Beyond FTAs: Deepening North American Integration

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FTAA negotiations are an important step along the road to western hemispheric integration. The alternatives are multilateral liberalization or market-driven integration, a route followed in East Asia for many years. Indeed, as integration deepens in the European single market project free trade agreements (FTAs) are coming to be regarded as relatively modest starting points for intergovernmental arrangements. Even so, in some Latin American countries significant political reservations remain about this route to better market access within the hemisphere, nor are special interests silent in North America.

In this paper I present a Canadian perspective on North American integration in the light of major changes in the world economy since the implementation more than a decade ago of the Canada–US FTA and the NAFTA. These changes highlight the need for completion of these FTA projects by totally eliminating tariffs and other border barriers and pursuing deeper economic integration that respects and preserves national sovereignty. I begin with a view of these changes. I then explore the challenges for North America as China and India become major players in global production systems in manufacturing and services and follow with an analysis of some of the implications for North American integration. I conclude that the rapid rise of China and India should be a catalyst for deeper integration in North America and, indeed, for a single market in the hemisphere.

Historically, Canada and the United States have had a close and mutually beneficial economic and security relationship. The Canada-US free trade agreement (FTA) was negotiated in 1987 and was subsequently the focus of intense political debate in the 1988 national election in Canada. Yet the FTA, when it was implemented in 1989, placed the economic dimension of the relationship on more secure footing than ever before. This foundation was extended under NAFTA to include Mexico.

The core of the FTA was not just the elimination of tariffs on merchandise trade and the inclusion of services and FDI, but the creation of rules for dispute settlement that were later adapted to NAFTA. The NAFTA was phased in during a period of unprecedented growth and dynamism in the US economy in the 1990s and Canada-US merchandise trade doubled in the first decade after the agreement.

The world has changed

Since the negotiations, the world was changed in at least four ways. First, global production systems were in their infancy at the time of those negotiations. today, IT innovation and advances in logistics have made possible the vertical dis-integration or segmentation of most commodity manufacturing and many services, locating each activity in the value chain where it can be most efficiently performed. Second, services trade has grown in importance (if not in ease of measurement). By 2004, commercial services trade was 23 percent of world merchandise trade, 20 percent of total trade within NAFTA and around 10 percent of Canada's total merchandise trade with the United States. Third, China and India have rapidly integrated into the world economy as domestic reforms, and in China's case accelerating value of FDI inflows over the past decade, drove such integration. Fourth, these trends had emerged before September 11, 2001, but those tragic events brought home the extent to which the flip side of openness necessary for deeper integration is increased vulnerability to disruption.

The three North American economies have only begun to deepen and formalize their economic interdependence. After the terrorist attacks, the near-closure of the US border and growing border congestion acted like a higher tariff, raising both business transactions costs and the uncertainties of managing cross-border supply chains. Border closings – distinct possibilities in the event of a future terrorist attack – illustrates how fragile are the legal and institutional frameworks for the North American relationship going forward.

The depth of economic interdependence in North America is illustrated by the fact that Canada and Mexico depend on the US market for between 80 - 90 percent of their exports; the United States sends 40 percent more of its exports to its two immediate neighbors than to the 15 main EU members. The auto, steel and energy sectors of the North American economy are now deeply integrated, due to a combination of market forces and the merchandise trade focus of intergovernmental agreements.

These changes in the world economy – growing insecurity and intensifying international competition -- imply that the imperatives of North American, and indeed hemispheric, negotiations should be to deepen integration to reduce as many of the remaining barriers to factor and product flows to realize the ideal: one price within the area; and to reduce costs and allow the exploitation of scale economies and movements among the growing knowledge agglomerations located in North America. We need a vision of a secure economic space common to three sovereign countries in which goods, services, capital, people and ideas flow freely – to provide new strategic opportunities for businesses and more and better jobs for people.[1] Using the advantages of the “neighborhood” to meet global competitive challenges is a superior strategy to going it alone.

