Applying Lessons Learned from Canada's Experience with NAFTA

Author Jonathan T. Fried

By Jonathan T. FRIED

As Japan debates its potential involvement in the Trans-Pacific Partnership and other regional and bilateral free trade initiatives, many observers have referred to Canada's experience under the North American Free Trade Agreement (NAFTA) in the 17 years since its entry into force. Having participated in its creation and its implementation, in my view, the assessment is clear: NAFTA has had an overwhelmingly positive effect on the Canadian economy. It has opened up new export opportunities, acted as a stimulus to build internationally competitive businesses, and helped attract significant foreign investment. This has translated into higher growth, competitive prices for consumers, and new job creation - all of which has influenced positively Canadian attitudes towards free trade in general. For Japan, which is embarking on its next phase of free trade through new negotiations with major trading nations, there may be significant lessons to draw from Canada's NAFTA experience.

NAFTA: What is it?

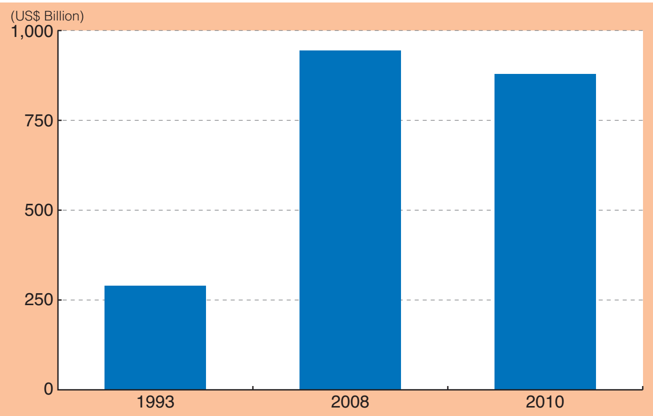
NAFTA came into effect on January 1, 1994. Built on the success of the 1989 Canada-US Free Trade Agreement, NAFTA emerged as a comprehensive trilateral agreement to complement multilateral efforts through the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO). While it was based on, and consistent with, the foundation of rules established through the GATT and now WTO, its disciplines go far beyond and it remains state-of-the art today.

The multilateral GATT/WTO foundation includes disciplines for trade in goods – at the border based on the most-favored nation principle and beyond the border based on the national treatment principle, as well as rules on government procurement, intellectual property, and non-tariff barriers, including technical barriers to trade (TBT) and sanitary and phytosanitary measures (SPS).

However, NAFTA goes a few steps further by providing greater precision on TBT and SPS disciplines, setting lower thresholds for federal government procurement pertaining to goods, services and construction contracts, securing protection and common rules for treatment of foreign investment and including entirely new approaches for services trade, competition, the temporary entry of businesspersons and more. While an important pillar of the GATT/WTO framework is effective dispute settlement mechanisms to ensure that trade is conducted on a non-discriminatory basis, NAFTA again goes further by including comprehensive, impartial, binding and transparent mechanisms for dispute avoidance, dispute management, and dispute settlement including a unique system of binational dispute settlement for anti-dumping and countervailing duty matters. Side agreements were also concluded on labor and on environmental cooperation.

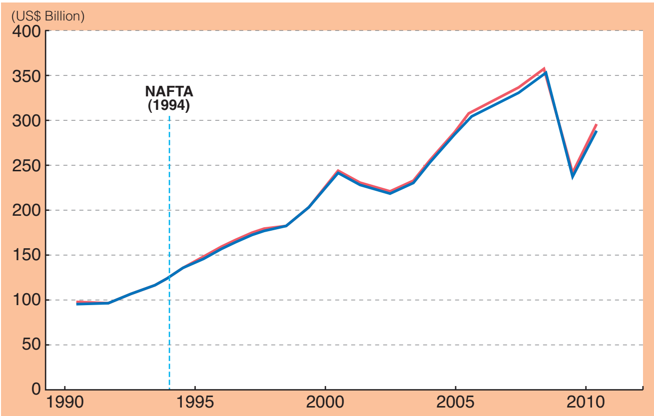
NAFTA was probably the first trade agreement to be built around the recognition that cross-border business is about much more than just the import and export of goods; trade is integrative and thriving when it is supported by the effective movement of people, the smooth flow of investment and capital, and effective regulations that do not impose unnecessary barriers. Further, trade takes place not only in finished products, but increasingly in components and

NAFTA Trilateral Trade



Source: Canadian Department of Foreign Affairs & International Trade

Canadian Merchandise Exports to NAFTA Partners



Source: Canadian Department of Foreign Affairs & International Trade services that feed into complex cross-border value chains. New and innovative approaches were therefore taken in crafting NAFTA to respond to the actual needs of companies.

