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United States-Canada Trade and Economic Relationship: Prospects and Challenges

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United States- Canada Trade and Economic Relationship: Prospects and Challenges

Summary

The United States and Canada conduct the world's largest bilateral trade relationship, with total merchandise trade (exports and imports) exceeding $499.3 billion in 2005. The U.S.-Canadian relationship revolves around the themes of integration and asymmetry: integration from successive trade liberalization from the U.S.- Canada Auto Pact of 1965 leading to North American Free Trade Agreement (NAFTA), and asymmetry resulting from Canadian dependence on the U.S. market and from the disparate size of the two economies.

The economies of the United States and Canada are highly integrated, a process that has been accelerated by the bilateral U.S.-Canada free trade agreement (FTA) of 1988 and the NAFTA of 1994. Both are affluent industrialized economies, with similar standards of living and industrial structure. However, the two economies diverge in size, per capita income, productivity and net savings.

Canada is the largest single country trading partner of the United States. In 2005, total merchandise trade with Canada consisted of $287.9 billion in imports and $211.4 billion in exports. While Canada is an important trading partner for the United States, the United States is the dominant trade partner for Canada, and trade is a dominant feature of the Canadian economy. Automobiles and auto parts, a sector which has become highly integrated due to free trade, make up the largest sector of traded products. Canada is also the largest exporter of energy to the United States. Like the United States, the Canadian economy is affected by the transformation of China into an economic superpower. The U.S. trade deficit with Canada has continued to increase, but the rate of increase declined in 2005 perhaps partly due to the 30% rise in the Canadian dollar since 2002. The United States and Canada also have significant stakes in each other's economy through foreign direct investment.

Both countries are members of the World Trade Organization (WTO) and both are partners with Mexico in the NAFTA. While most trade is conducted smoothly, several disputes remain contentious. Disputes concerning softwood lumber, wheat and the disposition of antidumping duties (the Byrd Amendment) have been addressed by dispute settlement bodies at the WTO and NAFTA. In addition, U.S. regulatory proceedings restricted the importation of Canadian beef (now lifted), and the United States has placed Canada on its Special 301 watch list over intellectual property rights enforcement.

The terrorist attacks of 2001 focused attention on the U.S.-Canadian border. Several bilateral initiatives have been undertaken to minimize disruption to commerce from added border security. The focus on the border has renewed interest in some quarters in greater economic integration, either through incremental measures such as greater regulatory cooperation or potentially larger goals such as a customs or monetary union. Congressional interest has focused on these disputes, and also on the ability of the two nations to continue their traditional volume of trade with heightened security on the border. This report will be updated periodically.

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The Economies of the United States and Canada

The economies of the United States and Canada are highly integrated, a process that has been accelerated by the bilateral U.S.-Canada free trade agreement (FTA) of 1989 and the North American Free Trade Agreement (NAFTA) of 1994. The two countries are natural trading partners, given their geographic proximity and their (partial) linguistic and cultural similarities. Because 80% of the Canadian population lives within 200 miles of the U.S. border and due to the impediments of Canadian geography, trade with the United States is often easier and less expensive than Canadian inter-provincial trade. Both are affluent industrialized economies, with similar (though not identical) standards of living.

However, the economies of the two countries diverge in numerous ways. First, the U.S. economy dwarfs that of Canada. U.S. gross domestic product (GDP) is over 11 times that of Canada in nominal terms and nearly 12 times that of Canada in terms of purchasing power parity.[1] (See **Table 1**.) This large and historic disparity has presented opportunities and challenges for Canada. NAFTA provides Canada with a large market for its exports at its doorstep, however it has also led to increased import competition for small-scale Canadian businesses. The Canadian economy is also disproportionately impacted by a U.S. economic slowdown or changes in the bilateral exchange rate.

Per capita GDP in Canada also trails that of the United States. During the 10-year period 1996-2005, the average growth rates of the United States and Canada have been virtually identical. However, since 2003 growth rates in the United States have exceeded those of Canada. The persistent (and growing) per capita income gap has proven worrisome to Canadian policymakers as it raises questions about Canadian productivity and competitiveness (see box).

