Free Trade in the Americas: Searching For a Long Term Solution

By Jeffrey Parnass

The United States and Canada are the world's largest trading partners. The U.S.-Canada free trade agreement (FTA), implemented on January 1, 1989, was the first in a series of steps that were taken to increase the already significant volume of trade between the two countries by eliminating tariffs on goods and by encouraging American and Canadian companies to invest on the other side of the border. The FTA already seems like a success. In 1989 alone, trade in goods and services between the two countries increased to $220 billion, up $30 billion from 1988. In addition, American exports to Canada increased by over 20 percent in that same year and American imports from Canada rose by 12 percent. As tariffs on different goods are phased out, trade between the two countries increased steadily. This has led to the growth of both economies and to an increase in world trade as a whole, as well as to a closer political relationship between the two countries that share the world's longest friendly border.

Recognizing that the $100 billion Canadian market should not be ignored, American companies have long sought and found a lucrative market for their products in Canada. Goods that have found a strong market in the United States are often popular in Canada as well. The geographic proximity of Canada to the United States and the fact that the two countries share a common language and similar business practices make the Canadian people very receptive to American ideas and goods. The costs of communication and transportation between the two countries are also relatively low. All these factors have contributed to making the trade across the border as important and as vast as it currently is. According to Kathleen Keim of the Office of Canada International Trade Administration writes, "The impressive U.S.-Canada economic and commercial relationship has flourished based on geographic, cultural, and historic similarities, which encourage north-south trade, despite the barriers on both sides of the border" (Keim, 3). As trade barriers continue to be removed through January 1, 1998, the economies of both countries should continue to grow in the long run. In the short run, however, companies trying to adjust their operating procedures to the new regulations on trade that occur each time a new phase of the agreement is implemented may encounter difficulties because of fluctuating exchange rates and changing access to capital. Because of such difficulties, some politicians and companies are wary of the speed at which they perceive the trade agreement is being implemented.

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When a Conservative government under Prime Minister Brian Mulroney was elected in Canada on September 17, 1984, the signing of a free trade agreement became only a matter of time because such an agreement was also strongly supported by the Republican administration. On October 4, 1987, the federal trade agreement was reached between the two countries. The goal of the agreement is explained eloquently by Michael Wilson, former Canadian Minister of Finance, who says that by agreeing to the terms of the agreement, both countries were "endeavoring] to . . . reduce technical barriers which interfere with trade, while still protecting health and safety, environmental, natural security and consumer interests" (Wilson, 23). Although the agreement would also eliminate many non-tariff barriers (NTBs), a three-tiered plan to remove all tariffs from goods traded between the two countries was at its core. Under the plan, negotiated by United States Trade Representative Carla Hills and Canadian Minister for International Trade John Crosbie, tariffs were to be reduced in three stages, with tariff reductions on different goods occurring on January 1, 1989, January 1, 1993, and January 1,1998.

On January 1, 1989, tariffs on 15 percent of all goods traded before the implementation of the agreement—including those on computer-related equipment, leather, fur, whiskey, needles, motorcycles, skis, ferroalloys, warranty repairs, and unwrought aluminum—were scheduled to be eliminated. In addition, cars that were more than eight years old would be allowed to cross the border duty-free, with the age limit to drop two years until 1994. Differential markups on imports of American-distilled liquor were also scheduled to be removed, American uranium enrichment restrictions were to be ended, and businesspeople would begin to benefit from improved and easier border crossing. The American government was to begin to reduce its role in reviewing takeovers of Canadian companies by American businesses. By January 1990, changes had been made to the original agreement. It was decided that some products would become duty-free on January 1, 1991, rather than in 1993, while the schedule for others was moved from 1998 to 1993. In addition, between January 1989 and January 1993, tariffs on Canadian exports of specialty steel products to the United States were to be completely eliminated and indirect takeovers of business completely freed from government scrutiny. However, in order to qualify for tariff removal under the agreement, goods had to originate entirely either in the United States or Canada. Goods that did not meet this criterion had to incur 50 percent of their manufacturing costs in either or both of these countries before they would qualify.

