

## **CANADA, THE FTA AND NAFTA: A VIEW FROM THE NEGOTIATING TABLE**

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### *Abstract*

This paper explores the history of Canada-US economic relations with particular emphasis on the factors leading to the conclusion of the Free Trade Agreement (FTA) of 1989 and behind Canada's decision to engage in the North America Free Trade (NAFTA) negotiations. It discusses the significance of the FTA and NAFTA for trade policy, notably in the extension of the negotiations into the areas of services, investment, intellectual property rights and environmental and labour standards, and concludes with a survey of unresolved problems.

As Canada's negotiator for the Textiles Chapter of NAFTA and subsequently Director General for Canada-US Trade Relations, I am often asked for my assessment of the impact of the NAFTA. My usual response is to reference former Chinese premier Chou En Lai. When he was asked to assess the significance of the French Revolution, he is said to have responded: 'It is still too early to tell'. There is indeed a need to take a long-term view when analyzing the importance of historic events. Nevertheless, it is already apparent - less than four years after NAFTA's implementation - that this agreement has formed part of a dramatic sea-change in Canadian trade and economic policy.

The most important directional change for Canada, however, came not with the negotiation of NAFTA but rather five years earlier, with the implementation of the Canada-US Free Trade Agreement, colloquially known in Canadian trade policy circles as 'the FTA'. It is hard to imagine a more natural pair of free trade partners than Canada and the United States. The trade flows between them are the largest between any two countries in the world. Over 80 percent of Canada's exports are destined for the US market and nearly 25 percent of US exports go to Canada. Canada's population of only 30 million people purchases more US products than over 350 million consumers in the European Union. The province of Ontario alone imports more from the United States than does Japan. And there is more trade between Ontario and the neighbouring state of Michigan than between the United States and China.

These impressive bilateral trade flows have been enhanced by the Canada-US Free Trade Agreement but are a reflection of even more fundamental factors. Henry Kissinger captured the North American regional reality when he commented that 'Canada and the United States are doomed by geography and history to friendship, irritation, cooperation, disputes and a parallelism of outlook'. Robert Thompson, a Canadian politician, put it more succinctly: 'The Americans are our best friends - whether we like it or not'.

The pace of Canada-US integration has been constantly accelerating for many decades, to the extent that the United States now dwarfs any of Canada's other trading partners. Prior to World War II, Britain remained the destination for nearly 40 percent of Canadian exports. By the 1950s, however, this had declined to 15 percent. And today Britain, while still Canada's third largest export market, takes only 2 percent of total Canadian exports. The United States, on the other hand, has steadily increased its importance in the Canadian trade profile - from roughly 60 percent of total Canadian exports in the decade of the 1960s, to currently over 80 percent - and still growing.

As trade flows swelled between the two countries, the economic logic of a free trade agreement became increasingly compelling. Yet the decision by Canada to engage in a free trade negotiation with its southern neighbour triggered a gut-wrenching public debate and enormous controversy. In fact, the 1988 general election in Canada came close to being a single issue campaign, fought on the question of whether or not Canada should go forward with the FTA.

In the United States, on the other hand, the Canada-US free trade negotiations barely swum into the public consciousness. There was the usual carping by Congressional Committees and narrow sectoral interest groups about various detailed issues under negotiation. In general, however, the FTA was a 'ho hum' event in the United States - generating almost no broad public debate and seen as adding relatively little in terms of either new threats or new opportunities.

The differing reactions to the FTA in Canada and in the United States are perhaps evidence of the old adage that 'Americans are benevolently ignorant of Canada, while Canadians are malevolently well-informed about the United States'. The Canadian reaction must also be viewed against the fact that the issue of free trade with the United States has been at the centre of one of the oldest debates in Canadian history.

