a base case in which it is assumed that these uncertainties will follow neither the best nor the worst of the possible outcomes. What, then, are the most important events, over the next 12 to 18 months, that will indicate whether we will stay on the base-case course or move towards the optimistic or pessimistic course?

Interest rates are, by far, the most important factor to watch. A sustained jump of 1 percentage point in short-term interest rates (triggered by such factors as currency instability, efforts to avoid a surge in inflation, or a renewed debt crisis among the developed countries) would soon dampen economic growth in the United States and Canada, and thus shift the outlook in the direction of the pessimistic case.

Markedly different developments with respect to the U.S. outlook in 1988 and 1989 would be the second most critical element to monitor. A sudden curtailment in U.S. consumer spending, a prolonged automobile strike, or a stalling of the current gradual improvement in trade volumes would constitute negative signals, whereas an acceleration of the improvement in net exports or sustained demand for autos would be a positive sign. A related positive sign would be a revival of growth in Japan and West Germany, accompanied by measures to reduce the federal deficit in the United States.

The third factor in importance would be trade policy. The ratification of a Canada-U.S. trade deal would be a substantial stimulus to growth in Canada, although its impact is likely to be phased in over a five- to ten-year period. In contrast, a highly protectionist U.S. trade bill or failure to ratify the Canada-U.S. deal would be unfavourable for growth.

Finally, implementation of the Stage One proposals for tax reform would give a small but welcome boost to growth prospects in 1988 and 1989.

Individual Canadians do not have much control over the level of interest rates or growth in other economies. Collectively, however, Canadians can exercise control over their own system of taxation and can set priorities for spending programs. The base case, even with the tax reform package included, indicates that, in the medium run, constraints will continue to weigh on the operation of fiscal policy and that unemployment rates of unacceptable levels will persist, particularly in the Atlantic region and in the West. Tax reform is, in fact, a modest plus in the medium run, as it will bring about improvement in all major economic indicators except for inflation and the current-account balance.

Another important choice that is at least partly within Canada's control is that of its commercial policy. Because our base case does not include the impact of a potential change in Canada's current trading relationship with the United States, we had to make a separate, in-depth analysis of the repercussions that free trade might have on economic growth and job creation over a somewhat longer period, to 1995. That analysis is the object of the next chapter.

3 Future Trade Prospects

Since the inception of the General Agreement on Tariffs and Trade in 1947, there have been dramatic increases in world trade as a result of the liberalization achieved through seven rounds of multilateral negotiations. This growth in trade has helped to improve international relations, strengthen the performance of western economies, and foster industrialization in a number of developing countries.

But in recent years, even though tariff rates have come down and the increased growth in world trade has outpaced the growth in world output, new restrictive trade practices have mushroomed. Today, the world market is being choked by the growing use of such practices, and the international trading rules set under the GATT are increasingly being evaded and ignored. Among industrial countries, nontariff barriers (NTBs) have proliferated with the increased use of voluntary export restraints, orderly marketing agreements, contingency protection (countervailing duties, antidumping measures, and safeguards), subsidies, and discriminatory government procurement policies. The GATT has not been successful in containing the upsurge in NTBs, as it does not have internationally agreed-upon mechanisms to monitor them or to apply disciplinary procedures against them. This has exacerbated trade frictions and eroded confidence in the GATT machinery.

The current Uruguay Round of GATT negotiations is likely to be protracted, and there is a great deal of uncertainty about the outcome. Previous rounds of trade negotiations had explicit unifying themes; for example, the Kennedy Round (1963-67) represented a major attack on tariffs, while the Tokyo Round (1973-79) sought new discipline on nontariff barriers. The Uruguay Round, however, will focus on several key areas. It must achieve a "standstill" on existing trade restrictions; it must deal with sophisticated means of government intervention and protection, such as countertrade and discriminatory government procurement; it must work to liberalize trade in difficult sectors such as agriculture, steel, and textiles; it must develop new rules to govern trade in services, trade-related investment issues, and intellectual property protection; and, above all, it must find innovative ways to bring the developing countries more fully into the GATT framework.

A New Protectionist Climate

Meanwhile, U.S. support for the present GATT trading regime is weakening. Over the last three decades, the United States, because of its dominant position in the world economy and because of its ability to maintain balance-of-payments equilibrium, provided the leadership needed to maintain the liberal GATT system. In addition, successive U.S. governments have believed that an open international trading regime would help their country to attain its domestic goals of economic growth and full employment. Now the situation is changing. Because of the emergence of Japan and Europe as world economic powers and because of the dramatic deterioration in its own balance of trade, the United States is losing its ability to support and lead the international trading system. Furthermore, there is no longer a consensus among U.S. policymakers that the GATT trading regime promotes domestic economic objectives. Many Americans now believe that the present international trading regime is "unfair": they see huge inflows of imports as taking away sales and jobs from them, and they blame other countries for not opening up their markets to expanded U.S. exports. Thus, to a surprising number of influential Americans, including most members of Congress, the remedy lies in reducing the level of foreign competition through aggressive trade initiatives and heightened protectionism.

At this juncture, the mood of the U.S. Congress is to gain access for U.S. goods and services into foreign markets, punish what it unilaterally defines as the "unfair" trade practices of foreign competitors, and, by various means that include political pressure, force a harmonization of trade policies in keeping with U.S. interests. Canada, with its heavy dependence on U.S. trade, has definitely become a vulnerable target.

Of special concern to Canada are the provisions broadening the definition of "unfair" subsidy under U.S. trade-remedy law. If adopted, they could encourage more U.S. firms or industries to seek countervailing actions against a wide range of Canadian exports, for an assortment of reasons. In addition, countries having what Congress deems to be "unwarranted" trade surpluses with the United States – Canada, among them – are likely to face a disturbing deterioration in their trade relations with that country through contingent protection, duty surcharges, voluntary export restraints, tied sales, countertrade, and strong diplomatic pressures to divert import purchases to costlier U.S. sources. Even if the U.S. Administration vetoes whatever joint bill is passed by both Congressional bodies, the emerging strength of the "fair-trade" (as opposed to "free-trade") sentiments augurs a period of increasing trade-negotiating aggressiveness in the United States. In such a hostile environment, the possibility of striking a trade accord that would give Canadian exporters preferential access to the U.S. market and that would limit the scope for U.S. retaliatory or protectionist measures is very attractive.

Of course, it is generally agreed that multilateral free trade would provide greater net benefits for Canada, because the gains from trade would increase as the number of trading partners increased. In addition, multilateral free trade would avoid the trade-diversion costs that occur under the bilateral option. These are the costs incurred when Canadian importers switch their purchases from least-cost third countries (such as Japan) to the United States because imports from the latter now come into Canada duty-free, whereas imports from the third country are still subject to duty. Under multilateral free trade, there would be no such trade diversion. Furthermore, in view of strong concerns about political, social, and cultural independence, multilateral free trade might be more acceptable to Canadians from a political point of view.

It must be recognized, however, that over 75 per cent of Canadian trade is conducted with the United States, which means that between 20 and 25 per cent of Canadian domestic production depends directly on U.S. buyers. Therefore, a stable, predictable, and liberal trading environment with the United States is crucial to Canada's continued prosperity. Indeed, Canada needs a strong merchandise trade surplus with the United States to offset its chronic deficit in services (including debt servicing) with that country.

Last year, we demonstrated that, overall, Canada would benefit significantly, in terms of output and employment, from freer-trade arrangements with the United States.[1] We also showed that if Canada were drawn into a major protectionist confrontation with the United States and other western nations, the country would suffer immense losses, particularly in employment. The protectionism scenario that we discussed suggested that Canada could lose the equivalent of two years' growth of output and half a million jobs if it were the victim of retaliatory measures by the United States. Thus one of the most urgent economic issues facing Canada today is that of securing and enhancing its trade position with the United States and its other trading partners. Either a bilateral or a new multilateral agreement under the GATT could help to achieve this aim. In this connection, Canada's current goals and strategy for negotiating with the United States are seen as complementary to its objectives in the multilateral trade negotiations at the new Uruguay Round.

We shall soon know whether or not a bilateral agreement is a real possibility. From Canada's point of view, to be truly advantageous the agreement must exempt Canadian goods and services from the extreme forms of U.S. contingency protection that Congress now seems prepared to impose on its trading partners. Carefully crafted and with sufficient safeguards, a bilateral agreement could be an important milestone in making both Canada and the United States more competitive in the world economy and in strengthening their common negotiating objectives at the GATT.

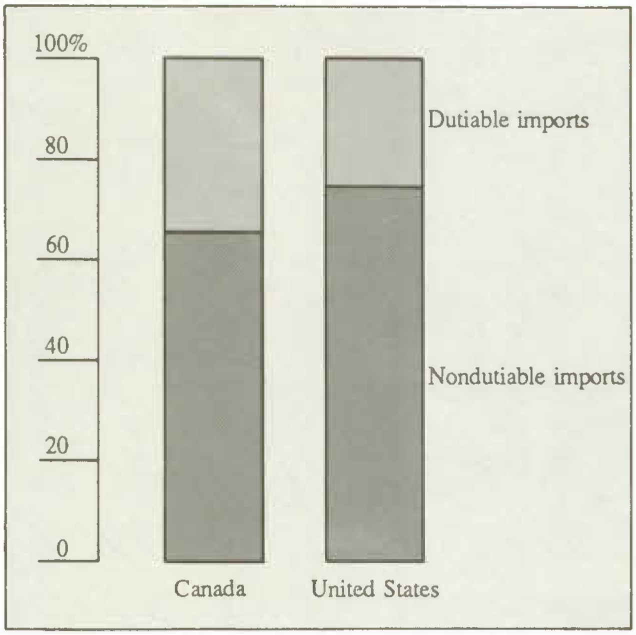
In this chapter, we report on work that the Council has done in two areas: the measurement of nontariff barriers, and the analysis of the Canada-U.S. productivity gap. That work has been used as the foundation for updated simulations of the potential impact on output and employment of a comprehensive free-trade agreement. The estimates are more detailed than those which we presented a year ago. They cover 36 industries and the 10 provinces. We caution our readers, however, that our simulations assume a more comprehensive agreement than any deal that is likely to be struck. Moreover, not all members of the Council are happy with the use of mathematically based models as proxies for the real world or with the interpretation and the claims that may be made of the results. Several members have expressed personal disquiet on this subject, and their comments are found after Chapter 5. Nonetheless, in order to be as fair as possible, once the details of the accord are made public, we shall run the simulations again as part of our evaluation of the agreement. In addition, we are nearing completion of a quantitative analysis of a possible multilateral trade deal.

Current Barriers to Canada-U.S. Trade

In considering a new trading arrangement with the United States it is useful to know what its maximum scope would be. It is not widely known, for instance, that much of the current trade between the two countries is already free of tariffs. About three-quarters of Canada's exports to the United States, and two-thirds of the reverse trade flows, enter free of duty (Chart 3-1). A considerable portion of this reflects arrangements under the Canada-U.S. Auto Agreement. But even in the case of other manufactured goods, over half of Canadian imports from

Chart 3-1

Dutiable and Nondutiable Imports, Canada and United States, 1987



SOURCE S. Magun, S. Rao, and B. Lodh, "Impact of Canada-U.S. free trade on the Canadian economy," Discussion Paper 331, Economic Council of Canada, Ottawa, August 1987.

U.S. sources enter duty-free. So a new North American trading arrangement, however historic in political terms, will be a logical extension of the mutually favourable trading arrangements and tariff concessions that have developed over the years.

Tariff Barriers

It should be noted, though, that where tariffs do apply, the level of protection is considerably higher in Canada than in the United States. Canada's nominal tariff rates on dutiable imports average 11.2 per cent, compared with a U.S. average of 6.5 per cent (Chart 3-2). And right across the board, Canadian manufacturers enjoy higher tariff protection than their U.S. counterparts (Chart 3-3). The implications of this for a possible Canada-U.S. free-trade arrangement are threefold. First, with the mutual elimination of tariffs between the two countries, Canada would give up a significantly higher level of tariff protection than would the United States. Second, as a result, the Canadian consumer would have relatively more to gain from eliminating tariffs. But, third, the relative burden of competitive adjustment for individual firms and workers, and therefore the need for phasing in the reductions, would be greatest on the Canadian side.

Nontariff Barriers

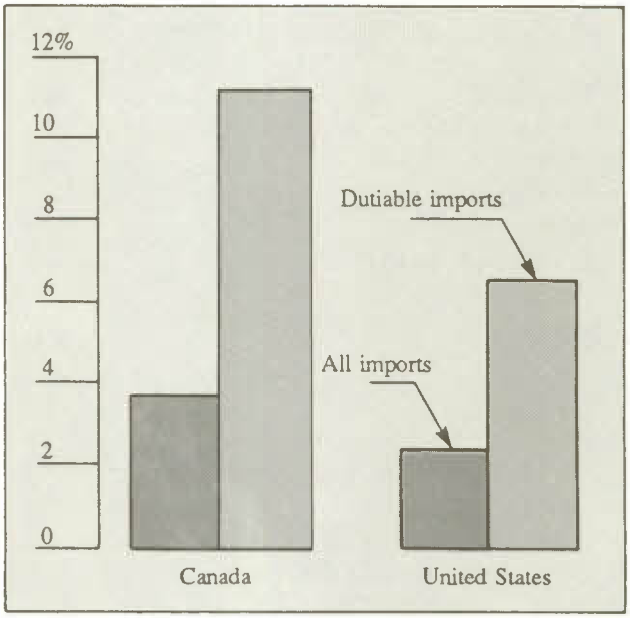
Tariff barriers are, of course, only part of the story. Increasingly, countries have turned to various forms of discriminatory trade practices to protect domestic production and employment, to promote the economic development of depressed regions, to preserve and expand particular export markets, as well as to promote particular constituency interests within national boundaries. The extent of these practices is large and undoubtedly results in substantial welfare losses for all nations. All countries are guilty to a greater or lesser degree.

In the face of some of these practices abroad and under pressure from domestic producers hurt by imports or by the loss of export markets, the United States has increasingly used the power of its trade laws to impose contingency protection measures. Canada has been a major target. The recent countervailing duty on softwood lumber, for example, was justified on the grounds that it was needed to offset an alleged subsidy by Canadian provincial governments.

An overview of recent trade actions taken by the United States against Canada, and vice versa, is shown in Chart 3-4. (Note that trade actions here do not cover the many other trade barriers that have existed for some time

Chart 3-2

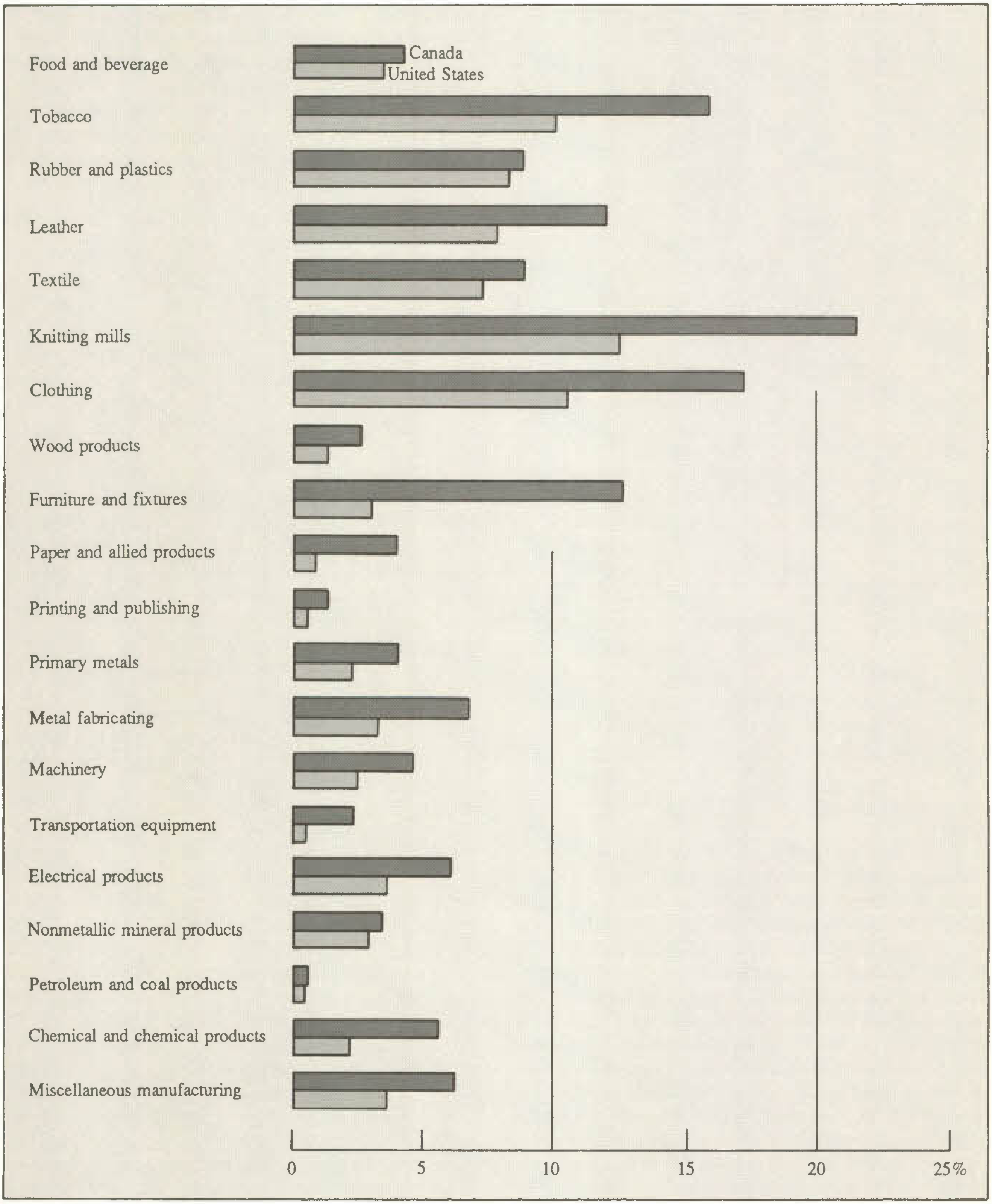
Tariff Rates on Imports, Canada and United States, 1987



SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

Chart 3-3

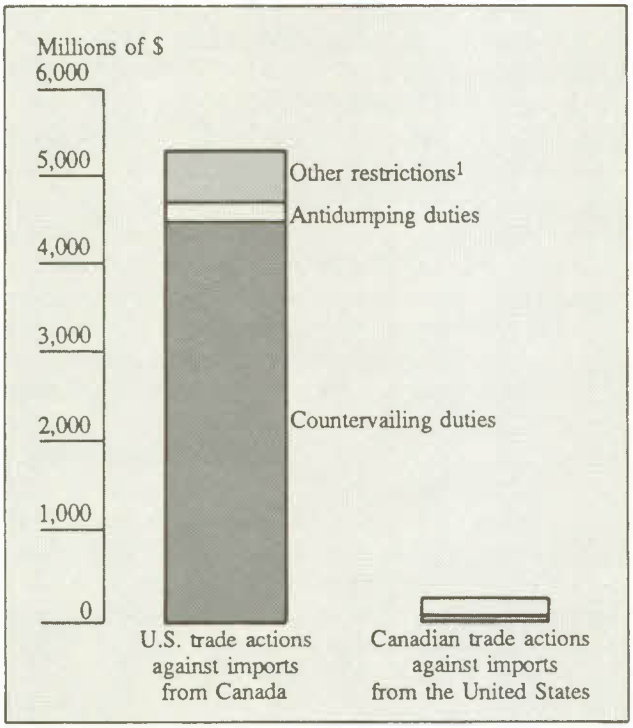
Tariff Rates on Manufacturing Industries, Canada and United States, 1987



SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

Chart 3-4

Value of Imports Subject to Bilateral Trade Actions by Canada and United States, by Type of Action, 1984



1 Quotas, voluntary export restraints, safeguards, etc.
SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

between the two countries in the form of customs valuation, quotas, import licensing, health and safety standards, and so on.) Canada's actions against the United States are largely concentrated in antidumping activity, whereas U.S. trade actions against Canada are concentrated in countervailing duties (CVD), with some use of antidumping duties. U.S. action has been taken against Canadian lumber, hogs, Atlantic groundfish, sugar, and steel. These can be characterized, by and large, as barriers to Canada's resource-based export trade. Conversely, Canada's actions have been spread over a large number of manufactured imports from the United States, with the sole exception of the recent CVD action on grain corn.

Lumber is by far the most important contingent protection case ever filed by the United States against Canada – and indeed the largest CVD case on record. By 1985, U.S. softwood imports from Canada had grown to almost US$2.9 billion annually and represented over 4 per cent of total Canadian merchandise exports to the United States. The CVD applies to almost 90 per cent of Canadian lumber exports to the United States, thus underlining the trade confrontation between the two countries. If one adds to lumber the other CVD cases – hogs and Atlantic groundfish – about 5 per cent of Canada's total merchandise exports to the United States are subject to CVD penalties. In contrast, the value of Canadian merchandise exports covered by U.S. antidumping duties is about C$220 million, or about 0.2 per cent of the total. In all, U.S. actions (up to 1986) against Canadian merchandise trade applied to about C$5.3 billion, valued at the 1984 levels of Canadian exports to the United States.

Canadian actions against imports from the United States have affected merchandise worth approximately C$235 million, mainly through antidumping rulings by the Canadian Import Tribunal. The Canadian CVD action in 1986 imposing a 65-per-cent duty on U.S. grain corn was the first of its kind against the subsidization of U.S. agriculture.[2]

Thus there is an asymmetry in the imposition of recent NTB trade actions, with Canada bearing the larger burden. It is not only past U.S. actions that give cause for worry; there is also deep concern about further measures that the United States may take in the near future, including restrictions on Canadian potash, printing, uranium, and cattle and beef.[3]

A distinction must be drawn between the value of exports affected by nontariff barriers and the actual impact of the barriers on export sales. For example, if a Canadian product is much in demand in the United States, the additional costs from the imposition of countervailing duties will likely be absorbed by the consumer, with little loss of sales for the Canadian producer. In other cases, the duties may prove prohibitive. Whatever the actual consequences, there are distortions in trade, resulting in increased prices to the consumer.

To estimate the effect on prices and the consequent distortions of NTBs on the trade flows, the concept of the tariff equivalent of NTBs is used.[4] Tariff equivalents show the degree to which NTBs result in higher import prices and thus distort the choice of goods made by consumers. We have examined the tariff equivalents of many standard NTBs – including, over and above contingent protection measures, the effects of quotas, voluntary export restraints, prohibitions (health and safety standards), import licensing, and discretionary customs valuation. Table 3-1 shows the major tariff equivalents of Canadian and U.S. nontariff barriers, by commodity. As can be seen, U.S. nontariff barriers against Canadian exports are concentrated in agricultural products, food and beverages (including meat and dairy products), lumber and wood products, and iron and steel. Canadian NTBs are directed at

Table 3-1

Tariff Equivalents[1] of Major Canadian and U.S. Nontariff Barriers, by Commodity, 1981-86

	Canadian NTBs	U.S. NTBs
	(Per cent)	
Grains	12.5	–
Live animals	11.5	10.5
Other agricultural products	12.0	10.5
Meat products	10.0	12.0
Dairy products	22.0	15.0
Flour, wheat, and meal	6.9	6.0
Breakfast cereals	1.0	8.5
Sugar	–	15.2
Alcoholic beverages[2]	40.0	20.6
Lumber	–	10.0
Other wood, fabricated	–	20.0
Iron and steel	2.6	9.5

1 The tariff equivalent of an NTB measures the implicit percentage increase in the import price of a commodity resulting from the application of the NTB to an exporting country by an importing country. NTBs here include quotas (global or country-specific), voluntary export restraints, import licensing, customs valuation, prohibition, and contingency protection.
2 The figures include the effects of provincial or state liquor control boards' decisions with regard to imports.
SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

agricultural commodities and at food and beverages, including alcoholic beverages.

Agricultural Subsidies

This raises the issue of agricultural trade. Within GATT, the OECD, and other international bodies, agriculture is the focus of the most extensive debate about subsidization and restrictive trade practices today. Direct agricultural subsidies cover a long list of items, such as cash grants and income support (deficiency payments, disaster payments, payments in kind, or diversion payments). Indirect subsidies include the imputed value of capital subsidies, price supports (subsidies to domestic producers to cover domestic costs over and above what markets can bear), subsidized interest rates, tax or duty remissions, input subsidies, tax incentives, and the like. The estimation of direct and indirect subsidies, by country and by commodity, presents difficult data problems. International comparisons of subsidy per unit of commodity (for example, dollars per bushel of wheat) are hazardous because of the difficulty of comparing official exchange rates, which can change rapidly.