On January 1, 1993, tariffs were to be lifted from another 35 percent of dutiable goods, including subway cars, printed matter, paper products, paints, explosives, telecommunications equipment, furniture, plywood, and some meats. The embargo on the import of used cars was also scheduled to end. In January 1994, American customs user fees were to be eliminated, American foreign trade zone provisions were to change in Canada's favor, and most important to Canada, new rules on dumping were to take effect.

In 1995, 1996, and 1997, tariffs were scheduled to be cut even more and in 1998, tariffs were to be removed on the remaining goods, namely agricultural products, textiles, apparel, appliances, beef, railcars, and tires. The agreement also stipulated that both countries would exclude each other from their respective meat import laws, Canada would exclude the United States from having to obtain import licenses for wheat, and the

United States would exempt Canada from its import restrictions on products containing sugar. Canada would increase its import quotas for poultry and eggs and reduce its price mark-up differential between American and Canadian wines over a seven-year period. Restrictions by both countries on energy imports were eliminated and new areas of competition in securities and banking were created. One clause was added to the agreement to alleviate the fears of those who believed that their country would incur tremendous losses of money during the transition period in which the agreement was to take effect. This clause stated that if during that period imports from one country caused substantial injury to the products of the other country, then duty reductions provided for by the agreement could be suspended for a maximum of three years, but only one such action per product could be taken. A Canada-United States trade commission was established to supervise the implementation of the agreement and resolve any disputes that might occur as a result of it.

As far back as 1957, two nonprofit research organizations, the National Planning Association and the Private Planning Association of Canada, had sponsored the establishment of a research group called the Canadian-American Committee. This group, which consisted of representatives from the United States and Canada, had drafted their own plan for a free trade agreement in February 1965. This document, titled A Possible Plan for a Canada-U.S. Free trade Area, stated that Canada would probably need a longer period of adjustment to any free trade agreement and to tariff reduction requirements than the United States would. It recommended a plan to make the adjustment for Canada a little easier by insuring that "for basic tariffs exceeding 5 percent, the United States [should] make five annual 20 percent cuts [while] Canada [would make] 10 annual 10 percent cuts." (Canadian-American Committee, 5). Under the free trade agreement, the terms of tariff reduction were not so one-sided. The clause that allows for temporary suspension of any part of the agreement that is found to be causing severe losses for any one industry applies equally to both countries.

The FTA was based in part on a General Equilibrium Trade Model created by Professors Richard Harris and David Cox. The model assumed that there were three factors of production—capital, labor, and materials. While one could be substituted for another, labor and materials were assumed to be mobile only within Canada while capital was assumed to be mobile internationally. The model was a three-region one, it identified the regions of trade as Canada, the United States, and the rest of the world (ROW). Import prices were fixed in the model based on the assumption that Canadian demand for imported goods was too small to affect world prices. The supply of Canadian exports were assumed, however, to affect world prices. The model also assumed that income and economic activity outside Canada remained unchanged as a result of the agreement. These assumptions allowed for the fact that a free trade agreement might or might not cause Canada's terms of trade to improve. The reduction in American trade barriers would allow Canadian producers to raise export prices since part of the burden of current American barriers fell on Canadian producers. On the other hand, lower domestic trade barriers would result in an increased supply of exports, as resources could be shifted from import-oriented to export-oriented industries. This would serve to lower export prices. Thus, the model concluded that the terms of trade would not be increased completely in one country at the expense of the other. This helped relieve the fears of many people, particularly those who owned businesses in Canada, who felt that the agreement would lead to overall decreased terms of trade for them. The model also stated that the agreement would have a different effect on different goods in different regions of the two countries.

