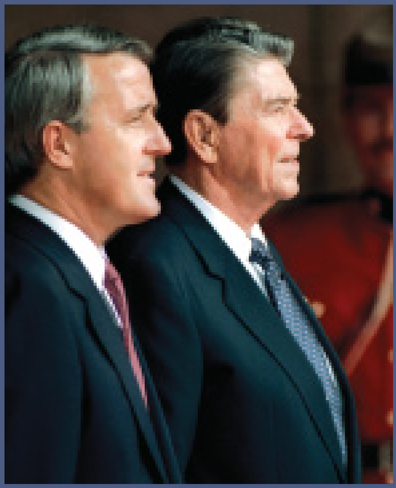
# HAS NORTH AMERICAN INTEGRATION RESULTED IN CANADA BECOMING TOO DEPENDENT ON THE UNITED STATES?



Eugene Beaulieu

The Canada-US Free Trade Agreement (FTA) dramatically increased trade and investment between Canada and the United States, and this deeper economic integration resulted in Canada becoming more specialized in production and more dependent on the United States as an export market. The benefits of increased specialization in production and trade flows have been higher Canadian productivity and income. However, some argue that Canada is now too economically dependent on the United States and that trade and investment policy must be employed to diversify the destination of Canadian export markets. The University of Calgary's Eugene Beaulieu argues that concerns about the economic risks of depending on exporting to a single country are overstated. Further, even if there were a compelling argument for export-diversification programs, these policies would likely be ineffective. Given the extent of economic integration, the trade-policy priority should be to lower the costs of doing business across the Canada-US border.

L'Accord de libre-échange entre le Canada et les États-Unis a fait bondir le commerce et les investissements entre les deux pays, favorisant du même coup une intégration économique qui a renforcé la spécialisation du Canada en matière de production et accentué sa dépendance à l'égard du marché américain. Jumelée à la hausse du flux des échanges, cette spécialisation a permis d'accroître la productivité et le revenu national du Canada. Mais certains jugent que nous sommes devenus trop dépendants des États-Unis et qu'il nous faut réorienter nos politiques commerciales et d'investissement de manière à diversifier nos marchés d'exportation. Selon Eugene Beaulieu, de l'Université de Calgary, on surestime toutefois les risques de dépendance liés aux exportations vers un seul pays. Et même si l'on trouvait des arguments convaincants pour imposer des mesures de diversification, celles-ci se révéleraient sans doute inefficaces. Étant donné l'ampleur actuelle de l'intégration économique, notre politique commerciale devrait plutôt privilégier la réduction du coût des échanges transfrontaliers.

There are two main concerns expressed about the Canada's economic dependence on the US. One is the "all the eggs in one basket" concern related to increased risk associated with increased specialization in one geographic market. According to Gilbert Winham and Sylvia Ostry , Canada is facing a new crisis due to vulnerability as a result of its trade-dependence on the United States. Even the Governor of the Bank of Canada has argued that Canadians need to look beyond the North American continent. In a recent speech, David Dodge argues:

*During the 1980s and 1990s, free-trade agreements with the United States and Mexico focused Canada's attention on the opportunities south of the border. Individual Canadians and businesses have been making the tough adjustments that are necessary to face increased competition and to take advantage of new opportunities. While keeping that continental focus, it is now important that we broaden our sights and focus on opportunities that are opening up in the rest of the world.*

The other concern is that Canada will (or has) become not only economically dependent but also politically integrated with the United States. This issue typically reflects a concern over the loss of Canadian sovereignty. John McDougal, in IRPP's *The Art of the State Vol. 2*, argues that the concern is not about sovereignty per se, but about the "decline in the scope and effectiveness of the exercise of authority by national governments." There is a related concern that Canada's trade dependence on the US exposes Canada to uncertainties due to the recent move by the US to politicize trade relations by connecting trade policy to other political objectives. In May 2003 then US trade representative Robert Zoellick announced that co-operation in foreign policy and security issues is a precondition for any country wanting to negotiate a free trade agreement with the US.

Winham and Ostry argue that there are two basic alternative strategies Canada can follow in the face of what they perceive as a crisis of vulnerability from trade dependence: 1) move Canada to deeper economic and political ties with the United States; and 2) diversify trade in a "second policy direction." They come down on the side of the second policy direction.