The OECD and the U.S. Department of Agriculture have attempted to overcome the limitations imposed by exchange-rate changes by estimating what is called a "producer subsidy equivalent" (PSE). The PSE is the total value of all subsidies (direct and indirect), expressed as a percentage of the actual value earned by producers (i.e., market value plus direct subsidies). We have updated some of the information on the PSEs for Canadian and U.S. agriculture, taking into account the recent escalation of deficiency payments for wheat in the United States and of payments made under the *Western Grain Stabilization Act* or by the Canadian Wheat Board to maintain the incomes of Canadian wheat growers. Table 3-2 compares U.S. and Canadian PSE levels for various agricultural products. The various schemes of agricultural price and income support differ in the two countries. Canada makes extensive use of marketing boards – some with supply-management powers. There are also income stabilization schemes that guarantee farmers a stipulated percentage of the average price or the cash margins received during the preceding five-year period. The federal government contributes to the major income stabilization schemes and provides subsidies to the dairy industry as well. The United States uses a combination of nonrecourse loans and "loan rates,"[5] target prices, and deficiency payments (which make up the difference between the target prices and the loan rates); it subsidizes farmers by keeping target prices, and thus deficiency payments, at artificially high levels.

Many observers have expressed concern over the fact that the U.S. Department of Agriculture overestimates Canadian subsidy support for agriculture. In particular,

Table 3-2

Producer Subsidy Equivalents of Canadian and U.S. Agricultural Subsidies, by Commodity, 1982-86

	Canada	United States
	(Per cent)	
Wheat (1986 only)	33.0	45.0
Corn	5.0	30.0
Rice	–	33.0
Oats	6.0	–
Barley	28.5	30.0
Canola (rapeseed)	14.0	–
Soybeans	7.0	7.0
Sugar	40.0	60.0
Cotton	–	40.0
Dairy products	58.0	46.0
Beef	7.0	7.0
Pork	2.5	5.0
Poultry meat	15.0	7.0
Sheep meat	4.0	–

SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

they dispute the U.S. practice of including crop insurance, the actuarially sound portion of stabilization policies, and the Canadian Wheat Board as elements of nontariff protection in the calculation of Canadian PSEs. In the context of the current trade negotiations, they believe that the Canadian government has a responsibility to underscore the difference between the role and operations of the Canadian Wheat Board (and other marketing boards) and the more direct support programs used by the U.S. government.

While Canada is concerned about its bilateral trade in agriculture, its major concern has to do mainly with the United States and the European Economic Community as producers and exporters to other countries. The proliferation of agricultural subsidies in the United States, Europe, Canada, and elsewhere is worrisome for two reasons: because the subsidies impose huge costs on treasuries and taxpayers; and because they are fostering excessive production. Because these issues are multilateral, the search for solutions will require a high level of cooperation among all members of the international community. Of foremost importance in this respect will be the strengthening of the GATT and of its codes and procedures of surveillance. We expect that progress on this front will be slow and "grinding," however; consequently, in the discussion that follows, we assume that no major changes will be introduced in either Canadian or U.S. agricultural policies as a result of the current bilateral negotiations.

The Potential for Productivity Gains in Manufacturing

So far, we have commented on the growing strength of U.S. protectionism and on the danger that it represents for Canadian exporters and for the world economy as a whole – including, we are convinced, the economy of the United States. This is a negative, yet realistic, rationale for Canada to seek out an accord with its large neighbour. The more compelling and more enduring argument has to do with the economic opportunities for Canada in an expanded North American market.

Studies done for the Council in the late 1960s and the early 1970s concluded that Canada's labour productivity and average real income per employee were substantially below U.S. levels, largely because of poor productivity performance in the manufacturing sector.[6] This, in turn, was attributed to inefficient production practices, small and inefficient plants, and short production runs – all consequences of the small size of the Canadian market. Therefore, it was argued that, by permitting Canadian producers to take advantage of scale economies and specialization, diminished multilateral barriers or free trade with the United States would improve productivity and raise real incomes in Canada.

Since then, recent research has suggested that national productivity and per-capita income have grown faster in Canada than in the United States over the past 25 years (Table 3-3). Measured in terms of equivalent purchasing power, Canada's per-capita real income rose from 70 per cent of the U.S. level in 1960 to about 91 per cent in 1986. This is really a remarkable improvement. But most of the relative gains in productivity occurred in sectors other than manufacturing. True, there was a significant improvement in manufacturing productivity in the 1960s – much of it imparted by the Canada-U.S. Automotive Agreement – but, by the 1980s, Canadian manufacturers as a group had once again begun to lose ground to their U.S. counterparts. According to our calculations, the average output per person-hour in Canadian manufacturing is now around 74 per cent of the level observed in U.S. manufacturing – roughly the same relationship that prevailed a generation ago. This gap in manufacturing productivity would seem to confirm our earlier view that, despite the flurry of expanded manufacturing activity in central Canada, U.S. manufacturing firms have been more successful than Canadian firms in rationalizing their operations and improving their productivity.

One must, of course, be cautious in interpreting figures that are highly aggregative, especially when their basis involves daily decisions in thousands of enterprises. Manufacturing performance notwithstanding, Canadians must be doing something right if their living standards

Table 3-3

Ratio of Canadian to U.S. Income per Capita, Aggregate Labour Productivity, and Manufacturing Productivity, Selected Years, 1960-86[1]

	Per-capita income	Aggregate labour productivity	Manufacturing productivity
		(U.S. = 100)	
1960	70.1	75.6	..
1965	72.5	75.5	73.0
1970	76.4	79.5	83.0
1975	87.5	86.0	83.0
1980	90.5	89.3	82.0
1986	90.6	91.0	74.0

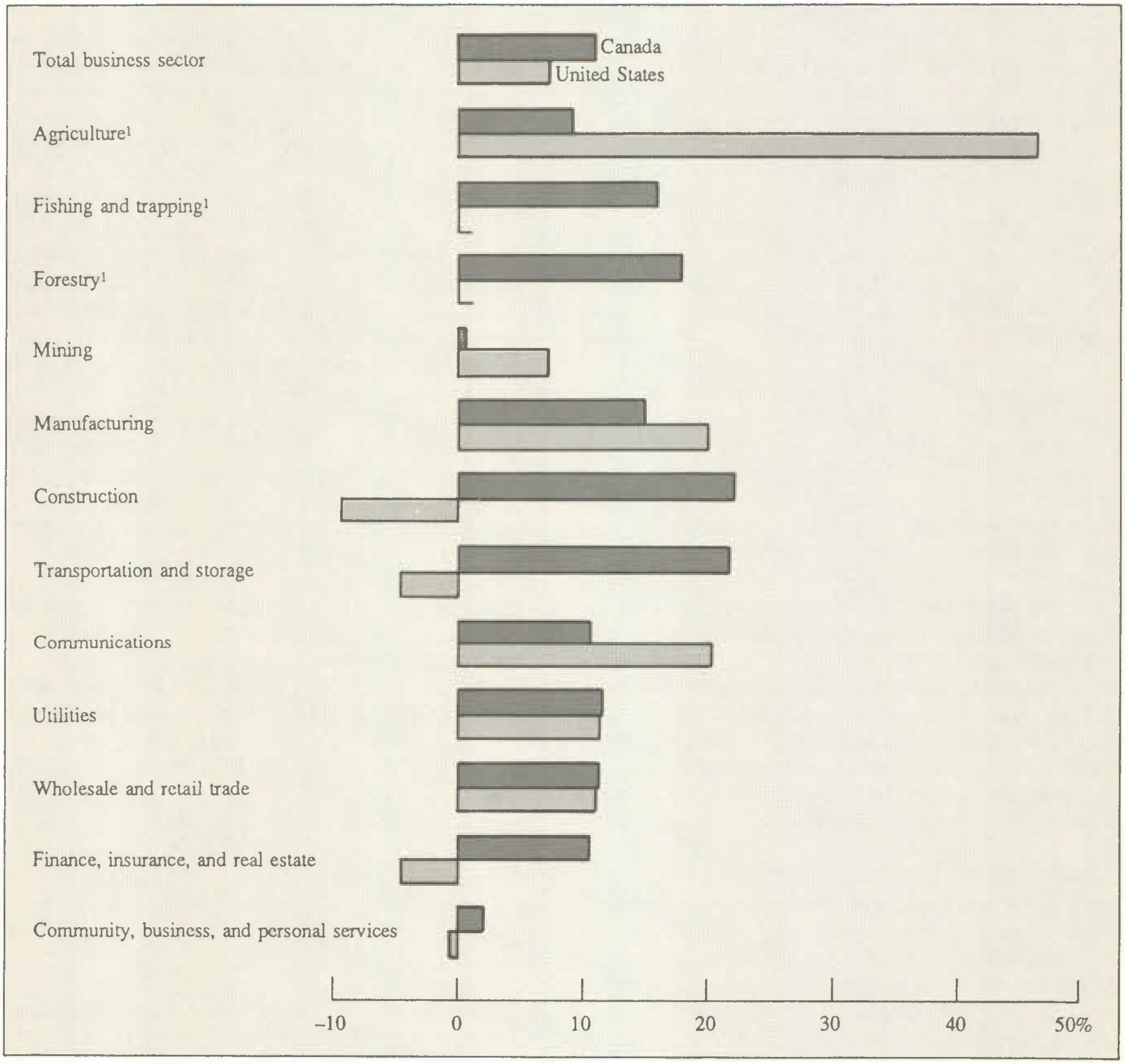
1 Income per capita = GDP per person; aggregate labour productivity = GDP per person employed; and manufacturing productivity = GDP per person-hour. The Canadian data have been converted into U.S. dollars by using the purchasing-power-parity (PPP) exchange rate.

SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

are improving relative to those in the United States. Indeed, as Chart 3-5 shows, taking all commercial activities into account, not just manufacturing, output per person-hour in Canada in the first half of the 1980s increased faster than in the United States. Foremost among the industries that showed the most improvement were forestry, and transportation and storage. By contrast, in the United States there were actual productivity declines in construction, transportation and storage, finance, and commercial and personal services over the same period. Why Canadian industries outperformed their U.S. counterparts in some sectors but underperformed in others is a matter of some speculation; but it certainly warrants more intensive study than is given here.

Chart 3-5

Change in Output per Person-Hour, Canada and United States, by Industry, 1980-85



1 In the United States, the "farm sector" includes agriculture, fishing and trapping, and forestry.

SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada and the U.S. Bureau of Labor Statistics.

While a large portion of Canada's exports already enter the United States free of duty, that is not the case with most manufacturing products. Duty-free and secure access to the large U.S. market would enable many Canadian manufacturing firms to take advantage of scale economies through larger plant size, product specialization, longer production runs, faster adoption of new technology, or the exploitation of new market niches. This, in turn, should enable them to improve production efficiency and, as a result of the lower unit costs, increase sales and employment. This view certainly underlies the support that the Canadian Manufacturers' Association and the Canadian Federation of Independent Business have given to the Canada-U.S. free-trade negotiations.

Trade liberalization could improve Canadian manufacturing productivity through two main types of efficiency gain: industrywide economies and the rationalization (or restructuring) of industries.[7] Efficiency gains could occur through industrywide savings in marketing, research and development, lobbying, and so on; but in general they would not be very significant. Scale economies that induce changes in the structure of manufacturing industries would be much more important. It is somewhat difficult to predict their influence, however, since that would presuppose a knowledge of the productive capacity, costs of production, and output of individual firms. The problem is compounded where products are highly differentiated with respect to composition, function, brand, or trademark. And while there is a positive relationship between the size of a firm and its relative efficiency, it is not absolute. In some cases, a manufacturing firm might find it more profitable to fill successfully a niche in the wider market.

In short, while we cannot be precise about the timing or the location, we are confident that the access to a wider market through a free-trade accord would encourage Canadian manufacturing firms to rationalize their operations, reduce the number of inefficient plants through mergers and takeovers, and modernize their production activities in order to compete successfully. This restructuring process would likely be accompanied by an increase in the average size of the manufacturing plant.

How large are the productivity gains that could potentially be derived from a free-trade accord as a result of greater plant size, rationalization, niche-finding, and so on? We have seen that Canadian manufacturing, on average, is about one-quarter less productive than U.S. manufacturing. This gap is indicative of the potential gains to be made from rationalization within Canada's manufacturing sector as a whole. In any given industry within that sector, the size of the potential gains can be measured by the reduction in production costs and can be estimated roughly by determining the number of suboptimal plants (small plants with relatively high production costs), their share in the total output of the industry, and the sensitivity of costs to changes in plant size.

Over the past year, we have done a considerable amount of new work in examining the potential productivity gains that an accord offers to individual industries. In contrast to our global assumption, in last year's Annual Review, of an overall increase of 5 per cent in total factor productivity in the manufacturing sector, we have now incorporated specific estimates of the potential gains in productivity that could result from scale economies and plant rationalization in 20 industries in that sector.

For both Canada and the United States, estimates have been made of the number of plants of optimal size – i.e., capable of producing at the lowest unit cost possible – and of suboptimal size. For Canada, Table 3-4 shows the numbers of suboptimal plants in each industry and their share of industry output, as well as the estimated gains in productivity or cost reductions that would occur if these plants were to rationalize as a result of Canada-U.S. free trade. The results show that about 70 per cent of all manufacturing plants, producing about 20 per cent of all manufacturing output, are operating at a capacity below what is considered optimal for the industry. They suggest that if all manufacturing plants were producing a uniform product at optimal capacity, the total unit costs in that sector, including the costs of raw materials and other intermediate products, could be reduced by 3.8 per cent, on average. And since the manufacturing sector's gross output accounts for a large proportion of GNP, the gains in GNP and real income from that source alone could be large.

Two qualifications must be made immediately, however. First, the potential cost saving in an industry where all firms operate at optimal size is not a measure of that industry's potential productivity gain, since the latter figure includes the cost of inputs; an industry's productivity must therefore be measured solely in terms of its value-added. Second, even though a plant may be operating at a suboptimal level, that does not necessarily mean that it is inefficient. It may be producing more customized or specialized products than the lowest-cost firms in the industry – products that meet a more limited demand. In such cases of "product niche-finding," one would not always expect plants to expand under free trade.

Taking these two qualifications into account, estimates were developed of the potential productivity gains to be made from the type of plant rationalization in each

Table 3-4

Estimated Cost Saving from Rationalization of Suboptimal Plants in Canadian Manufacturing Industries[1]

		Suboptimal plants			
	Total number of plants	As a proportion of total number	Output, as a proportion of total industry output	Average cost disadvantage[2]	Assumed gain in productivity[3]
			(Per cent)		
Industry:					
Food and beverage	4,795	69.2	26.8	4.2	8.9
Tobacco products	26	--	--	--	--
Rubber and plastics	999	61.4	8.4	1.2	1.5
Leather	447	68.0	27.4	3.3	4.6
Textile	967	42.0	15.1	3.6	5.0
Knitting mills	281	55.7	22.1	2.2	2.9
Clothing	2,179	69.0	38.2	2.8	3.6
Wood products	3,208	76.2	21.3	3.5	4.9
Furniture and fixtures	2,190	74.4	22.8	3.7	4.4
Paper and allied products	732	42.6	56.9	6.7	9.7
Printing and publishing	4,093	93.7	38.0	5.1	4.8
Primary metals	441	25.5	12.3	1.0	1.5
Metal fabricating	4,862	69.8	19.5	3.8	4.7
Machinery	1,491	81.0	19.2	2.5	3.8
Transportation equipment	1,216	13.4	1.4	5.1	11.0
Electrical products	1,076	76.0	33.9	6.9	9.1
Nonmetallic mineral products	1,566	71.4	29.9	5.5	6.2
Petroleum and coal products	108	--	--	1.0	5.9
Chemical and chemical products	1,212	62.9	17.2	2.2	3.2
Miscellaneous manufacturing	2,693	75.1	15.2	6.6	8.5
All industries	34,578	69.3	19.7	3.8	6.1

1 Suboptimal plants are plants that do not meet the requirements of minimum efficient scale. The data used in this table are for 1979 – the most recent year for which they are available. However, the assumed gains in productivity are based on calculations for 1987 and take into account the fact that some rationalization took place following the 1981-82 recession.

2 The cost disadvantage is expressed as the cost saving that would have been achieved in the industry if all the plants had had the same costs as the minimum-efficient-scale plants. The calculations are based on total costs, including those of intermediate inputs.

3 The figures show gains in total factor productivity, based on value-added data (net output). Only half of the potential cost saving (gross-output basis) is assumed to be realized. This, in turn, is converted to a value-added basis by multiplying half of the cost saving by the ratio of gross output to value-added (industry-specific).

SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

industry that might accompany a Canada-U.S. trade accord. The results range from a high of 11 per cent for transportation equipment to a low of zero for the tobacco industry. For manufacturing as a whole, the estimate of potential productivity gains, weighted according to industry output, is 6.1 per cent. Naturally, the necessary process of rationalization and modernization would not occur overnight but, rather, over a period of time.

Trade liberalization, by promoting domestic competition, could also contribute to narrowing the remaining gap in productivity and real incomes in a number of other important ways: by speeding up the reallocation of resources from declining to growing industries, by encouraging quicker adoption of new technology, and by increasing the flexibility of markets. Indeed, these other dynamic gains in efficiency from freer trade, though they are difficult to measure, could be no less important than the gains arising from plant rationalization. They, too, could help to hold down costs, reduce inflation, and lead to increased productivity, output, and employment growth in Canada.

The rationalizing of an industry takes time, and it often inflicts pain on those communities or workers that face a plant shutdown. Fortunately, the majority of plants do not shut down. Rather, through new management or new investment (or both), they revitalize, strengthen, and expand their output and sales. Moreover, the Canadian manufacturing sector, whatever its relative productivity vis-à-vis that of its U.S. counterpart, is very dynamic. Each year, on average, between 2,000 and 3,000 new plants open up, while almost as many merge or close down. Generally speaking, plant "births" exceed plant "deaths." It is in this context that one must view the opportunities that North American free trade offers many Canadian manufacturing enterprises.[8]

It must be acknowledged, however, that the considerable interindustry variation in potential productivity gains and the marked variations in the numbers of low-cost and high-cost plants within each industry imply extensive adjustment problems for weak industries and those with large numbers of inefficient plants. This is particularly true for such industries as printing and publishing, electrical products, miscellaneous manufacturing, and food and beverages. These industries comprise a large proportion of small and inefficient plants, and the estimated percentage of cost saving to be gained from their rationalization is well above the average for manufacturing as a whole. For example, in the electrical products industry, three-quarters of all existing plants, which account for about one-third of the industry's output, are below the minimum average-cost scale, suggesting the need for substantial restructuring. Indeed, in an earlier report, we showed that in this and many other nondurable manufacturing industries, a large number of plants are in the low- and medium-technology categories, use less than state-of-the-art machinery, equipment, and materials, and are in need of modernization.[9]

Thus, while Canada-U.S. free trade will provide substantial impetus to Canadian manufacturing industries to improve their productivity and to become more cost-efficient and competitive, it may also pose a significant threat to the survival of some small and inefficient plants, unless their management is able to overcome their scale disadvantage through innovative cost-cutting and aggressive marketing practices. In some industries, too, the opening of the U.S. market may well encourage changes in the location of production and distribution facilities so as to favour exports; this could have a very positive effect on some communities and a disruptive effect on others.

The Impact of Bilateral Free Trade on Output and Employment

Using new and up-to-date estimates of tariff and nontariff barriers in the two countries, as well as the newly developed industry-specific estimates of potential productivity gains, the Council's researchers simulated the medium-term impact of a comprehensive Canada-U.S. free-trade agreement on output and employment in 36 Canadian industries, with the help of CANDIDE Model 3.0 and Statistics Canada's Input-Output Model of the Canadian economy.[10] By doing so, they effectively combined models that are uniquely qualified to do an integrated analysis of the industrial and regional effects of a change in trade policy. We recognize, of course, that econometric models offer a stylized view of an economy that is changing rapidly and that their results must be interpreted with care. Nonetheless, we believe that the estimates reported here are valuable because they provide persuasive evidence of the direction and relative size of the potential economic impacts of a comprehensive Canada-U.S. free-trade deal.

The adjustments to the original base-case projections, published last year in our Twenty-Third Annual Review, are described in Appendix Figure B-1. As was the case then, two main simulations are presented. The first examines the impact of trade liberalization achieved through the removal of tariff and nontariff barriers in the two countries. In the second scenario, the removal of the trade barriers is supplemented by industry-specific productivity enhancements in each of the affected Canadian manufacturing industries.

These two free-trade scenarios arbitrarily assume that all tariff and many nontariff barriers (which include the procurement policies of the federal governments in both countries but exclude those of state, provincial, and local governments, as well as domestic subsidies) will be removed immediately, beginning in 1987. Of course, an actual free-trade deal, if one is ratified, will likely be narrower in scope and contain a phase-in period in order to give firms and people time to adapt.

Since exports and imports are not disaggregated by country of origin and destination in CANDIDE Model 3.0, the simulation results do not capture the full impact of trade diversion on the Canadian economy. As indicated earlier, Canada-U.S. free trade could raise the cost of imports to Canada and reduce the gains from the free-trade deal because of the switch in the sources of Canadian imports from least-cost third countries to the United States. By the same token, the diversion-of-trade effect could have a favourable impact on Canadian exports to the United States. When the outcome of the current negotiations is known, our research team will undertake new simulations that, in addition to modeling the costs and benefits of trade diversion, will also allow for the actual phasing-in of the removal of trade barriers. They also plan to take into account the favourable impact of free trade on business investment.

Table 3-5

Impact[1] of Two Canada-U.S. Free-Trade Scenarios on GNP, Employment, and the Unemployment Rate, Canada, 1995 (1986 and 1987 Estimates)

	Real GNP		Employment		Unemployment rate	
	23rd Review (1986)	24th Review (1987)	23rd Review (1986)	24th Review (1987)	23rd Review (1986)	24th Review (1987)
	(Per cent)		(Thousands)		(Percentage points)	
Removal of trade barriers (Simulation 1)	1.9	1.6	205	189	–0.9	–0.6
Removal of trade barriers plus productivity improvement (Simulation 2)	3.6	3.3	376	350	–1.6	–1.3

1 Measured as the difference between the levels obtained in the base case and those obtained in the scenarios.
SOURCE Estimates by the Economic Council of Canada.

Simulation results for the two scenarios are recorded in Table 3-5. The aggregate output and employment effects in the two scenarios are very similar to the results reported in last year's Annual Review. They confirm that a free-trade agreement with the United States would considerably increase output and employment in Canada. Slight differences between the two sets of results arise from data revisions with respect to tariffs, nontariff barriers, and the specific estimates of productivity gains within each industry.

Most of the stimuli to output and employment would come from increases in consumer expenditure and investment as a result of lower prices and lower production costs, and of improvements in real incomes. In the case of the more cautious estimate – i.e., Simulation 1, which assumes that no productivity improvements occur as a result of scale economies and rationalization over the period to 1995 – a bilateral free-trade agreement removing virtually all of the trade barriers between the two countries would create about 189,000 new jobs (net of job losses) in Canada, and Canada's GNP in 1995 would be 1.6 per cent higher than it would be in an environment without free trade. If one takes account of the stimulus that the estimated productivity improvements would impart to per-capita income, spending, output, and employment – i.e., Simulation 2 – the net addition to employment over the same period would be about 350,000 jobs. This would increase GNP by 3.3 per cent and reduce the estimated unemployment rate by a full 1.3 percentage points in the year 1995. Translated into real income, the average Canadian would be at least $500 better off than if there were no free-trade agreement.

These gains would not be at the expense of, but rather in tune with, parallel gains in the United States. While it was not possible to simulate the effects of an accord for that country, it is clear that Americans, too, would experience higher growth rates and increases in employment and real incomes. Free trade would make both countries richer as a result of the mutual elimination of trade barriers and the related efficiency gains associated with the wider market.

A Sectoral View

Canadians are not only interested in the aggregate effects of an eventual free-trade agreement with the United States, but they are also concerned about its possible effects on individual industries. While acknowledging that there may be overall benefits for Canadians, many worry that these significant positive effects could conceal possible negative effects on individual industries or regions. The industrial distribution of the aggregate changes in output and employment that is projected to arise from bilateral trade liberalization is shown in Table 3-6. The different impact of changes in exports, imports, consumer expenditure, and investment on individual industries determines the structure of output and employment gains or losses in each industry.