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The terms of the FTA seem to indicate that the United States and Canada were on the way to establishing economic unity, but as John Whalley notes, this is far from true: "The Canada-U.S. agreement is certainly not the free trade agreement that it is labeled to be. It is a trade agreement, but not one which achieves, or even seeks to achieve, free trade between the United States and Canada." In fact, he continues, "One can plausibly argue that trade between Canada and the United States was already largely duty-free, except for key sectoral areas such as textiles, steel, and agriculture." Before the agreement, almost 80 percent of the trade between the United States and Canada was nearly duty- free and that the average tariff on Canadian exports to the United States was only about 1 percent. Even during the ten-year tariff elimination period, existing trade restrictions will still remain in place in key industries such as agriculture, textiles, and steel. Both governments, for example, will continue to monitor closely the transportation of fruits and vegetables across the border (Whalley, 133).

Nevertheless, the FTA has brought about a significant reduction in obstacles to trade. The C. D. Howe Institute summarized the results of the agreement in a report titled Canada's Trade Options in a Turbulent World in the following way: "As trade barriers have been reduced, both . . . exports and imports have increased in virtually all sectors. . . . Industries have begun to] specialize in particular niches so that trade has increased in each direction, in each industry" (Howe, 109). Trade barriers distort production decisions, but with the removal of trade barriers, countries that could not trade freely before can now produce and export goods that are relatively less costly to produce domestically and import those that are relatively more expensive to produce at home. Each country can acquire goods more cheaply under comparative advantage specialization than they could in the absence of trade. In theory, lower costs of production that result from free trade lead to lower prices for consumers. This, in turn, gives consumers more money to spend on other goods. American goods now become cheaper for Canadians to buy and Canadian goods become cheaper for Americans. As a result, the economies of both countries will be stimulated by the fact that Americans will choose to buy Canadian goods rather than those produced by other countries and vice versa. Overseas trading partners of both countries will also gain from the increase in income that will result for both Americans and Canadians as a result of the lower prices that the agreement will produce because these people can then

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f As far as production is concerned, both pnomies will benefit from the agree-Knt. As the market in which companies ian sell their goods expands, their pro-duction will increase as well. This allows companies to take advantage of the prin-riple of increasing returns to scale so that they can produce at the point where each unit costs less than the one before it. In addition, companies can now take better idvantage of the process of "learning by doing." As they produce more to meet the needs of their newly expanded pool consumers, they are able learn the cheapest production processes more quickly, allowing them to make the most profits. Finally, the agreement gives com-panies in both countries more certainty as to how to go about developing a strat-egy for marketing in the other country. Once the entire agreement goes into effect, countries will no longer have to worry about calculating tariff costs into their production functions as they to try lo compete with companies that produce the same product in the other country.

Different regions of both countries have begun to take advantage of the gains to be made from trade without barriers. For example, as operating businesses in the Toronto area has become increasingly expensive, Canadian companies have begun relocating to Buffalo, New York. According to Kathleen Keim, "Ontario executives are attracted by Buffalo's proximity, lower cost of living and doing business, and access to a large market" (Keim, 4). This has led to what Keim calls the "Golden Horseshoe" of industrial development that stretches along the western shore of Lake Ontario from Toronto to Buffalo. Another example of how a region of the country has used the trade agreement to its benefit is present-ed by Tommy G. Thompson, the Governor of Wisconsin. He tells how the Council of Great Lakes Governors, which he chairs, has pooled their dollars to establish a joint liaison office in Canada to coordinate market research, collect trade leads, and provide assis-tance to companies in the Great Lakes States. He hopes that the closer relations that the governors on this council have begun to establish with the premiers of the provinces with which these states share borders will help increase trade and improve economies on both sides of the border.

