David Dodge: Economic integration in North America

Remarks by David Dodge, Governor of the Bank of Canada, to the Couchiching Institute on Public Affairs, Geneva Park, Ontario, 7 August 2003.

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For more than 70 years now, the Couchiching Institute on Public Affairs has been bringing Canadians together with the purpose of asking some thought-provoking questions and encouraging lively, stimulating debates and action on a variety of key public policy issues. For example, it was at Couchiching, 56 years ago, that the idea of creating a North Atlantic Treaty Organization (NATO) was first floated publicly by Escott Reid, a senior official with the Canadian Department of External Affairs. NATO was established a year and a half later, reflecting almost exactly the vision that Reid outlined in his speech at Couchiching.

I am delighted to have been invited to participate in this year's conference, the theme of which is "Continentalism: What's in It for Us?" True to form, here again is a topic that is thought-provoking and, some might say, provocative!

Before I venture any thoughts on the subject, let me make it clear that I am not here as an *advocate* for greater North American integration. This is very much a *political* decision for Canadians and their elected governments. It is a big decision, and all of us, as a democratic society, will have to determine what we really want.

I'm not a politician; I'm an economist. So, what I intend to do tonight is to lay down some parameters for an appropriate discussion of the issues relevant to greater *economic* integration in North America.

First, I would like to review the benefits and costs of economic integration. By economic integration, I mean the free movement of goods and services, capital, and labour and the harmonization of the rules governing the operations of these three key markets. I will briefly review the progress Canada has made on each of those fronts, and the benefits we have derived from opening up our markets to international competition and to the free flow of capital. Next, I will talk about the remaining impediments to fuller economic integration. And finally, I will briefly discuss where we might go from here.

The economic benefits and costs of open markets

(i) Free trade

International trade in goods and services takes place because countries have different resource endowments and labour skills and because consumer tastes vary from country to country.

David Ricardo, a 19^{th}-century British economist, argued that a country could gain from trade even when another country had an *absolute* advantage in producing all goods and services. He argued, rightly, that by concentrating on producing those goods and services in which a country was *relatively* more efficient, and importing those products in which it was *relatively* less efficient, it could increase its national income. And this would be so even if that country was *absolutely* less efficient in producing all products. This is the famous principle of *comparative advantage*. It is on this principle that economists base their view that barriers to trade reduce economic welfare in all countries. When countries export goods and services in which they are most competitive and import those in which they are less competitive, consumers everywhere benefit, the potential output of all nations increases, and so does the global standard of living.

Opening up national borders also opens the door to greater global competition. And this acts as a potent incentive for businesses everywhere to become more efficient and productive. To relate this to Canada, international competition puts pressure on our domestic market to be more competitive, even in industries where the optimal scale may have only one or two Canadian firms operating. In the end, competitive pressure leads to greater efficiency, greater productivity, and higher standards of living.

So there are clear economic benefits to greater economic integration with the rest of the world. Of course, there are adjustment costs to be borne as barriers to trade are removed. Some firms and some industries will not be able to meet the foreign competition, and will die or contract. This is part of the process of releasing resources - both human and physical - to those industries or firms that are taking advantage of new markets abroad. So some kind of mechanism to equitably share the short-run costs of adjustment is important to reap the medium- and longer-run benefits of freer trade.

Since the Second World War, Canada has had a history of being open to global markets for goods and services. In my view, this interaction with the rest of the world has proven very successful and has benefited Canadians, and our foreign partners, enormously.

As you know, the Canada-U.S. Free Trade Agreement (FTA) of 1989 and the North American Free Trade Agreement (NAFTA) of 1994, which added Mexico to the partnership, were initially viewed with a great deal of skepticism in this country. And at first, the adjustment to the FTA was difficult. But, by the late 1990s, it was clear that freer trade in North America was bringing major benefits to Canada. FTA and NAFTA have opened up U.S. and Mexican markets, providing Canadian businesses with tremendous opportunities. They have also put pressure on our entrepreneurs to be more efficient - a challenge they have clearly risen to. Canadian exports have flourished, and consumers in this country now benefit from greater product choice and lower prices.