To put it in historical perspective, it is worth remembering that the FTA was in fact not the first but the third Canada-US free trade agreement to be negotiated. In 1854, the so-called 'Reciprocity Treaty' set out preferential access arrangements between the two countries for a number of key products. Although limited in coverage, it went about as far as free trade agreements were inclined to go in that era. By 1866, however, it had been abrogated by the United States, partly as a response to British support for the Confederacy during the Civil War. A further and even more far-reaching bilateral free trade deal was concluded in 1911. After being passed by the US Congress, however, it was rejected by the Canadian electorate. Wilfrid Laurier's Liberal party, which had negotiated it, was ejected from office in an electoral campaign where the opposition's rallying-cry was 'No truck nor trade with the Yankees!'

This experience left deep scars and long memories in Canada, with

the result that free trade advocacy did not reappear on the political agenda for many decades. Although there was some flirtation through sectoral free trade arrangements such as the Auto Pact and the Defence Products Sharing Arrangement, the notion of a broad free trade agreement with the United States - however sensible economically - was seen as 'politically courageous' and therefore to be avoided. In fact, the policy effort was largely in the other direction - it aimed at reducing a perceived export over-dependence on the United States and controlling a perceived 'sell off' of Canadian assets into US control. During the 1970s and early 1980s, the Foreign Investment Review Act (FIRA) and the National Energy Program (NEP) were erected as dykes to stem the rising tide of US investment. The so-called 'Third Option' policy was pursued, aimed at diversifying Canada's international relations through strengthening links with overseas partners, notably Europe. Much of Canadian economic thinking remained frozen in the patterns of the nineteenth century 'National Policy' - based on protecting Canadian manufacturing operations behind high tariff walls to keep out US imports.

How then did Canadian policy evolve from this position to one of endorsing Canada-US free trade by the late-1980s? A number of factors were at play.

First, in spite of all the political energies devoted to distancing Canada from the US economy, the more powerful geographic and economic realities prevailed. The percentage of Canadian trade conducted with the United States inexorably increased. It was more and more evident that Canada's economic success would need to be found in taking advantage of this swelling tide rather than in attempting to swim against it.

Second, the benefits of Canada-US economic integration were increasingly recognized. One shining example of this was the Auto Pact negotiated in 1965. It provided for limited sectoral free trade, enabling motor vehicle producers on both sides of the border to import vehicles and parts free of duty. In the case of the predominantly US-owned producers in Canada, this duty-free import privilege was contingent on meeting certain production-to-sales ratios and maintaining certain Canadian Value Added levels in their Canadian operations.

The Auto Pact provided the basis for a major rationalization in the North American industry. Prior to its negotiation, the Canadian automotive sector had produced almost entirely for the domestic market - a 'branch plant' industry consisting of US subsidiaries replicating their US operations behind Canadian tariff walls, but with fewer models and shorter production runs. Canadian consumers had less choice than their US counterparts and paid 30-40 percent more for the same vehicle model. At the same time, Canadian workers were paid less than in the United States because the inefficiency of the 'branch plant' operations paralyzed their productivity.

Under the Auto Pact, however, Canadian facilities were retrofitted to produce a limited number of vehicle models but to serve the entire North American market. The result was highly positive not only for the US-owned auto companies who could now rationalize their operations but also for Canada - an increase in productivity, an equalization of wages, and a dramatic decrease in consumer prices for Canadian autos. There was also an enormous surge of trade in the sector to the point that two-way trade in automobiles and parts soon accounted for nearly one-third of the total bilateral trade flows. The Auto Pact, while not without its own problems and controversy, provided concrete evidence that carefully negotiated Canada-US free trade arrangements could present a 'win-win' scenario.

Of course, threat can often be an even more powerful motivator than opportunity. And a third important factor in the push toward a Canada-US Free Trade Agreement was the growing Canadian concern about US protectionism. By the mid-1980s, the swelling US trade deficit (particularly with Japan), had led to intense protectionist pressures. These were most graphically illustrated in the Congressional consideration of the so-called Omnibus Trade Bill (also known as the 'Ominous' Trade Bill because of the new legislative weapons which it would add to the US protectionist arsenal). The Nixon economic measures of 1971 had already taught Canada that its 'special relationship' with the United States was no guarantee against being side-swiped by US trade actions directed more broadly. Moreover, Canada was itself becoming a more frequent target of US trade measures, particularly in the field of anti-dumping and countervailing duties. Although these statutes were intended to deal with 'unfair trade practices' (i.e., injurious dumping and subsidization), they were being used increasingly by US industries as harassment tools against import competition.