The challenges of global production systems

Consider the context for this vision in which the changing face of global competition dominates. UNCTAD and WTO analysts and others have thrown light on offshoring of manufacturing and services. China’s attractiveness for standard technology manufactured goods assembly has been celebrated; India’s successes in supplying call center and IT services slightly less so.

The magnitude of the competitive challenges to North American economies from China and India is illustrated by some empirical examples. China’s rapid export surge of manufactured goods has affected import competing producers and their unskilled labor

[1] See Dobson (2002); Council on Foreign Relations (2005) among others.

forces. A USITC study[2] made public around NAFTA's tenth anniversary examined the structure of import competition in the US merchandise trade over the 1998-2002 period. In 2002, the authors found 51 percent of total US imports were fairly evenly distributed among Canada (with an 18 percent share), Mexico (12 percent), Japan (10 percent) and China (11 percent).

Among the interesting findings in this study were the relative growth rates of those import shares over the previous five years: Canada's share grew at a 21 percent rate; Japan's was stagnant; Mexico's grew 44 percent, while China's share grew by 76 percent. In footware, China's share was 67 percent in 2002 with growth rate of 28 percent during the previous 5 years, while Mexico's 2 percent share resulted from a negative growth rate of 20 percent over the period. Apparel showed the same story. Auto parts, which are so important to Canada and Mexico, showed each had 25 percent share; China at a miniscule 2 percent, but China's growth rate was 174 percent compared to Mexico's 43 percent and Canada's 21 percent. What these numbers help to illustrate is the shock to traditional suppliers administered by the speed of China's penetration of the US market. We are all familiar with the shock to producers based in the US itself. I suspect similar trends would be found in Latin American economies.

Some students of services offshoring predict that it is likely to deliver a larger shock to the US economy than offshored manufacturing has done because it will be something that US CEOs do to their own workers in order to remain competitive.[3] While the impact on total employment is still small, they argue that the shock will come through downward pressures on real wages in the jobs that remain in North America, and the impact on white collar workers with political voice. At the same time, however, as WTO (2005) analysis shows, lower costs of imported inputs reduce costs and raise productivity allowing for higher rewards to domestic workers. Which effect is the strongest is the empirical question that requires much more research. What is certain is that some workers will be dislocated and ways should be found to ameliorate their distress.

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[2] Watkins (2003).
[3] See Cohen and Bradford (2003).

Hufbauer and Schott (2005) review adjustment assistance programs in the three NAFTA countries and conclude that Canada's are adequate, but the 2002 version of the Trade Adjustment Assistance Act needs to expand worker eligibility and increase the generosity of health insurance subsidies and wage insurance.

Canadian evidence from recent plant level studies casts some additional light on these issues. Increased competition following trade liberalization pressured managers to intensify their strategic focus. They reduced product lines, probably through offshoring, which helped to reduce costs, increase profits and invest in more R&D, which of course also contributed to enhanced productivity performance.[4]

UNCTAD (2004) estimates that between 1992 and 2002, US imports of selected business, professional and technical services grew at a 7 percent annual rate and totaled about $205 billion. Most service providers were concentrated in Ireland, India, Canada and Israel, which in 2001 accounted for 71 percent of the market. This analysis includes services offshoring which requires FDI by companies in affiliates and local service providers (as distinct from trade).[5] These activities are divided by value added into call centers at the low end; shared service centers requiring more advanced skills in accounting, programming and data analysis; IT services such as business processes, design, software development requiring advanced skills and specialization; and regional headquarters where head office functions are carried out. By 2003, developing and transition economies accounted for 51 percent of such FDI projects.

What is notable about Canada is that it attracted 12 percent of the call centers installed during the study period and only 2 percent of the higher value added IT service centers – in other words it is still stuck at the low end of the value chain.[6] Only 2 percent of the FDI projects were undertaken in Brazil, Chile and Mexico. UNCTAD (2004) further noted that among the world's 1000 largest companies as many as 70 percent have not yet offshored any business processes – the implication being that there is still a long way to

[4] Discussed in Trefler (2005:32).
[5] UNCTAD (2004).
[6] Pointed out in Trefler (2005).

go, with opportunities for improved competitiveness in sending countries, and more jobs, skills and market access for receiving countries.

