
FRBSF WEEKLY LETTER

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U.S.-Canada Free Trade

The U.S.-Canadian Free Trade Agreement became effective on January 1. It brought to a close 120 years of intermittent attempts at dismantling trade barriers between the two nations. By the end of this century, nearly all existing barriers to trade and investment between the two countries will have been removed, thereby creating the largest *internal* market in the world and ushering in a new era of accelerated integration of the two economies.

As with all arrangements aimed at achieving regional economic integration, the purpose of this Agreement is to stimulate economic growth and enhance consumer welfare in the two countries through more efficient resource allocation. In this instance, the Agreement also represents the first major reversal of a rising tide of protectionism in the U.S. during the last decade. Moreover, like the European Community's (EC) plan to achieve economic integration by 1992, the U.S.-Canadian Agreement sets up a concrete model for lowering barriers to international trade in services and international investment. This *Letter* discusses the principal features and limitations of the Agreement, and analyzes the likely impact of this important step forward in freer international trade.

Internal tariffs

Over a ten-year period beginning on January 1 of this year, the Agreement phases out all tariffs between the two nations. The existing tariffs are classified into three groups: those in the first group (five percent of dutiable imports for the U.S. and 13 percent for Canada) were abolished on January 1, 1989; those in the second group (60 percent of dutiable imports for the U.S. and 34 percent for Canada) will be abolished on January 1, 1994; and the remainder will be abolished on January 1, 1999. Thus, during the final year of this century, all tariffs between the two nations will have been reduced to zero.

Non-tariff barriers

The Agreement lowers the threshold value requiring open, cross-border competitive bidding on government procurements from \$171,000 in

the General Agreement on Tariffs and Trade (GATT) code to \$25,000 for bidders from the two nations. It commits both nations not to impose quantitative restrictions, nor to use discriminatory pricing, on either imports or exports in their bilateral trade. In concrete terms, the commitment assures U.S. industries uninterrupted access to Canadian oil and gas, an important commitment since this access was interrupted during the decade after the 1973 oil shock. It also binds Canada immediately to eliminate its discriminatory pricing for liquor and to phase out over seven years its restrictions on wine imports.

Services

The service industry has been the most rapidly expanding sector in both national economies, now accounting for 47 percent of national output in the U.S. and 60 percent in Canada. Competition in services between the two countries has been hampered not so much by explicit national prohibitions as by the absence of provisions that would enable or facilitate it.

The bilateral agreement breaks new ground by setting up a framework in which national treatment regarding the establishment of branch offices and licensing and certification procedures is accorded to cross-border service businesses. Lawyers, accountants, architects, engineers, computer-system designers, and telecommunication networks, to name only a few, will all find the new rules helpful in expanding their businesses across the national border.

Subsidiaries of U.S. banks in Canada will be exempt from the existing Canadian laws and regulations that limit foreign banks' market share (to 16 percent of the total banking assets in Canada) and expansion of capital. All U.S. financial institutions will be allowed to acquire securities firms or federally-regulated insurance and trust companies in Canada. They will also welcome Canada's abolishment of the "10/25 rule," which limits ownership in Canadian financial institutions to 10 percent for any individual nonresident, and 25 percent for all nonresidents together.

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Investment

Besides freeing trade in goods and services, the Agreement also lifts most of the existing restrictions on direct investment across the national border between the two countries and provides for national treatment in most cases. Canada agrees to eliminate screening requirements for the establishment of new businesses in Canada by U.S. investors, and to ease screening requirements for U.S. acquisition of existing businesses in Canada. By 1992, the screening requirements will apply only to the 600 largest firms in Canada. Moreover, Canada also binds itself not to impose new requirements on the sourcing of input and exporting of products by U.S. businesses in Canada. In the past, these have discouraged U.S. investments in Canada. These provisions remove the threat of Canada's return to the strongly interventionist policy towards foreign investment it has followed in the past.

Trade and investment disputes

The Agreement sets up procedures for notification, consultation, and resolution of trade and investment disputes in an expeditious manner, avoiding judicial appeals which usually drag on for years. To implement the procedures, a Canada-U.S. Trade Commission will be formed to resolve most bilateral trade and investment issues; these disputes will be resolved through binding arbitration. A separate consultative mechanism, involving the two national Treasuries, will be set up to handle disputes relating to financial services.

Major limitations

Although the U.S.-Canada Agreement moves these two countries closer to economic integration, it does not provide for complete integration. Barriers will remain under this Agreement even after 1998. The more far-reaching EC plan serves as a useful benchmark for comparison. (See *Letter* of August 12, 1988, for discussion of the EC plan.)