In terms of sectoral components of GDP, the United States and Canada are similar. Over two-thirds of both economies are devoted to the services sector, although the sector is relatively larger as a percentage of GDP in the United States (79% - 68%). The manufacturing sector's composition of GDP has fallen in both countries over time, but it is still relatively more important to the Canadian economy

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[1] Purchasing power parity (PPP) is a economic theory which holds that exchange rates between currencies are in equilibrium when their purchasing power is the same in each of the two countries. PPP is useful for cross-country comparisons because its measurement excludes exchange rate volatility and speculation.

(29%-20%). Agriculture makes up the remaining 2% of the Canadian economy and 1% of the U.S. economy.

In terms of savings and investment, Canada and the United States have diverged. Canada's experience with fiscal profligacy in the 1970s and 1980s caused the country to eschew deficit spending in the 1990s. It has had a public sector surplus for eight years and has lowered its ratio of public debt-to-GDP from 100% of GDP in 1996 to 68.3% of GDP in 2004. The United States has a lower ratio of debt-to-GDP, but it is trending upward with current fiscal policies. Personal savings rates are now effectively negative in both the United States and Canada equaling a -0.5% and -0.4%, respectively, in 2005.[2]

Table 1. Selected Comparative Statistics

Indicator	United States	Canada
GDP (2005) Nominal (billion US$) Purchasing power parity (PPP) (billion $)	 12,486 12,486	 1,124 1,057
Per Capita GDP (2005) Nominal ($) PPP ($)	 42,125 42,125	 34,880 32,790
Real GDP Growth (2005)	3.5%	2.9%
Average Annual GDP Growth Rate (1996-2005)	3.34%	3.33%
Recorded Unemployment Rate (2005)	5.5%	6.7%
Exports (%GDP) Imports (%GDP)	7.2% 13.4%	32.0% 27.9%
Sectoral Components of GDP (%) Industry Services Agriculture	 20.3% 78.5% 1.2%	 29.4% 68.4% 2.2%
Current Account Balance (% GDP)	-6.5%	1.7%
Public Debt/GDP	37.4%	68.3%

Sources: Economist Intelligence Unit; Census Bureau; Bureau of Economic Analysis; Statistics Canada.

[2] Scotiabank Global Economic Research Report, "Spend or Save: Which Way Will the Pendulum Swing in 2006," February 23, 2006.

Some of the differences between U.S. and Canadian economic performance may be traced to the differences in the role and structure of the government in economic life. While both countries can be identified as generally free-market capitalist economies, at times Canada has adopted more interventionist economic policies. Prior to the FTA with the United States, Canada protected her small-scale manufacturing enterprises that produced solely for the domestic market with high tariffs. While these plants provided jobs to Canadian workers, they resulted in higher prices for Canadian consumers and led to an inefficient allocation of national economic resources. Canada has also provided its citizens with a more generous social safety net including a government-run national health service. Canadian citizens pay higher taxes to receive these benefits, but private industry is relieved of providing health care coverage.

A different relationship between the Canadian federal government and the provinces also affect economic dynamics. Canadian provinces have relatively more power vis-a-vis Canada's federal government, than that U.S. states with the U.S. government. For example, natural resources are under the policy control (and in many cases, ownership) of Canadian provincial governments. In the softwood lumber dispute, provincial ownership and management of forests have made the provincial governments key players in the negotiations. Alberta's vast energy reserves may also cause friction between it and other "have-not" provinces without similar resource endowments. The Canadian federal government attempts to provide a uniform level of services across the provinces by providing "equalization" payments to poorer provinces, however, these payments are a source of continuous squabbling between the provinces, on one side, and the federal government.

The Trade and Investment Relationship

Canada is the largest single nation trading partner of the United States. In 2005, total merchandise trade with Canada was $499.3 billion (a 12.6% increase over 2004), consisting of $287.9 billion (12.5% over 2004) in imports and $211.4 billion (12.6% over 2004) in exports.[3] Trade with Canada represented nearly 19.4% of U.S. total trade in 2005, with Canada purchasing 23.4% of U.S. exports and supplying 17.2% of total U.S. imports last year. While Canada is an important trading partner for the United States, the United States is the dominant trade partner for Canada. The United States supplied 56.6% of Canada's imports of goods in 2005, and purchased 84.0% of Canada's merchandise exports.