I cite these statistics to make three points. First, some aspects of global supply chains are possible without liberalization of trade and investment. Indeed, India's historically restrictive policies towards merchandise trade and FDI were a significant impetus for some of India's leading entrepreneurs to focus on what goes on *inside* computers, driving what became India's IT services revolution. Second, global supply chains in manufacturing *are* dependent on trade liberalization as is FDI in offshore services affiliates. In Asia, much of that liberalization has been unilateral. Third, the distance still to go in services offshoring suggests a potentially disruptive impact over time on the importing and investing countries. The major implication of these changes, though, is not to protect against such competition, but to adjust. The premium on domestic economic flexibility is high and rising, creating urgent domestic policy reform agendas and raising the stakes to maintain the momentum of trade liberalization.

The implications for North American and FTAA agreements

Deepening the now-dated trade liberalization agreements will have to recognize that security and economics are now intertwined in North America. Canada and the US have a long history of working together on these issues going back to NORAD and NATO, and more recently on the 2001 Smart Border Accord.

The next steps require a vision of a common North American economic space made up of three sovereign countries and one economic system that reflects the enormous stake each of us has in the others' welfare -- and an action plan. Topping the action plan is what Michael Hart, Allan Gotlieb and I call completing the free trade project by eliminating border tariffs completely and adopting a common external tariff. Another item in the action plan is to move the border away from the border using modern technologies for pre-clearance and hi-tech screening of low risk frequent travelers. Yet another element is to address differences in regulatory regimes by getting rid, unilaterally if necessary as we are contemplating doing in Canada, of regulations and standards that do not serve any safety purpose beyond "being different" but that inhibit cross-border trade and investment. Another item is to find ways to replace US trade remedies with a single North American competition policy and rules about subsidy practices. Finally, we need new institutions of governance and conflict resolution.[7] One of the institutions should be annual leadership summits. The summit held here at Baylor University in March 2005 should not be a one-off, but rather the beginning of regular attention at the top to the realization of the common vision. A more comprehensive security-economic agenda has been proposed by a three-country study group sponsored by the Council on Foreign Relations in 2005.[8]

The implications are pretty clear: freer access to one's neighbors' markets allows businesses to exploit economies of scale and develop new business strategies that include services offshoring. In Canada, for example, we should recognize that offshored services not only reduce costs but allow companies to improve the quality of their services. If we are to meet the intense competitive challenges we face from new competitors, we also need to move up market to higher value added services. For us, and I suspect for most other economies in the hemisphere, the productivity objective inherent in higher value added goods and services requires knowledge and technology. The United States is our hub and its innovations are ones that China and India accept and adapt; we in the western hemisphere should do more of this than we do. Freer flows of capital, technical and business people, as well as goods and services are also required. Of course business strategies require knowledge of the risks and how they will be managed, so credible dispute settlement procedures are also essential.

At the same time, each country should examine its own domestic policy environment and assess the effectiveness of its education and innovation systems, its framework policies and social safety nets for their effectiveness in promoting adjustment. Canada's commitment to education and basic and applied research has increased in recent years. But much more needs to be done to restructure the tax system to encourage saving and

[7] Gotlieb, Dobson and Hart (2005).
[8] Council on Foreign Relations (2005).

reward risk taking by businesses. Major policies, such as those governing financial institutions, need to be changed to allow productivity growth in major sectors.
WTO (2005) reports that in the two biggest success stories, Ireland and India, governments strongly supported the rise of the IT sector (although in India it was largely ignored until it had become established) with framework policies and a combination of specific policies including trade liberalization for imported inputs, removing restrictions on FDI, favorable taxation, and low-interest export credits.

Finally, I will comment on Canada's revealed stance towards deepening NAFTA and the FTAA. Briefly stated, the official policy stance is one of incrementalism: small changes, a lot of talk, and not much action.

