

Is the Impact of the North American Trade Agreements Zero? The Canadian Case

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Paul Krugman, the American trade economist, was reported as saying during a Canadian visit that the impact of NAFTA on the US and Canadian economies is zero (Contenta 1997). His contention that international trade is less important than many people think might have some merit for the US which is commonly viewed as a continental trade-zone in its own right (*The Economist* 1997) and where less than 12% of GDP is contributed by exports. In this paper I contend that NAFTA and its precursor FTA have generated important impacts on the much smaller and more open Canadian economy.¹

The theory of regional, as distinct from multilateral, trade agreements provides an initial base for doubting whether Krugman's statement would apply equally to the smaller economy. Commentaries on the form of FTA and NAFTA also point to a real mismatch between Canada's aspirations and the resultant agreements. After distilling some key current ideas, I explore evidence of recent Canadian economic shifts and the extent to which these may be attributable to the trade agreements. In identifying the locational and industrial implications of the free trade agreements for Canada, I have focused on four broad questions.

Has Canada become less attractive to foreign investment as a result of FTA-NAFTA? Traditionally, there has been a net in-flow of foreign capital. Although the trade agreements removed restrictions on direct investment, and though anti-free trade voices warned about the extension of foreign control of Canadian resources and other assets, concern has been voiced that foreign manufacturing subsidiaries and branch plants would retreat to US, and later to Mexico, and gut Canadian manufacturing.

Have East-West flows of goods and services within Canada been reduced in favour of a stronger international North-South orientation? With reduced Canadian barriers to imports it was widely surmised that many types of supply systems linking US regions with neighbouring regions in Canada would substitute for domestic arrangements.

Has there been a restructuring of Canadian trade, especially with US? The Canadian hope was that reduced US barriers to Canadian goods and services would remove the constraints of a small national market and stimulate increased exports of secondary manufactures and highly processed commodities. This would have the effect of reducing Canada's traditional dependence on exports of raw materials.

Has the prospect of greater North American integration improved the competitiveness of Canadian industry? Canada's broad industrial goal was to generate a faster upward trajectory for productivity as a way to gaining international industrial competitiveness. Firms would fail if they

did not adapt to more open markets but increased competition at home would help identify internationally capable firms and industries, especially those that could benefit from specialisation and economies of scale.

Theoretical Background

The growth and the geographic and structural change in international trade over the past three decades have stimulated an extensive literature, much of which has come to be known as the "new trade theory". This has drawn concepts such as increasing returns to scale and technology-based specialisation from industrial organisation theory and integrated them into the analysis of international trade (Krugman 1992). Lower transport costs, better communications, and lower trade barriers have had some influence on the growth of trade. Increasing importance, however, is placed on the technological convergence of developed countries and the growth of intra-industry (and intra-firm) trade, especially for technology intensive goods.² Moreover, there has been growth in exports of products from developed and some developing countries that meet the needs of highly specialised (niche) markets (Lawrence 1996).

The search for international markets by corporations is linked to their desire to secure scale economies as a way of offsetting the costs of innovation.³ Firms competing internationally need a presence in their foreign markets to identify changes in tastes in these areas, to anticipate the needs of users, and to acquire innovations developed in these locations. For these reasons, foreign direct investment and exports have become complementary activities and this applies to manufacturing especially but also to associated services, and newer services such as those based on IT. Thus, the globalisation of industrial firms and their strong interest in the harmonisation of regulatory policies (Ostry 1996) lies squarely behind the actions of countries to negotiate agreements over trade, competition, technical standards, intellectual property rights, and investment (Lawrence 1996).

The ideas of particular importance for this paper that are found in the "new trade theory" are those dealing with the potential merits and impacts of regional trading arrangements. Contemporary regional agreements have complex goals and provisions that go much further than tariff liberalisation, or removal of so-called "barriers at the border" (Lawrence 1996). While they seek the growth of exports through reduced import tariffs they are also concerned to reduce non-tariff barriers and to increase regional economic integration by means of institutional compatibility, and harmonisation of the rules of competition (including standards) and investment. There is considerable debate in the trade literature over the merits of the multilateral approach to the liberalisation of trade compared with "regionalism" (Gibb and Michalak 1994). The heart of the issue involves the structure of regional agreements and those of EU and NAFTA are often cited because of their extension into areas of institutional agreement well beyond the reduction in barriers undertaken under the auspices of GATT, and now the WTO.⁴ While explaining that GATT had provided reasonable conditions under which it would approve regional agreements, Bhagwati (1993) argues that the "revival of regionalism is unfortunate", cautioning that its growth can only weaken the drive of countries for multilateral free trade. He and other proponents of multilateralism explain that regional agreements are strongly inward-looking and are designed to divert trade away from economies that are not members.⁵ The tendency of these agreements is to design complicated trade barriers built on arbitrary definitions

of the "nationality" of products (Bhagwati 1997; Corden 1997). In this respect, they are preferential trading agreements rather than advances in free trade.⁶

Regionalists, however, point to the propensity for trading agreements to be developed by neighbouring members of major world regions. The implication is that the route to agreement among regional partners is easier and quicker than negotiations conducted among the full international cast of nations. Krugman (1993) suggests several factors were important in the US switch toward regional trade agreements instead of its formerly exclusively multilateral approach, in particular:

- problems caused by negotiations among the large numbers of players
- the rise of new protectionist devices such as anti-dumping rules and voluntary export restraints which have complicated negotiations on a multilateral basis
- the reduced interest and power of US to enforce cooperation over trade, and
- institutional differences, especially between Japan and US, that undermine the process of reaching cooperative solutions at the multilateral level.

The actions of small economies also may be influenced by some of the factors outlined by Krugman. But it is also evident that they have been motivated as much, if not more, by the lure of access to larger markets that multilateralism under GATT did not provide. Consequently, some have sought "safe haven agreements" with their large trading partners (Whalley 1993), hoping to avoid future protectionist actions and the negative impact of potential trade diversion measures. The asymmetry in power between large and small countries, however, reduces the effectiveness of small countries in bargaining. For this reason, Corden (1997) argues that regional free trade agreements are prone to loopholes which prevent assured free entry of the small country's goods in the larger market. He cites as an example of the problem anti-dumping cases which he regards as back-door protectionism. Small countries are also more vulnerable to the slippery nature of capital: locational competition to attract industrial firms increases the mobility of capital and thus the ability of countries to obtain compliance with higher standards declines (Lawrence 1996).