This article critically examines the case that Canada is now too dependent on the US and that the trade-policy priority should be diversifying Canada's export destinations. First, the paper argues that Canada has historically been dependent on the one or two primary export destinations. Also, throughout Canada's history, there has been concern about this dependence. The historical perspective reveals that there is a trade-off between the gains from specialization derived from deep integration and the volatility that the lack of market diversification affords. The benefit is economic growth and prosperity, and the cost is increased risk and the volatility of world markets. This paper argues that the benefits from Canada's dependence on international trade (high export/GDP ratio) and from reliance on one primary market (86 percent of exports going to the US) outweigh the downside risk. Moreover, Canada has policies to deal with the volatility associated with this exposure. The risks of trade dependence are manageable. Even if there was a compelling case for policy to diversify the trade destination of exporters, it is not clear how effective this policy direction would be. Given the extent of economic integration in North America, the policy focus should be on reducing border frictions between Canada and the US and reducing the costs of doing business across North America. This policy priority should be complemented by continuing to improve the world trading system through multilateral negotiations and negotiating improved access to other regions through regional and bilateral negotiations, if need be.

First, is Canada too dependent on the US? There are three reasons why the answer to this question is "no." First, these are long-held concerns that have been expressed throughout Canada's history — through periods when Canada was much less dependent on the trade with a single country. The historical evidence suggests that the fears of "too much dependence" are overstated, and that the benefits of the dependency outweigh the associated risks. Second, the argument that Canada is somehow putting "all of its eggs in one basket" is a misleading metaphor. Canadian exporters are part of a global economy, and integration in a North American allows these firms to compete globally. Third, a look at Canadian trade patterns and comparisons to other countries provides evidence that although Canada is extremely integrated with the US economy, the benefit of this relationship is greater than the downside risk.

There is nothing particularly new about the dependency concerns in Canada, which can be traced back at least to the 1950s. Historically, Canada has experienced both growth and development through dependent trade relationships and has suffered economic setbacks from shocks to these dependent relationships. It is well known that Canada has been dependent on international trade and investment from colonial days, and that Canada has developed and grown rich through international trade. However, along with the prosperity and development, Canada has been stung from losing markets to its predominant trading partners. Canada's early economic development up to 1840 was fostered by preferential treatment and access into the British market. Canada lost her privileged access to the British market after 1840 with the repeal of the timber tariffs and the Corn Laws in 1846 and the *Navigation Acts* in 1849. The loss of this access coincided with an economic slump in the British North American colonies, and the consequences of the loss of an important market became clear. In the short run, the Britsh North American colonies responded by seek-

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ing a new market for their resources and entered into the Reciprocity Treaty of 1854 with the United States. Over the period of the treaty, 1854-66, reported Canadian exports grew by over 300 percent and the share of exports destined for the US reached as high as 70 percent.

Canada continued to orient itself toward trade with the United States and negotiated an ill-fated Reciprocity Agreement with the US in 1911. The Depression of the 1930s was a hard lesson for a small economy like Canada's, which was dependent on the exports of a few commodities to a small number of markets. In 1929, merchandise exports represented 22 percent of Canada's GNP. In contrast, merchandise exports were only 5 percent of GNP in the US. The importance of exports for income was more acute in some sectors like forestry, farming and mining, where 80 percent of produce was exported. Canada also lacked diversification in export goods as 80 percent of Canada's exports were made up of three primary products: grains, animal products and forest products. Canada was also reliant on two export markets: the US and the UK (in 1929, over one-third of exports were to US, one-third were to the UK), and through the gold standard, the monetary policies of the three countries were bound together. With the glut of wheat and other primary products on world markets by the late 1920s, commodity prices were low and Canadian exporters were not doing well. The US and UK's moves to protectionism, the 1930 Smoot-Hawley Tariff in the US, in particular, resulted in draconian reductions in Canadian exports. By 1932, exports to the US were half of their 1929 level and to the UK, two-thirds of their 1929 level. While it is clear that the high reliance on exports of a few commodities left the Canadian economy particularly vulnerable in the 1930s, it is not clear that there were any alternative trade arrangements that Canada could have pursued to avoid the devastating effects of the Depression. Most, if not all, economies were moving in protectionist directions in the 1930s and had experienced precipitous drops in income. There were no alternative export markets to which Canada could have turned.

Serious concern about growing dependence on exports to the United States emerged in post Second-World War period, with the rapidly growing share of Canadian exports to the US. In 1947, 39 percent of exports went to the US and 27.5 percent to the UK. In 1950, the UK share had fallen to 15 percent, and the share of exports to the US increased to 65 percent. The rapidly growing US economy was a tremendous boon for Canada and — again — it was not clear what alternatives existed.

