



Free Trade at 25

HOW THE FTA POSITIONED CANADA FOR THE 21ST CENTURY

Douglas Porter

Douglas Porter, Deputy Chief Economist, BMO Capital Markets, analyses the far-reaching and long-lasting effects of the Canada-US Free Trade Agreement (FTA) on its 25th anniversary. Porter argues that the FTA, and the subsequent North American Free Trade Agreement (NAFTA), were critical ingredients in helping modernize the Canadian economy, and have ultimately played a significant role in transforming Canada from a relative underachiever among industrial world economies to a relative overachiever.

Dans cette analyse des effets profonds et durables de l'Accord de libre-échange canado-américain (ALE) conclu il y a 25 ans, Douglas Porter, économiste

en chef adjoint de BMO Marché des capitaux, affirme que jumelé au subséquent Accord de libre-échange nord-américain (ALENA), il a clairement favorisé la mod-

ernisation de l'économie canadienne et fait évoluer le Canada de pays relativement sous-performant à pays relativement surdoué parmi les nations industrialisées.

The Canada-US free trade negotiations reached agreement in October 1987, exactly a quarter century ago. While the agreement did not come into force until the start of 1989, and only after a bruising Canadian federal election focused almost exclusively on the Free Trade Agreement (FTA), there is little doubt that businesses and the economy began preparing for free trade almost from the minute the ink was dry in the fall of 1987.

Over the past 25 years, the Canadian economy has dealt with a number of transformational issues, some driven by changes in domestic policy and some foisted upon the country from abroad. The former group would include the Goods and Services Tax (and later Harmonized Sales Tax in many provinces), inflation targeting, and sustained government restraint in the second half of the 1990s. The latter group would include a collapse in interest rates, a tech sector boom and bust, the rapid industrialization of China, a commodity price boom, a 75 percent appreciation of the Canadian dollar in the short span of five years in the 2000s, the global financial crisis of 2008/09, and the Eurozone sovereign debt and banking crisis. But among all of these profound shifts, arguably none has had as far-reaching and long-lasting effects as the FTA and its 1994 successor, the North American Free Trade Agreement (NAFTA).

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REPORT FROM THE C.D. HOWE INSTITUTE

While proposed Canada-US free trade deals have a long history – featuring prominently in the 1911 federal election – the genesis of the FTA really began in the 1982 recession. In the wake of that devastating downturn, which brought even deeper GDP and employment losses than the 2008/09 recession in Canada and saw the unemployment rate spike to 13 percent in late 1982, the Trudeau government asked the Macdonald Royal Commission to find steps to strengthen and improve the Canadian economy. One of the key recommendations of the Macdonald Commission was to seek a free trade agreement with the United States. As Michael Hart commented in a recent C.D. Howe report, “Canada’s choice also reflected recognition of the dynamism of the US economy, the waning prospect of the EU’s

ever emerging as anything more than specialized, regional market for Canadian suppliers, and frustration at the slow pace of multilateral trade negotiations at the GATT in Geneva. At the time, there was also some hope that stronger Canada-US ties would create an enhanced platform from which Canadian firms could pursue emerging markets in Latin America and Asia.”

When the Macdonald Commission reported, the Mulroney government seized on the recommendation, and began negotiations in June 1986. The deal was struck little more than a year later, signed in early 1988, and approved later that year in both countries – but only after the highly contentious Canadian election campaign during the autumn.

Negotiations to expand to NAFTA began in earnest in the early 1990s, with a deal signed in San Antonio by the three leaders of Canada, the US, and Mexico on December 17, 1992. And, it became a hotly debated topic in 1993, proving much more politically sensitive than the FTA. It was officially approved in the US in November 1993, following a tight vote in the House of Representatives (and relatively easy passage in the more trade-friendly Senate). While NAFTA was a feature in the 1993 Canadian federal election, along with pledges to renegotiate it by the eventual winning Chrétien Liberals, it played far from a dominant role in the campaign, in stark contrast to the FTA five years earlier. The final side deals on labour and the environment, which the Liberals had pledged during the election, proved relatively minor. In contrast to the US experience, NAFTA was much less contentious than the FTA in Canada, partly reflecting the much smaller impact of Mexico on Canada’s economy, as well as generally positive early reviews of the FTA.