Despite these problems, many scholars think that regional trade agreements "are here to stay". This sentiment may reflect the way international trade patterns have resolved into an ever smaller number of mega-sized trading-regions whose upward trajectory of internal flows has matched flows at the supra-national level (Poon 1997). The driving forces have been the globalisation of corporations, the reductions in trade-barriers effected by GATT, and market convergence in income, technology and tastes. The form of the international system that emerges seems sympathetic to the general goals of regional agreements and some commentators view them as an intermediate stage towards multilateral negotiations. In attempting to be systematic about this possibility, Lawrence (1996) makes the case that regional free trade agreements will advance the WTO agenda if two conditions prevail: they should not generally exemplify protectionist motivations, and they should be open to expansion.

Canadian Institutional Background

Free trade with US has been a recurring idea for Canada and in recent decades a sequence of Canadian studies advanced this proposition and supported renewed interest. In simple terms, their orthodox economic argument was that access to the US market, which is ten times the size of Canada's, would lead to the restructuring of plants, firms and industries, strengthen manufacturing and its technological base, and diversify Canada's strengths away from resource dependence. There was always debate on the merits of the case⁷, however, and critics like Wilkinson (1986) were concerned about "the common and overly optimistic perception by Canadian economists" of what Canada could expect to achieve.⁸ New political coalitions emerged in 1980s, however, and free trade became more than a theoretical proposition. Soon after the conclusion of the Tokyo Round of tariff reductions, Canadian business organisations especially the Business Council on National Issues (BCNI) began lobbying for an agreement with US (Cameron 1988; Nevitte 1995).⁹ The BCNI was a key player because it represents the interests of large corporations and is the "forum for multinational capital" (Langille 1987). These firms, already beneficiaries of increasing returns, could only improve their North American position if market integration became a real possibility. In this respect, the "new trade theory" represents the interests of large corporations even within regional trade agreements.

While reduced tariffs might have been important to individual producers, what Canada needed was a means to limit US protectionism (Ostry 1992) and FTA was seen as the way to secure access to the US market and to obtain remedies for persistent anti-dumping and subsidy-countervail actions. These emerged as vital components of Canada's regional trade policy because US is "the world champion in the use of these co-called unfair trade practices" (Weintraub 1997). They involve the repeated targeting by US lobby groups of the level of Canadian shipments of particular products and generate uncertainty about Canada's access to the US market. Canada and US found it impossible, however, to negotiate a common set of rules for subsidies, countervailing duties or anti-dumping duties in the FTA though bilateral procedures were developed to attempt the resolution of trade disputes on a case-by-case basis.

Strategically, Canada had a strong, defensive interest in being a full partner in NAFTA. The alternative, a formal "hub-and-spoke" arrangement, would have left Canada (and Mexico) with inferior access to the North American market. Canada had no interest in allowing US to establish a bilateral deal with Mexico and it had every incentive to insure that Canadian firms and locations were not disadvantaged.¹⁰ In addition, NAFTA was seen as a further opportunity to resolve trade irritants by clarifying subsidies and limiting the application of countervailing duties (Hufbauer and Schott 1992). The substantial power of US trade and industrial lobby-groups against imports, however, has not been curbed and contingent protection, known as "the black hole" of FTA, still remains in NAFTA (Wonnacott 1995).

The theoretical literature on trade agreements warns that Canada should have expected only limited gains from trade agreements with US because of the power imbalance. An important example is the privileged access US obtained to Canadian resources and resource-based products (Wilkinson 1991).¹¹ In practice, too, the specific trade disputes between Canada and US support the small country syndrome outlined by Corden (1997) and others.¹² If we apply Lawrence's criteria for judging whether a regional free trade agreement supports the WTO agenda, it is

evident that on the matter of openness of the agreement that political conditions in US have swung against Chile joining the NAFTA. On the second issue of fairness, complex rules of origin that apply to automobiles, televisions, and textiles as part of NAFTA exemplify intent to divert trade. Nevertheless, the strongest conclusion is that the strength of the aggravation caused by uncertainties associated with access to the US market has been reduced.¹³ Therefore, on institutional grounds, FTA and NAFTA have not been a zero. In the following sections, I examine some economic indicators of the possible outcomes of the agreements.

[FIGURE 1 Foreign Direct Investment in Canada and Abroad 1980-1996](#)

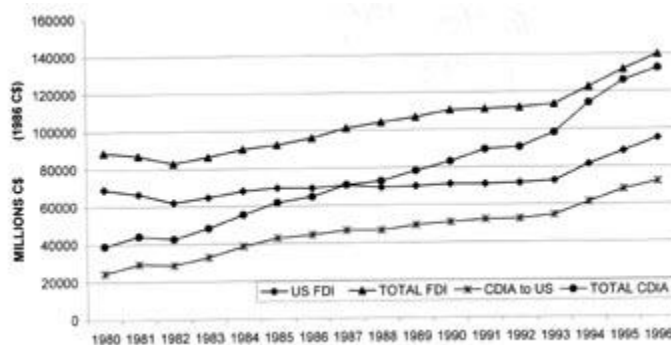


FIGURE 1 Foreign Direct Investment in Canada and Abroad 1980-1996

Shifts In Foreign Investment and Canadian Trade

Foreign Direct Investment

Although the FTA and NAFTA are called trade agreements, the free trans-border flow of capital was also a corporate goal because of the complementary relationship between trade and investment, a connection recognised in modern trade theory. Since 1994, which marked the end of the recession period, the "trade" agreements appear to have increased Canada's global investment links with more Foreign Direct Investment (FDI) into Canada and from Canada to other countries (Figure 1). We can assess the impacts of the agreements in the context of the long-term evolution of the patterns of Canadian foreign investment. In the following account, the accumulated value of foreign investments commonly known as the book value of investment at year-end is used as this accommodates flows in and out, reinvestment of earnings, and depreciation and appreciation of assets.

Foreign direct and portfolio investment have strong historical association with Canadian economic development.¹⁴ FDI is very heavily entrenched in manufacturing with 65% of sales by manufacturing firms in Canada being made by foreign owned firms (Corvari and Wisner 1993). In the past, many investments in manufacturing were a response to tariff barriers and it was expected that FTA and then NAFTA would lead to various forms of North American corporate rationalisation. While this could reduce the level of FDI in Canada there have been good reasons to expect Canada to attract direct investment. Canadian wholesale and retail trade have been opened to greater cross-border integration, and new investment has occurred in, and more is

expected in, the resource and financial sectors and in emerging economic activities. Similar expansions of Canadian investment in Mexico and in US were also anticipated.