The scope of the U.S.-Canada Agreement is much less ambitious than that of the EC plan in several respects. First, hidden barriers to trade and investment arise because of differences in national policies regarding taxation, commodity specification standards, and product-testing certification, among other things. The EC plans to eliminate these barriers by standardizing or harmonizing all such policies. The U.S.-Canada

Agreement, in contrast, contains no such provisions. Similarly, the EC already has a Common Agricultural Policy providing for unrestricted agricultural trade among member nations, while Canada and the U.S. have decided each to retain their own agricultural policies, including domestic farm subsidies and import quotas. They defer attempts at lowering agricultural trade barriers to the ongoing GATT negotiations. Moreover, the EC already has achieved unrestricted movement of labor among member nations; U.S. and Canadian nationals, in contrast, will continue to be treated as aliens under each country's labor laws.

In addition to these broad differences between the EC plan and the U.S.-Canada Agreement, there are specific limitations in the Agreement, which reflect the special concerns of the two nations. In direct investment, for instance, the Agreement preserves the Canadian energy sector and "culture industry," including broadcasting, newspaper, and film, for exclusive Canadian ownership, and as already noted, places restrictions on U.S. acquisition of Canada's 600 largest firms.

A particularly troublesome area in U.S.-Canada trade has been each nation's anti-subsidy and anti-dumping laws that provide for imposition of duties on imports found to be subsidized by governments or priced below cost of production in the originating nations. Since 1980, Canada has imposed duties on imports from the U.S. in 24 such cases, and the U.S. on imports from Canada in 15 cases, although the total value of affected imports is larger on the U.S. side.

Resolution of these issues has been difficult because of disagreement on what constitutes a subsidy and on what subsidies are "distortive" and "unfair" trade practices. In a broad sense, because Canada has socialized medicine and other social welfare programs not available in the U.S., Canadians have been concerned that U.S. industries might invoke these programs as an indirect subsidy to production in Canada, and call for countervailing duties against imports from Canada.

More specific concerns have to do with trade in particular products. For instance, a countervailing-duty case has been brought against U.S. lumber imports from Canada on the ground that

the stumpage fee for logging in public forests in Canada is significantly lower than that in the U.S. Although the U.S.-Canada Agreement does not preempt such future disputes, it does establish an expeditious procedure for resolving future disputes, including binding arbitration.

Another major limitation arises from the two nations' Constitutions, which limit the federal government's power on each side in domestic regulatory matters. An illustration stems again from the lumber industry. Building codes are a matter of local regulation in both countries. The U.S. lumber industry has complained that building codes in certain Canadian provinces require plywood of a certain grade which precludes U.S. export, and in one case, lumber is required to be cut from Canadian logs. By its Constitution, the Canadian Government could only, and did, agree to try to persuade the local governments concerned to change such codes, but it had no power to order changes.

Benefits

Since the Agreement provides for a ten-year phase-in, its immediate impact on the two national economies is likely to be small. In the long run, however, adjustments will inevitably bring about changes in both nations' economic structures, expanding production in some industries and causing shrinkage in others in each nation. Consumers in both nations are bound to benefit, as wider choice of goods and services will be available at lower prices. In time, the benefits of economic integration and the losses associated with the remaining trade and investment obstacles may become more apparent, and the two nations may decide to seek more complete economic integration along the lines of the EC.

Studies suggest that U.S. exports to Canada now subject to Canadian import duties are likely to rise by 18 percent, while U.S. dutiable imports from Canada should rise by only five percent because of the higher average Canadian duty (10 percent) than the average U.S. duty (3 percent) on imports from each other. However, since dutiable imports accounted for only about one-quarter of the bilateral trade between the two countries in both directions, the direct impact of tariff elimination is likely to be small.

Far more significant are the effects of the non-tariff provisions of the Agreement, which should increase productivity, as business firms on both sides of the border take advantage of the reduced trade and investment barriers to achieve greater economies of scale and to redirect their resources to more competitive uses. Estimates of the total effects of the Agreement suggest that it will raise real income in Canada by 2.5 to 3.5 percent, and increase U.S. real income by less than one percent. The considerably larger proportionate benefit to Canada is attributed to Canada's gaining access to a market 10 times its size and to the significantly higher restrictions on trade and investment Canada has erected in the past and has now bound itself to remove under the terms of the Agreement.

Another benefit is the assurance that no future restrictions will be placed on trade and investment between the two countries. The rise of protectionism in the U.S. in the 1980s posed a serious threat to Canada, as the U.S. market accounts for three-fourths of Canadian exports, and Canada's exports to the U.S. account for more than 20 percent of Canadian national output. The Agreement reduces this risk to Canadian businesses. Although exports to Canada account for 24 percent of total U.S. exports (far larger than the 11 percent accounted for by Japan, our next largest trading partner), these exports are only about 1.6 percent of U.S. national output. Nevertheless, assured access to Canadian markets and to the supply of resources such as oil, gas, and electricity mean a lot to specific U.S. sectors and regions.

Finally, because it lowers the bilateral trade barriers between the two nations but leaves their respective trade barriers against others unchanged, the Agreement is bound to lead to some diversion of trade from other nations. However, to the extent that the Agreement fosters bilateral economic integration, it will stimulate economic growth in both countries and expand the market for third nations' exports. Consequently, the net impact may not be detrimental to the rest of the world.

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