Trade is a dominant feature of the Canadian economy. While in the United States, the value of trade (exports + imports) as a percentage of GDP was about 20.7% in 2005, the comparable figure for Canada was nearly 60%. Canada's goods exports represent 32% of Canadian GDP and exports to the United States alone represent 26.9% of Canadian GDP. A further 15.7% of Canadian GDP is used to purchase U.S. goods. Canada is relatively more exposed to the world economy and

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[3] Trade figures are expressed in terms of general imports (customs value), and total exports (FAS value) as compiled by the U.S. International Trade Commission. Canadian figures are from Statistics Canada.

to the fortunes of other economies, foremost the United States, than most other countries.

Autos and auto parts are the top U.S. exports to, and imports from, Canada. Computer equipment, electrical equipment, engines, turboengines, recorded media, optical equipment and precision instruments are other major U.S. exports. Primary U.S. imports from Canada outside the automotive sector are energy (natural gas, petroleum products, electricity), engines, aircraft equipment, wood, and paper products.

That the United States and Canada trade substantial volumes of the same goods bespeaks the economic integration of the two economies. This integration has been assisted by trade liberalization over the past 35 years, beginning with the Automotive Agreement of 1965 (which eliminated tariffs on shipments of autos and auto parts between the two countries), through the Canada-U.S. Free Trade Agreement of 1989 (FTA), and NAFTA. Under the FTA (which was incorporated into NAFTA), bilateral tariffs except for certain agricultural products were phased out over a 10-year period culminating in 1998.

The elimination of tariffs and the reduction of nontariff barriers have contributed to the process of specialization, as each country is able to produce goods for a larger continent-wide market. Thus, firms are able to improve productivity through increased economies of scale and coordinated production. Such specialization led to increased bilateral trade, much of it in intermediate products. One study estimated that about 45% of U.S.-

The Productivity Conundrum

Economists have long noticed that measures of productivity are generally lower in Canada than in the United States, and that this disparity has persisted despite the increasing level of integration between the two nations' economies. Productivity typically is measured as output per input (single-factor productivity) or as a bundle of inputs (total-factor productivity). Productivity typically measures output per unit of labor or per unit of capital. Total factor productivity measures the residual after accounting for capital and labor, which accounts for technological change or innovation. These measures are important because over time, productivity improvement is an important determinant of a nation's living standard or its level of real income and growth

According to two recent studies, Canada's lower productivity accounts for the largest component of the income gap between the United States and Canada. They note that Canada has invested less in machinery and equipment per worker since the 1980s, resulting in less capital intensity (less capital per worker). Canada's research and development (R&D) as a proportion of GDP is lower than that of the United States and other OECD countries. Usage of information and communications technology (ICT) is also less extensive than the United States, although the OECD reports that Canada ranks third in OECD countries after the United States and Sweden in ICT application. While Canada ranks favorably to the United States in primary and secondary educational attainment, Canadians fall behind their American counterparts in the attainment of university or advanced degrees and in opportunities for on-the-job training or continuous education. Finally, industrial organization also plays a part. According to the Conference Board of Canada, Canadian manufacturers are more heavily concentrated in lower productivity growth industries. Smaller enterprises (SME) are generally less productive than larger ones, and SMEs are a greater share of Canadian manufacturing and employment. Canadian plants of foreign firms are generally more productive than indigenous companies, perhaps because they import best-practices and technical know-how from their home operations. This may account for the productivity prowess of Canadian auto operations.