For Canada, the softwood lumber case became the classic example of how US 'unfair trade' legislation could be used unfairly. Through unfounded allegations about Canadian provincial forestry practices, and a politically influenced decision in what should have been an impartial quasi-judicial US investigation, Canada faced the threat of prohibitive US countervailing duties being applied against billions of dollars in Canadian lumber exports. When this forced Canada to negotiate an export tax agreement to constrain its own shipments, the degree of Canadian exposure to US protectionist pressures was abundantly clear. Much of the dynamic of the Canada-US free trade negotiations was shaped by the softwood lumber experience and by Canada's conclusion that we needed new rules to control the 'rolling elephant' with whom we were sleeping.

A fourth and more positive motivation for the FTA derived not from a narrow assessment of threats or opportunities in the Canada-US trade relationship but from a broader analysis of Canada's role on the global stage. With the increasing pace of globalization, there was a growing recognition that

the choice for nations was either to compete economically or to stagnate. Canada was highly conscious of its position as the only G-7 country without secure and open access to a market of at least 100 million people. The United States and Japan had their own large domestic markets and the European countries were united in their Common Market arrangements (which, in the mid-1980s, were being further reinforced by the Single Market 'Europe 1992' initiative). In order to achieve the economies of scale and competitiveness required for the coming era, Canada had little choice but to grasp the thorny nettle of a free trade negotiation with its continental partner. Otherwise, it might face the prospect of being 'relegated' from the Premier League of world economies.

Canada's decision to engage in the FTA negotiations was also influenced by experience in other negotiating fora. In the early 1980s, an effort had been made to approach the Canada-US relationship through 'sectoral and functional' negotiations addressing specific issues and individual sectors. This had been inspired in part by the success of the Auto Pact. The approach fell flat, however, as each side sought to include only those areas perceived as being to its own advantage. Based on this starting point, the discussions failed to agree even on the scope and coverage for negotiation. It became more and more evident that the only deal in prospect was the 'big deal' where 'across-the-board' free trade would be on the table.

The inclination to grasp this nettle was also strengthened by developments at the multilateral level. The 1982 GATT Ministerial had been a notable failure and the prospects for further new strides in multilateral trade liberalization appeared remote in the mid-1980s. By 1986, the Uruguay Round had been successfully launched but was off to a painfully slow start. Canada began to gravitate toward what would soon be called its 'two track trade policy' - maintaining a firm over-riding commitment to the GATT system but at the same time pursuing a bilateral/regional strategy in order to go 'farther and faster' in negotiations with its most important trading partner.

The philosophical underpinning for the Canada-US Free Trade Agreement was laid out in the Macdonald Commission Report issued in 1985. Led by a prominent former Liberal Cabinet Minister, the Honourable Donald Macdonald, the Commission received inputs from all Canadian stakeholders and provided a highly credible and articulate rationale for a Canada-US free trade initiative. The report called for a 'leap of faith' by Canadians - faith in themselves and in their ability to compete, even against the world's pre-eminent economic superpower. Some wags spoke about a 'leap of faith through the window of opportunity onto the level playing field', conveying a somewhat suicidal image. In spite of considerable trepidation, however, the negotiations were engaged. Three years after the Macdonald Commission Report, the Canada-US Free Trade Agreement had been concluded.

The negotiations themselves form a gripping story - full of tough exchanges and high drama. Yet they were only a prelude to an equally intense battle over whether or not the Canadian public would support the agreement. The election of 1988 was marked by hyperbole and fear-mongering about the FTA. Allegations were made that it would undermine Canadian culture, lead to an erosion of Canada's social programs and health care, result in a flight of US investment and massive job losses as tariff walls crumbled, and condemn Canada to a role as 'hewer of wood and drawer of water'. An exaggeration of the threats on one side led to an overselling of the benefits on the other. The decision was a 'close run thing', as Wellington said of Waterloo. Yet, in the end, the 'leap of faith' was made.