In most industries (29 out of the 36 analysed here), the impact of bilateral free trade with the United States on output and employment would be positive and significant. Most of the net output and employment gains would occur in the primary industries, in construction,

Table 3-6

Projected Impact[1] of Canada-U.S. Free Trade on Output (GDP) and Employment, Canada, by Sector, 1995

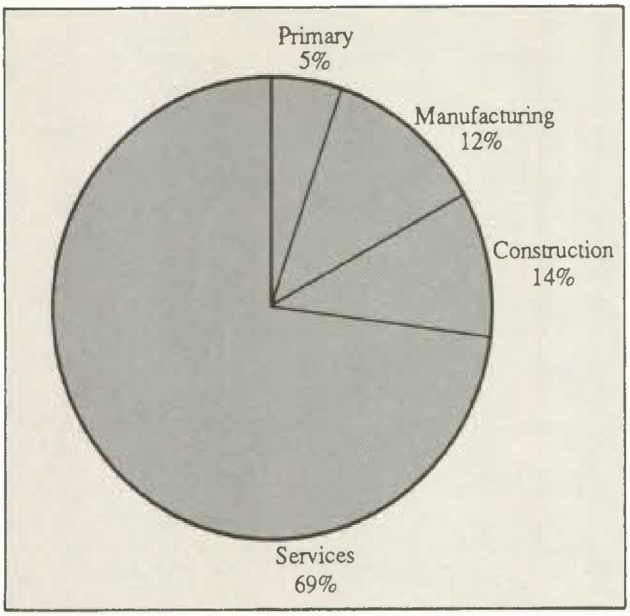
	Simulation 1: Removal of trade barriers				Simulation 2: Removal of trade barriers plus productivity improvements			
	Absolute change		Percentage change		Absolute change		Percentage change	
	Output	Employment	Output	Employment	Output	Employment	Output	Employment
	(Millions of 1981 $)	(Number of persons)			(Millions of 1981 $)	(Number of persons)		
Agriculture	83.3	2,385	0.59	0.60	280.4	7,511	1.98	1.90
Forestry	103.2	2,555	3.35	1.97	120.8	2,797	3.93	2.16
Fishing, hunting, and trapping	12.2	414	1.42	1.35	17.0	539	1.97	1.76
Mining	241.5	3,599	0.77	0.86	513.6	6,708	3.20	4.70
Food and beverage	229.3	5,214	2.02	1.66	431.0	8,969	3.81	2.85
Tobacco products	0.3	6	0.05	0.07	1.7	23	0.26	0.27
Rubber and plastics	–94.7	–2,124	–2.53	–2.26	–27.5	–629	–0.74	–0.67
Leather	–37.0	–1,637	–8.04	–6.20	–32.9	–1,359	–7.15	–5.15
Textile	–70.1	–1,537	–3.16	–2.52	–21.8	–429	–0.98	–0.70
Knitting mills	–16.6	–703	–3.80	–3.69	–6.7	–258	–1.54	–1.35
Clothing	22.9	986	1.10	1.10	57.1	2,300	2.75	2.57
Wood products	222.5	5,346	4.44	4.53	267.4	5,941	5.34	5.03
Furniture and fixtures	6.0	219	0.47	0.44	32.6	1,177	2.52	2.38
Paper and allied products	26.8	353	0.27	0.22	122.4	1,746	1.24	1.11
Printing and publishing	169.3	4,405	3.24	3.22	395.5	9,642	7.57	7.05
Primary metals	278.7	5,361	4.43	3.20	363.2	6,542	5.77	3.90
Metal fabricating	35.5	769	0.58	0.56	185.3	3,850	3.05	2.82
Machinery	77.1	1,245	1.11	0.99	231.5	3,453	3.33	2.75
Transportation equipment	104.8	1,704	0.99	0.89	210.6	3,019	1.98	1.57
Electrical products	–306.4	–6,672	–5.34	–5.03	–161.0	–3,280	–2.80	–2.47
Nonmetallic mineral products	35.9	603	1.28	0.90	110.2	1,850	3.92	2.76
Petroleum and coal products	4.8	69	0.67	0.51	13.1	180	1.83	1.32
Chemical and chemical products	–79.3	–876	–1.06	–0.82	42.7	625	0.57	0.59
Miscellaneous manufacturing	–67.3	–2,471	–3.63	–3.90	–18.3	–731	–0.99	–1.15
Construction	1,117.9	26,416	3.79	3.62	2,205.2	48,742	7.47	6.67
Transportation and storage	459.8	7,399	1.44	1.52	850.5	12,686	2.66	2.60
Communications	12.5	840	0.09	0.32	71.7	2,045	0.51	0.77
Electric power, gas, and other	247.8	1,552	1.40	1.08	473.7	2,774	2.68	1.93
Wholesale trade	534.3	13,836	2.08	2.08	938.7	22,744	3.66	3.42
Retail trade	859.4	49,161	2.60	2.60	1,440.9	77,111	4.36	4.08
Other finance, insurance, and real estate	1,004.8	21,707	2.22	2.19	1,921.6	38,697	4.25	3.90
Education and health	203.9	5,109	2.04	3.06	349.0	8,256	3.49	4.94
Amusement and recreation	108.0	3,735	3.24	1.41	183.1	5,947	5.49	2.25
Services to business management	376.7	14,845	1.77	0.88	740.2	27,304	3.48	1.62
Accommodation and food	344.6	18,077	2.48	1.64	614.7	30,169	4.43	2.74
Other services	75.5	8,110	0.51	0.54	135.0	13,339	0.90	0.88
Total	6,328.0	189,000	1.60	1.40	13,052.0	350,000	3.3	2.6

1 Measured as the absolute or percentage change from base-case results.

SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

Chart 3-6

Projected Distribution of Net Jobs Created as a Result of Canada-U.S. Free Trade, Canada, by Sector, 1995 (Simulation 2)



SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

and in the service sectors, while the manufacturing sector would account for the rest.

Employment in service industries would expand substantially. Indeed, two service sectors alone – retail and wholesale trade; and commercial, personal, and business services – would contribute close to two-thirds of all the new jobs. This reinforces the observation that the indirect effects of freer trade, working through lower prices and increased consumer expenditure and investment, are just as important as the direct stimulus to the economy that an accord would generate.

Under Simulation 1, the durable-products industries within the manufacturing sector would, on average, benefit more from trade liberalization than the nondurable-products industries. In fact, six of the seven manufacturing industries in which output could be expected to decline as a result of free trade belong to the nondurable sector – i.e., rubber and plastics, leather, textiles, knitting mills, chemicals, electrical products, and miscellaneous manufacturing. These industries are now highly protected and would thus have to undergo important structural adjustments in order to remain competitive. They already face stiff competition from the low-wage developing nations. Since the United States is a high-wage country, however, their net loss in output and employment as a result of bilateral trade liberalization would be fairly modest – around 16,000 jobs, or less than 3 per cent of their present work force. This suggests that relative to the overall gains to be made, the adjustment costs from bilateral trade could be quite manageable.

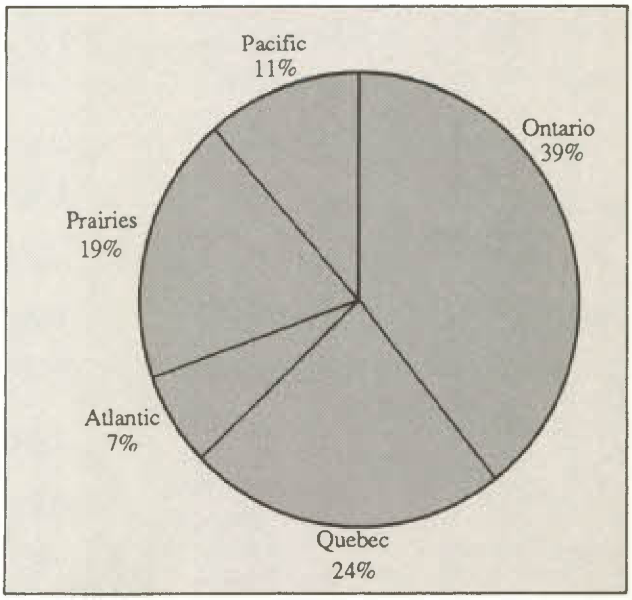
The relative changes that would occur in the industrial distribution of output and employment under Simulation 2 would be in the same direction as those observed under Simulation 1; however, the manufacturing sector's share of the net additional gains in total output and employment would be significantly greater, rising from around 5 per cent of additional employment, for example, in the first scenario to about 12 per cent in the second scenario. The reasons for this are twofold: with higher incomes, more Canadians would buy manufactured products; and with substantial gains in manufacturing productivity, the prices of manufactured goods relative to services would fall, encouraging more domestic and export sales, and thus leading to increased output and employment. Nonetheless, the service sector would still dominate as the major source of the net additional jobs (Chart 3-6).

A Regional Perspective

It is also important, when considering the effects of Canada-U.S. trade liberalization, to assess its likely impact on each of the provinces. Our researchers were able to do this by using the provincial distribution of output and employment by industry that is implicit in Statistics Canada's Regional Input-Output Model. The

Chart 3-7

Projected Distribution of Net Jobs Created as a Result of Canada-U.S. Free Trade, Canada, by Region, 1995 (Simulation 2)



SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

Table 3-7

Difference in Projected GDP between the Base Case and Simulation 2, Canada, by Province, 1995

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	Canada[1]
					(Millions of 1981 $)						
Total difference	164.63	36.68	271.29	253.25	2,918.95	4,783.50	504.74	515.27	1,195.82	1,551.60	13,051.98
Primary industries	15.52	3.22	11.00	13.47	82.34	124.47	33.51	98.71	423.25	115.29	931.78
Manufacturing											
Durables	3.05	0.45	11.40	14.60	259.23	715.52	33.60	11.55	54.59	135.66	1,239.71
Nondurables	13.71	2.29	24.56	21.73	290.38	418.43	27.27	11.36	47.55	98.72	956.20
Construction	43.05	8.27	51.94	52.53	504.07	647.09	72.30	102.33	421.05	281.03	2,205.19
Services	89.29	22.46	172.39	150.91	1,782.94	2,877.99	338.07	291.32	1,049.38	920.89	7,719.10
					(Per cent)						
Total difference	3.5	3.6	3.5	3.5	3.2	3.2	3.3	3.3	3.5	3.6	3.3
					(Percentage points)						
Contribution of:											
Primary industries	0.3	0.3	0.2	0.2	0.1	0.1	0.6	0.6	0.7	0.3	0.3
Manufacturing											
Durables	0.1	--	0.2	0.2	0.3	0.5	0.3	0.1	0.1	0.5	0.3
Nondurables	0.4	0.4	0.3	0.4	0.3	0.3	0.3	0.1	0.1	0.2	0.3
Contruction	1.1	1.0	0.9	0.9	0.7	0.6	0.6	0.8	0.9	0.8	0.7
Services	1.6	1.8	1.9	1.8	1.8	1.8	1.9	1.6	1.6	1.8	1.8

1 Includes Yukon and the Northwest Territories.
SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

differences in projected output and employment between the base case (no free trade) and Simulation 2 (free trade plus productivity enhancement), for each province and each major sector, are presented in Tables 3-7 and 3-8. Chart 3-7 shows the regional distribution of additional net jobs as projected in Simulation 2.

At the provincial level, the impact of a free-trade accord will be determined largely by the composition of the industries that are located in each province. We have seen that even with the cautious estimate embodied in Simulation 1, 29 of the 36 manufacturing and nonmanufacturing industries would gain from free trade. Hence we would expect that most, if not all, provincial economies would benefit under Canada-U.S. free trade. Furthermore, as most of the gains would occur in the service sectors and the distribution of service-sector output and employment is more or less similar from one province to the next, the gains from free trade would likely be distributed fairly evenly across all the provinces.

Under Simulation 2, the overall provincial changes in output (measured by the percentage deviation from base-case levels) vary within the narrow range of 3.2 to 3.6 per cent. Output in the Atlantic provinces, Alberta, and British Columbia would rise above base-case levels by slightly more than the national average of 3.3 per cent. This comes about mainly because the primary industries, which are important in these provinces, would benefit from the removal of existing U.S. trade barriers (especially the NTBs on softwood lumber and fish). Strong gains in the construction industry (the indirect effects) also add to the direct stimuli. In addition, the Atlantic provinces would benefit from a healthy increase in the food and beverage industry as a result of sales to the U.S. eastern seaboard – especially sales of processed fish. British Columbia would benefit from the strong gains in fishing and forestry, as well as in the wood products industry.

Quebec and Ontario, with relatively more manufacturing than the other provinces, would experience slightly less than the average percentage gain in output. Accounting for more than 75 per cent of total manufacturing output in Canada, they would bear most of the adjustment problems incurred by the weaker nondurable industries; however, they would also take the lion's share (about 60 per cent) of the absolute (net) gains in output.

The employment benefits of free trade would also be distributed fairly evenly across all provinces. They would parallel the distribution of output effects, with the increases varying across provinces from 2.5 to 3.0 per cent. The Atlantic provinces, the Prairie region, and

Table 3-8

Difference in Projected Employment between the Base Case and Simulation 2, Canada, by Province, 1995

	Newfound-land	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskat-chewan	Alberta	British Columbia	Canada[1]
					(Number of persons)						
Total difference	5,413	1,189	9,020	8,097	82,820	136,828	15,023	11,492	39,695	39,558	350,000
Primary industries	452	131	646	517	2,797	4,201	719	1,222	3,891	2,815	17,555
Manufacturing											
Durables	44	--	302	379	5,513	11,978	655	226	867	2,589	22,552
Nondurables	439	75	632	404	6,493	8,767	663	255	914	1,438	20,079
Construction	1,135	284	1,490	1,348	11,281	14,544	2,058	1,987	9,294	5,250	48,742
Services	3,341	699	5,950	5,450	56,737	97,338	10,928	7,802	24,729	27,466	241,072
					(Per cent)						
Total difference	2.8	2.8	2.7	2.8	2.5	2.5	2.8	2.7	3.0	2.8	2.6
					(Percentage points)						
Contribution of:											
Primary industries	0.2	0.4	0.3	0.2	0.1	0.1	0.2	0.3	0.4	0.2	0.2
Manufacturing											
Durables	--	--	0.1	0.2	0.2	0.3	0.2	0.1	0.1	0.4	0.2
Nondurables	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.2
Construction	0.7	0.8	0.5	0.5	0.4	0.3	0.4	0.6	0.8	0.4	0.4
Services	1.5	1.3	1.6	1.7	1.6	1.6	1.8	1.6	1.6	1.6	1.6

1 Includes Yukon and the Northwest Territories.
SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

British Columbia would experience employment growth slightly above the Canadian average; Ontario and Quebec, slightly less. Even so, as with output, about 60 per cent – or close to 220,000 of the estimated 350,000 new jobs (net of job losses) – would occur in these two provinces.

Trade-Related Employment Adjustment

Whereas Simulations 1 and 2 show the net effects of a free-trade accord on industries and provinces, what is of concern to the men and women whose jobs may be affected are the gross flow figures – i.e., those which take into account the displacements that may occur within an industry and that are masked by hirings in the same industry but by a different firm, or in a different occupation or location. These figures are hard to come by, let alone to predict. We have, however, made some preliminary calculations, which should be interpreted as indicative and directional; we realize that these estimates bear on individual choices and opportunities and that they cannot, therefore, capture the personal grief or joy that a job loss or job find will impart.

At the same time, we must emphasize strongly the fact that job change is a regular, frequent part of life for a large number of Canadians. In a typical year, between four and five million people, or one-fifth of the working-age population, lose or leave their jobs.[11] Even more people enter new jobs. About half of those who change jobs do so voluntarily, moving on to new opportunities; about one-quarter (1.2 million people) are permanently laid off – that is, lose their jobs involuntarily; and another million experience temporary layoff, to be rehired later by the same employer. Thus the labour market is characterized by a substantial number of people losing, gaining, or changing employment. Some of those who are laid off can adjust easily, while others have more difficulty acquiring new skills or finding new employment.

Our research supports the view that, nationally, a free-trade accord would create many more jobs than it would eliminate. Simulation 2, which takes account of productivity improvements and industry rationalization, presupposes the greatest number of job losses, as well as job gains. Yet it projects, as we have pointed out, a net gain of 350,000 jobs over a period of eight years. Based on past industrial experience of layoffs and voluntary separations, we expect that this works out to about 180,000 jobs being lost and over 530,000 jobs being created. Job gains and losses, however, would be distributed differently across various industries (Table 3-9). Over the eight-year span, it would mean about 118,000 new jobs and 75,000 job losses in the manufacturing sector; about 331,000 new jobs and 90,000 layoffs in the service sector; and about 85,000 new jobs and 18,000 jobs lost in the primary sector and in construction. Regionally the gains and losses would be distributed pretty much in line with the employment projections cited earlier; in other words, the central provinces would lose the most jobs and would also gain the most jobs. On a net basis, all provinces would gain.

Women would likely benefit more than men from trade liberalization, because the largest percentage of job gains and losses would be concentrated in white-collar clerical and service occupations (Table 3-10), where female workers dominate numerically. However, a significant number of women now working in textile and knitting mills in the small towns of Ontario and Quebec could be forced to find new jobs.

We have tried to identify the types and the quantities of the jobs that are most likely to be affected by a free-trade agreement. The results suggest that there would be a great deal of movement within occupational groups. The job losses would be concentrated in product-fabrication, processing, service, sales, clerical, and managerial occupations; but at the same time those are the very occupations in which the greatest number of jobs would be generated. This heightens the probability that most job losers would find alternative opportunities in the same or a closely related occupation.

What these figures suggest is that, during the period when Canadians are adjusting to a comprehensive free-trade accord, close to 23,000 jobs would be lost each year through permanent layoffs, and over 66,000 jobs would be created; in other words, the new jobs would outnumber the lost jobs by a ratio of nearly three to one. Both these numbers are small relative to the usual movement in the labour force (Chart 3-8). Indeed, the 23,000 permanent layoffs induced by free trade would account for only 2 per cent of the layoffs that occur in a normal year. We conclude, therefore, that most Canadian workers would be able to adjust to the job shifts brought about by an accord, just as they adjusted to changes brought about by the Kennedy and Tokyo Round tariff reductions. This optimism is based on two factors: first, the number of

Table 3-9

Projected Cumulative Employment Flows Resulting from Canada-U.S. Free Trade, by Industry, Canada, 1987-95 (Simulation 2)

	Jobs created	Jobs lost	Net job gains
	(Thousands)		
Industry:			
Agriculture	11.2	3.6	7.5
Forestry	8.8	6.0	2.8
Fishing, hunting, and trapping	1.8	1.3	0.5
Mining	12.0	5.3	6.7
Total, primary	33.9	16.3	17.6
Food and beverage	15.4	6.4	9.0
Tobacco products	0.1	–	–
Rubber and plastics	3.4	4.0	–0.6
Leather	–	1.4	–1.4
Textile	1.5	2.0	–0.4
Knitting mills	0.2	0.5	–0.3
Clothing	5.0	2.7	2.3
Wood products	12.1	6.1	5.9
Furniture and fixtures	2.8	1.7	1.2
Paper and allied products	6.1	4.4	1.7
Printing and publishing	11.7	2.1	9.6
Primary metals	10.8	4.2	6.5
Metal fabricating	10.2	6.3	3.9
Machinery	10.6	7.2	3.5
Transportation equipment	16.4	13.4	3.0
Electrical products	2.3	5.5	–3.3
Nonmetallic mineral products	3.5	1.6	1.9
Petroleum and coal products	0.5	0.3	0.2
Chemical and chemical products	3.5	2.9	0.6
Miscellaneous manufacturing	1.5	2.3	–0.7
Total, manufacturing	117.6	74.9	42.6
Construction industry	50.8	2.1	48.7
Electrical power, gas, and other	5.3	2.6	2.8
Transportation and storage	19.9	7.2	12.7
Communications	3.7	1.7	2.0
Wholesale trade	32.4	9.7	22.7
Retail trade	85.4	8.3	77.1
Other finance, insurance, and real estate	46.1	7.4	38.7
Services to business management	66.8	39.5	27.3
Education and health	8.5	0.2	8.3
Amusement and recreation	7.1	1.1	5.9
Accommodation and food	34.2	4.0	30.2
Other services	21.9	8.6	13.3
Total, services	331.3	90.2	241.1
Total	533.5	183.5	350.0

SOURCE L. Lavallée and S. Magun, "Canada-U.S. free trade and labour market adjustment," a paper prepared for the Economic Council of Canada, September 1987.

additional layoffs would be small; and, second, the people forced to look for work would do so at a time when employers will be hiring new staff.

Some workers, however, may need special attention. This may especially be the case in those trade-sensitive sectors (rubber and plastics, leather, textiles, knitting mills, electrical products, and miscellaneous manufacturing) which are projected to decline slightly as the result of free trade. If the skills of their workers are not transferable or if the workers are older or live in small communities, they will probably need support from federal or provincial labour-market and regional-development programs.

Table 3-10

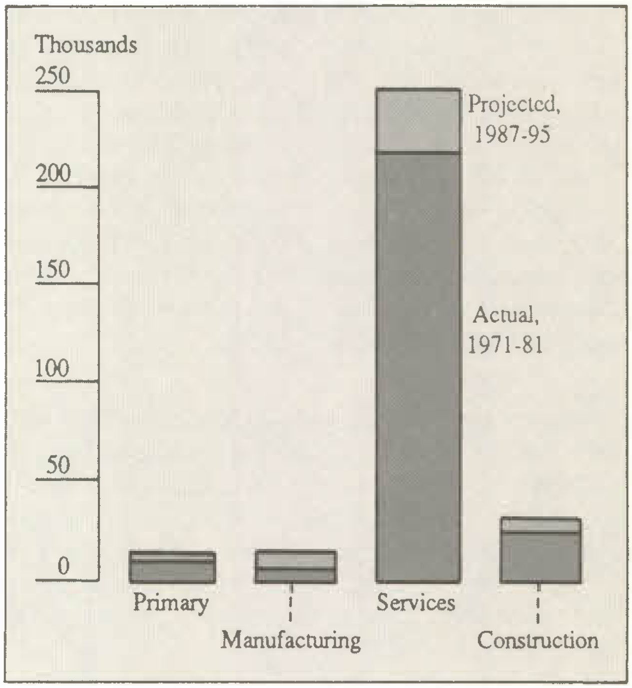
Projected Cumulative Employment Flows Resulting from Canada-U.S. Free Trade, by Occupation, Canada, 1987-95 (Simulation 2)

	Jobs created	Jobs lost	Net job gains
		(Thousands)	
Occupation:			
Managerial/administration	35.3	11.8	23.5
Natural sciences	13.6	6.5	7.1
Social sciences	4.6	2.2	2.4
Teaching	19.4	11.3	8.1
Medicine/health	20.6	11.6	9.0
Art/literary	7.6	1.6	6.0
Clerical	100.5	29.7	70.8
Sales	69.4	12.2	57.2
Service	65.4	17.7	47.7
Total, white-collar	337.8	105.4	232.3
Farming	13.3	4.0	9.3
Fishing	2.0	1.2	0.7
Forestry	6.0	3.9	2.1
Mining	4.5	1.8	2.8
Processing	23.9	12.0	11.9
Machining	17.4	10.1	7.3
Product fabrication	45.6	24.2	21.4
Construction	44.0	6.4	37.6
Transportation equipment	12.6	4.5	8.1
Material handling	11.1	4.8	6.3
Other crafts	8.1	2.4	5.7
Not classified	7.2	2.7	4.5
Total, blue-collar	195.8	78.1	117.7
Total	533.5	183.5	350.0

SOURCE Lavallée and Magun, "Canada-U.S. free trade and labour market adjustment."

Chart 3-8

Annual Net Change in Canadian Employment under Normal Conditions and under Free Trade, by Sector



SOURCE Estimates by the Economic Council of Canada.

Conclusion

In this chapter, we have examined the implications of rising protectionism. The recent passage of highly protectionist bills (H.R.3 and S.490) in both Houses of the U.S. Congress signals a change in legislation that could seriously jeopardize Canada's exports to that country and lead to a rapid deterioration of the world trading system as a whole. The House measure, which broadens the definition of an "unfair subsidy," will make it easier for U.S. firms to launch countervailing actions against a range of Canadian exports. The Senate provision that would widen the grounds for U.S. industries to demand relief when they experience excess capacity is even more ominous. At present, the United States has excess capacity in a number of resource industries, including lumber, lead, zinc, and potash; this provision could, therefore, seriously endanger our sizable exports of those resources.

The rising protectionist sentiment in the United States has not gone unnoticed elsewhere; if it is translated into law, it is certain that other countries will introduce retaliatory measures. In this deteriorating trade environment, Canada clearly needs to secure, through a bilateral free-trade accord, open access to the U.S. market. Such an accord would be of particular value to Canada if it were accompanied by an impartial mechanism for trade-dispute settlement.

In addition to securing existing markets for exports, a free-trade agreement with the United States could expand trade opportunities for both countries and contribute to a lowering of production costs. The simulations that we have described indicate that the removal of tariff and nontariff barriers could generate about 350,000 new jobs (in net terms) for Canadians over the period 1987-95. The simulations also indicate that, nationally, a bilateral free-trade agreement with the United States would boost real wages, increase production, stimulate business investment and industry revitalization, narrow the Canada-U.S. manufacturing productivity gap, lower prices, reduce total government deficits, and strengthen the Canadian dollar in relation to the U.S. dollar. Of the 36 industries analysed here, 29 would gain from free trade. Net job losses would be small, compared with the net number of new jobs created across various industries. Furthermore, free trade would benefit all provinces, and its gains would be fairly evenly distributed across the country.

As we explained earlier, these estimates provide a reliable guide to the direction and relative size of the economic effects of a trade deal. At the time of writing, however, the outcome of the trade negotiations was strictly conjectural. The simulations reflect the normal responses of consumers, producers, and investors to falling trade barriers, and no attempt was made to speculate about changes in behaviour, such as a possible influx of investment from third countries seeking easier access to the North American market. For this reason, we believe our work provides a sound and prudent benchmark for assessing the potential benefits of a comprehensive trade deal. Naturally, we are unable to evaluate the impact of the actual deal being negotiated until its details are made public.