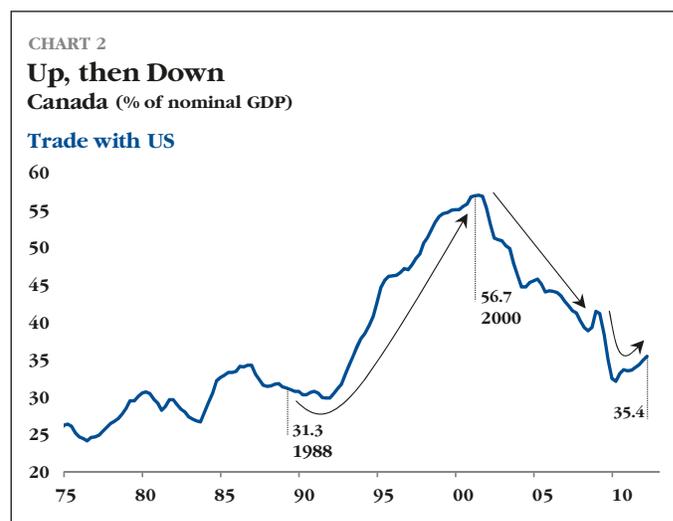
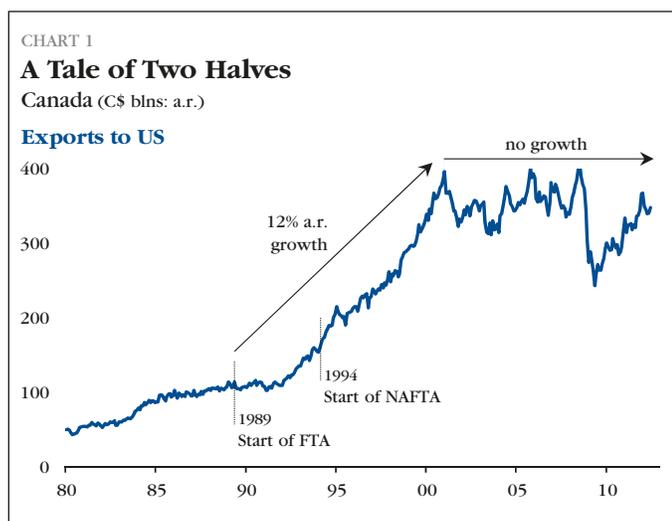
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Since NAFTA, Canada has signed a series of bilateral trade deals with some other smaller countries, including Israel (1997), Chile (1997), Costa Rica (2002), Colombia (2008), Peru (2008), Jordan (2009), Panama (2010), and EFTA (2009). The country is also in negotiations with Japan, Korea, and the European Union. Prime Minister Harper aims to strike a wide-ranging deal with the EU by the end of 2012, although there have already been nine formal rounds of negotiations and there are still a few key sticking points. Given the likelihood of years of subpar economic growth in Europe, as it deals with its debt crisis, the Trans-Pacific Partnership may ultimately hold more promise for future trade growth.

There are numerous ways to assess the FTA. Since it was fundamentally a trade agreement at heart, the impact on trade is probably the best way to start. But, perhaps the most straightforward way of assessing the FTA, and also the most common way of gauging its impact, may also be the most misleading – the value of Canadian merchandise exports to the US. Proponents of the deal readily pointed to the rapid run-up in Canadian sales to the US in the first decade after the deal came into effect. Bilateral exports shot up from barely \$100 billion per year in the late 1980s to more than \$350 billion by 2000, an incredible annualized growth rate of more than 12 percent (chart 1). It was a broadly similar, if slightly less dramatic, picture on the import side. That tremendous burst in trade flows is typically seen as a strong endorsement for the deal, and the majority of analysts pointed to it as all the evidence needed to judge the FTA (and NAFTA) as a success, particularly at the 10-year mark of the deal. (See, for example, “Two Cheers for the FTA: Ten-Year Review of the Canada-U.S. Free Trade Agreement”, by John McCallum.)

Canadian exports to the US have grown at an average annual rate of just over 5 percent since 1988, only slightly faster than Canadian nominal GDP growth of 4.6 percent over that stretch. While no doubt still a solid growth performance, note that exports to the US rose at a 13 percent annual rate in the 1971-88 period ahead of FTA, versus an average annual increase of 11.3 percent in nominal GDP.