Changes in Canada's investment abroad has been occurring over the past three decades but the trade agreements appear to have added a new set of options. Historically, Canadian investments abroad were modest but the corporate development of the Canadian economy, especially the expansion of the international operations of Canadian corporations, has altered this one-sided pattern of investment. In the 1960s, the book-value of FDI in Canada was about five times the value of Canadian investments abroad but the pattern of change has reduced the ratio to 3.5 times in the 1970s and the relationship now has fallen to nearly parity. This is the result of the substantially faster increase in Canadian foreign investments abroad. In the period 1980-1988, average annual growth was over 8% compared with 2% for FDI in Canada, while over the next 8 years (1988-1996) the average annual rate for FDI in Canada increased (to 3.7%) the growth rate for direct investments abroad (7.8% pa) remained substantially greater. Compared with the accumulated value of Canadian direct investments abroad, annual flows abroad are tiny -- about 2% -- and are very much smaller than annual capital expenditures made within Canada.¹⁵

Before FTA, Canadian corporate investment in US allowed manufacturing firms to cope with US tariff and non-tariff restrictions on imports. For others involved in activities such as retailing and urban development the larger US market had encouraged Canadian firms to seek growth by investment.¹⁶ As Canadian investment grew it favoured the US whose share expanded from 51% in 1972 to nearly 70% by 1984. Since FTA, however, the incentive to invest in the US has weakened and Canadian investments have expanded in other countries across the sectors.¹⁷ Non-US locations now account for 46% of Canadian foreign direct investments. This reflects the attraction of other production and service bases for Canadian firms, the accumulated capital already invested in US, and the greater ease with which Canadian firms now can access the US market from a home base. Nevertheless, Canadian investment has been made in the Mexican banking sector and in the auto, software, real estate, services and mining industries (Rugman et al 1997). Infrastructural projects are particularly important avenues of investment expansion as they increase the capacity of Canadian manufacturing firms to sell in both US and Mexico -- gas pipelines in US and Mexico and rail system integration are notable cases.¹⁸

Over the past three decades, there has been increased interest by non-US investors in Canada and their share has grown from 17% in 1960 to 36% in 1990-92. However, most of the shift occurred during the late 1980s, before FTA. During the 1990s, some US firms and others with origins outside North America have reduced their Canadian direct investments but others have taken over Canadian businesses.¹⁹ Both processes were an expected result of free trade.²⁰ By contrast with US and European companies, however, Japanese corporations collectively were later investors. They have developed resource projects and invested in new manufacturing plants and their actions imply that production costs and location do not necessarily work against Canadian sites (Edgington 1995). If anything, NAFTA confirms to Japanese companies that North America is one integrated production network. New Japanese interest is anticipated in services and property. Until recently, further Japanese investment was expected in the auto industry but now this is in doubt as a consequence of Canada's June 1998 decision to maintain tariff discrimination against imports of vehicles by companies not members of the Canada-US Auto Pact.

Contrasts in Acquisitions

Despite the high level of foreign ownership in Canada, investment opportunities continue to be realised. Many are found in activities that generate new firms and almost all of new foreign direct investment (97.5%) is made in the form of acquisitions rather than the establishment of new businesses (Hurtig 1998). Inbound direct investment in Canada has tilted towards technology intensive industries (MacPherson 1996) and for at least the last decade there has been a steady pattern of acquisition of technology-intensive firms accounting for about 60% of all acquisitions. About half these were computer service/software companies while the others came mainly from a variety of manufacturing industries. US companies grabbed over 60% of these acquisitions the majority of which (over 70%) are in Ontario. If the total number of high-tech firms acquired during the past decade (378) is compared with the province's total of industrial R&D units (2,200) the considerable significance of these acquisitions can be gauged. There has, however, been no research using recent data on the impact of this ownership switch: for example, research is yet to be undertaken on whether the core operations of software firms remain or are moved and integrated into US locations.

In the past, Canada has been much more sensitive to the pattern of foreign acquisitions. A peak was reached in 1973 when the Foreign Investment Review Agency (FIRA) began reviewing corporate acquisitions to ensure that foreign investments were in Canada's interests. Since then, these review provisions have been progressively weakened and the size of firms that may be taken over has floated up to \$168 million (1996) from the \$5 million threshold introduced when FIRA became Investment Canada in 1984 to \$150 million in 1992 (MacPherson 1996).

If a strong presence of foreign investment has characterised manufacturing and software production, there has been institutionalised resistance to foreign ownership in the financial sector, especially in banking. Nevertheless, an evolving pattern of regulatory change in the financial sector was absorbed as part of the FTA and NAFTA negotiations. The 1980 Bank Act clarified and in some ways liberalised the conditions under which foreign banks could operate in Canada. By the mid-1980s, too, as noted earlier, banks had moved into the investment (securities) industry thus beginning the process that would open up each of the four pillars of the financial establishment to ownership by institutions from other parts of the sector. In this environment, FTA guaranteed freedom of US banks from certain asset constraints while NAFTA established agreement on a set of principles that govern each country's financial institutions (Chant 1997). The net effect has not been a surge in foreign ownership of bank assets in Canada probably because of remaining restrictions, including the limitation that foreign banks must be stand-alone subsidiaries (Chant 1997).

There is a clear contrast between the direct US ownership of Canadian non-financial capital which has reached almost 25% and Canadian bank assets where it is only 2% (von Furstenberg 1997). Nevertheless, there is clear international interest by investors in Canadian bank stocks. This is seen especially in the way, in recent years, the price/earnings ratios for Canadian bank stocks have converged with those of US banks. Part of the explanation for this shift might be the expansion in the assets of Canadian banks which have absorbed other financial houses in Canada (trust companies and brokerage firms). Presumably their share prices reflect their investments in

US and Mexico. The Royal Bank, for example, now has 9% of its assets in US and the Bank of Montreal 28%.

[FIGURE 2 Canada: Imports and Exports and US \\$ Exchange Rate 1980-1996](#)

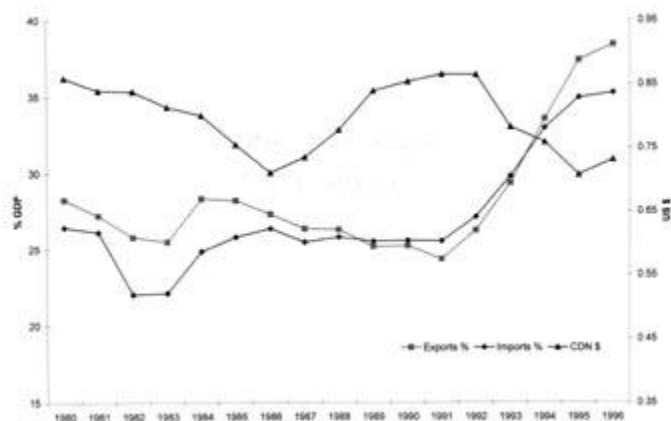


FIGURE 2 Canada: Imports and Exports and US \$ Exchange Rate 1980-1996

[TABLE 1 Canada - Growth in Goods and Services Trade \(\\$ billions\)](#)