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Even in the late 1950s the extent of Canadian dependence on trade with the United States was considered an exceptional and unprecedented economic relationship between two sovereign nations. Moreover, the exceptionally close economic ties between Canada and the United States had already become a concern for Canadian politicians, policy-makers and academics. At a speech at Carleton University in 1958, the great (Canadian born) trade economist Jacob Viner remarked that "These are all exceptionally high ratios for economic relations of one country to another. They cannot be matched, taken together, I feel certain, for any other two countries in the free world." In 1956, J. Douglas Gibson argued that:

> *Many Canadians feel a little uneasy because we now send such a large proportion of our exports to the United States. Though a feeling of concern is understandable, the fact is that we have had no practicable alternative to increasing our exports to the United States. In the post-war period the big increase in demand has come from the United States and it must be admitted that the increase has been very welcome in Canada. No remotely comparable opportunity for expanding our export markets has been available in the sterling area or elsewhere, particularly in the early post-war period when we were worried about obtaining adequate markets.*

In 1959 Simon Kuznets pointed out that one source of the unease is that Canada's dependence upon United States markets makes Canada sensitive to "the vagaries of United States economic policy." So the dependence could lead to increased risk from business cycles, economic shocks that adversely affect the US economy or economic policy.

From 1870 to 1980, the increased reliance on the US as an export market reflected the high growth of demand for industrial inputs in that country, and the fact that Canada increased exports by increasing the number of products for export. The increased reliance on the US as an export destination after the Second World War reflects the expansion of the level of exports in response to rising US demand as opposed to diverting exports away from alternative markets to the US. The US industrial demands for commodities in which Canada was abundant caused the expansion in exports and the Canadian capital boom of the 1950s.

It is astounding that the same concerns about trade dependence that we hear today were expressed at a time when Canadian dependence on the US economy was much less than it is today. Moreover, Gibson argued that reliance on the US as an export market was likely to diminish once the economies of Europe stabilized, and was therefore not reason for concern. Gibson's expectation that reliance on the US market for Canada's exports would diminish could not have been more wrong. Reliance on the US has grown, and concerns over the reliance on trade with United States continue to be voiced.

Winham and Ostry argue that the Canadian concentration of trade creates vulnerability and draw an analogy with a company that makes most of its sales to a single buyer. The argument of vulnerability comes down to the standard analogy that treats Canada as one agent selling one product to one large buyer. This leads to the argument that selling lemonade to one buyer leaves one vulnerable and exposed. At a recent BorderLines conference, the eminent McGill historian Desmond Morton opined that Canadians "have pinned our prosperity to trade with a single convenient customer on a cheap Canadian dollar. Any of us with brains enough to run a lemonade stand knows the risk of a single customer."

The logic of this argument is questionable and the analogy is fallacious. Are Canadian businesses, with access to a market of over 290 million people, really selling to a single customer? Canada is not one seller peddling one good to one large buyer. Canadian export dependence on the US is comprised of thousands producers peddling thousands of different goods to millions of American firms and consumers. According to Statistics Canada's data based on the Exporter Registry, 41,267 establishments exported goods in 2001 — up from 30,589 enterprises exporting in 1993. The lack of diversification argument looks pretty weak in this context.

The importance of exports for the Canadian economy measured by the ratio of exports to GDP is higher now than at any other time in Canadian history, with perhaps the exceptions of the first and second world wars and the reciprocity era of 1854 to 1866. Although the ratio of Canada's exports to GDP is high compared to the United States, it is not an outlier compared to other high-income countries. Compared to 166 countries for which data are available, Canada's ratio of exports to GDP ranked 64th in 2001. Figure 1 presents a scatter plot of the ratio of exports to GDP against country size (measured by GDP) for the high income countries (defined as those with per capita GDP greater than US$12,000 in 2001). Canada is not at all an outlier in terms of the ratio of exports to GDP given the size of the country. Canada has a higher ratio than the largest countries in the world, but as the regression line shows, the ratio is inversely related to country size. The outlier countries include Luxemburg and Hong Kong with

