NORTH AMERICAN ECONOMIC INTEGRATION:
ASSESSING THE OPTIONS

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Introduction

The first purpose of this briefing note is to shake some long-standing myths and presumptions about the nature and consequences of economic relations between Canada and the United States. Once this background is established, it will be used to argue that recent proposals for preferential deepening of North American economic linkages, – such as a customs union or the use of a common currency, or both – would be damaging for Canada and of no interest or benefit to the United States.

Background

Striking but still largely unknown facts: Trade, capital movements, and migration are all much more local and national than international. More than a decade after the Free Trade Agreement (FTA) between Canada and the United States the intensities of merchandise trade (merchandise trade flows include goods but not services, and is reported by Statistics Canada and the media every month) are ten times as intense as those between Canadian provinces as between Canadian provinces and US states of equal size and distance. The differences between domestic and international linkages are even greater for services, for total capital movements, and for migration[1].

How can this be so, since we are told so often that something like a quarter of Canada's Gross Domestic Product (GDP) goes to the United States? This is in part because the United States is ten times as large as Canada in terms of population and production, while Canadian provinces are about the same distance from each other, on average, as they are from typical US states. It is also in part because GDP and merchandise trade measure different things, so that for some countries merchandise exports exceed GDP, even if most GDP remains at home.

To understand this latter point, think about the North American auto industry, best viewed as a factory with an international border running down the middle of the assembly line. Each time a car part or vehicle moves from a Canadian to a US location, the whole item is treated as a Canadian export, even if most of it either originated in the US or had

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[1] Recent results and references to the fast-growing literature are reported in my short book **Globalization and Well-Being** (UBC Press, paperback 2003) with fuller but earlier reporting in my earlier **How Much Do National Borders Matter?** (Washington: Brookings Institution, 1998). The UBC Press book also provides references to the well-being research drawn on later in this note, and deals also in more detail with currency union and trade relations.

previously been exported from Canada in a more basic form. Thus total exports of autos and parts easily exceed total GDP (which measures value-added, with double-counting removed) of the car industry.

Trade not only drops greatly as borders are crossed, it also drops with distance, by much more than could be explained by transportation costs. I think that the sharp declines of the intensity of econom

To non-economists, this probably all seems unsurprising, if not boringly obvious. But it is important nonetheless, since it cuts to the core of the arguments often used to support the desirability of ever-greater international trade intensities. The burden of the evidence is that at least among the industrial countries there is already sufficient trade openness to achieve the main gains in efficiency and variety that international trade can provide. For developing countries the story is rather different, as more openness can be advantageous as m gaps are great, so are the potential gains, but they take time and care to develop in ways that are politically, economically, socially and environmentally sustainable for all parties. These opportunities are far more prevalent for Canada in the world at large than within North America. The past growth in Canada-US trade as a share of total trade is thus to be seen as a working out first of the Auto Pact and then of the FTA, with increases in the trade share with the United States in the wake of each.

Second, it is sometimes argued that if the United States is increasingly likely to use economic policies for political objectives, and if there is likely to be a proliferation of regional trading blocs, then Canada has little realistic choice but to be under the US umbrella. It is true that there has been an increase in the number of preferential trade agreements in the world, and most analysts think that this poses both economic and political costs for the world as a whole. Unfortunately, Canada must take a substantial share of the blame for this, as most of these arrangements (including NAFTA and many others) were developed in the wake of the FTA and used many of the templates developed for the FTA. When the FTA was being debated in the 1980s, most economists accepted that there were costs of taking a preferential rather than a multilateral route, but thought that these costs could be accepted if the FTA rules could then be applied multilaterally. Unfortunately this was just what did not happen, and the undesirable flowering of preferential trading arrangements followed instead. But the best way of proceeding from here is surely to make changes in the broad direction of movement, by making sure that future developments of the FTA make it more rather than less compatible with globally open trade. More on this in a moment.

Third, it is sometimes argued, just as was done in the case of the FTA, that expanding preferential access between Canada and the United States can be done in parallel with increasing trading opportunities elsewhere. This third point should be made a primary objective, as it implies less rather than more use of preferential trading rules. I have argued elsewhere that for Canada to operate to global and national advantage in the development of international institutions, and to operate effectively in helping other countries, it is important to be seen as a small but independent player with no ambitions to global power. This is increasingly difficult to do if Canada is seen as giving special preference to its economic and political relations with the United States. In these circumstances Canada would lose much of its perceived capacity to contribute and gain at the global level, with no offs content there may be in duty-free shipments from one NAFTA country to another), and the other a move to a full customs union. The research on the determinants of the value of the Canadian dollar shows an important role in cushioning world swings in raw material prices, something that would be lost if the US dollar were adopted. Finally, of course, the US dollar is not the stable centre of the world monetary system, but the currency of a country with unsustainably large fiscal and external deficits. Most research suggests that the removal of these deficits will entail, among other things, further changes in exchange rates against major world currencies. But no one knows what changes, by how much, and when. In these circumstances, it would be especially threatening to Canadian macroeconomic stability to attempt to track, let alone to adopt, the US dollar.

Managing Bilateral Economic Relations

While the evidence seems to me to support strongly a multilateral strategy, and rejection of any preferential deepening of the north-south economic relation, whether through customs union or a common currency, there are nonetheless bilateral issues that require bilateral attention. The biggest practical issues, relative to the movements of trade and people, relate to border crossings. Here the solution lies in the development of practical means of improving access without decreasing security. This is easy to do, because the border is never likely to be a high-return place for interdictions of terrorists. The issues and resolutions differ from one region to another, depending on the types of trade and communities in the two countries. It is a remarkable success story, and deserves to be celebrated.