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Activity	1981			1989			1994			1996		
	\$	\$	%	\$	\$	%	\$	\$	%	\$	\$	%
		1986	GDP		1986	GDP		1986	GDP		1986	GDP
Inter- prov.	98	121	27.5	152	132	23.3	155	124	20.7	160	124	20.0
shipments												
Internat.	97	120	27.2	164	143	25.2	251	200	33.6	307	238	38.5
Exports												
Internat.	93	115	26.1	166	145	25.4	246	196	32.9	281	218	35.2
Imports												
GDP	356	440	--	651	567	--	747	595	--	798	618	--

Confirming the Pattern of Canadian Trade

Canada is the most export dependent economy among the G7 and this openness has been increasing over time. Not only did exports double in (constant) dollar value, 1980-1996, but also the share of GDP attributable to exports has jumped from 25% (1989) to 38% (1996) (Table 1). Imports have moved in a similar way (Figure 2). There has been a strong geographic component to growth: trade is focused on the US even more than previously. Its share of exports once 64% (1980) is now 83% (1996)! So strong is this trade dependence that many commentators single out the very limited exports to non-North American destinations as a hazardous feature of the economy. While FTA and NAFTA certainly stimulated these cautionary assessments, the increase in shipments to the US conforms to a pattern of increasing economic association. Over the long-term, the proportion of GDP attributable to merchandise exports to US has been inversely related to the declining rate of tariff protection (McCallum 1995).

The period since 1991 has been one of substantial growth of imports and exports and both cyclical factors (the end of the recession) and institutional changes appear to be responsible. Though the task here is to assess the trade impacts stimulated by FTA and NAFTA, this is made difficult by the shifts in the value of the Canadian dollar (CDN \$). In particular, from 1988, high interest rates were used by the Bank of Canada to fight inflation and the CDN \$ appreciated against the US dollar from 72c to over 87c (Figure 2) and high interest rates and a high dollar led the economy into recession in 1989. The domestic market shrank as a result of recession and monetary policy, the bankruptcy rate increased significantly, some foreign manufacturing firms closed and in other cases restructuring was given a very strong impetus. The new trade circumstances combined with the cyclical and exchange situation in an especially potent fashion. The CDN\$ remained high until 1991 when it was allowed to return to 74c. Increased exports coincide with the shift in the exchange rate and with the faster real growth in the US which experienced a less severe recession. After FTA, Canadian firms paid serious attention to the opportunities available in the US market. These evolving relationships have been particularly influential because they occurred at when there were negative impacts on domestic trade because of the severity of the Canadian recession at the beginning of the 1990s, and the slower pace of domestic economic recovery.

North-South versus East-West Trade

One way of gaining some perspective on the impact of these changes in economic conditions is to evaluate shifts domestic flows compared with international trade. Throughout this century, an inter-regional trade system in Canada has supported the industrialisation of the central provinces that have generated east-west flows of an exceedingly broad variety of basic materials and durable and non-durable consumer goods. In simple terms, under various levels of tariff protection, some economies of scale were generated in the production and distribution functions of the central provinces and these compensated for shipment costs incurred in supplying the extensive, narrow spatial band of the national market. Canadian manufacturing also attained substantial diversity and technological development which were assisted by tariffs and policies supporting R&D and the adoption of new process technology.

Locationally, Canada's economic pattern is simple as is true for trade. Ontario has 50% and Quebec 28% of Canadian manufacturing (employment) and the proportion for Ontario rises to 55% for secondary manufacturing. The other regional economies are specialised in resource

extraction and processing an economic structure which was responsible for the substantial openness of the Canadian economy before the Auto Pact of 1965 and for the susceptibility of these other provinces to fluctuations in international markets (Barnes 1996; Norcliffe 1996). An effective set of backward linkages has not been established between the resource industries and Canadian suppliers of machinery (Britton 1996; Cohen 1991) and this is one reason why secondary manufacturing is too small in regions, other than Ontario or Quebec, to have experienced significant trade-based industrial restructuring. Firm-specific effects could be cited for each province but the largest aggregate industrial effects come from Ontario's firms and these dominate the national pattern of change.

[TABLE 2 Shifts in International and Inter-provincial Trade 1989-1996](#)

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	Average Annual Rates of Change (based on \$ 1986)		
	Ontario	Rest of Canada	Canada
Inter-provincial service exports	1.3	-1.8	-0.4
Inter-provincial goods exports	-2.7	-0.2	-1.2
International services exports	7.7	5.3	6.5
International goods exports	7.9	7.6	7.7

Some commentators have suggested that the impact of the trade agreements would be to weaken the east-west orientation of Canadian regional economies and to strengthen their north-south connections (Bourne 1995; Courchene 1995). This has occurred though the pattern was set long before the trade agreements. Even during the 1980s, inter-provincial trade grew at only a third of the rate of growth of Canadian GDP though actual decline did not occur until the 1990s (Table 2).²¹ While inter-provincial shipments contracted, 1989-1996, GDP grew at an annual average rate of 1.2% and international exports grew at 7.7% through the recession and into the period of recovery. The result has been that inter-provincial flows of goods and services, equal to exports in 1981, slid to only half the level of exports by 1996 (Table 3).

McCallum (1995) and Helliwell (1995, 1997) have investigated the much greater development of inter-provincial merchandise exports relative to the size and location of economic regions distributed south and north of the Canada-US border. At the time FTA was introduced, trade between provinces was more than 20 times larger than trade between a province and a state.²² Between 1989 and 1996, merchandise exports to US grew by an annual average of 9%, and the resultant ratio of inter-provincial exports/ exports to US shifted from 100% to 50%. McCallum's equation would now find that inter-provincial merchandise trade has declined to about 10 times as large as would be expected taking distance and scale into account.

[TABLE 3 Inter-provincial/International Export Ratios \(%\)](#)

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	1989	1996
Canada - Goods and Services	93	52
Goods	74	41
Services	209	131
Ontario - Goods and Services	83	44
Goods	66	32
Services	191	124
Rest of Canada - Goods and Services	102	59
Goods	82	48
Services	224	138

Source: See Table 1.

Compared with merchandise exports, Canada has weak exports of services. In 1996, services were less than 15% the size of merchandise exports and less than 10% of goods exports to US. This pattern has proved more resistant to change than is true for goods and the 131% (1996) ratio of inter-provincial to international service exports reflects this. Perhaps this should have been expected from experience in US where services are substantially less export oriented than manufacturing (Howes and Markusen 1993). Nevertheless, a factor likely to influence the rate of change in Canadian service exports is the more highly regulated circumstances of financial and associated service firms (see above). Despite this, Canada's international service receipts have grown at an annual average rate of 6.5% while domestic service trade has been more-or-less static. These very different experiences have weakened the inter-provincial/international export ratio (Table 3).