The Council recognizes that while a free-trade deal with the United States would generally improve long-run economic efficiency, it would also cause stresses and dislocations that would force some industries and some workers to adapt to the larger North American market. We have shown that many Canadian plants would have to rationalize their production through mergers or takeovers, by designing better or new products, by improving the organization of production, or by finding market niches; others would go out of business. These changes are significant, but they are modest when compared with those which occur regularly in response to domestic and foreign competition. In most years, between 2,000 and 3,000 new manufacturing businesses are created, and a slightly smaller number disappear. We believe that most Canadian firms are flexible enough to cope with the pressures that free trade will bring. Indeed, many are already gearing up to meet the challenge.

The problems of labour adjustment resulting from a free-trade accord should also be considered within the context of the normal capacity of workers to adapt to changing opportunities. In Canada, annual job turnover is very high. Canadian workers are remarkably mobile: they move from one industry to another and from one occupation to another with amazing frequency. With such flexibility in the Canadian job market, most of those displaced by free trade would likely find new employment within a reasonable period of time.

In fact, it is often very difficult to determine whether a layoff was caused by domestic or foreign competitive forces, by technological innovation, or by changes in tariff or nontariff barriers. Often, all three factors will have an influence, because a free-trade accord will simply reinforce the pressures and opportunities for firms to adopt new technologies and to realign their product mix in order to meet the needs of consumers at home and abroad.

We believe, therefore, that the task for governments is limited. We do not see a need for specific trade-related adjustment programs. Rather, governments must focus on the needs of individuals for training and on the smooth functioning of labour-market information systems so that placement services will work efficiently. At present, there is a variety of federal and provincial programs – including training, mobility, and job-search assistance – designed to help those who have lost their job or who need assistance in finding a new career. Unemployment insurance is also an important source of income support during the transition.

In *Making Technology Work*, we called on both levels of government to review their existing programs or, if necessary, to consider new programs to ensure that those workers who are adversely affected by technological change will have adequate access to income support and to alternative training opportunities in keeping with their years of working experience. The same applies to those workers displaced because of trade.

In conclusion, the Council believes that a comprehensive trade agreement, such as the all-embracing deal analysed in this chapter, would generate significant economic benefits for Canada over the medium term. The benefits would flow primarily from the drop in consumer prices and from the associated increases in personal income caused by falling trade barriers. Because consumers live in all parts of the country, the gains from such a deal would be very widely dispersed. And while a greater proportion of the job losses would occur in the manufacturing sector, our research indicates that the losses would be transitional and not permanent. Overall, the job gains would outnumber job losses by a ratio of three to one.

We realize that, ultimately, Canadians will evaluate any deal that is negotiated on the basis of many considerations, not all of which are concerned with strictly economic gains and losses. Still, it is important to know that the deal simulated here would offer significant economic benefits to all Canadians. Once the details of an actual accord are released, we shall do our best to quantify the terms of the agreement, and we will report on its potential economic consequences for Canadians.

4 Global Pressures on Domestic Policy

In earlier chapters we observed that growing international interdependency is inevitably giving rise to pressures on western governments to harmonize some of their tax, transfer, and other programs. We have seen this process occurring in financial markets, where the forces of competition, both nationally and internationally, are prompting governments to deregulate in some areas and to alter or strengthen regulatory surveillance in others. We are seeing it in matters of taxation, where the thrust of change in many OECD nations, including Canada, has been to eliminate special exemptions, broaden the tax base, and bring down the rates. We are seeing it at the current GATT negotiations (the Uruguay Round), where strong efforts are now being made to widen the coverage of that organization's rules to cover a much broader range of commercial transactions than heretofore (agriculture, services, and investment regulations, for example). And it is evident in the efforts made by the G-5 and G-7 countries to weave a common, targeted course towards a more balanced, and therefore more sustainable, economic growth.

In general, Canada's interests are well served by these developments. The long-run effect will be to open or widen markets and to eliminate distortions that primarily serve only to support or protect special interests in one country or another. But that does not remove the need to examine closely the options being proposed – in both a multilateral and a bilateral context – in order to ensure that they are to Canada's long-run advantage. If, for instance, they are directed against institutions and programs to which Canadians are deeply attached and that help to unify and give expression to their Canadianism, Canadians must be satisfied that the changes will be for the better. We have particular concerns on this score, not only in the context of the present Canada-U.S. trade negotiations but over the longer term as well. In this chapter we begin by assessing the nature of the pressures from the United States to harmonize policy. We then go on to discuss four areas that are contentious: regional and industrial initiatives, unemployment insurance, health care, and culture.

The New Mood in the U.S. Congress

The crux of many potential problems is exemplified by the bill that was recently passed by the U.S. House of Representatives (H.R.3), especially where it deals with countervailing and antidumping duties. This bill was described earlier this year by the former (and recently deceased) U.S. Secretary of Commerce, Malcolm Baldrige, as "the most dangerous piece of legislation we've seen during this administration."[1] It provides for a unilateral broadening of the definition of an "unfair" subsidy that goes well beyond internationally accepted practices. It would subject a range of government services – social security, medical plans, and so on – to the test of whether they are "consistent with (U.S.) commercial considerations." But these "commercial considerations" are already rife with laws or practices that favour one or another of the very powerful U.S. lobby groups, leading one observer to note that many members of Congress are seeking "a playing field as level as the Rockies." For Canada, faced with U.S. pressures to achieve a "level playing field," the question then arises: What do you do when your neighbour's bulldozer is 10 times the size of yours?

At the time of writing, negotiators for both countries were working hard at defining, to their common satisfaction, what items and what issues would be included in a free-trade arrangement and what would be excluded. These definitions are potentially more important than the actual elimination of tariffs, for they will determine precisely what are nontariff barriers, subsidies subject to countervailing duties, non-negotiable items, and so on. They will determine how widely or narrowly the free-trade accord will extend into the very structure and dynamics of each nation's economic activities and institutions. They will serve as a pre-indication of the type of changes that each country will be pressing for in the current round of GATT negotiations. And they will establish the ground rules that will serve to resolve contentious issues in the future. The definitions are, therefore, basic to whatever dispute-settlement mechanism will accompany the agreement.

A free-trade accord, depending on what is included or excluded, can increase or decrease pressures to harmonize policies. According to a 1986 study by the C. D. Howe Institute, it would leave those pressures largely unchanged.[2] The study cited the eminent Canadian economist Harry Johnson:

> It is important ... to distinguish between the philosophy of free trade and the philosophy of a

> common market. The latter ... generally places an emphasis on uniformity of competitive conditions that is not logically necessary for the attainment of most of the benefits of free trade.[3]

The study concluded that "the policy areas that Canadians consider to be important ... are unlikely to be seriously affected." That conclusion was written, however, prior to the tabling of the trade bills in both Houses of Congress.

At this juncture, no one can predict what form of U.S. trade bill will be acceptable to both the Congress and the Administration. But, clearly, the possibility of a widespread application of trade sanctions by the United States, based on the proposed definition of "unfair" subsidies and on the test of whether foreign practices and programs meet (U.S.) commercial considerations, represents a frontal attack on the concept of national sovereignty that is at the heart of the GATT. By reaching so far into the internal affairs of other nations, a U.S. trade bill containing these provisions could effectively scuttle the proposals for trade liberalization now being pursued at the GATT and, indeed, invite retaliatory action or legislation that could endanger the GATT itself and lead to a full-scale protectionist trade war.

In the face of these developments, the occasion of a Canada-U.S. accord will give the Canadian government an opportunity to make a stand as well as a deal. Both nations are interested in allocating resources more efficiently and in the material gains inherent in wider trade opportunities. But both governments, together with provincial and state governments, must be free to pursue their political, social, and cultural policy responsibilities on behalf of their electorates without fear of trade-sanction harassment.

On many occasions, the Economic Council and others (including, for example, the Nielsen Task Force and the Business Council on National Issues) have questioned the proliferation of subsidies and other government interventions in the economy. The effect has usually been to divert resources away from their most productive uses and to raise the ultimate costs borne by consumers or taxpayers. But government intervention in the economy takes on many forms; it is often intended to enhance the economy's performance or to alleviate its excesses. Moreover, there is no common agreement as to what is either economically efficient or socially just. Inevitably, when comparing the host of measures adopted or not adopted by governments of the other country, there will be differences of view. Is the fact that emission-control subsidies are available to Canadian mining enterprises a legitimate cause for U.S. countervailing action, as the officials of the U.S. Mining Association suggest? Or does the nonenforcement of emission curbs on U.S. mining firms represent an implicit subsidy against which Canada should take countervailing action? When times are good, these issues may remain in abeyance; but as times get tougher and competition becomes more intense, they will surface. Much common sense and impartial goodwill will be needed to resolve them.

A critical issue that will therefore have to be resolved in the context of a Canada-U.S. agreement, as well as in the larger context of the relations of the United States with its GATT trading partners, is how widely or narrowly Washington defines a countervailable subsidy. Clearly, Canada cannot accept a definition such as that in the U.S. House of Representatives' trade bill, which would hold as countervailable all government services and programs in Canada that differ with (U.S.) commercial considerations. At the very least, Canada should hold to the present definition of "subsidy" that applies under the countervailing provisions of GATT. The GATT definition distinguishes between government financial support or services that are available on a universal basis and those which are applied selectively, effectively diverting resources to shore up selected industries or firms. Only the latter are considered as countervailable subsidies.

Whether or not some mutually satisfactory agreement can be reached on the definition of "subsidy," efforts in Congress to have Canadian (and other) businesses operate on the U.S. version of a "level playing field" are likely to continue. In the absence of countervailable trade sanctions, they may simply be addressed by other means.

Take one example. In Canada, most of our major social programs (social security and health care) are funded, wholly or in part, from general tax revenues. Only a portion of them are funded by payroll taxes or premiums levied directly on employers and employees. The result is that nonwage labour costs in Canada are low by international standards – about half what they are in the United States (Chart 4-1). This public subsidy of social programs could be seen, under the proposed U.S. trade legislation, as being unfair competition.

In the U.S. auto industry, for example, the major firms may pay about C$8,900 per worker in annual premiums for complete health, accident, dental, vision, and life insurance protection; in Canada, for roughly the same protection they pay about C$2,800.[4] While Canadian auto makers help to fund medicare through their share of corporate income taxes, their direct cost saving because of lower Canadian medical premiums amounts to millions of dollars annually. Because Canadian producers are the subsidiaries of U.S. automobile firms, the latter are not

Chart 4-1

Nonwage Labour Costs as a Proportion of Wages and Salaries, Selected OECD Countries, 1983

SOURCE Based on Organisation for Economic Co-operation and Development, Working Party No. 1 of the Economic Policy Committee, "Wage moderation and labour market imbalances," Paris, August 1986.

about to complain. But other, more beleaguered industries – the U.S. steel industry, for instance – are already lobbying Congress for assistance. If a joint trade bill is adopted with many of the present provisions intact, they could well argue that Canadian producers enjoy "unfair" benefits in the form of low payroll costs for health care and that Canadian governments should be encouraged to change their system of delivering health care services to the more "competitive" U.S. approach. Under this scenario, we have the paradox that Canada's public health-care programs, which are substantially larger than their U.S. equivalents, may be thought to entail a subsidy to Canadian industry, notwithstanding the fact that they require higher overall taxes for Canadians and, hence, directly and indirectly raise the cost structure of Canadian industry.

Indeed, this latter consideration applies not just in the case of health but along the broad front of Canada's regional and social programs. It is argued that because of the need to fund these programs from general revenues, corporate taxes as well as personal taxes are higher in Canada. Or that with governments running large deficits, savings that would otherwise be invested in the private sector are being directed to public use, thereby driving up interest rates in Canada, as well as the costs of doing business here. On the other hand, Canada has a lower defence bill than the United States, and this somewhat lightens the relative tax burden.

These cautions aside, the public debate surrounding both the Canada-U.S. trade talks and the growing protectionism in the Congress has caused Canadians to be very concerned that, under one guise or another, the U.S. government may seek to impose changes in important areas of Canadian public policy with a view to eliminating "subsidies" to Canadian producers or otherwise persuading Canadians to do things "the American way." In those areas where Canadian policy involves subsidies or restrictions aimed principally at shifting production and jobs from the United States to Canada, it is not unreasonable to expect the U.S. authorities to exert pressure on Canadians to change; and we believe that, on balance, modifications of this kind are a necessary part of the adjustment that Canadian industry must make to a changing world environment. But where the public policy has as its principal focus other types of national objectives (social concerns, cultural development, and the alleviation of regional disparities within Canada), then we take the opposite view – namely, that these items are not cards that need to be played in a trade negotiation. While some of these policies may have incidental effects on the location of jobs between countries, as opposed to within Canada, those effects are generally not large. Nor do they necessarily represent an advantage to Canadian employment, as will be suggested below.

Areas of Concern

Regional and Industrial Initiatives

Canada has had a long tradition of using federal government programs to encourage growth in its less advantaged regions, to reduce income and employment disparities among regions, and to make available a level of basic services that is relatively uniform across the nation. The major instruments for this purpose are the *Established Programs Financing Act*, under which the federal government provides cash payments to the provinces for hospital insurance, medicare and extended health care, and postsecondary education; the Canada Assistance Plan, which is designed to pay half of each province's welfare expenditures; equalization payments; and the remission of tax points to the provinces. In most cases, these federal transfers account for about 20 per cent of gross provincial revenues; for the Atlantic provinces, they represent over 40 per cent.

A second, indirect form of regional transfer is Canada's unemployment insurance system, which was deliberately designed to make available extended benefits to individuals in the Atlantic provinces and in other regions where unemployment rates are chronically high. A third form of regional transfer is found in a host of federal and provincial subsidy programs. Many of the federal programs have been administered by the Department of Regional Industrial Expansion (DRIE); but other departments, including the Department of Agriculture, have their own programs as well.

Currently DRIE is undergoing a revision of its mandate, with a view to decentralizing much of the decision-making with respect to regional incentive grants and devolving it to the regions through the establishment of agencies responsive to local circumstances and opportunities, such as the recently announced Atlantic Canada Opportunity Agency, the Western Economic Diversification Strategy, and the Northern Ontario Advisory Board. Whatever their title, these agencies will be instruments of federal industrial support and spending. The grants they administer are therefore likely to be the targets of U.S. countervailing action.

There are a number of precedents. In the early 1970s, in the Michelin case, regional development grants were found to be subsidies under U.S. law, and countervailing duties ranging from 1.2 to 2.5 per cent were imposed on the tire company's exports to the United States between 1973 and 1982. The U.S. International Trade Administration (ITA), in a recent Atlantic groundfish case, cited regional development grants as countervailable subsidies, since they apply only to specific depressed areas and are not generally available. Indeed, the ITA reviewed 85 federal and provincial programs in Canada and found that 55 of them conferred a subsidy on Canadian producers and exporters of certain fresh Atlantic groundfish.

The number of regional and industrial subsidies payable directly as cash grants or indirectly through loan guarantees, regulation, or tax incentives has been growing. According to one estimate, in 1980 they accounted for approximately 7 per cent of government expenditure in Canada – i.e., close to $8 billion, or 2.6 per cent of GDP.[5] They serve a wide variety of objectives, including regional growth or development, the encouragement of exports, the protection of a secularly declining industry, the bailing-out of firms in temporary (or sometimes permanent) financial distress, income compensation and stabilization, energy conservation, the diversification of a community's industrial base, and the promotion of research and development.

In general, we are not much enamoured by many of the regional and industrial programs now in place. With respect to regional industrial grants, while we are on record as having said, in an earlier analysis, that "the value of the jobs created appears to outweigh the inefficiency involved in locating production inappropriately,"[6] we generally share the view of the Macdonald Commission that, at best, "it may be that the policies have prevented regional imbalances from getting worse."[7] In a forthcoming Council document, we shall report on three Canadian industry-specific, trade-related adjustment programs: the Pulp and Paper Modernization Program (PPMP); the Shipbuilding Industry Assistance Program (SIAP); and the Canadian Industrial Renewal Board (CIRB), which is concerned with the textile, clothing, and footwear sectors. In the case of all three programs, with the possible exception of labour-adjustment assistance, we have found that government intervention was largely unwarranted.

In the United States, the federal government's regional and industrial goals are pursued somewhat more subtly than in Canada, principally through government defence and procurement contracts, trade protection schemes and subsidies for exports, and research and development. The Export-Import Bank of the United States provides loans, loan guarantees, and export credit insurance for U.S. exports, and the new trade bills before Congress would strengthen those subsidies.

State and local governments also offer a wide range of subsidized services and incentives to industry, many of which are directed at the manufacturing sector. Many states have programs designed to attract investment, to stimulate economic activity in depressed areas, to assist small and minority-owned businesses, to promote exports, and to encourage high technology and innovation, as well as pollution abatement and energy development or conservation. Tax incentives are widely used, as states compete for investment with their entire tax systems. Some states and local governments offer special tax advantages for new equipment and new employment; these take the form of fast write-offs, credits for jobs created, and property-tax reductions for new investment. There are also industrial revenue bonds – a form of financing made available by state or local agencies – whose main attraction is that interest is exempt from federal taxation. The tax saving on these bonds, estimated to be worth billions of dollars, is primarily a federal subsidy.

The local diversity and lesser visibility of these various direct and indirect U.S. subsidies make them difficult to track down and measure, and Canada has not often taken countervailing action against imports of U.S. manufacturing goods. It has seldom been to our advantage to do so, since we benefit from the imports' lower prices.

From the Council's viewpoint, the crucial question is whether a particular industrial program is aimed at reallocating investment and employment within Canada to reduce regional disparities or whether the program is aimed at supporting activities that would not otherwise be sustainable in the longer term. In the first instance, it is arguable that, regardless of the other merits of a particular program, it need not be subject to international negotiation. Indeed, a program with those characteristics implies that taxes are collected from the wealthier parts of Canada and redistributed elsewhere. Thus the program weakens the competitive position of the industries of those wealthier regions, both in domestic and international markets. For this reason, programs that reallocate activity within Canada are subject to federal-provincial discussion and negotiation. Because the wealthier regions will tend to resist such transfers, there is bound to be a political upper limit to the amounts that will be committed for such purposes. Such redistribution is unlikely to affect employment opportunities in the markets of the United States or of Canada's other trading partners to any great extent.

When, however, an industrial subsidy is aimed at attracting investment that would not otherwise be economic in Canada, it becomes a legitimate item for international negotiation. As pointed out above, both countries have an array of such programs.

We recognize that it may not always be simple to categorize individual programs between redistribution and subsidy. We do suggest, however, that the above considerations may at least provide a framework for thinking about the kinds of decisions that need to be made and that they may help policymakers to determine how they can legitimately continue with efforts at strengthening regions of high unemployment. Our ongoing research on regional policy and industrial adjustment are expected to shed further light on this issue.

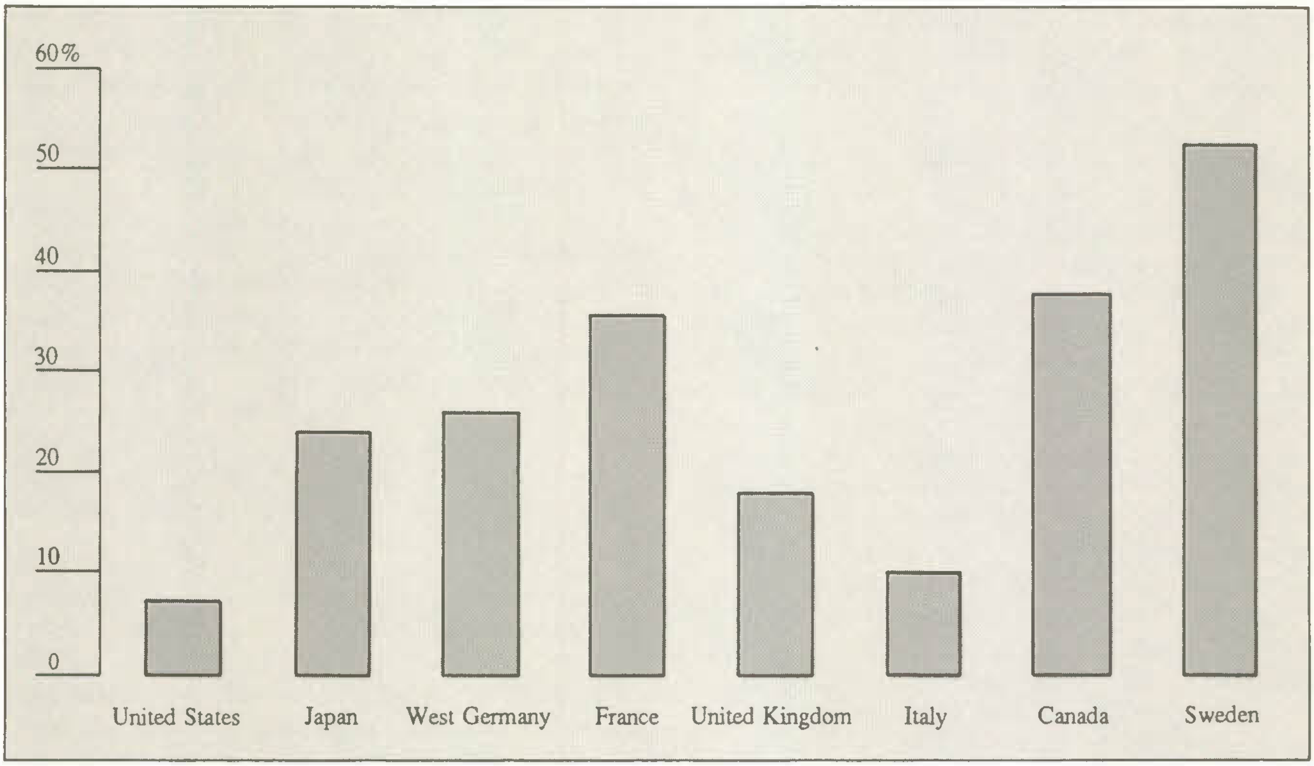
Unemployment Insurance

A related area where the playing field is currently not "level" has to do with Canada's income-transfer programs. Take, for example, the unemployment insurance (UI) system. A chronic complaint of the U.S. fishing industry is that the *Unemployment Insurance Act* offers a subsidy to Canadian fishermen. In a string of actions launched with the U.S. International Trade Administration, the point at issue was not the countervailability of the general unemployment insurance program; rather, it was whether the special provisions of the Canadian unemployment insurance system that apply only to self-employed fishermen represent a subsidy to the fishing industry. The ITA concluded that "unemployment insurance provided to self-employed fishermen is not provided on preferential terms and therefore is not countervailable."[8] But this judgment preceded the ITA's reversal on softwood lumber or the introduction of the much more sweepingly protectionist trade bills in both Houses of Congress. The worry here has to do less with the possibility of countervailing action – after all, unemployment insurance programs exist on both sides of the border – than with the broader pressures that might be applied to "harmonize" the two systems.

Traditionally, Canada has experienced higher rates of unemployment than the United States, partly because of seasonal extremes and the importance of its primary industries. The response, politically, has been in the form of a comprehensive and relatively generous income-support system that goes much further than the U.S. system in transferring income to the unemployed (Chart 4-2).

Chart 4-2

Unemployment Insurance Replacement Ratios,[1] Selected OECD Countries, 1984



1 Benefits as a proportion of the average wage, taking account of periods of ineligibility to receive benefits.
SOURCE Based on OECD, "Wage moderation" (Tables and Charts).

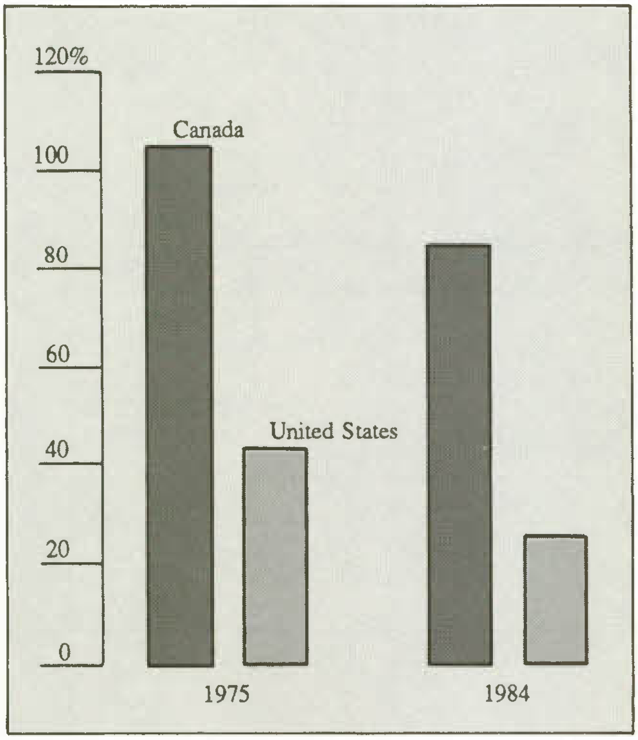
The Canadian system is unlike that of the United States in several respects. It is federally administered with, generally speaking, uniform eligibility and uniform contribution and benefit rules. This is modified only slightly by regional eligibility and by extended benefits that are triggered by specified rates of unemployment and paid for from general revenue rather than from employer/employee contributions. It is rife with cross-subsidies intended to assist workers in seasonal industries and in high-unemployment regions, as well as those on sickness and maternity benefits. No attempt is made to "experience rate" the contributions of employers, as is done in the United States. There, the program is principally state-administered, and eligibility and benefit rules vary from state to state. Generally speaking, the poorest states offer the lowest income protection.