Another way to look at the same figures from a different perspective is to consider exports to the US as a share of Canadian nominal GDP. From around 17 percent of GDP just before the FTA, the share surged to a peak of 33.3 percent in 2000, before tumbling back down to below 18 percent in 2009. The share has recovered somewhat in the past few years alongside the tepid recovery in US spending, but is now just a little above 19 percent. Similarly, total Canadian trade with the US (including merchandise exports and imports) rose from just over 31 percent of GDP prior to the FTA, to a peak of 56.7 percent in 2000, but has since receded to only slightly more than 35 percent – coming almost full circle (chart 2).



However, perhaps less well-advertised is the fact that Canadian exports to the US have since flattened; and, in fact, they have actually been below the 2000 peak in the latest 12-month period, even with a significant recovery from the 2009 depths. There are a variety of reasons for the shift from rapid acceleration to a lengthy lull. Sales were hit hard by the tech bust from 2000-2002, but also by a thickening of the border in the wake of 9/11 and the increased security measures. The latter effect has become semi-permanent, even with some initiatives to improve the flow of goods. But, just as exports of goods and services were beginning to make some headway again, they were then restrained by the persistent strength in the Canadian dollar (especially in 2006/07), and then heavily undercut by the global Great Recession in 2008/09. Export volumes are still struggling to recoup those recession losses, remaining below the 2007 peak, and are even further below the earlier highs hit in 2000 at the apex of the tech boom.

Taking the two extremely different periods together, Cana-

Does the retreat in trade with the US in the past decade cast doubt on the success of the FTA? Not really. The split personality of Canadian exports to the US in the past quarter century says as much about the wild swings in the Canadian dollar and the significant adjustments in the US economy as they do about the underlying strength of trade.

So, does the retreat in trade with the US in the past decade cast doubt on the success of the FTA? Not really. The split personality of Canadian exports to the US in the past quarter century says as much about the wild swings in the Canadian dollar and the significant adjustments in the US economy as they do about the underlying strength of trade. Recall that the trade data are reported in current Canadian dollar terms,

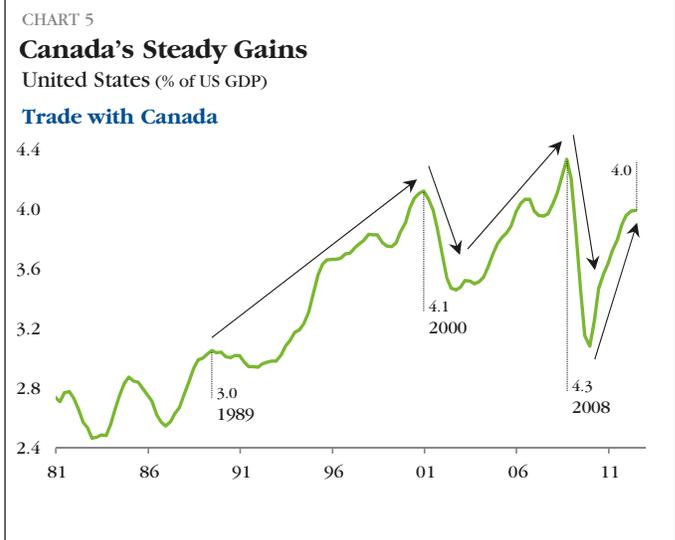
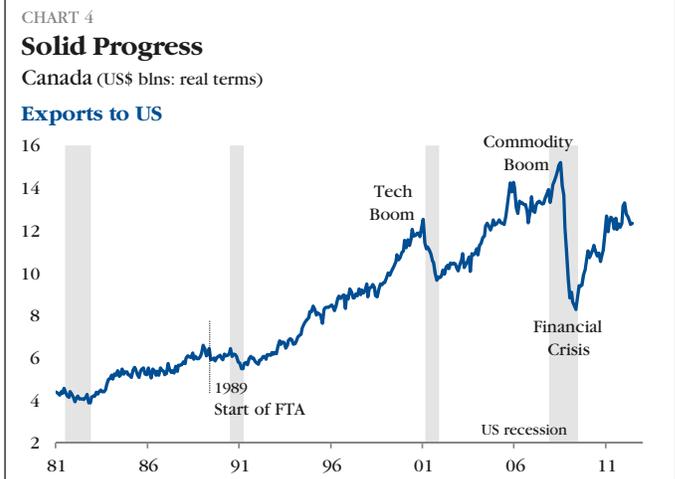
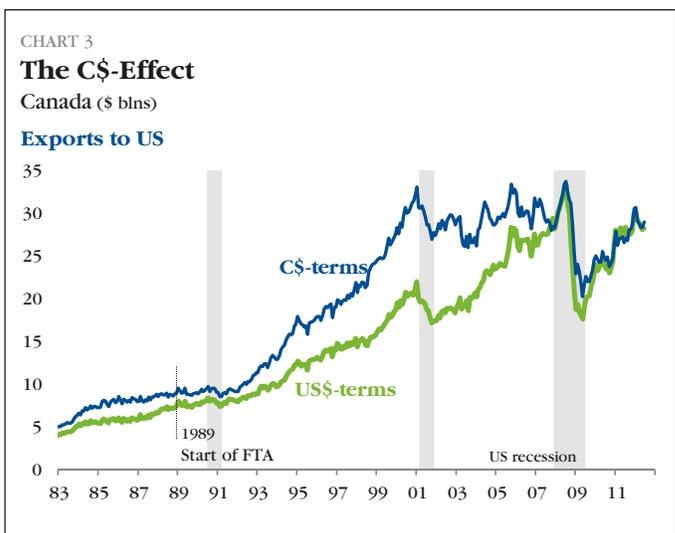
and the currency at one point rose by more than 75 percent in the short space of six years from early 2002 to late 2007. Since Canada is largely a “price taker”, and its exports are thus priced in US dollars, sharp swings in the exchange rate will readily translate into sharp swings in the Canadian dollar value of exports. In a nutshell, the apparent export surge in the 1990s was flattered by a plunge in the loonie, while the flattening out of exports over the past decade was exacerbated by the loonie’s historic sprint.