Under the FTA and NAFTA, we have achieved much freer trade in manufactured goods. And we have gone quite a distance with respect to certain services. But we still have problems in some key sectors. For example, we certainly have a long way to go when it comes to agriculture. And even though, nominally, we have free trade in forest products and steel, complications do arise because the United States retained its ability to apply trade-remedy laws. The current softwood lumber dispute is an example of the problems we face with U.S. trade-remedy laws, specifically anti-dumping and countervailing duties. It is partly because of such problems that some analysts in Canada have recently been advocating a customs union, or some type of common market, with the United States.

Clearly, some sections of NAFTA need further work if we are to eliminate all non-tariff barriers (such as countervailing and anti-dumping duties) and reduce the costs to industry of complying with a number of special rules, such as rules of origin. Dealing with these problems also means closer integration of regulatory regimes in North America.

Let me now turn from issues related to trade in goods and services to issues related to capital flows.

(ii) Free capital flows

Canada eliminated wartime foreign exchange controls in the early 1950s. Thus, for most of the post-war period, we have benefited greatly from the free movement of capital and from competition in financial markets.

Capital flows have played a very important role in Canada's development as a modern economy. Indeed, particularly through the 1950s, 1960s, and early 1970s, we were able to use foreign savings to finance the large investment projects that were necessary to develop our industrial infrastructure and increase our production potential, especially in the resource and manufacturing sectors. At the same time, Canadians have been able to set up businesses and pursue investment opportunities abroad. Through two-way direct investments, Canada has also had access to, and benefited from, technological innovations and processes developed elsewhere.

In a North American context, freeing up capital flows has not been part of formal negotiations between Canada and the United States. In both countries, this has largely been a domestic endeavour. By that, I mean that the integration of Canada-U.S. capital markets has proceeded as fast as we, and the Americans, have been able to reduce *domestic* impediments to freer capital flows.

(iii) Free movement of workers

Now, let me consider labour markets and the movement of labour between Canada and the United States.

Back in the 19^{th} century, there was considerable labour mobility between the two countries. But the movement of workers across the border suffered a serious setback after the First World War, particularly in the wake of the Great Depression.

Today, the border between Canadian and U.S. labour markets is somewhat more open than it was at the end of the Second World War. But, in comparison with the markets for products and capital, it is still *the* least open. This is because of immigration policies and a multitude of different provincial, state, or federal licensing laws in the two countries. To achieve the full benefits of a single market, significant freeing up of laws and regulations that impede labour mobility would be needed. But I recognize that this is extremely difficult, particularly in a Canada-U.S.-Mexico context.

This completes my brief review of the key Canada-U.S. markets for goods and services, capital, and labour. Having done that, I believe that it would be fair to say that, although there are now fewer "formal" tariff and non-tariff barriers between the two countries than there were 15 years ago, the reality is that borders still do matter. As John Helliwell reminds us, "border effects are still too large to be ignored and too complex to be easily classed as good or bad."[1]

(iv) Regulatory regimes

As I just pointed out in discussing labour markets, there are many non-tariff impediments to achieving the full benefits of economic integration.

Among these, importantly, are the different national, provincial, or state regulatory regimes. Here, it seems to me that one of the key questions we should be asking ourselves is whether we have given sufficient consideration to "harmonizing" a number of our regulations with those of the United States. By "harmonizing," I mean working to make the regulations of the two countries compatible or convergent, but not necessarily identical.

My sense is that, on this score, we have made some but not much progress. I will expand on this point later.

Where do we go from here?

So, where do we go from here?

Free trade within North America has brought us great benefits. Of that, there is no doubt. Ideally, though, what we should be striving for, as a country, is the removal of *multilateral* barriers to trade, so that the whole world can be open for business. The world community has been trying to do this since 1947. But it has been a very slow process because building consensus continues to be an uphill battle, as we are witnessing with the current Doha round of trade negotiations.

For me, free *world* trade is still the ideal. We in Canada cannot, and should not, lose sight of that goal by focusing *only* on free trade in North America. But, *if* we cannot tear down barriers multilaterally, we should at least continue to tear them down between provinces in Canada, between Canada and the United States, between Canada and Mexico and, indeed, throughout the Americas.

As I said earlier, a number of analysts in this country have recently been calling for fuller economic integration in North America - to be pursued through arrangements ranging from a customs union to some type of common market, and all the way to full economic and monetary union.

Of course, not everyone in Canada is convinced of the merits of fuller economic integration within North America. In fact, as you will probably hear later in this conference, many Canadians are concerned about the implications of such a move for our political sovereignty and policy independence.