That is not to say that Canada's unemployment insurance system is sacrosanct or that it is beyond the reach of reform. There are legitimate worries about the availability and level of benefits, and about the negative incentives that they may impart to those seeking work. On three occasions recently – in the Macdonald Commission Report, the Forget Inquiry, and the Parliamentary Committee report that followed – a wide range of recommendations for change were advanced that bear public scrutiny and debate. This Council itself has, on several occasions, recommended that a voucher system be introduced to encourage the use of UI funds for retraining or as a wage supplement in a newly created job.

But what has come through very clearly from public debate so far is that Canadians are not willing to see the program gutted or to give up regional or other portions of it unless there is a viable alternative put in place. Canadians would not, we believe, accept a U.S.-type unemployment insurance system. For, whereas in its breadth and reach the Canadian system compares favourably with European programs, the U.S. scheme is rated absolutely last among those of the major OECD nations. As Chart 4-3 shows, the number of unemployed receiving UI benefits in the United States is extraordinarily low, even though two types of state and federal programs are involved in the provision of regular benefits, as well as extended and supplemental benefits. The fact of the matter is that today only one out of four unemployed persons in the United States is receiving UI benefits. Three-quarters of the 8 million unemployed persons in that country receive no benefits, and because they are out of work, they have no medical coverage. Compare that with the situation in Canada, where almost 85 per cent of the unemployed are receiving benefits and are fully protected under universal medicare.

Chart 4-3

Unemployment Insurance Recipients as a Proportion of Unemployed Workers,[1] Canada and United States, 1975 and 1984



1 Measured by dividing total benefit weeks paid by 52 times the average number of unemployed workers.

SOURCE Based on O. Ashenfelter and D. Card, "Why have unemployment rates in Canada and the United States diverged?" *Economica* 53, no. 210 (Supplement, 1986): S184-85.

On an overall basis, Canadians pay far more to maintain their UI system than do Americans. The additional costs are imbedded in the Canadian cost structure and, as such, must affect Canada's competitive position for many goods and services. At the same time, there may be specific industries or regions within Canada that do particularly well out of the UI system as a result of regional factors, as mentioned above. In our view, it makes little sense to subject these particular features of Canada's UI system to international negotiations, as the real transfers here are among individuals, industries, and regions within Canada. Indeed, it would make more sense, in our opinion, to support a hypothetical Canadian negotiating position that would see the smaller U.S. insurance requirement for unemployment as a "subsidy" to U.S. industry and, as such, one that could justify countervailing duties on imports from that country.

Health Care

There are also fears within Canada that the environment created by the bilateral trade talks will force health care onto the bargaining table. Although there will always be some Canadians who wish to see changes to our health care system and while we must keep under continuing review ways of improving it, these considerations do not make health care a legitimate item for harmonization in the sense that Canada's system has a trade-diverting effect. What are the facts?

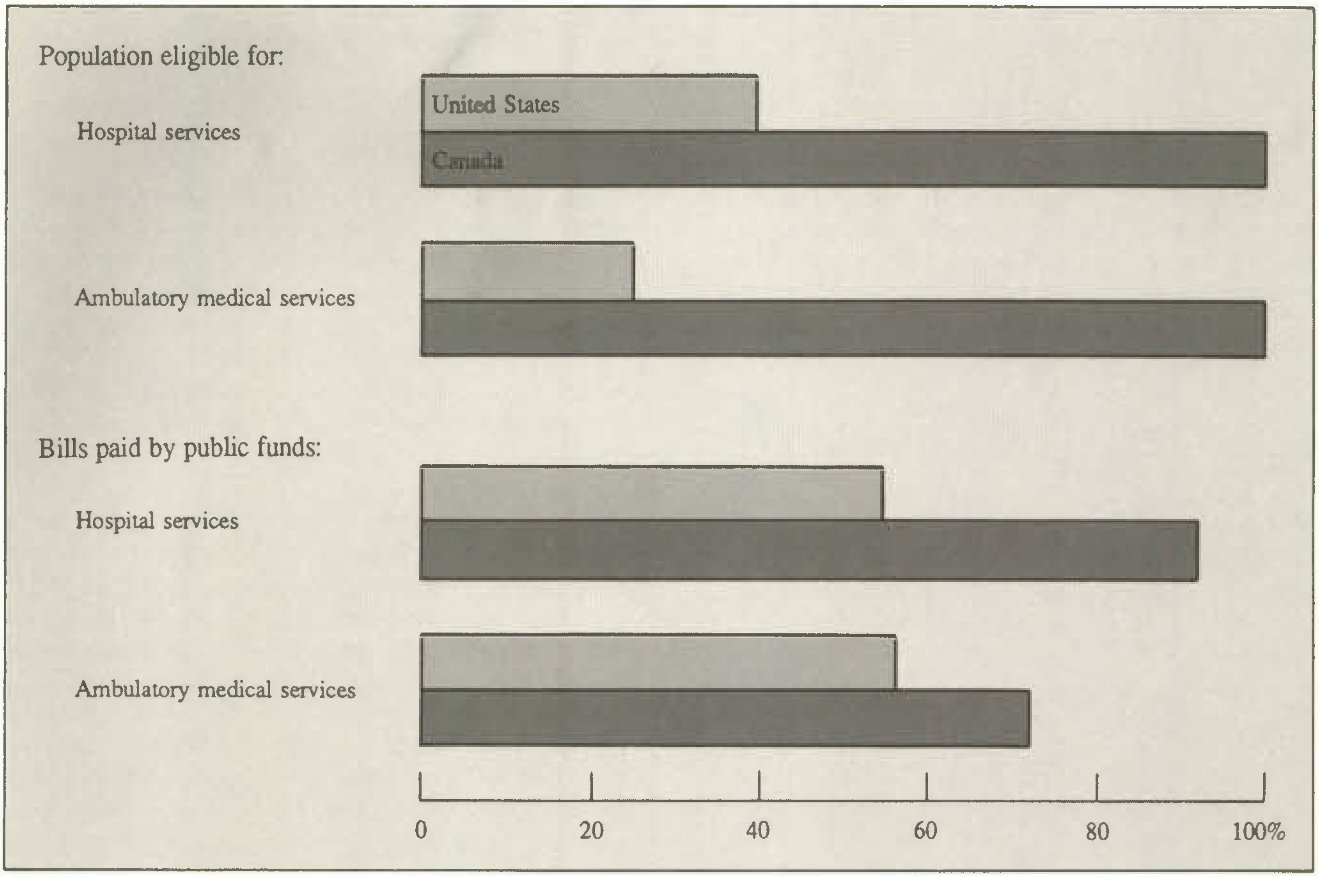
Through its 10 provincial governments, Canada has a well-developed health care system that is much admired internationally. Health care is an integral part of federal-provincial funding arrangements. Provincial health ministries administer a comprehensive insurance system that covers hospital care, medical care, and pharmaceutical costs (in most provinces). In most provinces, too, the programs are financed by individual and family premiums, combined with general tax revenues; in the other provinces, they are financed entirely from general revenues. Most hospitals are run as private, nonprofit corporations.

No matter what the yardstick, Canada's system for delivering health care is less expensive, and provides more, than its U.S. counterpart. Canadians enjoy a higher life expectancy and lower infant mortality. On a per-capita basis, taking all private and public spending into account, health care in the United States costs about one-third more than in Canada. In 1985, Canada spent 8.6 per cent of its GNP on health care and provided health insurance coverage to all; in the United States, by contrast, health care expenditures amounted to 10.6 per cent of GNP, yet millions of people in that country are without private or public coverage (Chart 4-4). In the United States, medicare is available only to persons aged 65 and over. For persons younger than that, health insurance is mostly provided under private plans, and much of the cost is carried by the employer. Private expenditures account for close to 60 per cent of health care costs in the United States, compared with about 25 per cent in Canada.

The U.S. Institute of Medicine states that 35 million Americans have no medical insurance and that the

Chart 4-4

Population Eligible for Publicly Funded Hospital and Medical Services, and Proportion of Medical Expenditures Covered by Public Funds, Canada and United States, 1983



SOURCE Based on OECD, *Measuring Health Care.*

disparities in access to health care are getting worse. The funding set aside for the care of the uninsured and needy is simply not sufficient. Medicare patients, fully covered under the federal health insurance program when it was first introduced during the 1960s, now face hefty deductibles for hospital care. Private insurance carriers and governments (combined) in the United States have been unable to contain costs for the same services to the same degree as have the federal and provincial governments in Canada.[9]

Not that they have not tried! Insurance carriers are negotiating volume discounts with health care providers and are trying to contain costs by sharing them with the beneficiaries. Federal budgetary allotments, which account for roughly 40 per cent of the U.S. health bill, have kept medicare payments flat. Hospitals have adjusted by cutting their operating expenditures. With hospital stays being shortened, with more outpatient treatment, and with reductions in admission rates, close to 40 per cent of U.S. hospital beds are empty. This overcapacity has added to the overhead and in some cases has given rise to financial losses. In the meantime, many hospitals are trying to keep afloat by raising their prices, forcing health insurance premiums up still further.[10]

Thus commercialization and cost containment under the pressure of competition have created an apparent excess of hospital facilities in the United States at a time when the health care needs of millions of Americans are not being met. Moreover, probably as a result of these cost-reducing strategies, the number of doctor-owned hospitals has declined to less than half what it used to be over the past decade. Typically these hospitals have been bought up by investor-owned, profit-oriented chains. There are now fears that the chains are skimming the "profitable patients" and dumping the unprofitable ones and the uninsured indigents, thereby threatening the financial viability of the remaining hospitals.[11]

Apart from hospital costs, there are other reasons why the health care system in the United States, which is largely privatized, is much more costly than the Canadian system. Not only are there more physicians per person in the United States (Table 4-1), but on average, they are more highly paid; and because of very considerable litigation in that country, they pay far higher liability insurance than do Canadian physicians. This is reflected in the comparison of payment schedules for selected surgical procedures. As Chart 4-5 clearly demonstrates, charges in the United States for the same operation run three to five times the Canadian equivalent. It is true that private U.S. institutions devote considerably more resources to medical research and development and are at the forefront of medical skills. Canadians benefit indirectly from the results of that research. Nonetheless, they clearly are not prepared to give up the health care advantages they now enjoy.

Table 4-1

Indicators of Health Care Utilization, Canada and United States, 1982

	Canada	United States
In-patient care (bed days per person, per year)	2.1	1.7
Hospital admission rate (percentage of total population)	14.7	17.0
Average length of stay (in-patient days per admission)	13.3	9.0
Number of persons per hospital bed	145	169
Number of persons per physician	520	498
Physician consultations per person, per year (1981)	5.5	4.6

SOURCE Based on Organisation for Economic Co-operation and Development, *Measuring Health Care, 1960-1983: Expenditures, Costs and Performance* (Paris: OECD, 1985).

Cultural Issues

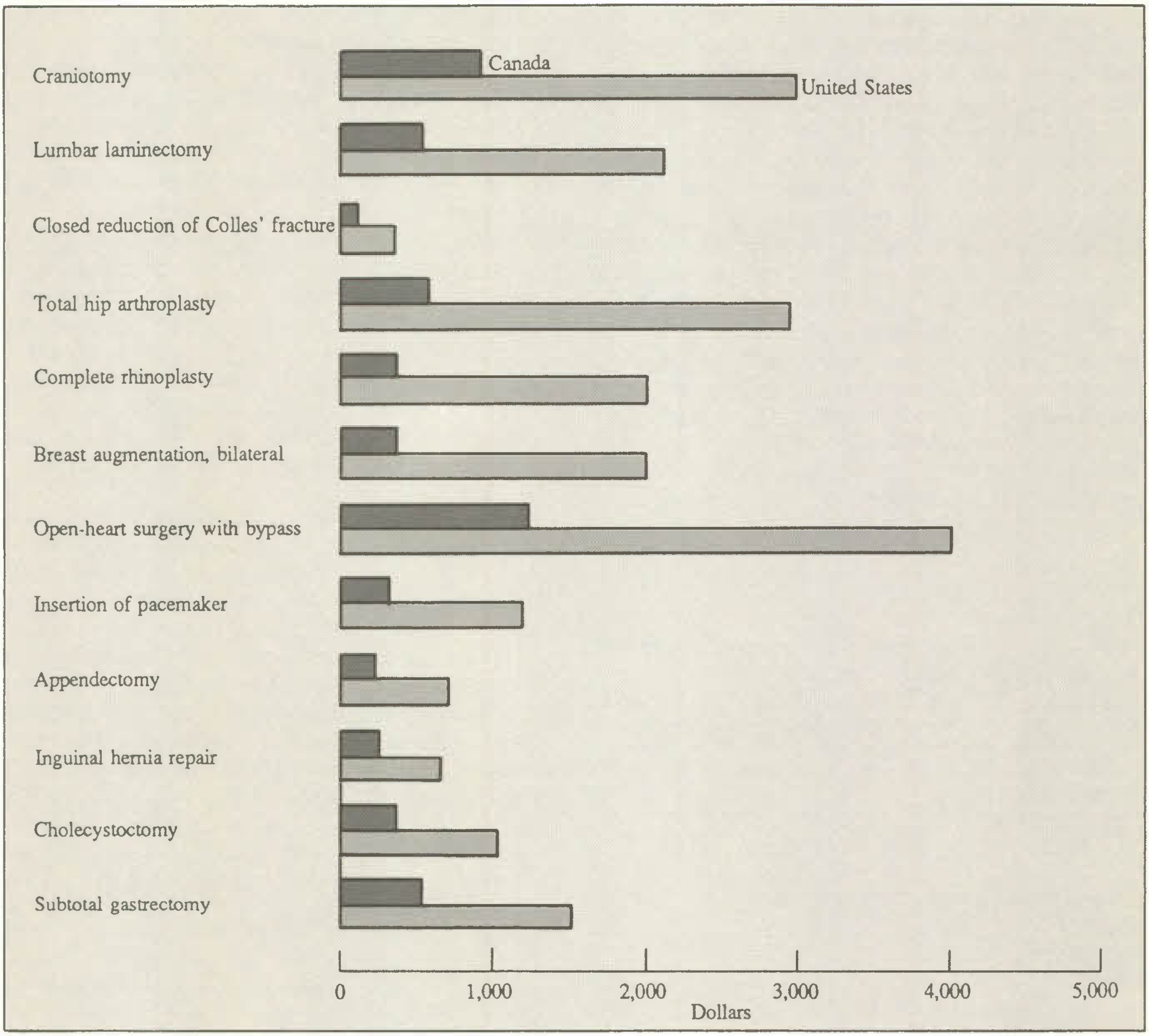
The free-trade talks with the United States have intensified concerns within Canada about what is often called "cultural sovereignty." Culture has several dimensions. Here, we are concerned with those aspects of culture – and the related people, firms, and industries – that are particularly important to the development of national unity and the continuing expression of Canadian identity. Moreover, it is only the commercial side of culture that we discuss below. Specifically, we are interested in the publication and distribution of books, newspapers, and magazines; the production and distribution of films and of television and radio programs; and the production and distribution of sound recordings. Many other important aspects of the cultural domain, including both the visual and performing arts, are subsidized in many countries, but they represent, in fact, a relatively small part of the economy of most countries. We assume that these topics have not been raised in the bilateral trade negotiations between Canada and the United States.

In general terms, the concern of many Canadians is that the current round of negotiations with the United States will further jeopardize an already very fragile – indeed, underdeveloped – group of commercial cultural industries. As will be seen below, a very high proportion of the cultural materials available in Canada are either imported or made in Canada by foreign-controlled firms. The presumption of those who are concerned is that the imported material, as well as much of the output of the foreign-controlled Canadian firms, is not representative of the way of life of Canadians. Therefore, action must be taken to ensure, at least to some minimum level, that cultural products are available that genuinely reflect the Canadian experience – the nature and legacy of things Canadian – taking account of our geography, our historical development, the role of the English and French languages in our daily life and institutions; the contribution of other cultural communities (including the aboriginal peoples), and the diversity of customs and lifestyles from one region to another. The primary objective, here, is not to create jobs in Canada or to divert trade. It is to ensure that, together with foreign cultural products, there is also substantial Canadian content available.

Governments, either federal or provincial, can mandate the content of certain cultural products. To a degree, we now have this in Canadian-content rules for radio and television. Provincial governments and school boards control, to an even greater level of detail, the content of books that are in the school curricula. But there is an understandable reluctance by public authorities to intervene in a detailed way in relation to the content of

Chart 4-5

Physicians' Payment Schedule for Selected Surgical Procedures, Canada and United States, 1986[1]



1 In national currencies.

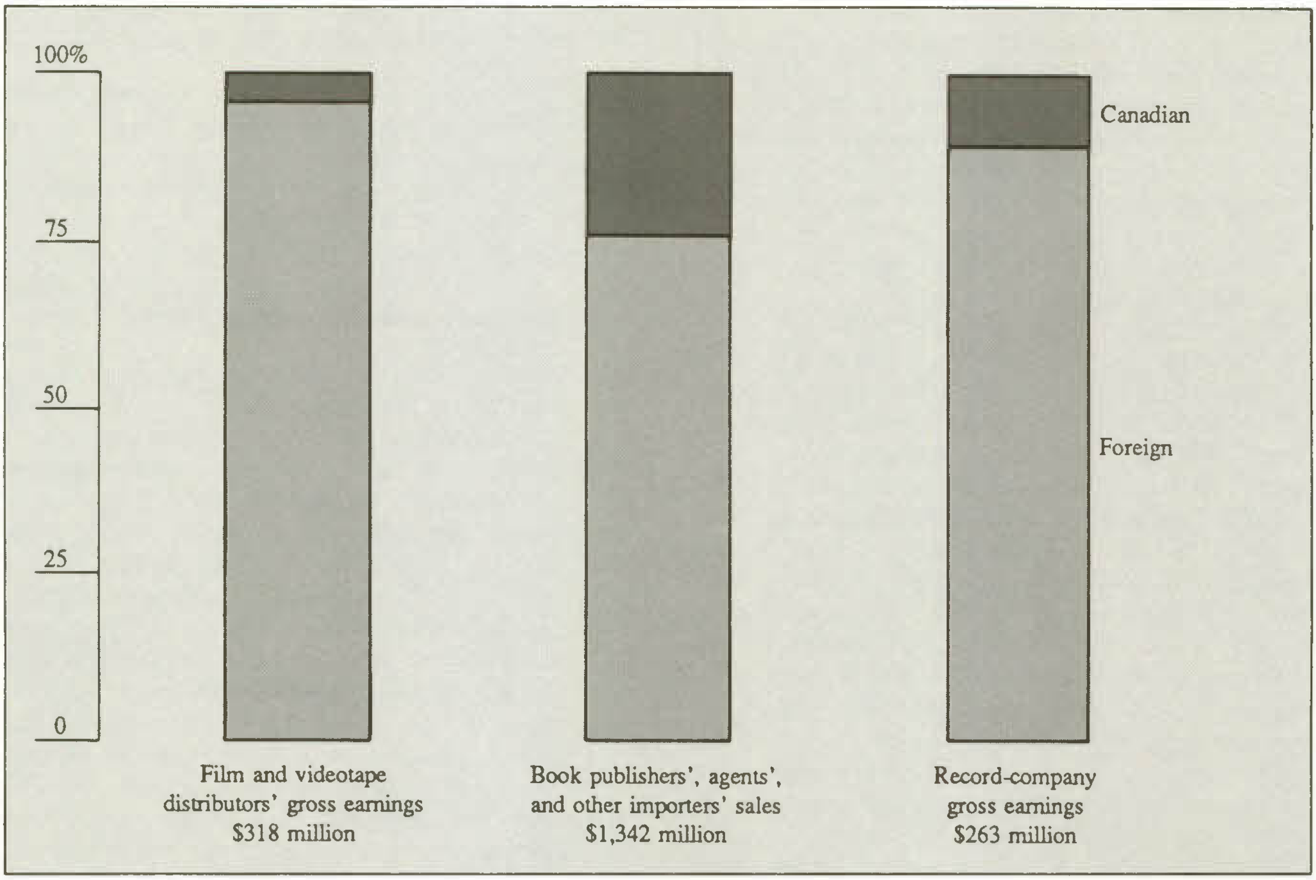
SOURCE Based on information supplied by Health Information Division, Health and Welfare Canada.

books, magazines, films, TV programs, and so on. Therefore, where there is intervention, it is generally aimed at ensuring some minimum role for Canadian-owned and -controlled cultural enterprises and, on occasion, at putting some limitation on the very high level of imports.

In considering cultural issues, it is very important to understand that Canada has not imposed major barriers to the cultural products and services of other countries. The statistics are quite clear in this respect: about 76 per cent of books sold in Canada are imported; foreign movies account for 97 per cent of Canadian theatrical screen time; over 90 per cent of dramatic television presentations are non-Canadian in origin; almost 90 per cent of sound-recording sales accrue to foreign-controlled firms; and foreign magazines account for over 75 per cent of newsstand magazine sales. Chart 4-6 shows, for 1984, the

Chart 4-6

Sales of Canadian vs. Foreign Products, Selected Cultural Industries, 1984



SOURCE Statistics Canada, "Canada's balance on international trade in the cultural sector," *Culture Communiqué*, Service Bulletin, vol. 9, no. 5 (August 1986).

extent of foreign sales in the film, book, and record sectors.

Indeed, Canada is one of the greatest importers of cultural products in the world. The overall deficit for the exchange of cultural goods for 1984 was $2.4 billion. The U.S. share of this deficit, sector by sector, is particularly striking: in the case of the trade deficit for books, 81 per cent; for newspapers and periodicals, 91 per cent; for motion pictures, 90 per cent; and for records, 52 per cent.

In Canada, the sale and distribution of most of the imported cultural products are handled primarily by subsidiaries of foreign production or distribution companies, which enables these firms to capture a good deal of the domestic revenues. In turn, this leaves Canadian-controlled enterprises chronically underfunded. The Canadian sound-recording industry, for instance, is dominated by 12 foreign-controlled firms that, in 1984, produced only 28 per cent of the Canadian-content recordings but received 89 per cent of the industry's operating profits. In the book-publishing industry, foreign-controlled firms published only 22 per cent of Canadian-authored titles; yet they accounted for 61 per cent of the industry's total revenues. And, of course, Hollywood "majors" dominate the film industry, generating about 90 per cent of the nearly $1 billion in revenues from Canada's film and video market; yet they distribute almost no Canadian films. The industry's share of revenue from the distribution of Canadian films accounted for less than 1 per cent of all film-distribution revenues earned in Canada.

The concern about content is, of course, far greater in English-speaking Canada than in the French-speaking parts of the country. For firms competing in the market for English-language products, it is clear that the overriding difficulty is the existence of an English-speaking neighbour whose economy is at least 10 times larger than ours and who is therefore able to benefit from economies of scale, either in production or marketing, that are simply unavailable to Canadian producers. While the facts vary from one cultural industry to another, it appears that, typically, Canadian-controlled firms are barely able to survive. The weak market penetration of these firms has left them undercapitalized, with low retained earnings and high ratios of debt to equity; and it has meant that financial institutions and other commercial lenders have been wary of lending them capital. This, in turn, has further restrained the effective marketing and promotion of Canadian products.

Meanwhile, the competitive environment is changing to the disadvantage of Canadian producers. In particular, the trend towards concentration is taking place through major corporate takeovers and mergers in the United States and Europe. Huge conglomerates, such as Gulf Western Industries Inc. and Coca-Cola Company, have combined to acquire interests in the cultural sector. They own Columbia Pictures and Tri-Star Pictures, Paramount Studios, Simon and Schuster, Prentice-Hall, and Famous Players Ltd. At the same time, certain cultural corporations have expanded and diversified their holdings to reap the benefits from economies of scope. For example, the consortium RCA/NBC/General Electric has moved into broadcasting and records; and CBS has extensive cultural interests, such as broadcasting, records, and magazines. At least 10 large U.S. corporations have holdings in six or more media industries – including publishing, sound recording, film production, movie theatres, network broadcasting, and cable television. Eight corporations have holdings in five media; 13, in four; and 38, in three.[12] The fears are that in an unregulated free-trade situation, the financial power and the sophisticated marketing and distribution strategies of these multinationals could well marginalize Canadian cultural products within the Canadian marketplace itself.

There are a few Canadian-controlled firms with an important position in the international marketplace. In recent years, for example, one Canadian entrepreneur has built up a very large chain of newspapers in the United States and the United Kingdom, as well as in Canada. Another Canadian businessman has successfully developed a major position in the film-distribution business. Nonetheless, some people are concerned that if Canada continues to limit the role of foreign cultural products, then our outward-looking business people may themselves be limited through the retaliatory actions of other countries. We acknowledge this point. It must also be recognized, however, that the U.S. and U.K. markets are so large that, regardless of the ownership of the enterprises that operate there, their markets will be able to command products that reflect the experiences of those countries. The same is not true when foreign-controlled firms operate in Canada. In other words, reciprocity is by no means a guarantee that our concerns about content can be satisfied. Indeed, it may have the opposite result.