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Comparing the Canadian dollar value of exports to the US with the US dollar value provides a very different picture of the past 25 years. The progress appears much steadier over the first 20 years, aside from the pullback during the tech wreck in 2001 (chart 3). While the deep downturn during the Global Financial Crisis in 2008/09 is similar by both measures, the overall pattern in US dollar terms is consistent with solid gains over the entire period. Taking it a step further, and adjusting Canadian exports for inflation, reinforces the point. From this perspective of real exports in US dollar terms, Canadian sales have expanded steadily, pushed above the long-term trend, at first by the tech boom and then by the commodity boom, and pulled below trend by the recent deep recession (chart 4).

From the US perspective, imports from Canada have expanded from 3.0 percent of US GDP prior to the start of the FTA, to an initial peak of 4.1 percent at the height of the tech boom in 2000 (chart 5). The share then slipped during the tech wreck, but regained steam and reached an all-time high of 4.3 percent just before the onset of the Great Recession, after which it declined to 3 percent. The share has since partially recovered to 4.0 percent of US GDP, an increase of 1 percentage point from pre-FTA levels. In other words, despite all the wild gyrations in the loonie, global commodity prices, and two deep downturns, Canadian exports have increased their standing as a share of the US economy over the past 25 years. While the gains are nowhere near as dramatic as the initial surge in exports seemed to imply, there has been unquestionable steady progress over the period.

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However, it is worthwhile pointing out that these gains came against a backdrop of persistent import penetration into the US economy. In fact, Canada’s share of US imports has declined in the past quarter century. From 18.5 percent of US imports prior to the FTA, Canada’s share has since receded to 14.3 percent in the most recent 12 months (table 1 and chart

6). That's the glass-half-empty perspective. The glass-half-full view would note that all industrialized economies saw large import share losses in the US since 1988, with Japan's plunging more than 14 percentage points, the European Union's falling almost 5 points and the Asian tigers losing nearly 9 points. Those combined losses were almost entirely taken by gains in two emerging economies – China (up 16 points) and Mexico (up 7 points). Given the enormous strides by these two, and other developing economies, the fact that Canada has largely held its own in the hyper-competitive US market should be viewed as an accomplishment.

Beyond increasing trade, the FTA and NAFTA were also aimed at strengthening and improving the environment for cross-border investment, especially foreign direct investment. While there have been some high-profile squabbles in the past 25 years, overall the FTA should be judged a success on this front. Foreign direct investment from the US into Canada averaged just \$1.7 billion annually in the six years prior to the FTA, \$4.7 billion per year in the first six years of FTA (and just prior to NAFTA), but then has shot up to \$19.8 billion per year since 1995 (chart 7). As a share of GDP, those figures are 0.3 percent, 0.7 percent, and then all the way up to 1.6 percent. A little bit more than half of the inflows since 1995 have been in the resource and financial services sectors.