Organization of Economic Cooperation and Development, *OECD Economic Surveys: Canada, 2004;* Conference Board of Canada, *Performance and Potential 2003-4: Defining the Canadian Advantage.*

Canadian trade was intra-firm trade, reflecting the substantial integration of the two economies and contributing to increased efficiency and competitiveness of firms on both sides of the border.[4]

Autos. Integration of the U.S. and Canadian automotive industries is an example of the benefits of specialization and economies of scale. Before the mid-1960s, each country's industry produced for its own market, due largely to tariffs imposed by both countries. Canadian auto firms (actually subsidiaries of U.S. firms) were considerably less productive than their U.S. counterparts because Canadian firms produced a variety of differentiated products for a relatively small domestic market in an industry characterized by economies of scale.

The Automotive Agreement of 1965 (Auto Pact) between the United States and Canada began the process of integration by eliminating tariffs on shipments of autos and auto parts between the two countries. Thus, each country's industry could specialize in a smaller number of products and use longer production runs. Coordinated production on both sides of the border increased significantly, as did bilateral automotive trade. Coordinated automotive production has raised living standards in both the United States and Canada, and has strengthened the global competitiveness of producers on both sides of the border.

Motor vehicles, vehicle parts, and engines make up 21.8% of U.S. exports to Canada and 22.7% of U.S. imports from Canada (see Table 2, p.7). Although vehicles and parts flow in both directions, the primary trajectory is that of U.S. parts exported to Canada for assembly, and vehicles exported back to the United States. In 2005, 2.38 million vehicles were imported from Canada. While Canada suffers from productivity problems in other sectors of its economy, its automotive plants are among the most competitive in North America. Part of the cost advantage traditionally has been due to the weak Canadian dollar (also known as the "loonie" due to representation of a loon on the C$1 coin), but that advantage has diminished with the loonie's 30% appreciation since 2002. Another major competitive advantage is Canada's national health system, which relieves the auto makers of approximately $1,400 in costs per vehicle.[5] However, one recent report suggested that the price advantage to Canadian production is dwindling, down to $250 per vehicle in 2003 from $400 in 2000.[6] Another suggests that the rising Canadian dollar will erase all cost-advantage to Canadian manufacturing by 2007.[7]

The restructuring of the North American automotive industry and the attendant plant closures and job layoffs has also affected Canadian automotive operations. General Motors' November 2005 restructuring announced the closure of the St. Catherines, Ontario, powertrain plant and an Oshawa, Ontario, assembly plant

[4] World Trade Organization, Trade Policy Review: Canada, Report by the Secretariat, October 6, 1996, (WT/TPR/S/22), p.6.

[5] "Ontario to Overtake Michigan As Auto Kingpin," *The New York Times*, November 29, 2004.

[6] Scotiabank Canadian Auto Report, June 28, 2005.

[7] "Canada en route to Losing Car-Maker Advantage," *Globe and Mail*, February 27, 2006.

resulting in the loss of 3,660 Canadian employees.[8] Ford's restructuring announced the closure of a shift in St. Thomas, Ontario, and a Windsor casting plant resulting in the loss of 1,000 jobs.[9] In addition, Canadian auto parts manufacturing reportedly has lost an estimated 10,000 jobs since 2003.[10] However, Toyota is expanding operations in Canada, and the Big 3 continue to plan significant new investments to upgrade plants.[11]

Energy. Canada is the largest supplier of energy (including petroleum, natural gas, and electricity) to the United States. While the dollar value of U.S. imports of Canadian crude oil and natural gas increased nearly 250% since 1998, the volume in terms of barrels and cubic feet has also increased almost 20%. In 2005, oil and gas displaced motor vehicles as the United States's largest import from Canada. Canada has traditional sources of crude oil in Alberta and off the coasts of Newfoundland and Nova Scotia. As the price of crude oil increases, petroleum extracted from Albertan oil sands are becoming a major part of Canadian energy supplies. Oil sands are surface mined, and the oil is extracted through pressurization. The process itself is energy intensive, water dependent, and not all that environmentally friendly. However, it is estimated that the potential oil extracted from the oil sands represent reserves second only those held by Saudi Arabia. Their importance as a source of supply for U.S. energy needs was underscored by the July 2005 visit of Treasury Secretary John Snow. Provisions of the FTA and NAFTA assure free trade in energy by prohibiting imposition of minimal export prices or export taxes, and restrict the imposition of supply restrictions.