Of course, with respect to industries where Canada lacks economies of scale or where there are economic impediments to growth, there is ready recognition that we may have to move out of certain lines and specialize in others to survive in the international marketplace. Canadians, however, do not believe that the marketplace alone can be allowed to dictate their ability to ensure some minimum level of Canadian cultural output.

Accordingly, to further Canada's cultural development and the share of its own industries in the domestic market, Canadian governments have intervened in a variety of ways, primarily by imposing direct restrictions on foreign competition (see Figure 4-1). These restrictions include Canadian-content regulations that inhibit the playing of U.S. television programs and music records in Canada; Bill C-58, which diverts advertising revenues from U.S. border stations by prohibiting Canadian advertisers from deducting U.S. expenditures from their taxes and which also discourages Canadian companies from advertising in U.S. periodicals; postal subsidies that provide a cost advantage to Canadian periodicals; customs rules that prohibit the entry into Canada of U.S. magazines that have more than 5 per cent of their advertising directed at Canada; the tariff on records and tapes, which forces the U.S. record companies to import master tapes and to produce records in Canada; and a capital-cost-allowance provision that allows tax incentives for Canadian film and television producers. Furthermore, Canada does not allow foreign control of Canadian TV, radio, and cable stations. Notwithstanding these particular measures and a variety of subsidies to support creative people in those industries, foreigners continue to play a very large role in the cultural marketplace in this country.

Canadians, of course, derive substantial benefits from the very wide choice and quality of U.S. films, television programs, recordings, and publications, and from the opportunity to market Canadian products and performances there. In the context of a Canada-U.S. trade accord, however, the imbalance of market power in favour of a huge, highly concentrated, and interlocked U.S. industry and the existence of a fragile, undercapitalized Canadian industry argue for continued entry barriers and government regulation if there is to be substantial Canadian content available in the market.

In the context of the current negotiations with the United States, we believe that the focus of Canadian

Figure 4-1

Protection Measures in Canada's Cultural Industries and Their Implications for U.S. Producers

	Protection measures	Implication for U.S. producers
Industry:		
TV, radio, and cable	Canadian-content regulations	Limit the play of U.S. programs in Canada. Could become more of an irritant as the CRTC demands more Canadian entertainment programs.
	Bill C-58	Diverts advertising from U.S. border stations to Canadian stations by prohibiting Canadian advertisers from deducting U.S. expenditures for tax purposes.
	Simultaneous substitution	Canadian stations can bump U.S. signals off cable when both are showing the same program at the same time.
	Cable ownership	Canadians can own U.S. cable systems, but Americans may not own Canadian systems. Neither country allows foreigners to own radio or television stations.
	Telefilm broadcast fund	Subsidizes Canadian television production, including that for sale abroad.
	Cancom	Canadian Satellite Communications Inc. picks up Detroit television signals in Windsor, puts them on satellite, and sells them, without compensating the Detroit stations. Cancom re-exports the signals to a U.S. company, which provides them to cable companies in remote parts of the United States.
Film and television production	Cable retransmission	Canadian companies do not pay for U.S. signals that they transmit over their systems. The Canadian government is sympathetic to U.S. demands for compensation and is expected to introduce some form of royalty in the revised *Copyright Act.*
	Investment Canada Act	U.S. investment in cultural industries is treated more harshly than that in other industries, even when a U.S. company merely takes over the Canadian subsidiary of another U.S. company.
	Film distribution	The Department of Communications wants to place a small category of films exclusively in the hands of Canadian distributors to provide greater support to Canadian filmmakers.
	Capital cost allowance	Represents a tax incentive for Canadian film and television producers.
Publishing	Bill C-58	Provides an incentive for Canadian companies to advertise in Canadian periodicals rather than in satellites of U.S. publications. It effectively prevents U.S. companies from owning Canadian publications that rely on advertising.
	Customs tariffs	Customs rules prohibit the entry into Canada of U.S. magazines that have more than 5 per cent of their advertising directed primarily at Canadians. This prevents U.S. periodicals from selling advertising on a Canadian split run of their U.S. editorial product.
	Investment Canada Act	The Government has specifically stated that U.S. companies acquiring Canadian book publishers, even from other U.S. companies, will have to sell control to Canadians within two years.
	Postal subsidies	Canada has an array of postal subsidies for publishers; these give Canadian periodicals a cost advantage. U.S. publications qualify for a subsidy only if they are printed in Canada.
Sound recording	Canadian-content quotas	U.S. records get reduced air play.
	Tariff on records and tapes	Impels the multinational record companies to import master tapes and press records in Canada. (The eight largest record companies in Canada are foreign-owned.)

SOURCE *The Globe and Mail*, April 4, 1987, p. D1.

concern about cultural sovereignty should be on both Canadian content and on competitiveness. Foreign ownership should be of concern only if it limits the other two factors; and trade barriers should be used not so much to exclude foreign output as to ensure some minimum allowance for Canadian content.

The Council has not carried out a detailed analysis of each cultural sector. Accordingly, we are unable to offer specific advice on each industry. To the extent that existing forms of intervention go beyond what is needed to ensure a reasonable level of Canadian content for the Canadian market, however – and this may well vary from one subsector to another – we should be willing to consider change, whether in the context of the trade talks or in any other fashion.

In short, our advice to Canadian legislators is: Canada's heritage has been founded on a wealth of multiple cultures, traditions, and relationships, combined within one nation; therefore, ensure that Canadians have adequate means and avenues to create and convey what is genuinely their own. Nevertheless, be very selective about the activities to be supported and their means of support.

Conclusion

Any reasonable set of rules that eventually govern the trade relations between Canada and the United States must be comprehensive enough to recognize that Canada has made a political choice to operate social and regional programs that, on a national basis, are more expensive than those in the United States. It also operates a health care system that is financed collectively rather than individually. More generally, publicly funded programs that are directed at redistributing income and economic activity across regions or at insuring against illness, accident, or job loss are common to most OECD nations; for that reason, they have been excluded from the GATT definition of countervailable subsidies. They are excluded because, by and large, their main objective is domestic, having little to do with international trade issues. In short, there is no case to be made for countervailing action against Canada. What is more, the Council as a whole supports the choice that Canadians have made, though we consider it our role to offer advice, from time to time, on how such programs might be improved.

As far as culture is concerned, we must point out that only the commercial culture industries are at issue. They include publishing, radio and television production, film making, and sound recording. Our analysis shows that U.S. penetration of these industries is already substantial.

Canadian government intervention in these areas reflects primarily a desire to ensure that some minimum level of Canadian content is available to Canadians. While there is some direct negotiation of content to achieve this objective, it is more commonly done indirectly, through the array of other instruments, including ownership restrictions, as described above. Such intervention, of course, may imply an economic cost to Canadians. Given the central importance of cultural products to Canadian identity and nationhood, however, we can accept that such decisions may be deemed essential.

It does not follow, however, that each sector within this group of industries needs protection. This is a matter for case-by-case consideration. The overriding objective is support for Canadian content and for viable industries that can provide that content. Among the various ways of achieving this objective, those which are the most visibly beneficial and the least restrictive are likely to be preferred.

5 Conclusions

One way or another, the next year will be a major turning point in Canadian history. If Canada is successful in reaching a free-trade accord with the United States, it will be launched on a new outward-looking track that will require major adjustments but one that also promises sustained benefits. If no trade deal occurs, Canadians will have to rethink seriously their approach to commercial policy and to international diplomacy. There is no denying that Canada is now highly exposed to an international scene that is growing more and more volatile. Events beyond our borders are shaping our present and our future. This is not a new situation; for years the health of our export industries, our monetary policy, and our exchange rate have been influenced by decisions and activities undertaken abroad – most often in the United States. What has changed in recent years is, first, the degree to which global markets are integrated and, second, the relative decline in the economic leadership of the United States. The awkward fact is that while Japan and West Germany are exercising increasingly important commercial roles internationally, neither country by itself is ready to provide commanding economic leadership. Both of these factors presage continued uncertainty in the world economy.

The United States no longer dominates world trade and financial markets. U.S. firms are being rivaled by firms from Europe and Japan, and increasingly by newly industrializing countries equipped with advanced technologies. Many large U.S. corporations have been internationalizing much of their production through offshore sourcing. At the same time, they are modernizing their domestic production facilities.

On the financial front, the United States has turned from being the world's largest source of capital to being the world's largest debtor nation, sporting the largest federal budgetary deficit in history. The Federal Reserve Board has maintained interest rates that, in real terms, are historically very high; as a result, large amounts of foreign savings have been drawn in to offset the huge U.S. trade imbalance. For almost five years, the combined stimulus of the budget deficit and lower rates of inflation has fueled a dramatic upswing in spending by American consumers on cars, housing, and other consumer goods. This has created a big appetite for imports and a large trade deficit.

Consequently, Canada has had the mixed experience of piggy-backing on a North American business-cycle expansion within a larger and longer international commodity-cycle slump. In oil, primary metals, and agriculture, substantial overcapacity has brought commodity prices to record lows. The scramble to recycle OPEC petrodollars, largely in less developed countries, has abated, and the flows of private lending to those countries have dried up. Only recently have oil prices recovered to the point where producers in western Canada are beginning to explore and invest again. In agriculture, the massive subsidization and the presence of large surplus world stockpiles mean that little relief is in sight. While some progress is being made in reducing acreage under production, we may be well into the 1990s before grain prices recover to the levels of the early 1980s.

Typically, commodity cycles tend to be fairly lengthy, as supply/demand imbalances take time to work themselves out. This is a serious handicap for Canada because of the importance of energy, agricultural, and other primary commodities to specific regions of the economy. Indeed, Canada's growth has been quite unbalanced. It has been concentrated almost entirely in the central provinces, led by export sales to the United States and by a substantial increase in consumer spending.

Low commodity prices have also crippled the Third World countries in meeting their debt-service obligations. While the most heavily indebted Latin American countries have made some headway in rescheduling their debt, a very large reservoir of indebtedness remains. With private sources for new loans dried up and the bulk of foreign savings flowing instead to the United States, many of these countries have desperate liquidity problems; they will have great difficulty in meeting their debt obligations unless their export sales and export prices recover. Their problem is exacerbated by capital flight and by extreme disparities in wealth that go beyond the disparities of income and wealth found in industrialized countries.

The growing integration of financial markets has imparted its own risks and uncertainties. Capital flows across borders are now determined to a considerable extent by the portfolio decisions of large investment funds in response to changing interest rates in different markets.

This adds extra liquidity and depth to financial markets, but it also increases volatility to such a degree that large purchases, sales, or defaults in one market are quickly transmitted to others. This, in turn, adds to exchange-rate and interest-rate uncertainty at a time when debt burdens are excessively high and debtors are therefore very vulnerable to unfavourable movements in capital flows or interest rates.

Looking ahead, the most alarming factor on the international front is the growing protectionism in the United States. The provisions of the two trade bills now being debated in the Congress are seen by many as a sign that the United States intends to alter the existing GATT rules to its own advantage, and to impose unilaterally its own rules and sanctions on world trade. The bills are highly punitive and could return western trading nations to a retaliatory trade war such as has not been seen since the 1930s.

The irony is that these bills have surfaced just as negotiations on a Canada-U.S. bilateral free-trade area are coming to a head. The timing is unfortunate. This fall, the U.S. Congress is to produce a single, joint trade bill that will then be reviewed by the President. If it is anywhere near as harsh as the two bills that have already been passed, it may be vetoed. But a presidential veto is likely to stir up enough irritation within the Congress that the latter may well feel motivated to reject any bilateral accord that might be reached. The possibility must also be considered that should an agreement be negotiated, it could be rejected by one country or another at the ratification stage. Bearing that risk in mind, we put forward, in the following sections, criteria for assessing a free-trade accord as well as policy options in the event that ratification is withheld.

U.S.-Canada Trade Issues

We have argued that it is in Canada's interest, in the face of growing U.S. protectionism, to seek out the stability for its economy that a trade accord with the United States could provide. We have shown that there would be real gains for Canadians from the type of comprehensive bilateral agreement analysed in Chapter 3, through reduced prices and higher real incomes, investment, and employment. The United States would also benefit in terms of incomes, investment, and jobs, though the gains would likely be smaller in relative terms. Since Canadian tariffs on manufacturing goods are substantially higher than equivalent U.S. tariffs, much of the adjustment would occur in the manufacturing sector. Nonetheless, the opportunities inherent in selling to a duty-free market 10 times the size of Canada, along with the possibilities for increasing productivity through plant rationalization and specialization, would strengthen Canadian competitiveness not only in North American trade but also in trade with third countries.

Should a free-trade accord be successfully ratified, we expect that it will be phased in gradually. Accordingly, we expect, in the light of past experience, that the problems of labour adjustment will be relatively small. For that reason, we reject the idea of special adjustment programs directed at the needs of the "trade-induced" unemployed only. Rather, we see a need to concentrate resources in labour market programs aimed at helping workers to move successfully from one job to another. Special emphasis should be placed on training workers for the jobs of the future and on efficient placement and advisory services, including the Industrial Adjustment Service. In addition, as we pointed out in our recent statement on technological change, Canada needs to put more effort into improving the quality of basic education so that people will learn how to learn and can therefore cope effectively with a rapidly changing workplace.

It is difficult to speculate on the form the accord will take, particularly in light of what is now known about the Congressional trade bills. The excess-capacity provisions in the Senate bill could be used in a direct and confiscatory way against Canadian resource exports, and the House of Representatives' interpretation of "unfair" subsidies is so broad and sweeping that it could encompass virtually any government program and thus be used as the basis for countervailing action against an almost unlimited number of imports. These two provisions alone are a direct threat to Canada's well-being and to its capacity as a sovereign nation to implement its own industrial and social policies.

As a medium-sized nation, thinly populated and geographically dispersed, Canada has invested a great deal of government funds in programs that are intended to spread economic growth across the 10 provinces and to ensure that social programs are both universally available and uniformly applied. Where the United States has tended to favour competitive market forces and private delivery plans, Canada has tended to rely on publicly administered services, more heavily funded from general revenues. Thus Canada has chosen a different form of financing and, in general, higher-benefit programs than those in the United States. It is quite clear that, under the Congressional trade bills, long-standing Canadian programs could be cited as justification for countervailing action against Canadian exports. Effectively, there could be an alliance between U.S. interests lobbying in pursuit of protectionist ambitions and those groups in Canada who would like to see the dismantling of some fundamental government programs.

We have pointed to three areas where Canadian programs might come under attack: regional and industrial subsidy programs, health care, and unemployment insurance. While we welcome developments that would encourage a rethinking of some of Canada's business subsidies, we believe that regional support initiatives intended to redistribute jobs and incomes within Canada are not legitimate targets for U.S. trade actions. As for social programs, they do not involve trade-diverting subsidies, and there is no legitimate basis, therefore, for the United States to attempt to force these items into the negotiating process or to attack them in some future trade action.

Finally, on the question of Canada's cultural sovereignty, we see the problem as one of a serious imbalance of resources, particularly in the English-language market. Canada has a remarkably open border on cultural matters; by and large, we are overwhelmed by U.S.-produced books, music, television, and movies. In some cases this reflects qualitative preferences; in others it does not. In many areas, such as film production, TV broadcasting, and book production, growing concentration and interlocking conglomerates in the United States leave little room for balanced competition in a free-trade environment or for sensitivity to Canadian concerns. This has prompted government intervention to ensure Canadian content. While there may be some opportunity for a resolution of specific irritations, our view is that the cultural industry, suitably defined, is one area where the terms of a Canada-U.S. accord must reflect Canada's sensitivities. At the same time, Canada may find it necessary to seek out forms of support for culture that minimize distortions to trade.

Criteria for Assessing a Trade Deal

The deadline for the Canada-U.S. negotiations is October 4th. Once an agreement is initialed by the negotiators, it will be tabled in Parliament and in the Congress for debate and ratification. This will be the most important period for Canadians. At that time, reasonable men and women will be able to study the implications of the accord for the long term, assess the balance of advantages that it gives each country, and evaluate the safeguards that will allow each country to pursue its economic and social objectives, both domestically and internationally, in ways that are free from a host of retaliatory and aggressive trade actions.

To be ratified, an accord must satisfy Canadians on a number of fronts:

1 In providing freer access to U.S. markets, it must take account of state and local barriers, as well as federal.

2 It must clearly identify areas of policy, trade, and investment that are non-negotiable, as well as domestic institutions, laws, and regulations that are beyond the reach of countervailing action.

3 It must contain clear definitions of subsidies that are countervailable, and of those that are not because they fall under the present GATT definitions of noncountervailable subsidies.

4 It should contain a dispute-settlement mechanism that would deal with trade irritants quickly and impartially.

The Alternatives

Finally, should the current trade negotiations break down before the October 4th deadline or should one country or the other decide not to ratify the agreement, we must consider what position Canada should take during the period of subsequent economic activity and trade.

The failure to reach a Canada-U.S. free-trade accord would be unfortunate but need not be catastrophic. A historic opportunity would have been lost to bring increased wealth and job opportunities to both Canada and the United States. But with almost 80 per cent of Canadian exports to the United States entering duty-free while the rest bear average duties of less than 7 per cent, and with about 65 per cent of imports from the United States entering Canada duty-free and the rest averaging duties of less than 12 per cent, both countries will remain each other's major trading partner. Under normal conditions, one could expect a continuation of the status-quo relationship. The Canadian economy would continue to grow more or less in keeping with the base-case projections outlined in Chapter 2. Fewer jobs would be created than under a free-trade regime, and incomes would be lower; but the standard of living would nonetheless continue to improve.

But these are not normal times. The danger lies in the inward-looking, protectionist mood in the Congress and among the American people. The rift on trade issues between the Congress and the Administration is real. But with the President's mandate beginning to wind down, increasingly the leverage is shifting to the Congress. Ultimately the two must agree on a trade bill. And if that legislation takes even part of the harsh line of the current Congressional trade bills, there are likely to be major trade confrontations with most western nations, including Canada. A subsequent trade war could have disastrous consequences and could eventually result in *de facto* defaults by debtor nations faced with an erosion of their export markets because of trade barriers.

What response should Canada take if no agreement is reached on an accord and if the United States elects to pursue an aggressive unilateral trade policy more or less independently of the GATT? Two options are possible. One is to take a defensive stance, countering restrictive action with restrictive action, in a series of mutually self-defeating disputes and rounds of nationalistic posturing. The other is to turn outward, using aggressive marketing and a combination of lobbying and proactive diplomacy to strengthen the multilateral commitment to trade liberalization.

The defensive option would involve a period of severe economic stress, as Canadian industry would be encouraged, as a result of retaliatory trade barriers, to concentrate on the domestic market, replacing imports and cutting exports. The trade barriers and the higher costs associated with less efficient production would raise prices and costs, reduce incomes, and curtail employment. As we showed in last year's Annual Review, the losses endured by Canada in a retaliatory trade war could be very substantial indeed.

The outward option would require a much more far-sighted and aggressive commercial policy, with Canada sounding the alarm about the risks of protectionism, encouraging Japan, West Germany, and the United States to make a more serious commitment to the current round of multilateral negotiations and pressing hard for an agreement to stop the addition of new trade barriers during the Uruguay Round of negotiations. After all, if our relations with the United States are not seriously impaired by the failure of the bilateral negotiations, there are many issues on the multilateral front on which we would naturally form a common front, such as agriculture subsidies, trade in services, and possibly intellectual property.

In reaching outward to the global marketplace, Canada would likely wish to press forward on two other fronts. First, Canadian governments and businesses would want to mobilize an even stronger and more sustained lobbying effort in Washington, in order to forestall as many protectionist actions against Canada as possible. Second, both would want to gear up for much more aggressive promotion of Canadian exports outside North America, especially in the Pacific Rim countries. There, Canadian firms would face market pressures that are even more demanding than those found in the North American context. In short, the alternative to Canada-U.S. free trade would not be the status quo but a tough and combative international marketplace. For firms and their employees, it would mean a challenging period of adaptation.

Medium-Term Outlook

Setting aside these international concerns, there are reasonable grounds for optimism about Canada's economic future. Unemployment is coming down throughout the country; in Ontario, the rates are down to levels not seen since the mid-1970s. There appears to be a renewed sense of confidence within the business community and good prospects that renewed investment in Canada may replace consumption as the engine of growth over the next several years. The recently announced Stage One of tax reform should, according to our estimates, provide some additional impetus to growth and employment.

In past Annual Reviews, we set out targets for Canada's economic performance. This year, as last year, our projections indicate that the economy is moving closer to those targets. They demonstrate that the government must continue to commit itself to a firm, steady-as-you-go policy of economic management, striving for progress on a broad front and not just with respect to a single economic objective, such as deficit reduction or lower unemployment. We repeat those targets here:

1 To achieve a trend rate of employment growth of between 2 and 3 per cent annually so as to reduce unemployment to between 6 and 8 per cent of the labour force by 1990 – that is, to relatively full employment, consistent with nonaccelerating inflation;

2 To restore a trend rate of increase in productivity, as measured by real output per employed person, of between 1.5 and 2 per cent annually;

3 To keep the trend rate of annual inflation down to 5 per cent or less, recognizing of course that there will be variations in inflation rates because of international and domestic factors;

4 To encourage a rate of domestic saving high enough to contain Canada's average dependency on net capital inflows to about 2 per cent of GNE or less;

5 To maintain the objectives and substance of the existing social policies insofar as they provide affordable benefits to Canadians; at the same time, to improve the efficiency of their delivery systems and, where possible, fill the most urgent gaps in their applications; and

6 To reduce the size of the federal deficit gradually to an easily manageable level, bearing in mind the cyclicality of the economy, and thereby to re-establish a sound fiscal relationship in the federal budget.

To these we add a seventh target – one that is, in fact, closely related to the others:

7 To achieve growth, employment opportunities, and social infrastructures that are regionally balanced.

The cohesion of the Canadian nation has been based, and still is, on the willingness of those in more prosperous regions and provinces to share with the less affluent. Canada's resources and resource-producing areas are fundamental to the long-run well-being of the nation. Yet their markets are volatile. In time of temporary or cyclical adversity, measures are needed to buttress these regional economies without impeding the longer-run adjustments that domestic and international markets require.

Apart from the very real economic and social costs inherent in the present regional imbalance, we believe that the direction in which the economy is moving is consistent with our targets, although it is unlikely that the unemployment-rate or productivity-growth targets will actually be met by 1990. We recognize that external shocks, such as a retaliatory protectionist trade war among western nations or a sharp increase in interest rates, could knock these targets seriously off course. Indeed, both the targets and the projections advanced in Chapter 2 presuppose that the U.S. government will be able to make some headway in addressing its federal deficit and that there will be enough improvement in the U.S. trade balances that the passion for aggressive and protectionist trade actions will subside.

Here in Canada, the federal government has been pursuing a policy of spending restraint without engaging in a vigorous slashing of social policies and entitlement programs. In our view, that is the right course. If our base-case projections are correct, then without the introduction of additional restraint measures or tax increases, the federal deficit will drop to 3.1 per cent of GDP, but it will not go lower until the next business-cycle expansion begins in 1991. Thus, although the trend is in the right direction, progress in deficit reduction is very slow. This obviously leaves little room for new initiatives. It also leaves the government vulnerable in the event of an early economic slowdown.

We have seen that an essential prerequisite for resolving many of the international imbalances is for the industrialized nations to sustain successfully their rates of economic growth. The same prerequisite applies to Canada's domestic economy. The structural adaptation and modernization of plant and equipment that must occur, if Canada is to remain internationally competitive, will be easier if the economy is buoyant and operates at an annual rate of real growth close to 3 per cent. In Chapter 2 we saw that a continuation of economic renewal, with real growth averaging more than 3 per cent and with healthy sales and investment in the North American economy, is a plausible though optimistic outcome. If it were achieved, such a solid economic performance would go a long way towards correcting the remaining damage caused by the 1981-82 downturn. But, while plausible, it seems to us less probable than the more moderate base-case outlook, which sees the corrections occurring more slowly.

In contrast, an early recession in the United States and in Canada could bring the current process of economic renewal to an abrupt end and send both unemployment rates and government deficits on an upward trajectory. Indeed, the ratio of federal debt to GDP in Canada would rise sharply in the pessimistic projection. The impact of stabilization programs and rising debt-servicing costs would absorb an increased proportion of government resources and leave the federal government with no room for manoeuvre at all. This vulnerability to an early downturn is a serious concern and underlines the need to make as much progress as possible on deficit reduction while the economy is relatively healthy.

Because of the constraints on the fiscal side, some have argued that federal authorities should rely more heavily on monetary policy to encourage growth, especially now that the Canadian and U.S. dollars have returned to exchange-rate levels that appear to be sustainable. But the internationalization of capital markets has effectively reduced the policy freedom that central banks have with respect to monetary instruments. The growing diversity and substitutability of financial instruments have meant that control over the money supply is no longer sufficient. Direct efforts to stimulate the economy by lowering interest rates may simply result in capital flight and in a deterioration of the Canadian dollar's exchange rate. In short, the Bank of Canada must pursue a very delicately balanced line with respect to international developments – particularly those dictated by the U.S. Federal Reserve Board – and to Canada's domestic objectives.