Although the free trade agreement has brought much prosperity to both coun-tries and has created 120,000 new jobs in Canada alone in the first five years in which the agreement has been in place, Canadians have become discontented with it. The Mulroney government lost the October 1993 federal elections in Canada partially because the country's adjustment to the agreement, which coin-cided with a much longer and deeper recession in Canada than in the United States, has been painful. According to Richard Harris in his article '"Market Access' in International Trade," which appeared in the book Investment Relations among the United States, Canada, and Japan, Canadian firms have been finding it difficult to "get enough volume for the economies of scale neces-sary to compete, not only for export, but with imports in the home market" with American companies that now have free access to the Canadian market. "Canadian firms," he continues, "encounter predatory or entry-deterring practices by ... U.S. oligopolists, who are usually firms of considerably larger size. [As a result, the Canadian firms] complain about market access" (Harris, 264-265). In her article "U.S. and Canada Agree to Accelerate Tariff Removal," Laura Gaughan of the Office of Canada International Trade Administration writes that "in order for tariff elimination to be 'accelerated,' the proposed tariff change should receive broad support in relevant domestic industries" (Gaughan, 6). Support for the trade agreement by Canadian businesses seems to be waning as they continue to find it difficult to obtain a share of the new American-Canadian market. However, despite the fact that many of the fears that Canadian businesspeople had about the implemen-tation of the free trade agreement have been realized, most of them still think that the negative effects their companies have incurred because of the agreement are only short-term and that the agree-ment will ultimately lead to large bene-fits for the Canadian economy in the long run.

Canadians also do not appear to be very satisfied with the short-term effects of the free trade agreement, and they have shown their economic dissatisfac-tion through the political process. Jean Chretien, the newly elected Liberal Prime Minister of Canada, may have won the 1993 election because he promised to renegotiate certain sections of the agree-ment. According to an article by Clyde H. Farnsworth titled "Canada's Trade Efforts Raise Hackles at Home" that appeared in the November 25,1994 New York Times, "Canada [has now begun] pursuing fast-growing markets in Asia and the Pacific to reduce its dependence on the economy of its neighbor, the United States" (Farnsworth, D13). Jim Moore, the vice president for policy at the Canadian Exporters Association, says that his government is conscious of the need to have more eggs out there and not just have them in one basket. However, Moore claims that "it's not so much a de-emphasis of the United States as the pri-mary market for most Canadian compa-nies as it is a need to remember that other parts of the world—Asia Pacific and Latin America—are expanding at an enormous rate." This, combined with the fact that the new Canadian government will most likely make cuts in the defense budget—which will make Canada's abili-ty to undertake peacekeeping missions supported by the United States more dif-ficult—is not likely to make the U. S. very happy. After spending so much time and effort creating a free trade agreement, the United States would like to see Canada continue putting all its eggs in the American basket.

The Americans are also having prob-lems with the free trade agreement. For example, the United States has registered a large grain trade deficit with Canada since 1989. By eliminating quotas on the amount of Canadian grain that can be imported into the United States, the Americans have hurt their own grain industry. In fact, American imports of grain from Canada have quadrupled because Canadian farmers can produce grain more cheaply than American farm-ers can as a result of Canada's freight subsidies, its more lenient environmental standards, and price secrecy by the Canadian Wheat Board. This has hurt American farmers and has led them to lobby Congress to reimpose tariff restric-tions on grain. The reason for this lobby-ing by the farmers is that they hope Congress will impose what Floyd Norris calls "tarrification." He says that when countries eliminate quotas, they may "set high tariffs that initially . . . keep out as much as the quota did" (Norris, section 4, page 3). It goes without saying that such a tariff imposition would make Canadians unhappy. By way of compro-mise, the American government has agreed to link this issue with another trade issue. Under the agreement that Canada has with the United States, the Canadian government must lower tariffs

on imports of poultry and diary products from the United States by 1998. This would hurt Canadian farmers, particularly those in Quebec. As a result, the American government may strike a deal with Ottawa that would allow the United States to reimpose tariffs on Canadian wheat and, in turn, permit Canada to leave in place the tariff that it currently imposes on American dairy and poultry imports.