China. China's emergence as an economic superpower and the United States response has become a major issue in the United States. In Canada, political discussion has been more muted, but some of the same issues are present. China is now Canada's second largest trading partner, and is growing rapidly. However, most of this increase is import-based. In 2005, Canada imported $24.4 billion in goods from China, primarily a typical array of labor intensive products: apparel, footware, consumer electronics, toys, and telecommunications equipment. Meanwhile, Canada's exports to China totaled $5.8 billion, primarily natural resources: forest products, metals, petroleum, and agriculture, but also aviation equipment and telecommunications equipment.

Canadians and Americans have similar concerns over the loss of manufacturing jobs in income competing industries to low-wage producers such as China. Perhaps more important, from the Canadian perspective, is the concern that Canadian producers will be pushed out of the U.S. market by low-wage competition. One study found that while such a threat is real, China now competes more with Mexico in labor intensive sectors than does Canada in the U.S. market.[12]

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[8] "GM to Cut 3600 Jobs in Ontario," CBC.Ca News, November 21, 2005.

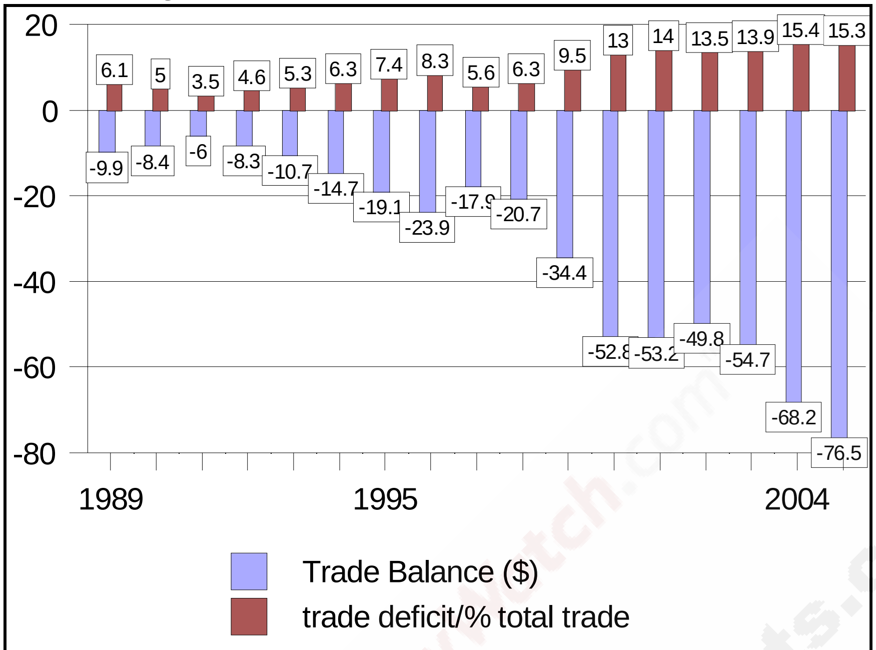
[9] "Ford's Canada Cuts Limited," *The Globe and Mail*, January 23, 2006

[10] "Auto Sector to Pump $4.9 billion into Plants," *Ottawa Citizen*, March 15, 2006.

[11] "Canada en route to Losing Car-Maker Advantage," *Globe and Mail*, February 27, 2006.

[12] Wendy Dobson, "Taking A Giant's Measure: Canada, NAFTA, and an Emergent China,"
(continued...)

Figure 1. U.S. Trade Deficit with Canada



Source: U.S. International Trade Commission

China's near unquenchable thirst for natural resources to fuel its economic boom has led it to attempt to purchase natural resource assets abroad, including a controversial bid for Unocal in the United States. Canadian firms have also become a target for takeovers by Chinese companies, and may now become more so in the wake of China National Offshore Oil Company's (CNOOC) withdrawal of its bid for Unocal. Two Chinese oil companies, including CNOOC, have purchased stakes in Alberta's oil sands projects, and a pipeline is to be constructed in conjunction with PetroChina from Alberta to the West Coast. An attempted Chinese purchase of Noranda (now Falconbridge), one of the world's largest zinc, nickel, and copper concerns, by China Minmetals was called off in 2004 due to rising share prices. However, the proposed deal did spark concern about purchase of Canadian resources by a subsidiary of the Chinese Metals Ministry and about the company's human rights and Communist party ties.[13]