Once again, I am here as an economist. So I will leave the political questions aside and focus instead on the factors that I see as relevant in the context of pursuing fuller *economic* integration.

But I should point out that, although the interest for Canada in further integration is primarily economic, it is quite clear that the Americans see border security as an important element of that integration. So, as we in Canada consider deeper economic integration, we also have to consider what measures we would take to actually build a common security perimeter around North America. I do not intend to elaborate on this, since there are others at this conference who are much more knowledgeable and able to comment. But it is very important to recognize that, for our southern neighbours, security integration and economic integration are clearly linked.

With that, let me return to the question, Where do we go from here?

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1 Helliwell, JF 1998. *How Much Do National Borders Matter?* Washington, DC: The Brookings Institution.

Let's start with *trade*. The key issue for Canada is to reduce “border risk,” that is, guarantee Canadian producers and service providers access to U.S. markets without hassle and expense at the border, and without the risk of suddenly being shut out of those markets by some discretionary U.S. action. This is important.

Here are some of the steps that could help in this respect:

- a common external tariff - that is, a customs union and common border practices for imports from, and exports to, overseas markets
- harmonization of trade and commercial policies and regulation
- an end to the application of trade remedies within North America and
- a uniform policy with respect to federal and state/provincial subsidies.

We could also work towards broadening NAFTA coverage to include agricultural products, although there are clear difficulties in this area. And we could work to remove barriers to trade in cultural, legal, financial, and communication services, although, here again, harmonizing regulatory regimes at the federal and state/provincial levels would be very difficult.

I must tell you that arriving at an agreement on measures to reduce border risk or to broaden the scope of NAFTA won't be easy. Most of the easier steps have already been taken. Remember, too, that the Americans have different concerns with respect to Mexico than they have with respect to us. There are many practical and political challenges to be overcome on the way. But if we could reach agreement on deepening and/or broadening NAFTA, it would be extremely valuable. It would spread the benefits of competition across more industries, reduce uncertainty stemming from unilateral trade actions, and greatly reduce non-tariff barriers (which are often even greater impediments to trade than tariffs). And if we could agree on common external trade rules and tariffs, rules of origin could be eliminated and matters at the border would be enormously simplified.

Let me now turn from trade in goods and services to other issues related to economic integration, or what the Europeans call, the creation of a “single market.” These issues largely relate to the harmonization of regulatory regimes, not only with respect to the market for goods and services, but also the markets for capital and labour.

There are efficiency gains to be made from moving to common *regulatory standards* in North America. Not only would common standards reduce the costs of compliance; they would also allow our entrepreneurs to compete with the Americans on a more level playing field. But, as the European experience demonstrates, achieving such common standards is a long, painstaking, and difficult process. What the Europeans did, in many instances, was to write a whole new set of rules to replace the often very divergent rules in the 15 member countries of the European Union. We do not face as daunting a problem in North America (at least in Canada and the United States) because the basic structure and philosophy of the regulatory frameworks governing commerce, labour, and financial markets are similar - though far from identical. So the job of harmonization at the national level will be somewhat less onerous than in Europe. But it will still be a lengthy and difficult process. Furthermore, the problem for us is that, given the size and weight of the United States, reaping the benefits of harmonization will mean that, by and large, we would probably have to move towards U.S. regulatory standards.

Clearly, there are some drawbacks to harmonizing our regulatory standards and procedures with those existing in the United States. U.S. standards may not always be absolutely ideal in a Canadian context. But the point is that we should not reject them out of hand because they are not perfect. Rather, we should assess them very carefully. And we should always be asking, Would we be better off adopting U.S. standards, so we can have harmonized regulatory regimes across North America, rather than adhering to our own, even though ours might be better suited to our unique circumstances?

What I'm saying is that, if we are going to preserve different regimes of economic regulation, we'd better have solid reasons for doing so. And we'd better make sure that the differences we maintain will indeed lead to better outcomes for Canadians.

To be sure, there are some things that we may want to do differently in Canada, based on social or political grounds. For example, one issue that Canadians are currently debating is the provision of health care and the regulation of public health and drugs. Immigration policy is another. All these issues deserve careful consideration. And we should encourage our analysts to examine closely the benefits and costs of maintaining divergent regimes versus the benefits and costs of pursuing regimes that move us closer to harmonization.