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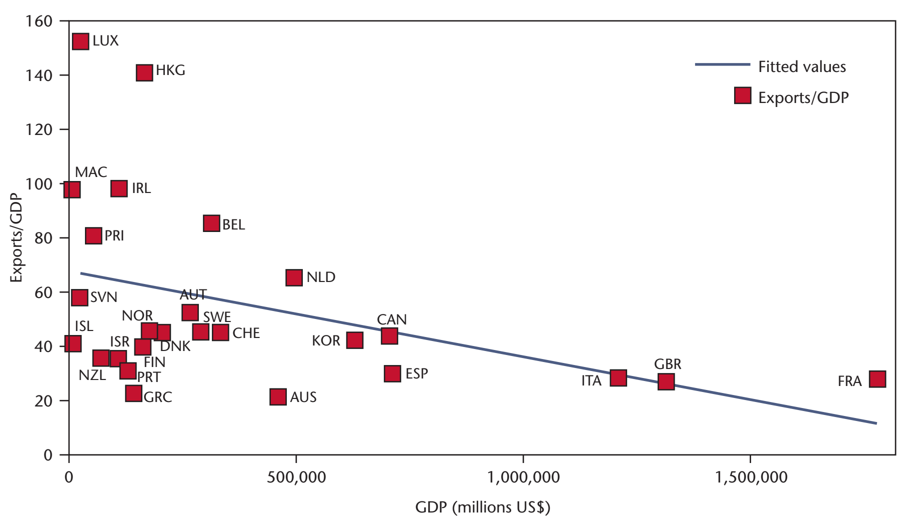
FIGURE 1. EXPORT SHARE OF GDP AND COUNTRY SIZE IN 2001WITH LINEAR REGRESSION LINE, HIGH INCOME COUNTRIES[1]




[1] Japan, Germany and the US are excluded due to scale and space constraints. These are the three largest countries and the picture is similar (but difficult to read) when they are included. High income countries are defined here as those with GDP per capita greater than US$12,000.
Source: World Development Indicators

export to GDP ratios greater than 100 percent. Ireland (IRL), Belgium (BEL) and the Netherlands (NLD) also have higher ratios of exports to GDP than their size suggests. On the other hand, Australia (AUS) and Greece (GRC) have lower than average export-to-GDP ratios given their economic size.

It is also important to recognize that Canada was not the only country to recently experience an increase in trade dependence. In fact, the rapid growth of world exports in the post-war period caused export revenues to be an increasingly important portion of domestic income for numerous countries. As Karl Moore and Alan Rugman in their 2001 article, *The Myths of Globalization,* point out, world trade flows have become increasingly regional and less global in nature. Intra-NAFTA trade went from 34 percent of North American trade in 1980 to 56 percent in 2000. Europe and Asia experienced similar growth in the share of regional trade. Although world trade flows have become more regional, Canadian trade flows became even more concentrated.

As late as 1980, increased specialization in the destination for exports was accompanied by greater diversification of products for export. Since 1980 the volume of Canadian international trade has continued to increase rapidly and has become even more specialized in its destination market partner, i.e. increasingly specialized in trade with the US. However, authors Acharya, Sharma and Rao, in *North American Linkages: Opportunities and Challenges for Canada,* find that most of the increase in trade has been intra-industry rather than inter-industry trade. The rapid increase in intra-industry trade suggests that trade flows have become more diversified in the variety of goods traded, but the authors also find that Canada's comparative advantage remains in commodity-intensive sectors. Acharya et al. examine the changes in export intensities and import penetrations for 84 industries between 1985 and 1997. They find that the number of industries with increased trade (larger export intensities and import penetration) increased during this period. In 1985, 30 of the 84 industries (or 36 percent) had export intensities of more than 30 percent, and by 1997, 50 industries (or 60 percent) had export intensities of more than 30 percent. Similar increases occurred in import penetration rates.

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Although there was a large increase in trade over a broad cross section of industries, the relative pattern of export intensity and import penetration was very stable from 1985 to 1997. Since 1997, however, the value of exports has increased due to increases in intra-industry trade in autos and in energy exports, where high prices have resulted in a highly specialized export composition. The large increases in total Canadian exports since 1993, and especially since 1997, are primarily from increases in the exports of automobiles and light trucks and oil and gas. A question of trade diversification versus dealing with volatilty.

In the previous section I argued that concerns over trade dependence are over-stated. In this section I question whether there is a role for policy to diversify the portfolio of destination markets. The 1957 final report of the Royal Commission on Canada's Economic Prospects forecasts of Canada's export-to-GDP ratio and percentage of exports to the US for 1980 were remarkably accurate, as in 1980 the export-to-GNP ratio was around 20 percent and the share of exports to the US was around 70 percent. This would suggest that the Autopact, the abandonment of the Bretton-Woods fixed exchange rate systems and large shocks like the OPEC oil crises that took place between 1957 and 1980 had little effect over the long run. What scope would the Canadian government have to influence the structure of Canadian trade flows?