Trade Deficit. The U.S. merchandise trade deficit with Canada in 2005 increased 24.7% (12.2%) from 2003 to a record $68.2 billion ($76.5 billion). Imports have been growing faster than exports as well. In the free trade era since 1989, the value of imports over exports increased from 3.5% of the value of total trade in 1991 to 15.3% in 2005. The increasing trade deficit with Canada has been blamed on many factors. Up until 2003, the persistent trade deficit was attributed, in part, to the weakness of the Canadian dollar. The loonie had steadily depreciated in value in the decade prior to 2003. Worth approximately $0.84 at the time of the U.S.-Canada Free

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[12] (...continued)
C.D. Howe Institute, September 2004.

[13] "Canada Welcomes China's Cash - Hospitality Toward Investments Run Counter to Mood in U.S.," *Wall Street Journal*, July 15, 2005.

Trade Agreement in 1989, the currency briefly sank to $0.63 in 2002. The loonie bounced back to an average of $0.71 in 2003, $0.75 in 2004, and $0.825 in 2005. (The loonie broke the $0.90 mark on May 2, 2006.) In 2005, at least, the depreciating U.S. dollar — which should make cheaper U.S. goods more attractive on the Canadian market — did not have an ameliorative effect on the U.S.-Canadian trade deficit. However, increased prices for natural resources and energy, attributed to the global expansion and Chinese development, may be a factor for both the loonie's strength and the persistent U.S. trade deficit in 2005 with Canada.

Table 2. U.S. Merchandise Trade With Canada, 2005

Export Category	Amount (billion$)	Import Category	Amount (billion$)
Motor parts	$25.9	Oil and Gas	$53.1
Motor Vehicles	$20.2	Motor Vehicles	$47.1
Computer Equipment	$8.4	Vehicle Parts	$18.0
Special Classification	$7.3	Pulp, Paper, Paperboard	$10.5
Semiconductors	$6.4	Returned/Reimported	$9.8
Agriculture/Construction Machinery	$6.5	Petroleum and Coal Products	$9.4
Machinery	$6.3	Special Classification	$8.0
Chemicals	$5.8	Aerospace Products and Parts	$7.5
Materials/ Resins/synthetic fibers	$5.8	Sawmill and Wood Products	$7.4
Iron/Steel/Ferroalloy	$5.6	Aluminum	$5.8
Engines/Turbines/ Power Transmission Equipment	$5.3	Nonferrous Metal and Processing	$5.7
Electrical/ Medical/Control Instruments	$4.8	Basic Chemicals	$5.6
Aerospace Products/Parts	$4.6	Resin, Synthetic Rubber, artificial fibers	$5.4
Plastics Products	$4.1	Veneer, Plywood, Engineered Wood Products	$5.2
Fabricated Metal	$4.1	Plastics Products	$4.9
All Other	$90.2	All other	$84.5
Total	**$211.4**	**Total**	**$287.9**

Source: U.S. International Trade Commission. (Figures are NAIC-4, Total Exports and General Imports.)

Services. The United States also conducts a substantial services trade with Canada. In 2004, the United States exported $29.7 billion worth of services to Canada and imported $20.0 billion, for a surplus of $9.7 billion. Canada is the third largest destination for U.S. service exports after the United Kingdom and Japan, accounting for 9.3% of U.S. service exports. Imports from Canada represent about 7.8% of total U.S. service imports, and rank second in magnitude after the United Kingdom. In 2003, U.S. service exports represented 60% of Canadian service imports, and Canadian service exports to the United States represented 59% of total Canadian service exports.[14]