One last point I would like to make with respect to regulation is that, *domestically*, we have a big problem in Canada. I am referring, of course, to the diversity of provincial standards in such key areas as labour markets, financial markets, and the markets for some services. Different criteria for professional certification of tradespeople, different provincial securities regulations, and different rules related to transportation come readily to mind. By and large, this kind of diversity does not serve us well. So it is very important that we also harmonize regulatory standards at home.

While most of the regulatory integration issues I have spoken about tonight apply to labour and capital markets as well as markets for goods and services, I want to make a couple of points specifically related to further integration in labour and capital markets.

Labour market integration would be greatly aided if Canada and the United States had procedures in place - procedures that were rapid, simple, and inexpensive - to grant work permits allowing citizens of either country to cross the border to take up jobs. Needless to say, this would be easier to negotiate if we were to simultaneously adopt a common immigration security perimeter for North America, although, logically, adoption of such a perimeter is not a prerequisite.

To ensure that there are *real* welfare gains, initiatives to open up labour markets would also call for greater harmonization of licensing standards, so that people could actually be employed on both sides of the border. Of course, a good first step in this area would be harmonization of policies and adoption of common licensing standards in labour markets across provinces within Canada!

Canadian and U.S. capital markets are already highly integrated and, as I said earlier, Canadians (and Americans) have benefited greatly from this open, transparent, and competitive market. As we all seek to improve corporate governance and to achieve greater transparency in the wake of recent corporate scandals, this is a real opportunity to achieve greater harmonization of rules in North America - not to mention globally. There is a willingness at the moment, on the part of authorities everywhere, to try to find a reasonable mix of principles and rules for accounting standards and securities regulation. We should seize the opportunity - and I believe we are in the process of doing so - to achieve greater uniformity of standards, not only with the United States but also among Canadian provinces.

In sum, to achieve maximum economic benefits, harmonization of regulatory standards and practices, particularly with respect to capital and labour markets, should be a priority as we move forward.

Economic integration and monetary union

One last issue I would like to address briefly tonight is that of monetary integration. I have been asked the question, *If* there was a political decision in Canada to adopt policies of deeper North American integration, would it still make sense for us to keep our own currency? Or should we be thinking about adopting the U.S. dollar as our currency?

First, let me stress that monetary union is an issue that should be considered once we have made more progress towards establishing a *single* market for goods and services, capital, and labour. Without a single, well-functioning market for labour, a single currency could impose great adjustment costs on workers. But suppose we were on track to achieve a single market. Should we then be thinking of a monetary union as well? The response to this, which I have set out in earlier speeches, is that it depends, to an important extent, on how close or how far apart are the industrial structures of the two countries.

Although it is always possible that at some future time those structures could converge (they could also diverge!), the reality is that, right now, they are quite different. This means that economic shocks tend to affect our two economies differently. In these circumstances, a separate floating currency facilitates adjustment to those shocks at least cost, in terms of lost output or higher inflation.

But *suppose* we were well on our way to achieving a true single market for goods and services, labour, and capital. Then it would be sensible to consider a common currency in the context of the industrial structures prevailing at that time, with a view to ascertaining whether the benefits of lower transaction costs associated with a common currency outweighed the higher costs of economic adjustment.

Conclusion

Let me wrap up by summarizing my main points.

Fundamentally, the decision to deepen economic integration in North America is a political one that Canadians and their governments will have to make.

From a purely *economic* perspective, I have, as an economist, a strong predilection for continuing to tear down barriers to trade - preferably, multilaterally, but, realistically, first within Canada and North America. Over the long haul, that is going to encourage a more efficient, productive economy, greater opportunities for Canadian entrepreneurs and workers, and, most importantly, higher living standards for Canadians.

To be sure, certain costs *are* involved in all of this. Fuller integration with the United States could make us more vulnerable to fluctuations in economic activity in that country. And we may no longer be able to tailor policies to fully meet our own needs or to foster particular Canadian industries. These are issues that we ought to be aware of and analyze very carefully. But economic theory and our experience so far support the view that, on balance, the benefits of opening up to the rest of the world outweigh the costs.

Tonight, I have laid down some of the factors that I consider relevant in trying to come to a judgment about the desirability of further economic integration in North America, and about what needs to be done *if* Canadians decide to pursue this.

I am looking forward to the insights that others may have on this issue as the conference unfolds.