The processes of adjustment to North American integration do show regional differences in services exports. Ontario is the national concentration of financial and insurance services and head office functions (these are primarily in Toronto) and in contrast to the negative trend for the rest-of-Canada its inter-provincial role in the provision of services expanded 1989-1996 at a modest rate (Table 2). By contrast, growth in service exports has been achieved by the rest of Canada and this has been based on service specialisations associated with the resource industries (Davis and Hutton 1993).

It is important to recognise that import competition has weakened Ontario's traditional hold on its inter-provincial exports of processed foodstuffs and durable consumer goods. The growth in imports occurred despite the recession and the fall in the CDN \$ in 1991 and they have had impacts on Canada's east-west trade system, the growth of merchandise imports having replaced some former domestic flows. This effect has been much weaker for service imports.

TABLE 4 Trade Balance, Canada, (1986 C\$ '000 000 000)

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	1989	1996
Exports	142.6	237.4
Goods	123.1	207.2
Services	19.5	30.2
Imports	144.6	218.0
Goods	117.9	180.5
Services	26.7	37.4
Trade Balance	-1.9	19.4
Goods	-5.2	26.7
Services	-7.2	-7.2

Source: See Table 1

Structural Changes in International Exports and Imports

The result of export growth compared with imports of goods and services is registered in the trade balance on goods and services (Table 4).²³ Since 1993, a period of trade deficit has ended. This reflects a variety of factors, including the faster rebound of US demand and presumably the 1991 shift in the value of the Canadian dollar. In the discussion that follows, I focus on the 1992-96 period when the value of the dollar was stable as a way of minimising the effect of this exchange rate variation.

The 1996 trade balance is the net outcome of a merchandise surplus (\$26.7 billion 1986 dollars) and a services deficit (\$7.2 billion). Canada has never joined the group of developed economies that have service trade surpluses because of the large scale of imports of services by foreign companies. Traditionally, the merchandise surplus in Canada's trade balance has been the result of resource-based exports and Canada's comparative resource advantages continue. Though there has been some reduction in the degree of export dependence on staples such as pulp, newsprint, and lumber, other products such as electricity, wood-fabricated materials, and specialised papers have experienced larger exports. It is in the manufactured end-products sector, however, where more dramatic change has occurred. In 1960, these were only 8% of Canada's exports though they contributed the major share of imports. Since then, there has been a substantial relative growth in this sector. By 1970, the export share of end-products had increased to 34% (Science Council of Canada 1981) and the upward trend has continued, reaching 41% before FTA (in 1988) and 48% in 1996.²⁴ Viewed against this background, FTA and NAFTA have reinforced or assisted trends that were already manifest towards greater proportions of end-products in Canadian exports.

Two very different components contribute to the expanding trade balance in manufactured end-products. The managed trade arrangement in the auto industry has generated a fairly reliable trade surplus in parts and cars for the last 15 years and its surplus has risen to nearly 35% of the

merchandise trade balance.²⁵ The expansion in auto trade exports has allayed some fears that the industry would be vulnerable as the industry switched from the regime of the Auto Pact to that of the trade agreements. The trade balance in other end-products continues its long-term negative pattern but it has experienced impressive improvement in a variety of technology-intensive sectors such as industrial machinery, other equipment and tools, office equipment, telecommunications equipment, precision equipment and aircraft and parts. Both imports and exports have grown but exports more so, narrowing the size of the gap. In 1995, also, exports of other end-products exceeded the scale of auto exports and this is a milestone of some significance at a time when Canada was improving its position in auto exports. It is important to recognise that increased exports in other end products inevitably require imports of equipment and components and sub-assemblies to sustain them. For this reason, it is the more impressive that the trade deficit recorded for other end products has been reduced from 80% of their exports to 43% over the five-year period of stable exchange rates.²⁶

Given the positive influence of the trade agreements on the growth of imports (noted above) the obvious question is: "In which product groups have trade effects been the strongest?" The first outcome to note is that there has not been radical change in the composition of products entering Canadian markets since 1989. Most of the structural changes have taken the form of higher rates of growth of imports from US in product groups such as furniture that were known to be trade-sensitive and where liberalisation occurred (Schwanen 1997).

The impact of NAFTA on Canada's trade with Mexico is more difficult to gauge especially in light of the Mexican currency crisis of December 1994. Ultimately, there should be a stronger effect on Canada's exports than imports because traditionally there were Mexican import restrictions while the Canadian market has been quite open. Nevertheless, the schedule for reduction in Mexican tariffs is quite gradual. Since 1990, Canadian imports from Mexico have been expanding at an annual average rate of 21% and this has not been changed by NAFTA. Meanwhile Canadian exports have grown at a rate less than 10% and the trade gap has been expanding. Canadian firms, however, are expected to have better access to the Mexican public sector market including the petroleum sector, transit infrastructure and telecommunications. Current projects involve the redevelopment and expansion of the telephone system and building and operating parts of the natural gas pipeline system. These investments have followed the opening of the Mexican market for oil and gas infrastructure in 1995. In this respect the plans developed by a number of pipeline companies build on their experience in the development of supply networks serving US markets with Canadian gas. Nevertheless, Mexico's trade with Canada is very limited at this point. The great increase in Canada's trade with US, 1989-1996, overshadows all other changes, too, including increased merchandise exports to and imports from EU (excluding UK), which have grown at 2.9 and 4% per annum.

Industrial Effects of the Trade Agreements

From the late 1980s, as I have indicated, the Canadian economy experienced severe strains. As part of this experience, it lost over 15% of its manufacturing employment (1989-1992). This involved nearly 300,000 fewer being employed in manufacturing within three years of the introduction of FTA (CANSIM database) while other estimates such as that of the Canadian Labour Congress (Merrett 1996) range as high as 400,000 persons or 20% of the manufacturing

workforce. Manufacturing jobs in industrial centres with large proportions of trade-sensitive industries were especially hard-hit. The Toronto CMA, for example, experienced a 21% reduction in manufacturing employment (1990-93). These losses cannot be attributed solely to the impact of FTA. Rather, the best explanation seems to be that the recession, and corporate responses to freer trade interacted with factors such as technological change and the outsourcing of service functions which have been responsible for generating the long-term rate of decline in the proportion of jobs in manufacturing.