Although both Canada and the United States have encountered problems observing the terms of the original agreement, and even though parts of it may yet be renegotiated, that treaty still remains crucial to the economic policies of both countries. Both the Clinton administration and the newly elected Liberal Canadian government appear committed to the agreement and seem to believe that it will lead to economic prosperity for their countries. This is reflected by the fact that they are in the process of ratifying a new free trade agreement called NAFTA, (North American Free Trade Agreement).

While NAFTA is an agreement among three countries—the United States, Canada, and Mexico—much of the agreement that pertains to trade between the United States and Canada is based on the original 1988 free trade agreement. However, most of the literature written about NAFTA deals with trade between the United States and Mexico and trade between Canada and Mexico since these are the new trade relationships formed by the agreement.

The goal of NAFTA is to expand the free trade area already created by the FTA. NAFTA will remove tariffs and other barriers between the United States, Canada, and Mexico to create a 6 trillion dollar market of 363 million consumers. NAFTA also provides an economic relationship that, in turn, could lead to a "political security zone" throughout North America.

Some provisions of NAFTA will eliminate tariffs on trade in goods between the three countries in the next fifteen years. NAFTA will also accelerate some of the tariff removal provisions included in the FTA and will toughen FTA restrictions on rules of origin, particularly in the United States-Canada textile and apparel trade. Quotas and import licenses will be eliminated, but just as under the FTA, all countries will still have the right to temporarily reimpose tariffs on industries being devastated by their removal. NAFTA also restipulates most FTA regulations on investment, government procurement, intellectual property, energy, agriculture, customs, and transportation. American and Canadian companies will be allowed to sell goods to Pemex, the Mexican oil monopoly, and to the Mexico's State Electricity Commission. The accord also establishes that cars must have 62.5 percent North American content in order to qualify for free trade status. American banks and securities will be also allowed to open subsidiaries in Mexico and American under the agreement.

Both American and Canadian politicians know that they will face even more opposition to NAFTA than was encountered by those who implemented the FTA. While the latter was a single agreement, NAFTA is a collection of central agreements, side agreements, and tariff-ending deadlines, many of which will require fifteen years to take effect. As a result, businesspeople have found it more difficult to grasp the ramifications of NAFTA than it was for them to understand how they would be affected by the FTA. Many Americans and Canadians fear that companies will transfer their operations to Mexico, where salaries and costs of production are lower, thus causing job losses in both the United States and Canada. Past experience with trade negotiations has shown both American and Canadian political leaders that no matter how much long-term gain is projected from any trade agreement, the agreement will be opposed if jobs are lost during the transition period. The average person does not care about an agreement that will lead to growth of the GDP or of international trade in the long run if that same agreement leads to his losing his job.

Canadians continue to voice their objections to NAFTA, feeling that the longer it takes for it to be implemented, the longer Quebec will avoid holding a referendum on secession. Yet the agreement is crucial to the economies of both Canada and the United States. These two countries conduct so much trade with each other that the long-term benefits of the agreement to each of them has the potential to be enormous. The Canadian province of Ontario alone conducts as much trade with the United States as Japan does, and in 1992, Canadian exports to the United States nearly equaled the total amount of Canada's exports to the European Union and Japan combined. All in all, Canada has profited more from the trade agreement than the United States, whose trade deficit with Canada [in 1993] was $2.7 billion bigger than in 1992.

Adjusting to the agreement has been hard for many businesses and consumers on both sides of the border. However, the economies of both countries have, according to Michael Wilson, "shown substantial flexibility and adaptability in the past to handle [the] structural changes . .. required by Canada-U.S. free trade" (Wilson, 41). Wilson seems on target. The elimination of barriers to free trade has led to the creation of jobs in both countries and has helped lift them both out of a recession. If the effects of the FTA had not been regarded as beneficial, NAFTA would never have even been proposed. If the governments of both the United States and Canada are given time to deal with the negative short-term effects of the agreement and are able to withstand the pressure to renegotiate the issue of tariff protectionism, the economies of both countries will succeed in adapting to the changes made by the agreement, resulting in long-term benefits for all concerned. IB

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