Moreover, as we have indicated, Canada's major problem over the next few years is that of achieving regionally balanced growth and employment. Monetary policy is relatively impotent in addressing that issue, as it cannot differentiate between regions. The recovery of commodity prices and the restoration of more favourable terms of trade will do more to correct regional imbalances than will federal remedial policies. But until those prices show sufficient recovery, there will be continuing pressure for federal fiscal initiatives. The creation of regionally based federal-provincial coordinating agencies should help in the design of sensitive policies to ensure that support programs are targeted to the most deserving groups and sectors.

Developments in agriculture have been particularly worrisome worldwide, setting in train a vicious circle whereby subsidies encourage surpluses, which drive down prices, which leads to increased subsidies that generate even greater surpluses, which are then often dumped in developing countries where they undercut domestic agriculture. We have already begun to study the question of future market prospects for grain in our research on the future of the grain economy of the Prairie region; the results of this study will be released during the course of 1988.

Reaching Outward

Whether or not the lowering of trade barriers worldwide is possible, the reality is that the high-income developed countries cannot compete in the manufacture of labour-intensive goods that can be produced more expertly and at lower costs in the developing countries. Increasingly, our competitive advantage will be in areas that involve a high degree of scientific and engineering skill and in which labour costs are a small proportion of total costs. Some commentators talk about a postindustrial society, in which advanced nations would specialize in services that would then be traded for manufactured goods produced in the industrializing countries. We do not share this view. Studies by the OECD and others have shown that about 60 per cent of commercial activity (including wholesale, retail, financial, and other commercial services) is related to the production, transportation, and distribution of manufactured goods. We have little doubt that manufacturing will remain a keystone activity of any medium-sized nation. In Canada, the introduction of automated techniques, robots, and computer-assisted production methods will change the labour force requirements of manufacturers. But industrial activity itself will continue to provide a vital and dynamic engine of domestic economic growth, constantly responding to changes in population, in consumer tastes, and in Canada's trading advantage worldwide. Here, the major responsibility falls on the private sector. Similarly, in the field of research and development and of science and technology, leadership must come from business management, and it must be supported by the universities and secondary educational institutions, as well as receive the cooperation – and ultimately the support – of labour. While in some areas Canada is a technological leader, in others it falls far behind its international competitors. As long as that remains so, Canadian productivity levels and living standards will suffer.

Finally, the spectre of protectionism and international financial instability apart, we see much on the horizon that gives cause for optimism. We have survived the worst recession since the 1930s, along with a severe drop in commodity prices that now seems to be bottoming out. Our commercial sector is leaner, and our financial institutions are more solvent. The prospects for measured growth in Canada seem firmly on track. Business investment is picking up; and unemployment is coming down, even in the most severely affected regions.

Several major federal economic initiatives appear to be heading in the right direction. The changes being introduced with respect to Canada's financial institutions should promote greater competition and provide new avenues for savings and investment. The recently announced tax-reform proposals should provide a modest stimulus to growth and employment in Stage One; when combined with a national sales tax in Stage Two, they could enhance growth in the longer term as well. The newly announced opportunity programs should provide greater reassurance to the provinces of the federal commitment to regional balance and, we hope, help to tailor federal programs more closely to local priorities and opportunities. And if a bilateral free-trade agreement is ratified early in 1988, it will provide additional impetus to growth in the medium term and put Canadian industry in a much stronger position to compete effectively in the global marketplace.

We showed in Chapter 3 that a comprehensive trade accord would bring Canadians substantial economic benefits by 1995. We shall, of course, rerun our analysis once the precise terms of the agreement are known. Our primary message in this Review is that, in a global economy, Canada has no choice but to reach outward to new markets if it is to achieve sustained growth. One way to reach outward will be to enter into a trade accord with the United States. If that should fail, for whatever reason, the other option is just as challenging, if not more so. For Canada must then define a role for a medium-sized economy in a world of large trading blocs, and Canadian industry must gear up to compete, not only in the United States but also in more distant markets. In short, the years ahead will be challenging ones whether or not Canada goes the bilateral route. Having witnessed the endurance and adaptability of Canadians through the traumas of the early 1980s, the Council has every confidence in their ability to meet the tests to come.

Comments

Dian Cohen

I believe that this year's Review makes a substantial contribution to the public debate on a Canada-U.S. free-trade agreement and more generally on Canada's prospects in a rapidly changing and uncertain world economy. It provides useful information on how individual regions, industries, and occupations would be affected by a comprehensive free-trade treaty with the United States, and in my view it rightly identifies issues where Canada should "make a stand as well as a deal." Its projections for the economic outlook seem reasonable; however, economic forecasting models, for all their usefulness, have their limitations, and events can quickly render their predictions obsolete. The Review acknowledges that the once-and-for-all free-trade scenario that is modeled is an extreme case, and not likely to be realized. Therefore, the numbers that follow with respect to detailed output and employment must also be considered extreme. Reality will probably offer much more modest rewards and raise new problems not considered here.

K. Kaplansky and D. Bellemare

This year's Annual Review is being published at a very critical time in Canada's history – one which may see the signing of a U.S.-Canada bilateral agreement to remove many of the trade barriers between our two countries. It is appropriate, therefore, that the Review focuses much of its attention not only on the potential positive impact of an agreement, but also on its possible adverse effect on social and cultural programs and policies that give substance and identity to this country.

Clearly, a carefully crafted U.S.-Canada trade liberalization agreement, with appropriate safeguards and phasing-in periods, and a mutually acceptable binding dispute-settlement mechanism, has much to offer for Canada, particularly in a trading world which appears to be increasingly protectionist. But such a trade agreement, if concluded, would only be of limited scope. It will not be a comprehensive free-trade treaty. Even though the Review correctly recognizes this in several passages, what it presents are blanket one-shot free-trade calculations, and these form the basis of the growth and employment estimates cited in Chapter 3. As an academic exercise the figures may accurately reflect the researchers' modeling methods and the assumptions that they used. But the calculations of gains are predicated on a hypothetical situation, and therefore are not relevant to the current political debate. Indeed, they distort the whole framework of this debate. The danger is that they will impart a false sense of optimism about the benefits, encourage partisan outbursts rather than rational discussion, and obscure the costs and difficulties of adjustment that must follow a bilateral trade agreement of any substance. In this sense we find far more realistic the views of experts, including former Alberta Premier Peter Lougheed, who are reported to have stated that they believe it will take at least a decade to gauge the impact of a U.S.-Canada trade pact and who doubt the possibility of ever accurately quantifying its benefits and costs.

In this connection we regret the manner in which the Council Chairman released, on August 25, Discussion Paper No. 331, which forms the basis of the simulations contained in Chapter 3. This release, despite a disclaimer, created the unfortunate impression that this working paper was endorsed by the Council; as a matter of fact it was received as such by the media and the government. We hope that this will never happen again.

If the negotiators do reach an agreement, and it is put before governments for their ratification, Canadians will wish to make sure that programs designed to promote regional balance, enhanced employment opportunities, income security, and national identity are not impaired. For this reason we support the views in Chapter 4.

But as in other years we are concerned that the Council again offers no solutions to the persistent and deplorable problem of over one million Canadian men and women unemployed. The problem is particularly acute in areas outside central Ontario, where in some places the prospects for renewed economic activity and jobs are bleaker than they have been in years. The Council has a responsibility under its mandate to make recommendations on how "all Canadians may share in rising living standards." Until the Council comes forward with specific suggestions for relieving poverty and high unemployment in the depressed regions of Canada, it is not fulfilling that mandate.

The Free-Trade Assumptions and Simulations

Most economists have a favourable prejudice towards the liberalization of trade. Economic theories stressing the advantages of free trade are very old. The arguments behind those theories can be explained in simple terms: in a world of free trade each country can allocate its human and physical resources to the production of goods and services for which it has an absolute or comparative advantage, and buy from other countries at cheaper prices those things that would be costly to produce at home. In this process of specialization of production, the argument goes, each country can improve its standard of living through a more efficient allocation of human and physical resources at the international level.

But these theories rely on many implicit assumptions. The first one is that human resources are always fully employed. Since there can be no unemployment, freer trade brings only a reallocation of labour between industries or occupations. In this ideal context of permanent and automatic full employment, it is mathematically correct to expect gains from free trade. But the exercise is only mathematical. To this mathematical exercise is added the argument that competition and laissez-faire will take care of the necessary adjustments and assure that all possible gains will be realized. This second argument is an act of faith, not of science. In reality, competitive markets have not guaranteed that human resources are fully employed. Thus while we do accept that freer trade can potentially produce gains for all countries, it is far from certain to us that the potential gains will in fact be realized.

The simulations of the hypothetical trade agreement suppose that all tariff barriers, almost all nontariff barriers on goods (including most quotas, voluntary export restraints, import licensing, customs valuation, prohibition, and contingency protection), and the domestic preferences contained in federal government procurement policies would be completely abolished. Nontariff barriers on services and prevailing subsidies are allowed to stand. Simulation 1 looks solely at the effects of eliminating the barriers on goods. Simulation 2 includes additional adjustments brought about by increases in manufacturing productivity. Both simulations demonstrate that Canada (and the United States) would gain from this hypothetical trade agreement in terms of net employment and output growth. While six or seven industries in Canada's nondurable manufacturing sector – including electrical products, leather, rubber and plastics, textiles, and knitting mills – would lose jobs, overall there would be net gains.

However, in this model the gains in jobs and income for Canada come mainly from the spending initiatives of Canadian consumers who, as the result of the agreement and the consequent decrease in the price of imports, would effectively enjoy an increase in their purchasing power. Some gains, according to this model, would also come from increased exports to the United States and from an increase in investment expenditures stimulated both by the decrease in the costs of equipment imported from the United States and the potential for Canadian exporters selling into the larger market. It is worth noting, though, that although Canadian exports would grow as the result of this hypothetical agreement, imports would increase even more, so that on balance Canada would buy more than it sells and its chronic current-account deficit would worsen.

Two assumptions are critical to the simulations. The first is that virtually all barriers to trade in goods, including the U.S. use of countervail and contingency protection, are abolished. As indicated earlier, this is not a very likely possibility. The second is that Canadian firms have effective access to U.S. federal government purchases, including defence purchases, and that their sales to the U.S. government procurement agencies be proportionate to their sales to U.S. private purchasers. But this is a very unrealistic assumption. Government procurement policies are traditionally very sensitive to domestic political and security considerations, and even if domestic preferences are officially abolished, unofficially there are many ways to maintain them. Thus if the negotiation results are limited solely to tariff reductions, the potential gains for Canadians would be very much reduced.

Because Canadian tariffs are roughly double those of the United States, this means, as the Review acknowledges, that if both countries eliminate them entirely the burden of adjustment will weigh more heavily on Canadian plants and workers. Indeed, this implies that at least part of the gains for consumers may be more than offset by the loss of income and jobs in the adversely affected manufacturing sector. The simulations avoid all adjustment problems by assuming that prices, incomes, individuals, and firms will all adjust easily and automatically. Given these very important, larger-than-life assumptions, one is surprised and disturbed that the hypothetical net gains in employment and in income for Canada, predicted by the simulations, are as small as they are.

We acknowledge that the CANDIDE model used in this report does not suppose that full employment is automatic or that all unemployment is voluntary. But it supposes that increased competition will permit the necessary adjustments without complications. We disagree with this hypothesis. In a world where unemployment is rampant, the CANDIDE model is unable to take into account the fact that Americans may take the opportunity, which a liberalized trade treaty presents, to export their unemployment by taking advantage of our tariff reductions and by developing subtle ways to protect their own private or public markets. Moreover, we respectfully contest the data presented in Chapter 3, page 40, to the effect that year in, year out, the Canadian labour market shows a remarkable degree of mobility. These data are based on Unemployment Insurance administrative records, and do not come from Statistics Canada's monthly Labour Force Survey, which is the internationally accepted data base and which tells another story.

Full Employment and the Role of Government

Our comments should not be interpreted as an objection of principle to a trade agreement with the United States. It is fair to say that in a world where permanent full employment prevails, there are important gains in the standard of living to be reaped through trade. However, since we do not have full employment we believe that Canadian governments, with the understanding and cooperation of labour and management, have a responsibility to complement trade policies with policy tools that are designed to achieve that objective. Freer trade or not, the necessary reallocation of human and physical resources to adapt to changes in market conditions does not take place automatically; and events have shown that increased competition alone will not guarantee full employment.

In this respect, Canada has a lot to learn from countries like Sweden, Norway, and Austria. Those countries export and import a higher proportion of GNP than Canada. For example, Sweden exports and imports more than 30 per cent of GDP, while this proportion is 40 per cent for Norway and over 35 per cent for Austria. These countries have understood that they can increase their standard of living through international trade, but they know that the condition for it is to maintain full employment. They have adopted the policy tools to achieve a full-employment strategy. They have understood for a long time that macroeconomic stabilization policy cannot do the job alone. Accordingly, they have accompanied it by comprehensive labour market policies and other instruments linked to regional and social development.

Sweden, for example, is well known for its efforts in the GATT sessions to facilitate the liberalization of international trade. At the same time, Swedish people know that freer trade does not have to mean harmonization among trading partners of social, political and economic practices. They know that it need not mean abandoning all public initiatives or public assistance to regions and to industries marked by special human-resource problems. And while public intervention to promote full employment may have some incidental indirect effects on the terms of trade, so do the activities of conglomerates and multinational industrial empires – activities which are largely ignored in the textbooks. In any society, governments intervene to provide economic and social benefits that exceed the economic and social costs. Such interventions are consistent with economic and social efficiency, and cannot be said to be unfair practices.

In conclusion, the federal and provincial governments, along with labour and management, must not look at the issue of a U.S.-Canada trade agreement in isolation. They should also be identifying the tools or programs necessary to implement a full-employment strategy for Canada – i.e., to guarantee the efficient use and allocation of human resources in the various regions of this country. And they should be careful that if an agreement is reached, it will fully permit the maintenance of a full-employment strategy, as well as programs intended to maintain Canada's distinct identity and to enable Canadians to share equitably the risks and opportunities that lie ahead.

The possibility of a Canada-U.S. trade liberalization agreement could offer many opportunities to Canadians. Our concern is that it be viewed realistically, and not as a magic cure for all our economic and social problems. It should be used rationally and wisely, in conjunction with a sensible recognition of the role of government and a new commitment to full employment and economic opportunity in all regions of Canada.

Raymond Koskie, Q.C.

It is with much regret that I find that the Twenty-Fourth Annual Review contains an inadequate and one-sided analysis of the free-trade question, ignores the most pressing of Canada's economic challenges – unemployment – and does not sufficiently or properly deal with the issue of tax reform.

Free Trade

The Council's approach to free trade is neither balanced nor fair. I believe its unreserved enthusiasm has led it to endorse a potential Canada-U.S. free-trade arrangement without knowing its form or content. Such haste on a question of this importance borders on irresponsibility. No definite assessment can be made of Canada's position in a free-trade agreement until the terms of that agreement are known. As the Toronto Dominion Bank recently commented in its publication, *The Economy*,

> . . . the jury is still out on whether a free trade agreement with the United States will be beneficial on balance to Canada. Many comprehensive studies have been commissioned which reflect both pro and con perspectives, and no conclusive result has been convincingly presented to date. The problem with reaching an unequivocal conclusion arises from the fact that the content and form of any trade agreement is unknown at present. (*The Economy*, Vol. 10, No. 3, Summer 1987, page 3.)

More seriously, it ignores a host of factors that could cause Canada's economic position to worsen under free trade. In particular, I would take issue with the assumptions and the analysis on the following points.

Manufacturing Productivity Gap – The Review assumes that freer trade will tend to narrow the Canada-U.S. manufacturing productivity gap. I seriously question this assumption in light of the fact that freer-trade measures implemented under the GATT during the past quarter century have failed to result in any narrowing of the Canada-U.S. manufacturing productivity gap.

Manufacturing Plants and Equipment – The Review does not make an adequate assessment of the relative strengths of Canadian and American manufacturing plants and equipment at the outset of any free-trade regime. The Council's own research establishes that American manufacturing facilities are significantly larger and more efficient than their Canadian counterparts. A free-trade deal would not only open America's markets to Canada but would also open Canada's markets to lower-cost American manufacturers, many of whom have significant excess capacity. The Council's data base does not reflect the excess capacity of American manufacturers or their stronger ability to penetrate Canadian markets.

New Investment – The Review seems to ignore that manufacturing is most economically located as close as possible to large markets and ample supplies of properly skilled labour. Manufacturers have therefore tended to concentrate their activities in areas with the largest populations. Since Canada is relatively sparsely populated, Canadian locations will be disadvantaged compared to American locations and Canada could have greater difficulty attracting new investment. To date, Canadian manufacturing locations have been attractive partly because of Canadian tariffs. Eliminating tariffs may eliminate an important incentive to locate in Canada and may be extremely costly in terms of Canada's ability to attract future investment.

Auto Pact – The Review neglects to deal with the possible impact of free trade in the auto sector. Currently, the Auto Pact provides for tariff-free trade in automobiles and parts, but provides definite guarantees for automotive manufacturing investment in Canada. No assessment is made of the impact upon Canadian manufacturing if such investment guarantees are thrown out.

Jobs – Last but not least, while the Review is quick to suggest that there will be a net job gain, I have serious concerns that the above factors will tend to reduce the number of jobs in Canada. Further, the Council is unable to provide specifics as to the types of jobs, viz., unskilled or highly skilled, poorly paid or well paid, that will allegedly be created, and this important omission cannot help but weaken its general claim that jobs will be generated. The international evidence is that liberalized trading arrangements may be of benefit where a full-employment policy is in effect, but Canada does not yet have full-employment policy. In our present circumstances, a free-trade arrangement with the United States could have serious negative consequences for employment in Canada.

This one-sided approach to free trade is particularly dangerous because of the very certain political costs that Canada will doubtlessly pay for a free-trade deal. The Council has a profound responsibility to present as balanced and as fair an appraisal of free trade as humanly possible. I do not believe that the analysis in Chapters 3 and 4 goes far enough in coming to grips with these issues.

Unemployment

Conspicuous by its absence from the Review is any urging of the government to fulfill its pre-election promise of "jobs, jobs, jobs." Canada's unemployment rate in July 1987 rose to 9.1 per cent, a completely unacceptable figure. The Council projects that unemployment will remain at 8.5 per cent between 1987 and 1991, yet it devotes no time to an examination of how Canada's ongoing unemployment situation can be improved. This, I find, is completely unacceptable.

The Council's approach to unemployment reflects a lack of sensitivity for those who have lost or are threatened with the loss of their jobs. The unemployed and their families suffer personal humiliation and a sense of social despair along with inevitable financial worries. The Council cannot begin to understand the reality of unemployment through its data bases, computer models and econometric projections. One must begin with the human side of the problem, which the Council seems completely detached from.

Canadians deserve a thorough and comprehensive analysis of how Canada can achieve full employment, including an examination of the experiences of other open international economies such as Sweden, Norway and Austria. The United States and Japan have also achieved significantly better unemployment rates than Canada, and an examination of those economies could also be helpful for the preparation of a full-employment strategy for Canada.

*Tax Reform**

It is discouraging to find that the Review does not thoroughly analyse the government's proposed tax reforms as set out in the June 18, 1987, White Paper. Contrary to the government's representations, these proposals will do little for lower income earners. Rather, the thrust of the White Paper is clearly to shift the tax burden more heavily onto the shoulders of middle-income earners. Even though tax rates on middle-income taxpayers will be reduced, this reduction will be somewhat offset by the elimination of the employment expense deduction, the conversion of tax deductions to tax credits at the 17 per cent rate, the elimination of the investment income deduction and the continuing deterioration of the value of relief for dependent children.

In fact, certain middle-income taxpayers will end up paying more tax. For example, a married taxpayer earning $30,000 in employment income with a non-working spouse, two children and $1,000 interest income will be paying 5 per cent more tax under these proposals than he does currently. The proposals to increase the tax burden on Canada's middle-income earners, while taxes on Canada's highest-income earners will fall, is both unfair and bad economic policy. Canada's middle-income earners are important mainstays of consumer demand, and their increased taxation will have a depressing effect on the Canadian economy.

Given that the debate about tax reform is now at centre stage in Canada, the Council's failure to produce a more thorough analysis of the alleged equity of the taxation proposals is distressing. The proposed elimination of the employment expense deduction, for instance, will work a serious unfairness on workers. Canada's tax regime has historically taxed employees' gross incomes, whereas it has allowed business persons to claim all necessary deductions so that they are taxed on their net incomes only. The $500 employment expense deduction was a small and inadequate way to recognize that employees also have expenses in earning their incomes and they should be allowed some deduction so that they too are taxed on their net, not their gross, incomes. But rather than putting employees and business persons on an equal footing for tax purposes, the White Paper proposes to completely abolish the employee expense deduction (*Tax Reform 1987: Income Tax Reform*, June 18, 1987, page 88). The removal of this deduction will net the government some $975 million in extra tax revenues in 1988 alone. The elimination of this deduction is the single largest revenue generator proposed by the government in its White Paper and is a grossly unfair and seriously regressive step.

As well, the White Paper has proposed to introduce a comprehensive sales tax in Canada. Although the specific proposal is not yet known, its basic principles deserve some comment. A sales tax which is not based on ability to pay but is rather levied regardless of the consumer's financial capacity, is seriously regressive. This tax will have an inflationary impact, and will risk commencing or accelerating a wage-price spiral. Finally, this tax will have the inevitable consequence of depressing aggregate consumer demand. These basic features of the sales tax deserve careful attention at this stage in Canada's tax reform debate, otherwise it will be a situation of too little too late.

* The Chairman of the Council submitted a brief which analysed the implications of the White Paper on Tax Reform to the House of Commons Committee on Finance and Economic Affairs on August 31, 1987.

A The Base-Case Assumptions

External Economic Conditions

The future performance of Canada's major trading partners, especially that of the United States, is critical in assessing this country's medium-term prospects. While the U.S. share of Canada's total trade is higher than the Canadian share of U.S. total trade, each country remains the other's largest trading partner. The integration of financial markets is also substantial, with funds moving between the two countries on a daily basis in search of the highest rate of return that either market has to offer.

As the economic expansion has matured in the United States, sectoral imbalances and regional stresses have increased. Falling oil and commodity prices have had negative impacts on activity in the southern and midwestern states, while the coastal regions, in particular the northeast, have prospered. The federal deficit and the trade deficit have come to dominate public debate in the United States, resulting in developments such as the *Gramm-Rudman-Hollings Act* (a phased plan designed to eliminate the federal deficit) and the present Budget Resolution debate. Growing protectionist sentiment and frustration over the $145-billion trade deficit culminated in the "Gephardt Amendment" to the U.S. House of Representatives' omnibus trade bill and other such measures. The Senate version of the omnibus trade bill is just as tough. While both versions contain strong protectionist elements, political considerations could lead to emphasis on both export creation and competitiveness – aspects supported by the Administration – rather than on retaliatory measures or measures aimed at restricting trade with partners who currently run large surpluses with the United States. It is against this background of stress and imbalance that U.S. economic prospects should be examined.

We expect real growth in the United States to average about 2.7 per cent during the period 1987-88 (Table A-1). This includes some strengthening of export growth as the long-awaited correction of the U.S. trade deficit, brought on by the devaluation of the U.S. dollar vis-à-vis the yen and the mark, gains momentum. Also anticipated is moderate strength in consumer spending (although new auto purchases are expected to be at a lower level), as real incomes continue to improve and the saving rate remains low. Increased export opportunities and tighter capacity

Table A-1

External Environment Assumptions, 1986-91 (Base-Case Projection)

	1986	1987	1988	1989	1990	1991	Average 1987-91
				(Per cent)			
Change in:							
Real GDP in the OECD area	2.5	2.4	2.9	2.0	1.0	4.3	2.5
International price of crude petroleum (in U.S. $)	–46.4	27.5	1.8	2.8	3.2	2.4	7.5
U.S. real GNP	2.5	2.4	3.0	2.0	0.6	4.7	2.5
U.S. consumer price index	1.9	3.9	4.7	5.1	4.9	4.3	4.6
U.S. industrial production	1.0	2.2	3.2	1.9	–1.8	5.4	2.2
Level of:							
U.S. unemployment rate	7.0	6.5	6.3	6.5	7.6	6.8	6.7
U.S. short-term interest rate[1]	6.5	6.7	7.5	8.6	7.2	6.9	7.4

1 Prime commercial paper rate.
SOURCE Estimates by the Economic Council of Canada, August 1987.

constraints are expected to strengthen the current lacklustre performance of investment spending, despite the negative impact that may result from the redefinition of the corporate tax base following the 1986 U.S. tax reform. During the period 1989-91, we expect a pause in real growth (with GNP increasing by only 0.6 per cent in 1990), continuing inflationary pressures averaging close to 5 per cent, and somewhat higher interest rates.