The results speak for themselves. NAFTA created the world's largest trade area of three integrated economies. From 1993 to 2008, total trade within NAFTA increased threefold, from approximately US$288 billion to US$946 billion. While these numbers dropped sharply following the 2008 financial crisis, total NAFTA trade has since recovered considerably, and we look forward to the day when annual trade within the NAFTA region will breach the US$1 trillion threshold. For trade in goods, Canada-US trade almost doubled to Canadian $ 502.4 billion in 2010, and Canada-Mexico trade grew nearly sixfold to C$27.1 billion in 2010. Canada's services trade has also increased substantially since 1993: Canada-US services trade more than doubled to C$92.4 billion in 2010, and Canada-Mexico services trade quadrupled to C$2.4 billion in 2008 (latest available data).

What NAFTA has Meant for Business

NAFTA has benefited Canadian businesses in different ways. The most obvious benefit has come from increased export opportunities resulting from lower tariffs, predictable rules, and reductions in technical barriers to trade. By itself, Canada is a relatively small market with a population of approximately 34 million and a GDP of approximately US$1.6 trillion. However, NAFTA has meant that Canadian businesses have come to enjoy virtually tariff-free access to a Canada-US-Mexico mega-market of over 450 million people with a combined GDP of over US$17 trillion. Geographically, many large Canadian cities are actually closer to major US markets than are other major American cities. In fact, of Canada's 20 largest cities, 17 are within a 90-minute-drive of the US border. These cities are thus well placed to export to the key hubs of the North American marketplace, especially given the proximity of Canada's industrial heartland of southern Ontario and Quebec with the major markets of the US Northeastern and Midwestern states.

However, the NAFTA success story for Canada is not simply about increased exports. In fact, NAFTA has led to more fundamental changes in how firms produce and trade. As market access improved, and open competition intensified, in tandem with increasing exports and imports, firms rationalized their production and became more specialized and thus more competitive by focusing on the activities they do best. Now, over half of Canadian manufactured exports to the US are intermediate inputs feeding into complex supply chains. While in the past Canadian, US and Mexican companies made and sold things to each other, now, Canadian, US and Mexican facilities increasingly *make things together,* through highly efficient cross-border supply chains, for eventual consumption within and beyond NAFTA. This evolution can be seen particularly in advanced manufacturing, specifically in the automotive, aerospace, and transportation equipment sectors. For example, in the automotive sector during the production process, a car and its components will cross the border numerous times before the final product is finished. This allows manufacturers to partner with specialized suppliers in the NAFTA area, which enables increased efficiency and competitiveness.

Another example of how NAFTA has fostered both domestic and global competitiveness in Canadian companies is that of the Canadian wine industry. While wine production in Canada goes back 200 years, prior to free trade, Canadian wine was produced largely from native North American "labrusca" grape varieties. These varietals could survive the cold but resulted in poor-quality wine that was consumed domestically because it was protected from foreign imports through high tariffs. The threat of tariff-free imported wines from California led most to predict that the Canadian wine industry would be obliterated, but in fact the opposite happened. As a measure to respond to free trade, Canadian wine-growers in the provinces of Ontario and British Columbia, with the support of the federal and provincial governments, began a major initiative to replace their labrusca vines with finer varieties of European "vinifera" grapes such as Chardonnay, Riesling, Pinot Noir, and Merlot, among others.

At the same time, the Canadian wine industry in Ontario and British Columbia created an appellation of origin program called the Vintners' Quality Alliance, which set and regulated winemaking and labeling standards that resulted in higher-quality products recognizable by the consumer. As Canadian wine-growers optimized production of the cool-climate grape varieties ideally suited to local soil types and micro-climates, wines that could compete on an equal footing with the best in the world began to emerge. Despite initial predictions, the number of wineries in Canada did in fact grow significantly, from around 30 in 1990 to over 400 today. Canadian wine now thrives not only at home but also around the world including here in Japan.