As it turned out, Canada could not have picked a worse time to implement the FTA. The first two and a half years of its implementation were marked by a recessionary environment in North America and globally. Plant closures, layoffs, rationalization and down-sizing were the order of the day. And of course, 'every sparrow that fell' was blamed on the FTA.

Against this backdrop, it is understandable that Canada was not at the forefront of originating the NAFTA initiative. The genesis of NAFTA lay in the US-Mexico political equation. In particular, it was founded on a US recognition that an economically prosperous Mexico was in the US best interest - from the point of view of immigration policy, foreign policy, drug control, as well as mutual economic benefit. When the US-Mexico discussions on NAFTA commenced, Canada was still catching its breath from the FTA negotiations. Yet there was an immediate realization that Canada had to be a full participant. The strong and immediate Canadian support for NAFTA was based on at least three very practical considerations. First, there was the attraction of the Mexican market - 90 million consumers and the fastest-growing market in North America. Canadian companies could not afford to be on anything less than an equal footing with their US competitors. Moreover, with Mexico being a much more heavily protected market than either Canada or the United States, the reciprocal bargain in removing all existing tariff barriers was very attractive.

A second motivation was the opportunity which NAFTA offered to improve and to build on the FTA. Canada insisted that the FTA provisions be the template for the NAFTA negotiations. It was clear, however, that new and better arrangements could be made in many areas - as was done, for instance, in the areas of rules of origin, investment, services and government procurement.

A third key motivator for Canadian participation in the NAFTA negotiations was to avert the danger that a 'hub and spoke' pattern might emerge within the North American market. If the United States were to become a 'hub' from which investors could serve not only the large US domestic market but also the Canadian and Mexican markets through free trade

'spokes', Canada would find itself in a disadvantageous position both for maintaining existing investment and attracting new investors. It was clearly in Canada's interest to ensure an integrated North America market where Canadian investment locations could cooperate on an equal footing.

While the 'hub and spoke' issue was a defensive reason for Canada's participation in NAFTA, the Canadian approach to the negotiations was built much more on confidence than on concern. The NAFTA vision fit perfectly with the new outward-looking Canadian trade policy which had been reflected in the decision to negotiate the FTA. The Canadian negotiating team soon began to play a pivotal role, often helping to craft the NAFTA deals between the more adversarial US and Mexican positions. In Canada, the NAFTA was not generally seen as a momentous new departure. It was a natural extension of the new direction which had been set in the FTA. True, the addition of Mexico brought in a developing country with a lower wage structure. But Canadians were already facing the challenge of full competition with the US giant. There was a sense that 'if you could make it there, you could make it anywhere'. The FTA had always been seen as providing a platform for Canadians to achieve global competitiveness. Canada was therefore ready and eager to become part of NAFTA - the world's largest regional free trade zone.

From this viewpoint of a new Canadian confidence, it was interesting, sometimes amusing, but on balance rather disturbing, to watch the intense NAFTA debate which developed in the United States. Although the FTA had caused hardly a ripple in the US political pool, the US NAFTA debate became almost a replay of the FTA debate in Canada - marked by the same red herrings and half-truths. There were dire and ridiculous warnings of a 'great sucking sound' of US jobs flowing to Mexico and of NAFTA triggering a downward spiral in North American wage rates, labour laws and environmental standards. When Ross Perot and Al Gore held their famous NAFTA television debate, Perot was so outmatched intellectually that the situation was almost laughable. Yet the very need for this debate was disturbing since it demonstrated the degree to which support in the United States for trade liberalization had fallen under threat. The NAFTA vote in Congress was a cliff-hanger to the end. Although the Clinton Administration did eventually win the battle, the intensity of the debate left a bitter legacy, sometimes referred to as the 'tequila hangover'. The inability to date of the US Administration to win 'fast track' legislative authority from Congress can be traced in part to the NAFTA backlash, as can the current diminished US leadership in the multilateral trade arena.