On NAFTA deepening, Canada's talk sounds good; it includes a menu of activities that are pursued incrementally. Yet this approach fails to take into account the diffused nature of the US political system which is unable to deal with incrementalism. Instead it responds best to big packages that are championed across a sufficiently large set of interest groups that competing interests cancel each other out.

The Waco summit of the leaders of the Canada, Mexico and the United States was a missed opportunity for developing a more ambitious North American integration agenda. Any bold initiatives must come from Ottawa and Mexico City if they are not to be dismissed as part of a hidden agenda of the dominant US partner. But domestic political considerations in both Canada and Mexico inhibited their leaders from initiating new ideas, despite President Bush's reported interest. [9] The resulting Partnership for Security and Prosperity is only a modest step forward, with responsibilities delegated to ministers and officials. A holding action is most likely in the next year in light of the 2006 electoral calendars in the three countries.[10] In the meantime, the United States pursues a

[9] As Hufbauer and Schott (2005:491) conclude, it makes sense for the Canadian and Mexican leaders to agree on agenda items between themselves and then make a joint demarche to Washington.
[10] Canada will have a national election in January 2006; Mexico faces a presidential election in mid-year and US mid-term elections occur in November 2006.

lengthening list of bilateral FTAs that either exclude Canada and Mexico or relegate them, as in the case of Chile, to a hub-and-spoke arrangement.

Not unrelated is the fact that the bilateral relationship has become a main street issue in Canada because of a widespread conviction that the US administration has failed to abide by the dispute settlement rules agreed to in the FTA and the NAFTA negotiations. Because of the many disputes channeled through both the WTO and NAFTA dispute settlement mechanisms, even though separate issues and on separate tracks, the situation has become so muddied that some extraordinary political action is needed to find a permanent resolution before it irreparably damages the relationship. The absence of an over arching vision for the relationship and badly-managed (though domestically popular) Canadian decisions to step aside from the Iraq conflict and the BMD initiative are probably part of the reason for a lack of US administration commitment to resolving the impasse. The United States should live by the rules of agreements that it has signed. But Canadians could also engage in more astute and adept management of the relationship.

What does all this mean for the FTAA? At the broadest level, global production systems work best when business decisions about locations for dispersed activities are based on market signals. The proliferation of bilateral agreements in the past few years has increasingly troublesome consequences for these systems. The complexities of differing rules of origin, for example, distort business decisions and raise costs and prices as firms become preoccupied with (a) keeping track of multiple rules and (b) conforming business decisions with rules rather than with products that are most cost-effective for the final consumer. The advantages of the economic diversity in the western hemisphere that might attract global production will be enhanced by one set of rules rather than a western hemisphere “spaghetti bowl”.

Some governments have yet to recognize this fundamental potential benefit of the FTAA. There is considerable official enthusiasm for promoting democracy and growth; for the principle of market access within a $17 trillion market and 800 million people; for better protection of investors, opportunities in services and a region-wide dispute settlement mechanism. But the existing level of integration is low – in Canada's case so low that trade with Latin America and the Caribbean is not broken out of trade statistics with the rest of the world. Indeed, more official energy is going into a bilateral agreement with South Korea. Still, the initiative to liberalize trade and investment is worth pursuing if it provides impetus for continued domestic reform and opening.

In conclusion, as global business becomes increasingly disaggregated the opportunities for deeper integration among neighbors, about which businesses have more knowledge than they do of more distant opportunities (the gravity effect in trade theory), should be exploited by businesses and facilitated by public policy. This was a major rationale for the North American FTAs. They have brought considerable benefits but now need to be deepened further to address new competitive and security challenges. It is also a rationale for the FTAA. The re-emergence of the world's two largest countries, China and India, as dynamic competitors in global production systems will, sooner or later, be a catalyst for deeper integration in the hemisphere. The two projects, North American and hemispheric, need not be mutually-exclusive.

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