In sectors such as office furniture, there were dire predictions that the sector would disappear as a victim of free trade. However, those Canadian firms that seized the dynamic efficiencies that can flow from producing for a larger customer base and those firms that took advantage of other favorable economic conditions at the time, such as the comparatively weaker Canadian dollar, increased their market share both at home and in the US. These firms did so while also investing in new machinery and technology, lowering production costs, increasing production capacity, developing innovative new products through modern processes, and focusing on higher-value-added production for niche markets. Pain was indeed felt, as not all manufacturers in these industries could survive the transition to free trade, but those that did became stronger and better equipped to cope with increased competition and other challenges such as periods of relative strength of the Canadian dollar.

NAFTA has also benefited small and medium-size enterprises (SMEs). At first glance, statistics suggest that trade is less important to SMEs than to larger firms since, for example, SMEs only account for 34.4% of the value of manufacturing exports and 29% in the mining, oil and gas extraction industries. However, small firms engage in global value chains in different ways than larger firms, often providing intermediate inputs to global value chains in Canada. This in turn can bestow additional benefits, as exporting customers look for improved productivity among their suppliers. Further, SMEs are relatively labor-intensive, thus making a significant contribution to employment for Canadians. Most significantly, in the agriculture, forestry and fishing sector, SMEs account for 81.5% of the value of exports.

Another dimension to the NAFTA story is the benefits that the agreement brought to Canada by helping to attract investment from global businesses choosing to serve the North American market

Canadian cities' proximity to major American markets

Source: Canadian Department of Foreign Affairs & International Trade

from a Canadian base of operations. The foreign direct investment stock in Canada from NAFTA partners grew threefold since 1993 to reach C$306.3 billion in 2010.

There are a number of reasons why firms choose to invest in Canada. Chief among these is low corporate taxes, which have been cut incrementally in recent years. The Canadian federal corporate tax rate was reduced to 16.5% in January 2011 and will be reduced again to 15% in 2012. This would bring combined provincial and federal corporate income taxes on new business investment to 26%, more than 13 percentage points below US rates. Companies that choose to locate in Canada also have access to highly skilled workers. For example, more than half of all working-age Canadians have a post-secondary education, which is the highest among OECD countries, and Canada's overall education system has been ranked first in the G7 and fifth in the world by the World Economic Forum. Companies are also often attracted by Canada's lifestyle advantage and quality of life, including Canada's respect for diversity and the safety of its cities. All of this has led the Economist Intelligence Unit to rank Canada first in the G7 and fourth globally as a country in which to do business over the 2010-2014 period.

Many Japanese companies have chosen to base their production or other activities in Canada to serve the North American market, no doubt influenced by the factors highlighted above. Honda's Canadian plant in Alliston, Ontario was the first to be built in Canada by a Japanese automaker. Engines produced at this plant are used in Honda Civic models that are sold across North America and Honda and Acura-brand finished vehicles produced there are sold not only in Canada and the US but in other export markets too.

In 2000, Toyota selected Cambridge, Ontario as the site of its first Lexus plant outside of Japan and, since production of Lexus vehicles began at that facility in 2003, it has produced the RX 350 model for the entire North American market. To this day, the Cambridge South plant remains the only facility outside of Japan to manufacture Lexus vehicles. In June 2011, J.D. Power and Associates ranked this facility as the best in the world in terms of initial auto quality for producing vehicles with the fewest defects and malfunctions. In August 2011, Toyota announced that it would assemble the electric version of the RAV4 crossover utility vehicle (jointly developed with Tesla Motors Inc.) at its plant in Woodstock, Ontario for sales in the North American market. This move confirmed its confidence in Canada as a base from which to manufacture cutting-edge, high technology vehicles to serve the latest market needs.

NAFTA not Static

Since NAFTA came into force, the leadership provided by the NAFTA Free Trade Commission (comprising the ministers responsible for international trade in all three NAFTA countries) has ensured that it continues to evolve to respond to commercial needs as well as emerging economic and political realities.

Chief among these challenges was undoubtedly the new reality brought about by the events of September 11, 2001. Immediately following those tragic events, the urgent need to strengthen security meant that many companies that had located different aspects of their business to optimize the respective advantages available in Canada, the US and Mexico suddenly found themselves faced with new delays at the border and, as a result, increased costs.

In response, several initiatives have been launched to meet these security needs without jeopardizing the free and open trade created through NAFTA that is so essential for North American prosperity. These include "Smart Border" action plans in the early 2000s and the Security and Prosperity Partnership (SPP), launched in 2005. Most recently, in February 2011, Canadian Prime Minister Harper and US President Obama built on these past programs by launching a "Shared Vision for Perimeter Security and Economic Competitiveness." Under this project, Canada and the US are aiming to enhance intelligence- and information-sharing, improve infrastructure and streamline procedures at ports of entry, further cooperate on cross-border law enforcement, and work together to prevent disruptions of critical infrastructure while strengthening cyber-security. A key motivation for this initiative was to continue to ensure that the important gains realized under NAFTA do not become eroded by an inadvertent "thickening" of the Canada-US border.