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On the flip side, Canadian FDI into the US has also picked up notably, rising from an average outflow of \$3.8 billion per year in the 1983-88 period and just \$2.6 billion annually from 1989-94, to \$22.3 billion per year since that point – even larger than the net inflows into Canada. The outbound investment from Canada and into the US has been dominated by the financial services sector, which alone has absorbed half of the total investment since 1995.

The above figures represent the annual flows between the two countries. Looking instead at the total existing stock of direct investment, US direct investment in Canada has jumped from \$76 billion at the end of 1988 to \$326 billion by the end of 2011. That represents an average annual growth rate of 6.5 percent, more than 2 percentage points faster than nominal GDP growth. The share of US FDI in Canada has thus risen from just over 1 percent of Canadian GDP before the FTA to almost 19 percent now. On the flip side, the stock of Canadian FDI in the US has risen from \$51 billion to \$276 billion, or from 8.3 percent of Canadian GDP just before FTA to 16.0 percent now.

TABLE 1
Tough Competition in the US
United States (% of total imports)
Imports by Country/Region

	1998	2011/12	Change
Canada	18.5	14.3	-4.2
Mexico	5.2	12.0	+6.8
EU	21.2	16.6	-4.6
Japan	20.3	6.2	-14.1
Asian Tigers	14.3	5.4	-8.9
OPEC	5.2	8.6	+3.4
China	1.9	18.2	+16.3
Other	13.4	18.7	+5.3

CHART 6
Shifting Sands
United States (% of total)

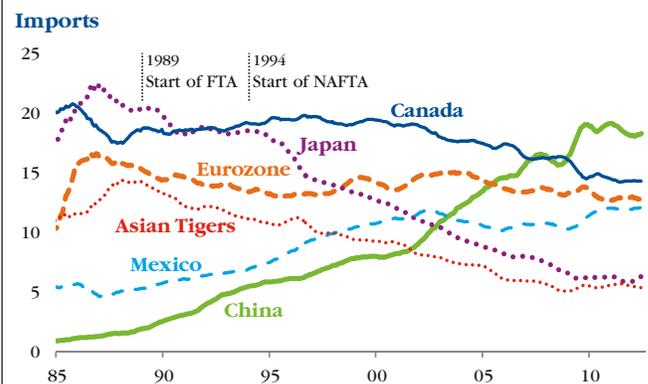
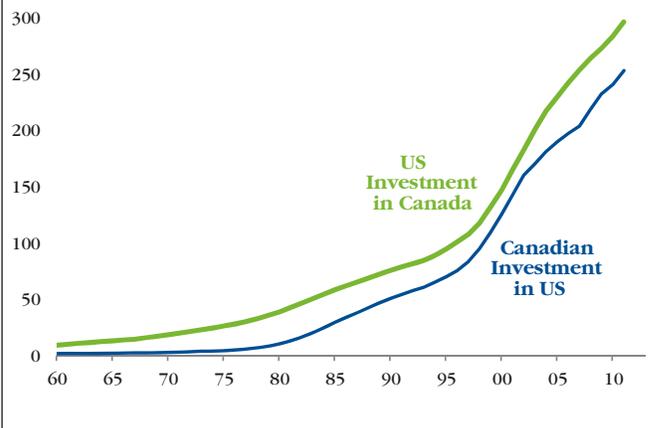


CHART 7
FDI: Upswing
(\$ blns: 6-yr avg.)



It was almost an article of faith that the FTA and NAFTA would lead to greater specialization in the Canadian economy, as smaller, less-efficient firms and sectors got squeezed out and larger and more efficient firms increased the size of operations. However, the scale of Canadian enterprises has not changed materially since 1997. Even with plenty of consolidation in the early years after NAFTA

CHART 8

Sectoral Shifts: Subtle

Canada (% of total)