Can, or even should, the federal government encourage Canadian exporters to divert some of its trade away from the high price market in the name of greater income stability? The answer to this question is not obvious. In a global marketplace, are there many segregated markets, which is a necessary condition for this sort of diversification policy? Or is there really one large integrated global market? If all markets are subject to the same business cycles as the US, then there may be little scope for true diversification. The relevant policy issue may be not trade specialization versus diversification, per se, but how Canada should address its income volatility.

Income from trade can be expected to be high and low depending on demand for Canada's exports, but total income over time will presumably be maximized by Canada specializing in its comparative advantage and exporting to the highest price buyer. Thus, the issue is really one of smoothing income over time. This can be done by Canada not fully pursuing its comparative advantage, or by not putting all its exports into a small number of markets, but it can also be achieved through other income-smoothing institutions that can be designed and run by government.

Consider that federal equalization payments in Canada were part of a strategy encouraging regional specialization in production within a diversified national economy. These payments smooth the incomes of the resource producing provinces. Employment insurance and personal savings are ways in which individual workers smooth incomes over the business cycle. On a more aggregate level, oil economies like Norway, Alaska and Alberta have established savings/stabilization/endowment funds to smooth government revenues and in some cases personal incomes over the oil price cycles. The Canadian Wheat Board was established to stabilize prices for farmers over the wheat price cycle. All of these arrangements are alternatives to the trade diversification strategy that smoothes incomes over time, while encouraging exporters to maximize incomes by selling to high price markets. Thus it would appear that the federal government may want to consider institutions for smoothing income as a practical alternative to a strategy of diversifying export markets.

Winham and Ostry argue that a free trade agreement was the proper response to the uncertainty over trade policy in the late 1970s and early 1980s, as the United States pursued a "unilateral" approach to international policy during that period. However, they argue that today, a policy of closer ties with the United States would be a mistake. This article comes to the opposite conclusion.

This paper confirms that the dependence of Canadian exports on US markets is at an all time high. It is instructive to note that the increased trade dependence on the US is partly the result of policy directions taken in the 1980s, when opponents of the FTA argued that Canada was already too closely tied to the American economy. Canada was already sending approximately 70 percent of its exports to the US, and some argued that the extent of dependence was not healthy for economic and political reasons. Proponents of the FTA argued that Canada really had no choice and had to secure market access to an increasingly protectionist United States.

The FTA and NAFTA were very successful at increasing the integration of the North American economy. However, history reveals that there is a great deal of persistence in trade patterns, and that deep North American, integration is part of a long and stable process. It is important to point out that Canada's move to regional trade agreements and a more integrated regional economy in the 1980s and 1990s was part of a decision by Canadians that diversification via protection was too costly. Canadian policy-makers and political leaders decided to follow the Macdonald Commission's recommendations that Canadian trade policy take a bold new direction and sign a comprehensive trade and investment agreement with the United States — the Canada-US Free Trade Agreement (CUSTA). The agreement was in response to the decidedly unilateral direction American international trade policy had taken, and was an effort to maintain market share with its largest trading partner and to forge a deeper economic integration with the largest and most dominant economy in the world. Canadian voters agreed with this new direction in trade policy and re-elected the Mulroney government in the great free trade election of 1988. Ergo the choice to sacrifice income level to reduce volatility may not be a palatable choice for voters.

I argue that the lack of diversity in export markets exposes Canadian exports to any barriers that arise at the US border. However, there are no compelling reasons to adopt policies designed to diversify exports. At a time when over 70 percent of Canadian exports went to the US market, Canadian voters endorsed a free trade agreement that fundamentally changed the direction of Canadian trade policy. The new trade policy direction contributed to even higher shares of Canadian exports going to the US market. Policies designed to diversify exports to other markets are at a minimum ineffective and may sacrifice income growth.

In a global marketplace, are there many segregated markets, which is a necessary condition for this sort of diversification policy? Or is there really one large integrated global market? If all markets are subject to the same business cycles as the US, then there may be little scope for true diversification. The relevant policy issue may be not trade specialization versus diversification per se, but how Canada should address its income volatility.

But the economic risks of depending on exporting to a single country are overstated. Further, even if there were a compelling argument for export diversification programs, these policies would likely be ineffective. Given the extent of economic integration, the trade policy priority should be directed at lowering the costs of doing business across the Canada-US border. With a priority of reducing border frictions within North America, Canada should continue to build the international trading system through multilateral and regional trade and investment agreements.

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