The introduction of the FTA and NAFTA made no allowance for the ease with which US-based firms could continue to sell in Canada while reducing their Canadian production and jobs. Likewise, no measures were put in place to assist the predictably greater problems of adjustment of small Canadian firms. Canadian election promises to introduce assistance for displaced workers were never met and it is a bitter irony that the smaller more vulnerable and trade-sensitive economy did without this while the US introduced a program devoted to trade assistance. Some jobs have been created or recovered in recent years (manufacturing jobs are now back to 92% of their 1989 level) and claims have been made that free trade has had little net effect on manufacturing jobs (Schwanen 1997). More weight, however, should be placed on the contrasting experiences of different industrial groups. Those that previously were tariff-free, such as aircraft and auto have regained a high proportion (93%) of the manufacturing employment they have lost since during the recession compared with 1989.²⁷ Moreover, these were the high wage industries in which wages increased to over 23% above the manufacturing average. At the other extreme, new competition and imports, the strategic closure of branch plants and the failure of firms have meant substantial contractions in jobs in a variety of industries known for inefficiency of scale and labour intensity. In the beverage, textiles, clothing and printing industries, for example employment in 1996 was only 76 of its level before FTA. In industries with this type of experience low average wage rates have fallen even further to 83% below the manufacturing average.

Weak Productivity Gains and the Technology Gap

Though exports increased during the 1990s, the rate of recovery of the Canadian industrial economy has been disappointing. Though the economy grew at 5.4% in 1994 the rate of growth declined in the following years to 2.5 and 2.4%. To the extent that manufacturing productivity continues to increase, it is at a very low rate, and the substantial productivity gap with US manufacturing has been widening. Between 1991 and 1996, US plants raised their rate of output per hour worked by over 18% but in Canada the rate was only 12% (Little and Stinson 1997). The productivity advantage of US over Canada which was 23% in 1985 had grown to 50% by 1996 (Crane 1997). Two factors compensate for these productivity differences. Wage gains in Canada have been held down as a result of higher rates of unemployment and have been considerably less than those in the US and the present level of the CDN \$ also shelters Canadian producers. Consequently, unit labour costs in Canadian manufacturing declined 1991-96 by 20% when expressed in US\$ and this generated Canadian advantages that will likely hold as long as the exchange rate does not climb.

Explanations of Canada's low level of productivity and poor rate of productivity growth have involved three arguments:

- tariffs have distorted the industrial choices that would otherwise have been made, especially by foreign firms
- the small scale of the Canadian economy and the inefficient scale of many producers that were dedicated to the Canadian market rather than to significant export sales, and
- the slow rate of innovation and technological change which permeates Canadian industry (Britton 1996).

In seeking FTA and NAFTA, Canada implicitly used trade policy as an instrument to encourage a structural economic shift towards high-value-added activities and the trade agreements were presented to Canadians in the industrial regions as a way to stimulate high-income jobs and increased productivity (Lipsey 1994). Despite this, trade policy has no direct leverage on the technology gap that pervades comparisons of Canadian and US manufacturing and this lack of linkage is illustrated by the absence of a general increase in productivity. Moreover, there has been no growth in the rate of spending on R&D in Canada and minimal expansion of the proportion of the workforce in Scientific and Technical occupations. It is no surprise, therefore, that there has not been a surge in the Canadian rate of industrial innovation or technological development. Nevertheless, theory identifies these factors as driving firms to enter international markets and as the basis for achieving sustained success. It would seem, therefore, that considerably more time will pass before any increases in technological inputs and outputs will have an effect on production and trade. Despite this, high value added exports have grown. These appear associated with increased specialisation within industries and firms and possibly with improved returns to scale in production. The more secure position in Canadian manufacturing currently held by high value-added activities is illustrated by the following case study.

Expansion of high value-added activities

Some firms rely heavily on their access to Canadian human capital, for example to support R&D, as the basis for Canadian production and exports.²⁸ Increasingly Canadian plants appear to be meeting the requirements of North American or world markets. The increased exports of high value-added goods appears to be an instance where improved industrial performance has been stimulated by the agreements.²⁹

The Electrical and electronic goods industry is the best example of this class of industry, it is the most highly R&D-intensive (R&D/revenue was 16.2% in 1995), and is responsible for 47% of Canadian manufacturing R&D.³⁰ Though it has established an international position through the growth of Northern Telecom and other smaller Canadian firms it has attracted substantial FDI. The record of the industry since FTA is very positive. It has, for example, increased its share of the Canadian manufacturing sector from 6.1% to 7.3%. Shipments increased by 5.2% (average annual increase), but the improvement in value added was a more modest 2.5%, implying the fast growth of assembly activities in this industry group. Nevertheless, structural changes are indicated by a 5.4% average annual increase in value added per employee achieved by an increase in the throughput of industrial plants (if not an increase in their average size), a reduction in the number of plants (15.6% fewer establishments) and a reduction in employment. The productivity improvements (reflected in Table 5) owe much to the very high level of adoption of advanced manufacturing technologies (Baldwin and Sabourin 1995).

[TABLE 5 Structural Change in the Electrical and Electronic Products Industries, Canada, 1988-1995](#)

TABLE 5 Structural Change in the Electrical and Electronic Products Industries, Canada, 1988-1995

	1988	1995	Average annual change %
Number of establishments	1,631	1,376	-2.4
Shipments	17,211	24,602	5.2
Employment	150,460	122,875	-2.85
Manufacturing value added	8,364	9,944	2.5
Shipments/employee x100	11.4	20.0	8.36
Value added/employee x100	5.6	8.1	5.4
Shipments/establishment x100	10.6	17.9	7.8

Note: All financial figures are expressed in terms of millions of 1986 C\$.

Source: www.Strategis.ic.gc.ca

[TABLE 6 Trade Changes -- Electrical And Electronic Products Industries, Canada 1988-1995](#)

TABLE 6 Trade Changes -- Electrical And Electronic Products Industries, Canada 1988-1995

	1988	1995	Average annual change %
Imports from US	10,157	18,556	9.0
Exports to US	5,478	14,974	15.4
Imports from rest of world	6,073	14,743	13.5
Exports to rest of world	1,971	3,397	8.1
Trade balance	-8,781	-14,928	7.9
Exports/domestic shipments %	43.3	74.7	8.1
Imports/domestic market %	62.4	84.2	4.4

Note: All trade data are expressed in terms of millions of 1986 C\$.

Source: See Table 5.

Since the ratio of exports to domestic shipments has surged from 43% to 75% it is clear that there also has been a significant reshaping of the market orientation and structure of this industry. Exports to US have increased at an average annual rate of over 15% (Table 6) and the trade deficit with US has shrunk to about 3/4ths of its former size. Ironically, the overall trade

deficit for this sector, however, has been driven up by the expansion in imports from the rest of the world, composed of both electronic components and end-products.

The positive pattern for this industrial group reflects the performance and scale of four industries: Telecommunications equipment, Electronic parts and components, Other communications and electronic equipment, and Electronic computing and peripherals. Collectively, they have lost establishments, and have expanded their employment at an annual average rate of only 1% but, during the 1990s, their shipments have grown by an annual average of nearly 13%! There are differences in performance within this group of four: Telecommunications equipment, in particular, has increased its R&D expenditures by 11.5% annually on average since 1989 and it broke from the modest growth pattern of the others in 1991. By 1995, this industry was spending nearly 22% of revenue on R&D and contributing 30% of manufacturing R&D.