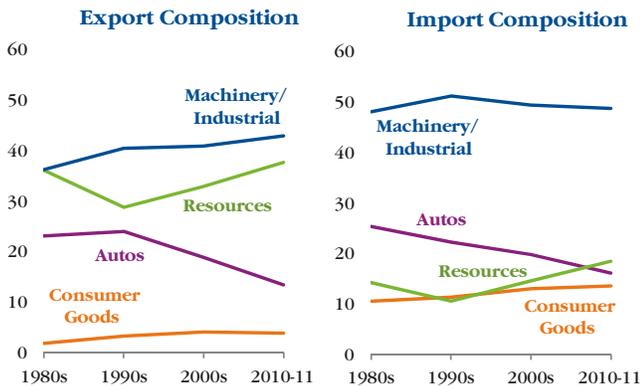
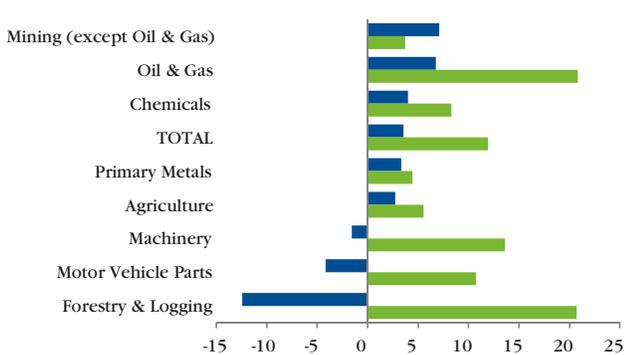


CHART 9

Exports by Sector

Canada (% chng: a.r.)

Exports to US



and the dissolution of smaller, less efficient, enterprises, the share of Canadians working at small, medium, and large companies remains nearly unchanged over the period at 66 percent, 21 percent, and 13 percent respectively. This is certainly not a mark against the FTA or NAFTA, as many smaller enterprises have sprung up in recent years, especially in services, amid the broad sectoral shifts in the economy over the past quarter century.

There have been some very significant differences between the export growth for certain sectors before and after the start of the run-up in commodity prices (and the coincident surge in the Canadian dollar), which began just over a decade ago (chart 8). Even with marked changes in relative prices and profound cyclical shifts, it appears that overall the FTA and NAFTA heavily supported export growth in the commodity sector (partly thanks to more affordable capital goods and increased investment in the sector) and in highly regulated niche industries (pharmaceutical products in particular). At the same time, cost-sensitive industries in the manufacturing sector have, in some cases, seen reversals of earlier gains in the American market (notably textiles and lumber), due to weakness in US demand and/or strength in the Canadian dollar.

Exports in the auto industry have been scaled down, with both economic conditions and relative cost issues playing crucial roles. Export growth averaged 10 percent annually from 1989 to 2000, and then fell at a 4.5 percent average from 2000 to 2011 (chart 9). Specifically, the engine and transmission component pushed ahead at full throttle with average annual growth of 18 percent after tariffs were lifted (only completed cars were exempt under the Auto Pact) from 1994 to 2000, before idling from 2000 to 2011. The auto sector portion of total Canadian merchandise exports has recently recovered to about 16 percent after sliding below 12 percent in 2009, but remains far below the 23 percent average share in the 1980s and 1990s. An even more dramatic shift in the transportation sector can be found in aerospace, where shipments soared at an average annual pace of 24 percent from 1994 to 2000, but have since stabilized, slipping 0.2 percent per year on average since 2000. Similar to autos, the machinery industry has seen exports to the US dip in the past decade, after double-digit growth in the 1990s.

CHART 10

Trade Growth by Decade

Merchandise Exports - Canada (% of GDP)



Merchandise Imports - Canada (% of GDP)



In the resource sector, the picture has been dominated by the massive swings in commodity prices, which largely masks underlying shifts. Still, oil and gas exports to the US increased at an annual pace of more than 20 percent from 1995 to 2000,

even amid relatively weak oil prices, but the higher dollar and falling gas sales restrained receipts from 2000 to 2011 to an average growth rate of 6.8 percent. The forestry and logging industry has managed to stave off weak US demand and quotas by shipping to China. However, sales to the US in this industry have braked from a 20 percent pace before 2000 to double-digit declines since that point (see sidebar on lumber). The mining sector has seen the strongest growth since 2000 with average gains of better than 7 percent, after barely moving in the prior six years, although the swings are dominated by price changes. Agriculture exports to the world grew by nearly 7 percent on average annually from 2000 to 2011, after holding steady from 1994 to 2000, although most of the appreciation stems from an increase in prices as sales gains to the US have been much more muted (averaging 5 percent in the past 20 years). The share of trade in GDP to the world, and specifically to the US, are detailed in chart 10.