But what has been the material impact of NAFTA implementation? One can look at this question from a number of vantage points, each of which has its blind spots. One approach is to analyze the impact of each of the various provisions of the agreement e.g.: general elimination of tariffs over ten

years; greater disciplines on non-tariff measures; specific sectoral provisions in areas such as energy, textiles and clothing, automotive products or agriculture; complex agreements on trade in services, investment and intellectual property; provisions to facilitate the temporary entry of business persons; the unique dispute settlement process to deal with anti-dumping and countervail cases; the ground-breaking side agreements on trade and environment and trade and labour standards. A detailed analysis of each of these provisions has the merit of precision and of focusing on what the negotiations were really about. In fact, those who rail about the impact of NAFTA on culture, social security, health care, water exports and the like, seem not to have actually read the agreement - or have failed to comprehend its textual subtleties. A substantive analysis of the NAFTA provisions, however, would require a full volume study and in any event would tend to miss some of the most important and far-reaching impacts of the agreement.

Even though my own experience has been one of fighting the technical battles in the NAFTA trenches, I consider it more valuable to stand back and to view the agreement from a broader perspective. In doing so, I would identify four particularly significant elements of the FTA and NAFTA. First and foremost is the role of these agreements in furthering the predictability of rules-based trade. This has always been a key objective of Canada's trade policy with the United States, whether pursued on a multilateral, regional or bilateral level. A rules-based trading regime is particularly important to the smaller trading partner as a means of offsetting the asymmetry of size and power. When Canada took its 'leap of faith' into the FTA, it was not with a view to removing US tariffs. In fact, 80 percent of Canadian exports to the United States were already entering duty-free and a further 10 percent at duty rates of less than 5 percent *ad valorem*. The objective in the FTA was less to enhance our market access to the United States than it was to secure it through mutually-agreed rules-based disciplines.

These rules have become essential tools in managing the Canada-US trade relationship, in keeping open the channels of trade, and in providing a predictable environment in which businesses can plan and invest for the future.

A second and related key feature of the FTA and NAFTA has been the role of these agreements in expanding the frontiers of trade policy. The FTA broke important new ground in areas such as services, investment and intellectual property. It influenced in turn the negotiations in these areas in the Uruguay Round of the GATT. The NAFTA went even further as a pathfinder agreement - the first full free trade deal between a developed and developing country, the first-ever trade agreement covering issues related to environmental and labour standards, and it continued the journey into previously uncharted territory on services, investment and intellectual property. The FTA and NAFTA are therefore noteworthy as the forerunners for a new era of trade agreements - an era when trade negotiations at all levels are becoming as much

about what happens in domestic regulatory systems as about what happens at the border.

Third on my list would be the impact of the FTA and NAFTA on business psychology. After all, trade flows are created not by governments or trade agreements, but by the activity of the private sector. The Canadian business community responded promptly and aggressively to the FTA. The planning horizons within Canadian boardrooms were immediately lifted in order to take account of the new market opportunities opened by the FTA, as well as to face the new reality that Canadian business and labour would need to compete head-on with their US counterparts. The result has been a much more sharply competitive environment but also a more confident and outward-looking Canadian business community - one that is ready to take on the challenges of globalization and to succeed.

A final over-arching impact of the FTA and NAFTA has been to raise the public consciousness of trade issues throughout North America. The debates on the FTA in Canada, and on NAFTA in the United States and Mexico, moved trade from the boardrooms to the kitchen tables, from the business pages to front page headlines. The result has not always been comfortable for trade policy practitioners, but it has set out a challenge which clearly must be met. We have traditionally lamented that 'good trade policy is often the victim of good politics' - a reference to the fact that narrow protectionist interest groups can often capture the political agenda. The lesson of the FTA and NAFTA debates is that we must work very hard to make good trade policy into good politics. We still have a long way to go in meeting this challenge fully. It will require the trade policy community to become as able at public education and advocacy as it is at negotiation.

As for the impact of the FTA and NAFTA on trade flows, it is always difficult to determine causality when a multiplicity of factors is at play. That being said, it is notable that Canada's exports to the United States have more than doubled in the ten years since the FTA was negotiated, while US exports to Canada have also increased by over 80 percent in the same period. Several studies, such as those by the Royal Bank of Canada and the C.D. Howe Institute, have also documented the fact that Canada's export growth to the United States has been strongest in the sectors liberalized by the FTA, as well as in intra-firm trade where MNE rationalization has increased the flows in both directions across the border. Canada-US bilateral trade has now reached the staggering level of over US\$1 billion per day. The FTA has been instrumental in making Canada one of the world's most globalized economies, with over 40 percent of Canadian GDP now attributable to exports.