Other Forms of Rationalisation of Canadian Manufacturing

By eliminating tariff protection in Canada the trade agreements unleashed competition from US producers. The output of branch plants could be rationalised on a North American basis, and low effective rates of compensation in right-to-work states and Mexico, combined with the drive to attain economies of scale, could drive out inefficient Canadian producers of low value-added manufactures. There is considerable documentary evidence that the population of firms in trade-sensitive industries has declined, there have been many limited-term and permanent layoffs, plant closures and bankruptcies of firms have been reported (Merrett 1996). I have taken the furniture industry as an example of an industry that has been regarded as highly trade-sensitive and traced some of the impacts that can be connected with the trade agreements.

The furniture industry was protected under high tariffs before free trade, the scale of plants has been small, certainly much smaller than plants in US, and labour is a high proportion of costs (over 33%).³¹ As a consequence of the trade agreements there has been a substantial decline in protection. US producers and imports held only 20% of the Canadian market in 1988 but have now captured over half of Canadian sales. The resultant new competition after FTA, the recession, and a high CDN \$ at that time stimulated structural changes. The number of establishments has dropped by one-third since 1988. Some firms have closed and some others bought or built plants in cheaper locations in the US southeast in response to lower labour and plant construction costs. The drop in the number of establishments is the sharpest contraction among the standard indicators for the industry (Table 7) though employment has been reduced by one-quarter.

Manufactured shipments and value added first declined as a result of recession and competition and then returned to about their 1988 level. The generalised effect of these changes across the decline-recovery cycle has been a 50% increase in the throughput or scale of the average plant. Competition, the result of trade changes, has had a lot to do with generating these shifts. Imports from the US, for example, experienced a major increase (15.2% average annual increase). They outstripped imports from the rest of the world, and have been associated with the closure of plants. Yet, the positive trade balance of the industry group was not disrupted because exports to

US more than doubled in value (Table 8). Office furniture appears to have led this expansion but other products have also experienced gains.

[TABLE 7 Structural Change In The Furniture Industry, Canada, 1988-1995](#)

TABLE 7 Structural Change In The Furniture Industry, Canada, 1988-1995

	1988	1995	Average annual change %
Number of establishments	1,947	1,273	-5.9
Shipments	4,278	4,133	-0.5
Employment	62,373	46,922	-4.0
Manufacturing value added	2,141	2,169	0.2
Shipments/employee x100	6.8	8.8	3.8
Value added/employee x100	3.4	4.6	4.4
Shipments/establishment x100	2.2	3.2	5.5

Note: All financial figures are expressed in terms of millions of 1986 C\$.

Source: See Table 5

[TABLE 8 Trade Changes -- Furniture Industry, Canada, 1988-1995](#)

TABLE 8 Trade Changes -- Furniture Industry, Canada, 1988-1995

	1988	1995	Average annual change %
Imports from US	454	1,220	15.2
Exports to US	1,047	2,380	12.4
Imports from rest of world	360	526	5.6
Exports to rest of world	48	94	10.1
Trade balance	281	729	14.6
Exports/domestic shipments %	25.6	59.9	12.9
Imports/domestic market %	20.4	51.3	14.1

Note: All trade data are expressed in terms of millions of 1986 C\$.

Source: See Table 5

Though the pattern of changes was cyclical and the positive form of the trade balance was restored when the CDN \$ resumed its lower level, the performance shifts in the industry are best explained by an increase in the specialisation of Canadian production. Industry representatives anticipated that firms would have to drop product lines, use modern technology and increase their inputs of marketing and product design (Hogarth 1990). One should not over-interpret the techno

logical achievements for this broad industrial group because the industry has achieved poor technology adoption ratings as recently as 1993. Nevertheless, some positive measures have been taken because increased productivity has been recorded (Little 1997) at about 3.6% per annum on average (1988-94) and this and the value of CDN \$ probably explains why exports as a proportion of domestic shipments have more than doubled (now 60%).

Foreign Firms

For foreign firms operating in Canada, in a wide variety of industries, the inevitable choices have been whether to export to the US market from a Canadian base, to reduce or forgo the Canadian production option and invest in production facilities in US, or to use existing capacity in US. Some US companies have switched from manufacturing to warehouse-and-sales operations in a variety of industries and the consequence has been that Canadian operations have had their value-added activities gutted. In other cases, firms have rationalised product lines to obtain economies of scale. Some firms have acquired the common shares in their Canadian companies and converted their operations into wholly-owned subsidiaries. They have fully integrated these operations and downgraded the importance of the Canadian head office. Some of these changes were associated with the elimination of "miniature replica branch plants"(Eden 1994) that had persisted despite earlier phases of trade liberalisation.³² This pattern of production was most prone to rapid change since its function was rendered obsolete by the trade agreements.

The analysis of recent trade data has shown that FTA/NAFTA have stimulated the expansion of closely related imports and exports. One possible explanation for this substantially increased intra-industry trade could be a stronger horizontal division of labour and increased intra-industry specialisation at the regional level. The considerable bilateral trade flows in the auto industry reflect exactly this situation. For other activities, however, it is difficult to develop a conclusive case using aggregate data, especially as trade data reflect flows of goods and services required for both production and distribution activities. More than any other group of firms, MNEs are capable and experienced in seeking efficiencies from free trade through plant specialisation with its associated reduction in the number of product lines in individual plants and segmented production processes among plants (Eden 1994). Both these strategies will increase horizontal and vertical intra-firm trade between the NAFTA economies.

Unfortunately, good data on intra-firm trade are not readily available. The best data accessible at the time of writing are from US and it is possible to make some preliminary assessments of change for 1990-1993.³³ In 1993, 38% of Canadian imports of goods from US were organised on an intra-firm basis compared with 45% of Canadian exports to the US. US corporations were the dominant force in intra-firm flows in both directions; 90% in the case of imports and 82% in the case of Canadian exports. By contrast, Canadian parents received only 4% of Canada's intra-firm imports from their US subsidiaries and were responsible for only 14% of Canada's intra-firm exports to US. These data include both intermediate goods for further manufacture and goods for resale. It is possible to get some idea of the scale of imported goods intended for resale from pre-FTA Canadian data. These show the propensity of foreign companies to import was five-times that of domestic companies confirming their strong interest in importing for resale purposes (Corvari and Wisner 1993).