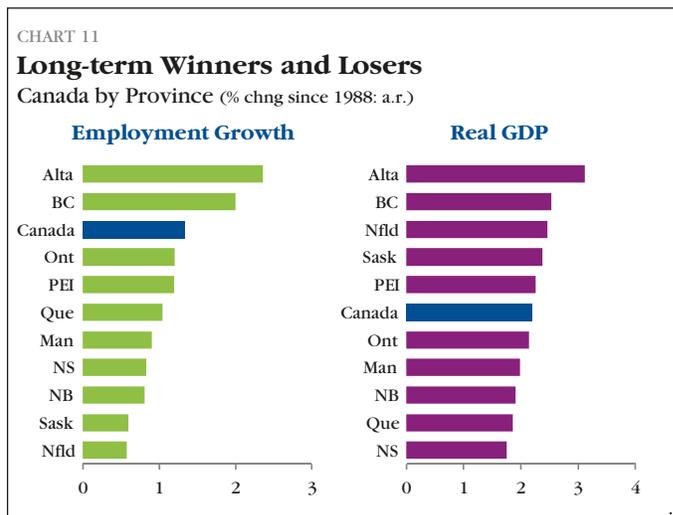
SOFTWOOD LUMBER

The sector was left out of the FTA, largely due to irreconcilable differences at the time, and proved to be a trade flashpoint over the years. Finally, a side deal was struck in 2006. Here is how the Department of Foreign Affairs and International Trade sees it:

To move beyond these disputes, Canada and the United States signed the 2006 Softwood Lumber Agreement (SLA) on September 12, 2006. The SLA, which came into force on October 12, 2006 for an initial seven-year term, saw the return of more than \$5 billion in duty deposits by US authorities to Canadian companies. The Agreement has promoted a stable trade environment for the softwood lumber industry and has maximized benefits to Canadian industry, its workers and their communities. With the strong support of industry and provinces, Canada and the United States agreed to extend the SLA for an additional two years, to October 2015. This agreement was signed by Minister Ed Fast and United States Trade Representative Ron Kirk on January 23, 2012, and was ratified by both countries on April 20, 2012.

Total Canadian lumber exports are now little more than \$5 billion per annum, or barely 1 percent of all merchandise exports, compared with a 4-5 percent share of total exports in the late 1980s and early 1990s, with the steep drop largely owing to the deep downturn in US housing, not a fundamental trade problem.

During the hotly contested and FTA-driven 1988 Canadian federal election, there were significant divergences among regions on support for free trade. Quebec and Alberta were by far the biggest supporters of the FTA, for very different reasons, and these two provinces voted overwhelmingly in favour of the deal. Note that the only other province where the Progressive Conservatives led in the popular vote was Manitoba, and the opposition parties combined to win more seats than the ruling party in almost all other provinces.



Over a 25-year period that saw many structural shifts, it is nearly impossible to pinpoint the regional impact of the trade deal. However, there is little doubt that Alberta has been the relative economic winner over that time period, posting both the strongest employment and real GDP growth of all the provinces since 1988 (chart 11). Of course, the rebound in oil prices from very weak levels in the years preceding the FTA and the development of the oil sands have together provided the fuel for the longstanding boom in Alberta. But, there is also little doubt that the generous treatment of energy in the FTA played a highly supportive role for investment and production in the sector as well, providing a sustained boost to Alberta's performance.

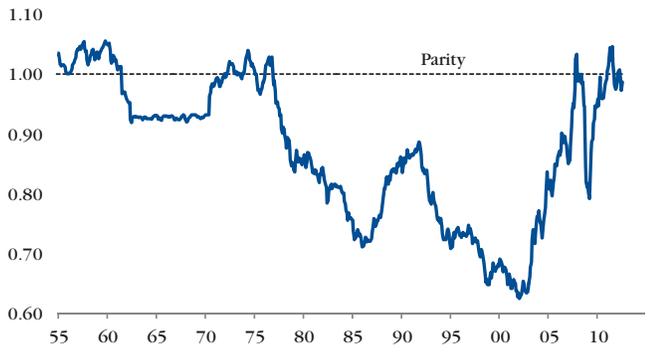
While some specific industry sectors in Quebec certainly benefited from the FTA, notably pharmaceuticals and aerospace, the province has seen slightly below-average job growth over the past quarter century and well-below average GDP growth.