The growth in Canadian trade with Mexico has also been strong since the negotiation of NAFTA. Although Canada-Mexico trade levels were starting from a relatively low base (e.g., just over Cdn\$800 million in

Canadian exports to Mexico in 1993), the growth in the first two years of NAFTA was over 30 percent. This was in spite of massive economic adjustments required in Mexico as a result of the December 1994 peso crisis - a crisis which would have been considerably worse for all concerned if the NAFTA had not been negotiated. The escalating Canadian business interest in Mexico augurs well for an ongoing strong growth in the Canada-Mexico economic relationship. It has also precipitated a broader Canadian business interest in Latin America, one to which the Canadian government has been responding through its negotiation of a free trade agreement with Chile and its leading role in the effort to create a Free Trade Agreement of the Americas (FTAA).

There are some who criticize NAFTA for not having solved the thorniest Canada-US trade problems and who point to the ongoing battles over such issues as softwood lumber, antidumping cases, cultural issues, agricultural trade and extraterritoriality (e.g., Helms Burton). As a warrior in these battles myself, I would be the first to acknowledge that the NAFTA does not have the capacity to solve all our bilateral trade problems. But to expect it to do so would be unrealistic. A trade relationship as large and as complex as that between Canada and the United States will inevitably have a certain number of friction points.

Many of the seemingly intractable problem areas in the Canada-US trade relationship are ones which the FTA and NAFTA did not significantly touch. A good example is the cultural sector where Canada insisted on a 'cultural exception' in both the FTA and NAFTA in order to maintain the capacity to protect the cultural industries considered so vital to the Canadian identity. In the agricultural sector, both Canada and the United States also kept certain sectors off the table, including the supply managed dairy and poultry sectors for Canada and the heavily protected sugar industry in the United States. On antidumping and countervail, the FTA made major strides. In fact, the unique Chapter 19 dispute settlement system, which was established to deal with these matters, has often been called the 'crown jewel' of the FTA. The agreement did not, however, go nearly as far as Canada would have liked. Chapter 19 has succeeded in bringing antidumping and countervailing duty measures under the review of an impartial binational Panel system. It has not, however, precluded the use of such measures within the free trade area, nor did it require any specific changes to the domestic legislative frameworks within which such measures operate. Accordingly, US countervail and antidumping threats and actions continue to raise uncertainties for Canadian exports, to the extent that some regard Chapter 19 as the FTA's 'black hole' rather than its 'crown jewel'. As evidence of the continuing problems, one need only consider the steel sector, where the trade flows across the Canada-US border have been heavily constrained as a result of antidumping measures being applied in both directions. Similarly, the threat of

US countervailing duty action has continued to plague Canadian softwood lumber exports, with the result that Canada was once again pushed into negotiating an export tax agreement in 1996 to restrain its own exports. This dispute, which was so important in the dynamic of the mid-1980s leading up to the Canadian decision to negotiate the FTA, seems to be the 'Energizer Bunny' of Canada-US trade disputes: it just 'goes on and on'.

While the FTA and NAFTA have clearly not solved all the problems, they have opened vast new opportunities for trade and investment linkages within the North American continent. They have also lifted the horizons of the business communities and the general public in all three countries. For Canada, the FTA and NAFTA have produced a new confidence and assertiveness on the trade agenda, as evidenced by Canada's position at the forefront of efforts to negotiate a Free Trade Agreement of the Americas and a free trade area within the Asia Pacific region, as well as by Canadian advocacy of a Trans-Atlantic Free Trade Area and of major new trade liberalization initiatives in the WTO. The FTA and NAFTA have indeed marked a turning-point for Canada. While the full impact can only be assessed over the longer term, the beginning is certainly a promising one.

#### **Author Note**

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