As for other obstacles, though tariffs have mostly been eliminated under NAFTA, regulatory-based differences still represent a significant obstacle to competitiveness, innovation and economic performance affecting trade in goods. Canada, the US and Mexico are thus actively working to simplify regulations and ensure their compatibility, where it is feasible to do so. To this end, two new bilateral regulatory cooperation councils were announced between Mexico and the US in 2010, and Canada and the US in 2011.

These and similar regulatory-based measures may also be

Canada's network of trade agreements

Source: Canadian Department of Foreign Affairs & International Trade

addressed under existing NAFTA subcommittees such as the Committee on Standards-Related Measures. This Committee serves as a trilateral forum for the resolution of standards and conformity assessment issues that impact trade among NAFTA partners and seeks to enhance cooperation on the development, application and enforcement of these measures.

Another way to ensure NAFTA's evolution is to continue to update rules of origin to reflect the ways that business is actually conducted. Rules of origin provide the basis for customs officials to determine which goods qualify for tariff-free access under NAFTA. This determination can sometimes be challenging in the world of complex global value chains where parts of goods are often made in multiple locations. To provide clarity and guidance, and to ensure that businesses can continue to benefit from the free trade enjoyed under NAFTA, the agreement's rules of origin have been liberalized on several occasions. Further changes, designed to ensure that the rules of origin reflect current sourcing and production patterns, are currently under consideration.

Yet another way to make sure that NAFTA remains useable and practical for companies is to study the experiences of small and medium-sized businesses and, based on that work, offer support to allow these firms to take advantage of trading opportunities in the NAFTA region and beyond. Based on the recognition that as North American SMEs begin to export, they are most likely to export to a customer in one of the NAFTA countries, a guide was recently published to assist these companies in taking that important step.

Looking Ahead

Different surveys and public opinion polls on trade that have been conducted over the years show that while some elements of NAFTA remain politically controversial, a solid majority of Canadians consistently supports the agreement and sees it as having brought benefits to the Canadian economy. Canadians' positive experience with NAFTA has also been a major contributing factor to the widespread support in Canada for free trade in general.

Canada continues to attach great importance to the multilateral trading system and the WTO. However, Canada's ambitious bilateral and regional trade agenda continues to build on the multilateral rules-based system. NAFTA's success has meant that it often forms a basis for Canada's trade agreements with other partners. Notably, unlike a customs union, NAFTA makes it possible for each of the three member countries to set its own external trade policy, and Canada is moving ahead rapidly and independently to forge new agreements with new partners. In addition to NAFTA, Canada has free trade agreements in force with Israel (1997), Chile (1997), Costa Rica (2002), the European Free Trade Association (2009), Peru (2009), and Colombia (2011). Completed agreements with Panama, Jordan and Honduras are in the process of being ratified. Moreover, Canada is pursuing new free trade agreements with over 50 countries, including such major players as the EU and India.

As Japan moves into a new phase of trade negotiations by considering negotiations with major trading nations including G7 countries, there are many lessons that can be drawn from Canada's experience. Among these lessons is that free trade can bring about positive effects that are sometimes unexpected, in terms of how industries benefit not only from increased export opportunities, but also from adapting to increased import competition by pursuing efficiency and quality improvements to achieve long-term sustainability and global viability. Far from making Canada more dependent on the US economy, NAFTA has made Canada more competitive and more global.

Conversely, NAFTA has been responsive to sensitivities through phase-in periods that provide transition time for industry to adjust to a duty-free environment

The pursuit of free trade agreements between Japan and G7 nations such as Canada is even more important against the backdrop of changing global economic realities. As emerging economies such as the BRIC nations rise in global prominence, free trade agreements become even more important as a vehicle for countries like Canada and Japan to maintain and sharpen our competitive edge. As heightened political risk and changing patterns of global trade threaten the secure and safe supply of key resources, closer ties between Japan and resource-rich nations such as Canada can be instrumental in contributing to energy and resource security. Canada and Japan are completing a joint study now to assess the benefits of an economic partnership agreement. A positive conclusion could point the way to an early launch of negotiations. JS

Jonathan T. Fried is Ambassador of Canada to Japan.