As noted earlier, the Canadian dollar has run the gamut of emotions and levels in the 25 years since the FTA deal was signed. Broadly speaking, it appreciated steadily in the first few years of the deal, plunged consistently over the 1990s, but then came roaring back in the 2000s (chart 12). Since the record high in late 2007, it has been largely driven by events far beyond Canada's borders, with the currency tied to all other so-called "risk assets" (global stock markets, commodity prices, and other resource-driven currencies). But through all the gyrations over the past three decades, commodity prices have been the single most important factor.

CHART 12

The Loonie's Long and Winding Road

(C\$/US\$)

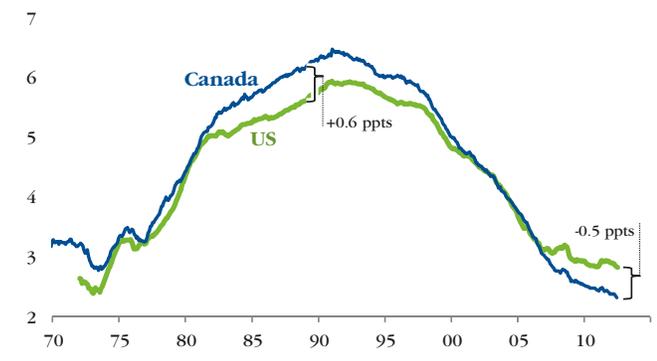
Canadian Dollar

There was some speculation early on that there had been some kind of unspoken or secret arrangement on the currency in the FTA negotiations. But history suggests that the Canadian dollar has consistently followed its commodity price lead. While monetary policy was unusually tight in the early days of the FTA, especially compared with the US, this was largely driven by the Bank of Canada's intense determination to bring slightly higher Canadian inflation down to 2 percent or lower (which later became enshrined in inflation targeting in 1991).

CHART 13

Inflation Turnabout

(25-yr % chng: a.r.)

Consumer Price Index

One of the primary positives cited for the initial FTA was that it would serve as a vehicle to help bring down the prices of many goods for Canadians as tariffs fell and competition increased. Also, the rationalization of production was seen as a means to help clip inflation. While there is absolutely no debate that inflation has been considerably lower in the past 25 years, averaging just 2.3 percent versus more than 6 percent in the previous 25-year period, there are many factors that have driven inflation lower. The average inflation rate had already dipped to just over 4 percent in the five years prior to the FTA, reflecting the deep recession in the early 1980s and

the associated attempt to rid the economy of double-digit inflation. That process was further advanced by the tight monetary policy in the late 1980s and early 1990s, as well as the adoption of inflation targeting in 1991. And, in the past 10 years, the strong Canadian dollar has acted as another powerful inflation suppressor.

In other words, there are a wide variety of factors that have helped keep inflation much lower since FTA than in the prior decades. The pace of the past 25 years (2.3 percent) is right in line with the average pace in the 50 years up to the oil shock in the early 1970s. So, the outlier appears to be the 1973-82 period on the inflation front. However, it is fair to say that the FTA did help grease the slide of inflation in the early 1990s, contributing to the intense anti-inflation thrust of the Bank of Canada at the time. Notably, average US CPI inflation has been 0.5 percentage points higher than in Canada in the past 25 years (2.8 percent versus 2.3 percent), while it was 0.6 percentage points lower in the prior 25 years before the FTA agreement (chart 13). While there are a number of factors that could help explain this turnabout of more than 1 percentage point in relative inflation performance, the FTA no doubt played a constructive role.

The overall conclusion is that the FTA, and then NAFTA, were critical ingredients in helping modernize the Canadian economy, and have ultimately played a big role in transforming Canada from a relative underachiever among industrial world economies to a relative overachiever.

The overall conclusion is that the FTA, and then NAFTA, were critical ingredients in helping modernize the Canadian economy, and have ultimately played a big role in transforming Canada from a relative underachiever among industrial world economies to a relative overachiever. Of course, there have been a number of reforms Canada has taken over the years, but in many respects the FTA paved the way for future tough decisions. While the FTA debate was highly contentious in 1988, it did fully engage Canadians in economic and trade matters. The deal also sharply clarified trade and investment rules within North America, and likely helped avert serious protectionist measures from arising within the region during the steep economic downturns of the past decade. Some of the purported benefits of FTA may have been overstated – average unemployment rates and productivity growth since 1988 have been amazingly similar to the prior two decades, for instance – but there has been a net strengthening in North American trade and foreign investment flows, and the deal helped grease the slide for Canadian inflation. 

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