[TABLE 9 Canada's Merchandise Trade With US \(US\\$ 1992\)](#)

TABLE 9 Canada's Merchandise Trade With US (US\$ 1992)

	1990	1993
Imports	82.1	101.4
Total intra-firm imports	33.0	38.4
Intra-firm imports in US firms	30.0	34.4
Intra-firm imports in Canadian firms	1.1	1.6
Exports	89.6	112.3
Total intra-firm exports	39.9	50.5
Intra-firm exports in US firms	32.5	41.6
Intra-firm exports in Canadian firms	6.7	7.7

Sources: US Department of Commerce, 1995a and b; Eden 1994

With the mixed nature of intra-firm trade in mind, the shifts between 1990 and 1993 (Table 9) are interesting if they point to long-term directions of change. In particular, intra-firm imports from US declined from 37% to 34% of all merchandise imports from US. This might imply a diversion of imports away from the manufacturer-as-wholesaler model and would be consistent with direct imports from US. This fits with the inference from trade data that imports for distribution purposes have expanded and have had an impact on former patterns of inter-regional trade. The flow of exports to US within US firms increased at an annual average rate of 8.6% and this is consistent with closer integration of US subsidiaries. Since 1982, there has been a steady increase in the participation of US companies located in Canada (and Mexico) in the US market and this is noted in *The Economist* (1997) as a peculiarly North American pattern.

Unfortunately, any variation in the structure of auto trade easily can affect the assessment of changes in intra-firm trade: published US data do not help in this matter because of disclosure constraints. We are left with two inferences:

- Canada's exports to its affiliates in US pale beside comparable flows in US firms and under the free trade regime these will not increase if Canadian firms are successful in exporting from their home bases. Some Canadian firms are established in US and Europe for a variety of marketing and technological reasons and others are establishing plants in Mexico to take advantage of low wage rates. The effect of these choices is to limit exports from Canada.
- Intra-firm exports to US (within US firms) have increased (in constant dollars) by 28%, 1990-93. While it is difficult to establish whether an increased development of product mandates is responsible for this shift, it does seem that US firms are integrating their Canadian subsidiaries more strongly into their North American operations. Nevertheless, survey research is required to establish what industrial functions they are developing from their Canadian bases and what new industrial trade patterns are being forged.

Conclusion

The trade agreements provide a fundamental institutional shift in Canadian economic policy, and though it has been only a decade since FTA, I expected to discover strong economic impacts at variance with the quote from Krugman. Some of the pre-FTA literature suggested that bilateral free trade with US would invigorate the economy and produce "dynamic gains" -- possibly like the proverbial impact of a cold shower (Drummond 1986). In the opposite camp, there have been alarming trade-related press reports, especially during the recession. The evidence points to two types of impacts. First, many changes seem part of a historical pattern of economic and institutional evolution. In particular, the agreements are compatible with many preceding changes in employment, investment and trade, or those likely to have emerged in Canada. Many institutional changes that are part of this pattern (for example, revisions in the patent regulations for pharmaceutical products, reductions in the rigour of the foreign investment review process, and deregulation of financial institutions) are consonant with the global trajectory of industrial reorganisation. Second, we have also seen marked increases towards greater economic integration and shifts of this type began during the period of response to FTA and before NAFTA though the same trends have continued.

It is clear that Canada is no less attractive to foreign investment than it was before the trade agreements, though this is true only for US sources of investment and not those from overseas. The organisational rationalisation of foreign firms in Canada has proceeded some way and taken several forms, some of which have reduced manufacturing activity in favour of distribution. Nevertheless, there have been new investments in resources and high technology companies that have more than compensated for other reductions in book-value.

Investment abroad from Canada has continued to grow though there has not been any surge of investments towards locations that are more central in the North American market. The strength of Canadian direct investment in US has waned, probably as a result of the greater direct access of firms from Canada, and Canadian firms have increased their investments outside North America. Some of these are in technology intensive manufacturing, some in finance, mining, and infrastructural systems, for example in Mexico. Attributing these arrangements solely to NAFTA, however, would be to ignore prior patterns of investment, and the long-term growth of Canadian direct investment abroad.

FTA/NAFTA appear to have weakened east-west economic bonds within Canada. Ontario, the leading concentration of Canadian manufacturing, now has a reduced role in domestic trade and in part this reflects greater international imports into wholesale and retail markets. Under the new trade regime, however, Ontario's international importance in manufacturing and services is enhanced. The greater strength and earlier recovery of the US economy accelerated the increase in Canada's merchandise exports to US but it is questionable whether renewed levels of Canadian consumption are unlikely to restore the relative scale of domestic trade. In services the established patterns have been less susceptible to change probably because financial and related services remain more highly regulated.

Though Canada's trade has expanded under freer trade, this does not reflect a simple relationship. Exports have responded very quickly to a fall in the level of the exchange rate and I infer that the

fall in the price of Canadian goods has been as significant an attraction as the ability of Canadian industry to produce and export more innovative products. That said, there has been diversification of Canadian exports into end-products other than autos and parts and other than resource commodities. The growth has been large enough to produce a positive trend in the merchandise trade balance despite only modest improvements in the trade deficit for services.

The industrial gains appear to be those derived from greater specialisation within industries; and some modest economies of scale probably have been realised. The productivity gap with the US, however, appears resistant to short-run improvement and points to the limited depth of the structural industrial changes that have occurred. The review of shifts in the performance of two contrasting industrial groups shows that the influence of production specialisation on productivity and exports can be impressive.

Hopes for the structural redevelopment of Canadian industry were based on conventional trade theory and increases in industrial specialisation imply some positive results. While specialisation within industrial groups by firms are suggested by the industrial data, better evidence on intra-firm trade would be a superior indicator of corporate reorganisation, especially among foreign firms. While there has been an increase in the average scale of establishments in the industries I have studied, this is associated with the closure of smaller, less efficient plants. Given that a significant and general industrial productivity gain has not occurred and is not imminent the returns to scale predicted by theory have yet to appear. Unlike the experience of the auto assembly industry in which a managed trade agreement ensured that scale economies would be developed, it is not likely that they will emerge in other secondary manufacturing industries. Rather, it would seem more plausible for us to watch for increased specialisation, hopefully combined with product innovation and organisational and production flexibility. These are industrial characteristics that make sense given the prevailing modest scale of Canadian plants.

Other trade theorists also suggested that regional trade agreements involving a small country and a very much larger partner were bound to produce a limited version of the market access that Canada sought in US. They were correct. Canadian firms in a number of industries have been compelled to accept "managed" trade so as to avoid US antidumping and countervail actions. Trade diversion and protectionist conventions have also been introduced by NAFTA by means of restrictive "rules of origin". The impact of these constraints is that the uncertainty associated with one spills over into the way expectations are formed elsewhere in the economy. At the outset I suggested that national viewpoints inevitably alter one's perspective on the FTA and on the NAFTA. For Canada, the impact of the FTA and the NAFTA clearly is not zero, though the results have been uneven in their clarity, irregular in conforming to expectations, and of unknown stability. But, then we are attempting to consider the front end of a long-term process of adjustment.

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