The Federal Reserve Board is expected to continue to emphasize growth while maintaining a vigilant attitude towards inflation. A tightening of monetary policy is anticipated in 1988-89 in reaction to moderate price pressures. Continuing downward pressures on the U.S. dollar will lead to weakened domestic growth and higher interest rates. Attempts at policy coordination among the G-7 countries to stabilize exchange markets and reduce real interest rates (such as the Plaza Two Accord and the Louvre Agreement) are expected to continue. The success of these activities depends, however, on the strength and direction of forces fundamental to the market – differentials in inflation rates, interest rates, and productivity growth among the G-7 countries.

Despite the $26-billion reduction in the U.S. federal deficit expected in 1987, the Budget Resolution debate points to serious concerns in Congress about the huge fiscal imbalance. The spirit of the *Gramm-Rudman-Hollings Act* motivates these concerns, but our judgment is that the targets will not be reached in the medium term. While continued spending restraint is expected in the short term, some increase in nondefence expenditures is anticipated before 1989. Given the present Administration's aversion to tax increases and the prospect of only moderate growth in the medium term, no further progress in deficit reduction is expected until a $40-billion personal and corporate tax increase comes into effect shortly after the next presidential election. The deficit will remain under 4 per cent of GNP over the projection period; it will fall below $170 billion in late 1991, which suggests continued reliance on foreign capital.

Because of the greater integration of the global economy, particularly in financial matters, the United States could be seriously affected by a world slowdown. The dramatic reduction, and recent partial recovery, in international oil prices has been a double-edged sword, often adversely affecting both oil-producing and oil-consuming countries. Heavily indebted nonproducing countries have experienced reduced import costs, but they have also suffered from leaner export earnings resulting from depressed world activity. Indebted oil producers have seen reduced oil revenues, which has made them less able to meet debt-repayment schedules and has reduced their consumption of foreign goods, largely from OECD countries. The recovery in prices will tend to offset some of these revenue losses while weakening an already sluggish world economy. The Third World debt problem is less threatening than it was five years ago, but a collapse of the efforts to deal more adequately with repayment problems would ultimately impact on the OECD countries, in particular the United States. We have assumed that the crisis environment surrounding this problem continues to ease through various programs of conventional and more innovative debt-repayment schedules satisfactory to all parties, such as are now being discussed within international financial circles and the U.S. Administration.

The outlook for our overseas trading partners mirrors many of these same stresses. Real growth in France and the United Kingdom is anticipated to be quite weak in 1988-89. Activity in West Germany and Japan is expected to be more in line with U.S. growth prospects, although the growth rates in these two countries are likely to be lower than those which the U.S. Administration might desire. This lacklustre performance for the world economy reflects, in part, a cautiousness born of earlier misadventures together with real interest rates that are historically very high.

The Energy Sector

With the success of recent OPEC action in setting production quotas designed to bring order to world supply conditions, world crude-petroleum prices have recovered, to stabilize at about US$19-$20 a barrel. This reassertion of OPEC influence has been reinforced by increased demand in response to the lower prices now prevalent in most countries. Oil consumption in the OECD area increased by 2.3 per cent in 1986, with a growing proportion being purchased from the OPEC countries.

Our base case anticipates that crude oil prices will average US$19.16 per barrel in 1987, representing a real-price increase of close to 24 per cent over the 1986 average price. We expect the price of crude oil to increase only marginally in 1988 (1.8 per cent), with no real-price gain in the subsequent three years. By 1991 the price is expected to average US$21.18 – still considerably below the 1985 level. Thus only modest upward pressure will be exerted on the inflation rates of OECD countries by petroleum prices. Given current world supply-and-demand conditions, coupled with the OPEC philosophy, it is realistic to assume that orderly pricing activity on world markets for crude petroleum will continue until at least the early 1990s, although the risk of political crisis or military conflict in the Middle East will remain.

With the reduction in oil prices and the gradual deregulation of natural gas prices, the price of natural gas is expected to remain in its current range until 1988, after which time its increments will track those of the price for crude petroleum. This results in a depressed picture for natural gas revenues – a matter of considerable concern to the gas-producing community; this concern is exacerbated by the competitive pressures in the U.S. market, as well as by an unfavourable regulatory environment.

The phased deregulation of oil and gas prices, combined with the prevailing system of federal and provincial energy taxation, has meant that the Canadian economy has not benefited from falling energy prices to the same extent as other countries. Estimates put the price reduction to the consumer in Canada at 6.2 per cent in 1986 (Table A-2), even though world prices have fallen by a much larger percentage. After stabilizing in 1987, domestic prices are expected to increase by 5.8 per cent annually during the period 1988-91. Canadian energy consumption is expected to increase by 1.1 per cent in 1987, with demand growth then averaging about 1.8 per cent per year during the period 1988-91 and with increasing reliance being placed on imported oil as Canadian oil productive capacity declines.

The recent recovery in prices has made profitable a larger proportion of nonconventional oil and gas production, particularly in enhanced-recovery areas. Oilsands producers (such as Suncor and Syncrude) are undertaking limited expansion, facilitated by government assistance and considerable belt-tightening by the companies. With some international price stability in view and a new, temporary program of cash subsidies for exploration and development, a resurgence in conventional oil and gas drilling activity is anticipated, resulting in the return of an increasing portion of the industry to viable, yet leaner, health. This picture is reflected in our base-case energy-investment profile.

The serious reduction in the level of exploration activity is clearly illustrated by the 39 per cent decline in oil and gas mining investment that occurred in 1986. We expect some recovery in investment expenditures, averaging a 1.8 per cent real growth rate during the period 1987-91. This will allow a moderate expansion in conventional exploration activity but will defer nonconventional activity beyond the projection period. While not as dramatic, investment spending by Canada's large electric utilities sector declined by close to 3 per cent in 1986. We anticipate some gradual recovery in the medium run,

Table A-2

Energy Assumptions, 1986-91 (Base-Case Projection)

	1986	1987	1988	1989	1990	1991	Average 1987-91
				(Per cent)			
Change in:							
Prices							
Crude petroleum – import price (in Canadian $)	–43.0	9.5	1.6	3.0	3.6	3.3	4.2
Energy – consumer expenditure deflator	–6.2	1.1	5.2	6.5	6.7	4.7	4.8
Natural gas – export price	–22.5	–18.9	2.3	3.4	3.4	2.8	–1.4
Demand							
Energy – consumer expenditure	3.0	1.1	3.0	2.9	–0.7	1.8	1.6
Natural gas – exports	–17.5	24.8	3.1	2.0	2.0	2.0	6.8
Investment							
Oil and gas mining							
Construction	–37.3	–7.7	6.6	4.8	4.3	2.0	2.0
Machinery and equipment	–50.9	–9.9	6.8	1.7	2.6	0.6	0.4
Utilities							
Construction	3.1	–1.0	8.8	4.1	0.0	0.0	2.4
Machinery and equipment	–10.7	7.7	10.2	4.3	0.1	0.0	4.5

SOURCE Estimates by the Economic Council of Canada, August 1987.

providing for an average growth rate of 3.2 per cent in the base case – a growth rate that remains modest by historical standards.

Domestic Fiscal and Monetary Policy

As has been the case for several years, fiscal policy at all levels of government can be characterized by spending restraint, supplemented by the introduction of fiscal measures (the increased use of surtaxes) designed to reduce budget deficits. The federal budgets of 1985 and 1986 took concrete steps to accelerate the reduction of the federal deficit through increased taxation and reduced spending. While provincial governments followed similar strategies, the impact of depressed energy and farm prices increased regional stress in budgetary matters, also influencing federal plans.

The current base case incorporates existing legislation in past federal budgets, including that of February 1987 and Stage One of the June 1987 tax reform proposals (Figure A-1). All provincial budgets in effect in July 1987 are also included. Since the fiscal agendas are influenced by factors such as indexation, interest-rate changes, and real activity levels, the base-case outlook for inflation, international oil prices, interest rates, overall economic activity, and unemployment will play a major role in the outcome of any deficit-reduction strategy. These factors will continue to influence government revenues and expenditures, irrespective of the government's determination to follow a particular fiscal plan.

In accordance with the emphasis on overall restraint, growth in public-sector wages has been held in line with growth in the consumer price index. Thus we expect no real gains for these wages, with the average growth rate for the projection period anticipated to be 1.4 per cent. We have also assumed a continuation of the present restraint in spending on real goods and services, although there will be variations between governments. Growth in government spending is set below the general growth of the economy; as a result, it will decline as a share of GDP in most instances, and in no instance will it increase.

The Bank of Canada is assumed to continue its present policy, which balances the need for lower interest rates with activities associated with maintaining order in the market for the Canadian dollar. We anticipate that such a policy stance will also be guided by developments on the inflation front. Here, we expect that the Bank will act to quell any possible resurgence of inflation, if its assessment of developing price trends so warrants. Exchange-rate considerations, we anticipate, will ensure that Canadian nominal interest rates move more or less in tandem with those of the United States.

Figure A-1

Domestic Policy Assumptions in the Base Case

Energy pricing

- Crude petroleum and natural gas pricing as per the 1985 Western Accord and the subsequent Agreement on Natural Gas Prices.
- The pricing of domestic crude petroleum and natural gas is closely related to international pricing developments, as natural gas pricing was deregulated on November 1, 1986.

Tax policy

- All tax schedules (personal, corporate, and indirect) announced in preceding budgets and in the June 1987 White Paper on Tax Reform are incorporated as of July 1987.
- Energy taxation schedules as per the Western Accord, the natural-gas pricing agreement, and subsequent taxation amendments.
- The petroleum and gas revenue tax is phased out as indicated in the Western Accord and subsequent amendment schedules.
- The motive-fuels excise tax is implemented as per the 1985 Budget and subsequent amendments.
- All provincial budgets as of July 1987 have been incorporated.

Expenditure policy

- Government spending on goods and services is restrained, with annual increases in real expenditures averaging as follows:
  - federal government wage spending, 1.4 per cent (civilian, 1.5 per cent and military, 0.9 per cent) and nonwage spending, 2.8 per cent;
  - wage spending by all other government levels (provinces, municipalities, and hospitals), 1.5 per cent; nonwage spending, 3.1 per cent.
- The current prices of goods and services are set in line with growth in the consumer price index at about 4.3 per cent per annum; and those of government fixed investment are set at 3.5 per cent per annum.
- Transfer payments are indexed as legislated.
- Federal spending associated with capital assistance and subsidies reflects existing government policy.

Monetary policy

- Canadian interest rates are in line with U.S. rates.
- The money supply is accommodating, but some tightening of monetary policy occurs in 1989.

B Figures

Figure B-1

Adjustments Made in CANDIDE Model 3.0 to Develop Canada-U.S. Free-Trade Scenarios

	Simulation 1: Removal of tariff and nontariff barriers	Simulation 2: Removal of tariff and nontariff barriers, plus industry-specific productivity improvements
Canadian tariffs	Removal of Canadian post–Tokyo Round tariff rates is introduced by adjusting import prices. This adjustment has the effect of increasing imports from the United States, thus reducing domestic prices and increasing real wages, consumption, output, and employment.	Same as in Simulation 1
Canadian nontariff barriers	Removal of Canadian nontariff barriers (quotas, voluntary export restrictions, countervailing duties, antidumping safeguards, customs valuation, health and safety standards, and import licensing) is introduced by adjusting import prices (tariff equivalents). This adjustment has the effect of increasing imports from the United States and reducing domestic prices, thus increasing real wages, consumption, output, and employment.	Same as in Simulation 1
U.S. tariffs	Removal of U.S. post–Tokyo Round tariff rates is introduced by adjusting export volumes. Changes in export volumes are computed in accordance with changes in export prices (implied by the changes in tariffs), base-case export volumes, and export-price elasticities. In most of the cases, CANDIDE export-price elasticities are used. In a few cases where CANDIDE elasticities take on extreme values, we have constrained them to unity. This adjustment has the effect of increasing exports to the United States, thus increasing domestic output and employment as well.	Same as in Simulation 1
U.S. nontariff barriers	Removal of U.S. nontariff barriers (same coverage as the Canadian NTBs) is introduced by adjusting export volumes. Changes in export volumes are computed in accordance with changes in export prices (tariff equivalents), base-case export volumes, and export-price elasticities. This adjustment has the effect of increasing exports to the United States, thus increasing domestic output and employment.	Same as in Simulation 1
Government procurement	Liberalization of federal government procurement practices (including defence) in the two countries is introduced by adjusting import and export volumes (commodity-specific). This adjustment has the effect of increasing net exports to the United States, thus increasing domestic output and employment.	Same as in Simulation 1

(cont.)

Figure B-1 (concl.)

	Simulation 1: Removal of tariff and nontariff barriers	Simulation 2: Removal of tariff and nontariff barriers, plus industry-specific productivity improvements
Scale and rationalization effects		Gains in total factor productivity in manufacturing industries resulting from scale economies and rationalization are introduced by adjusting output and employment. For each of the manufacturing industries, only half of the potential gains in productivity resulting from rationalization are introduced in simulating the impact of Canada-U.S. free trade on output and employment in Canada. This adjustment has the effect of reducing domestic prices, thus increasing real wages, net exports, consumption, output, and employment.[1]
Timing	Free trade, starting in 1987 (all trade barriers are removed in 1987).	Same as in Simulation 1
Government revenue	Neutral effect: the revenue shortfall caused by the removal of Canadian custom duties is offset by increased personal income taxes.	Same as in Simulation 1
Harmonization of national economic policies	There will be *no* harmonization of economic policies under free trade. Fiscal policies and regulation of services are not affected by free trade.	Same as in Simulation 1

1 Estimates of potential cost savings (total-factor-productivity improvement) resulting from rationalization in the 20 manufacturing industries, based on total-costs data (gross output), are displayed in the fourth column of Table 3-4. As discussed earlier, these estimates assume that under bilateral free trade with the United States, all the suboptimal plants, through consolidation, will move to or above the minimum-economic-size levels. However, the actual cost saving in the manufacturing industry resulting from restructuring could be significantly less than the potential gains reported in Table 3-4 for the following reasons. First, these estimates are based on 1979 census data. Since then, high real interest rates, a severe recession in 1981-82 and the weak recovery thereafter, and increased competition from imports have forced many companies to rationalize their operations, which means that some of the estimated gains from consolidation may already have been realized. Second, the observed constancy of the Canada-U.S. manufacturing productivity gap over the period 1965-86 and the costs of restructuring (layoff of workers, plant closures, and so on) suggest that the actual gains in productivity could fall short of the potential gains. Finally, because of the rapid pace of technical change in communications, electronic media, and product innovations, the size of the plant is becoming less important in productivity enhancement. For each of the manufacturing industries, only half of the potential gains in productivity resulting from rationalization are introduced in simulating the impact of Canada-U.S. free trade on output and employment in Canada.

Figure B-2

Subsidies Reviewed by the U.S. International Trade Administration in Its Final Report on the Atlantic Groundfish Case, 1986

Programs that confer a subsidy:

- Fishing Vessels Assistance Program
- Programs of the Promotions Branch of the Department of Fisheries and Oceans
- Assistance for the construction of ice-making and fish-chilling facilities
- Certain types of Investment Tax Credits
- Programs for Export Market Development
- Regional Development Incentives Program
- Industrial and Regional Development Program
- Fisheries Improvement Loan Program: Loan guarantees
- Grants to fishermen and fish processors from Special Recovery Cost Project Program (SRCPP) funds by the Department of Fisheries and Oceans
- Preferential user fees to fishermen under the Small Craft Harbour Program
- Government equity infusions into National Sea Products Ltd. and Fishery Products International Limited (FPIL)

(cont.)

Figure B-2 (concl.)

Joint federal-provincial programs:

- Agriculture and Rural Development Agreement
- P.E.I. Comprehensive Development plan
- General Development Agreements
- Transitional programs
- Economic and regional development agreements
- Interest-free loans to National Sea Products Ltd.

Provincial programs:

New Brunswick

- Loans from the Fisheries Development Board
- Fish-unloading systems and ice-making program
- Insurance Premium Repayment Program
- Interest-rate rebates
- Technical services

Newfoundland

- Grants for purchasing and constructing boats
- Grants for the rebuilding and repair of fishing and coastal vessels
- Grants to cover operating expenses
- Loans and loan guarantees from the Fisheries Loan Board
- Operating of fisheries facilities and services
- Construction and repair of fisheries facilities
- Enhancement of fishing operations
- Marketing assistance

Nova Scotia

- Fishing Vessel Construction Program
- Loans from the Fisheries Loan Board
- Industrial Development Division grants
- Market development assistance

Prince Edward Island

- Fishing Vessel Subsidy Program
- Near and Offshore Vessel Assistance Program
- Engine Conversion Program
- Commercial Fishermen Investment Incentive Program
- Assistance for the construction of ice-making and fish-chilling facilities
- Fish Box Pool Program
- Technical Upgrading Program
- Fresh-Fish Marketing Program
- Fishing-Industry Technology Program
- Technology Improvements Program
- On-board Fish Handling Systems Program

Quebec

- Vessel Construction Assistance Program
- Gear Subsidy Program
- Insurance Premium Subsidy Program
- Large Vessel Construction Program
- Loans from the Ministry of Agriculture, Fisheries and Food
- Grants for engine purchases
- Grants for fish transport and seafood processing tanks
- Grants to processing enterprises for capital equipment
- Ice-making and fish-chilling assistance

SOURCE Alan M. Rugman and Andrew Anderson, *Administered Protection in America: Implications for United States-Canadian Trade Policy* (Montreal: Institute for Research on Public Policy, 1987).

Notes

Chapter 1

1 J. N. Bhagwati and D. A. Irwin, "The return of the reciprocitarians: U.S. trade policy today," *The World Economy* 10, no. 2 (June 1987).

2 See W. J. Baumol, "Productivity growth, convergence and welfare: What the long-run data show," *American Economic Review* 76, no. 5 (December 1986); and A. Maddison, "Growth and slowdown in advanced capitalist economies: Techniques of quantitative assessment," *The Journal of Economic Literature* 25, no. 2 (June 1987).

3 The U.S. House of Representatives bill is entitled *Trade and International Economic Policy Reform Act of 1987* (H.R.3), while the Senate bill is called the *Omnibus Trade Act of 1987* (S.490). Both bills refer in their subtitles to fair and open trade, but H.R.3 includes reciprocity, whereas S.490 identifies a balance between benefits and concessions within sectors as a major objective.

4 Bhagwati and Irwin, "Return of the reciprocitarians."

5 J. Frankel, *International Capital Flows and Domestic Economic Policies*, National Bureau of Economic Research, Working Paper 2210 (New York: NBER, April 1987).

6 M. Feldstein, "Muddling through can be just fine," *The Economist* (June 27, 1987):25.

7 Frankel, *International Capital Flows.*

8 For example, Japanese car makers now have sufficient assembly capacity in North America to replace millions of units imported from Japan in recent years. The appreciation of the yen makes "made-in-Japan" automobiles considerably less price-competitive in the United States.

9 European Management Forum, *1986 World Competitiveness Report* (Geneva: EMF, 1986), cited in J. R. D'Cruz and J. D. Fleck, "The 1986 EMF scorecard on Canada: Mixed, but encouraging," *Business Quarterly* 51, no. 2 (Summer 1986):85.

10 For example, thanks to electronic developments, it has been estimated that "the costs of processing and transmitting information have declined by as much as 98 per cent in the past 20 years." See Bank for International Settlements, *Recent Innovations in International Banking* (Basle: BIS, 1986), p. 195.

11 J. Williamson, "Exchange rate management: The role of target zones," *American Economic Review* 77, no. 2 (May 1987):200.

12 C. Goodhart, "Financial innovation and monetary control," *Oxford Review of Economic Policy* 2, no. 4 (1987):100.

13 These figures have been calculated on the basis of the annual reports of the individual banks.

14 *The Globe and Mail*, August 22, 1987; the figures are for August 1987 and were provided by Merrill Lynch.

15 Economic Council of Canada, *Making Technology Work: Innovation and Jobs in Canada* (Ottawa: Supply and Services Canada, 1987).

Chapter 2

1 J. W. Crow, Reprint of a luncheon address to the Calgary Chamber of Commerce, May 19, 1987, in *Bank of Canada Review* (May 1987):30.

2 The federal government's proposals for tax reform are to be implemented in two stages. Stage One encompasses changes to the personal and corporate income tax systems, while Stage Two is concerned with sales tax reform. See M. H. Wilson, *Tax Reform 1987: The White Paper* (Ottawa: Department of Finance, June 1987).

Chapter 3

1 Economic Council of Canada, *Changing Times*, Twenty-Third Annual Review (Ottawa: Supply and Services Canada, 1986).

2 S. Magun, S. Rao, and B. Lodh, "Impact of Canada-U.S. free trade on the Canadian economy," Discussion Paper 331, Economic Council of Canada, Ottawa, August 1987.

3 In August 1987, the U.S. Department of Commerce handed down a preliminary ruling that antidumping duties of up to 85.2 per cent should be imposed on Canadian potash exports to the United States. In another action, the U.S. International Trade Commission found no grounds for applying countervailing duties on Canadian exports of live cattle and beef.

4 See Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

5 "Under a nonrecourse loan, a farmer obtains a loan at a specified level on the amount of his wheat or corn or rice that he pledges as security. The ordinary loan is for a period of less than a year. At the time the loan becomes due, the farmer has the right to pay off the loan with interest and recover his security (the product pledged) or to deliver the farm product to the government and have the loan cancelled. He chooses the second alternative when the market price is below the loan rate. It is the loan rate that sets the minimum price of the market, and in the case of grains, significantly influences the level of the minimum world market prices." In D. G. Johnson, K. Hemmi, and P. Lardinois, *Agricultural Policy and Trade: Adjusting Domestic Programs in an International Framework*, A Report to the Trilateral Commission (New York: New York University Press, 1985), pp. 10-11.

6 See, in particular, Economic Council of Canada, *Looking Outward: A New Trade Strategy for Canada* (Ottawa: Information Canada, 1975), Chapter 3.

7 See Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

8 Economic Council of Canada, *The Bottom Line: Technology, Trade, and Income Growth* (Ottawa: Supply and Services Canada, 1983), p. 118.

9 Economic Council, *Making Technology Work.*

10 See Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade."

11 M. Robertson, "Perspectives on labour adjustment in the Canadian economy," Employment and Immigration Canada, Ottawa, February 1987, mimeo.

CHAPTER 4

1 Malcolm Baldrige, "Remarks before the Merrill-Lynch International Advisory Council Program," Toronto, May 28, 1987; text made available by the United States Embassy, Ottawa.

2 C. D. Howe Institute, *Policy Harmonization: Implications of a Canada-United States Trade Agreement* (Ottawa: Department of External Affairs, February 1986).

3 H. G. Johnson, "The implications of free or freer trade for the harmonization of other policies," in H. G. Johnson, P. Wonnacott, and H. Shibata, *Harmonization of National Economic Policies under Free Trade*, Canada in the Atlantic Economy, No. 3 (Toronto: University of Toronto Press, for the Private Planning Association of Canada, 1968), p. 15.

4 These figures are based on personal communications with officials of one of the major North American automobile companies.

5 A. Blais, *A Political Sociology of Public Aid to Industry* (Toronto: University of Toronto Press, 1986), p. 34.

6 Economic Council of Canada, *Living Together: A Study of Regional Economic Disparities* (Ottawa: Supply and Services Canada, 1977), p. 215.

7 *Report of the Royal Commission on the Economic Union and Development Prospects for Canada*, vol. 3 (Ottawa: Supply and Services Canada, 1985), p. 213.

8 Quoted in P. Wonnacott, *The United States and Canada: The Quest for Free Trade – An Examination of Selected Issues*, Policy Analysis in International Economics No. 16 (Washington, D.C.: Institute for International Economics, March 1987), p. 102.

9 Health and Welfare Canada, *National Health Expenditures in Canada with Comparative Data for the United States: Provincial Data and Sectoral Analysis, 1970-1985*; and additional information from the Health Information Division, Health and Welfare Canada.

10 J. O'C. Hamilton and M. J. Pitzer, "Prognosis: Empty beds and falling profits," *Business Week*, January 12, 1987, p. 102.

11 A. Silversides, "U.S. profit-driven health care criticized for hurting millions," *The Globe and Mail*, June 5, 1986, p. A16.

12 Department of Communications, *Vital Links: Canadian Cultural Industries* (Ottawa: Supply and Services Canada, 1987), p. 15.

List of Figures, Tables, and Charts

Figures

Tables

Charts

Project Contributors

Research

R. A. Jenness, Director
L. Auer
S. Gera
B. Lodh
S. Magun
K. Patterson
P. S. Rao
A. Ryba

Performance and Outlook

R. S. Preston, Director
B. Cain
P. E. Nevin
H. M. Saiyed
M. E. Willis

Thanks are due to Fran Peake, Carole Bazinet, and Mary Rowe, secretaries, and to various support groups at the Council, in particular the Statistical Services, the Text Processing Centre, the Information Division (including the Translation Section), and the Registry Service, for their contribution to this report.

Economic Council
of Canada

Conseil économique
du Canada