Canada ranked last among the Group of 7 leading industrial countries in the importance of services trade to its economy with trade in services making up only 12.7% of exports and 16.8% of imports in 2004. Commercial services made up about half of Canadian service trade in 2004 and travel and tourism totaled another 27.5%. U.S. travelers accounted for 59% of worldwide travel expenditures to Canada in 2004; Canadian tourists spent 55.8% of their tourist dollars in the United States that year.[15]

Investment

The U.S.-Canada economic relationship is characterized by substantial investment in each nation by investors of the other. The United States is the largest single investor in Canada with a stock of $216.6 billion in 2004, a figure that has more than doubled from $97 billion in 1997. This figure represents 10.5% of U.S. direct investment abroad (DIA), and U.S. investors accounted for 65% of inbound foreign direct investment (FDI) in Canada in 2004.[16] Finance and insurance, manufacturing, and mining/energy are the three largest categories of U.S. FDI in Canada. Canada has a prominent (though not the largest) FDI position in the United States at $133.8 billion, 8.8% of the total FDI stock in the United States. The United States is the most prominent destination for Canadian DIA, with a stock of 44% of total Canadian DIA in 2004.

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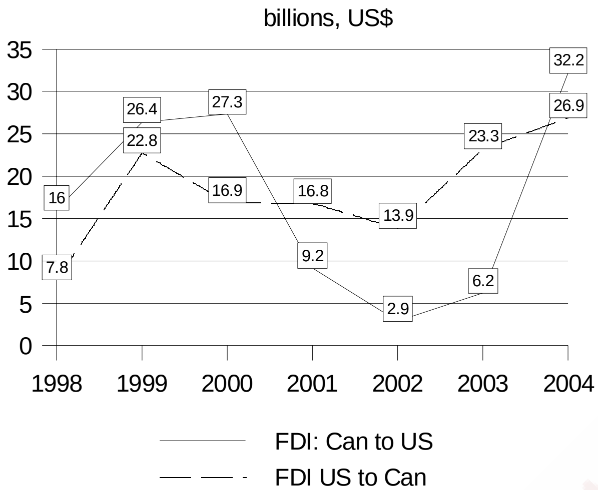
[14] U.S. Bureau of Economic Analysis, *Survey of Current Business*, October 2005; Industry Canada, *Trade and Investment Monitor 2004*, [http://strategis.ic.gc.ca/epic/internet/ineas-aes.nsf/en/h_ra01873e.html]

[15] Statistics Canada, Canada's Balance of International Payments, Table 5D: "Canada's International Transactions in Services by Selected Countries."

[16] Statistics Canada, *The Daily*, May 17, 2005 ([http://www.statcan.ca/Daily/English/050517/d050517a.htm])

Canada is also highly dependent on FDI. In 2004, FDI represented 28.3% of Canada's GDP, and Canadian DIA represented 34.5% of GDP, both figures up from about 20.0% in 1995. However, other trends are more ominous for the Canadian investment picture. Canada's share of North American and global FDI has dropped in the last decade. Canada's share of North American FDI has dropped from 17.0% to 13.0%, while the U.S. share has increased to 78.0% from 76.0%. Also, the Canadian share of inward global investment stock fell from 7.7% in 1980 to 3.0% in 2002.[17] Flows of FDI have slowed for both nations after 2000, but have picked up again in the current economic expansion.

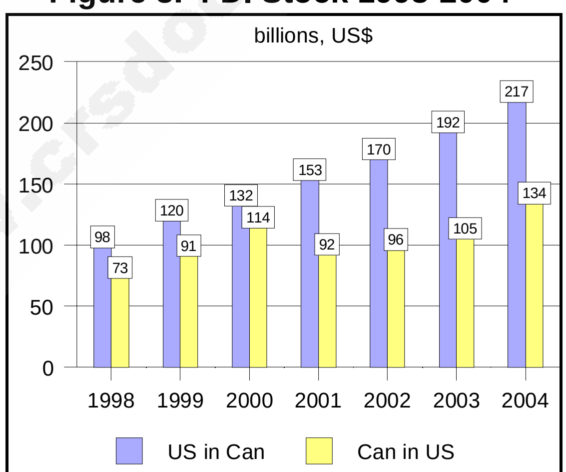
Figure 2. FDI Flows 1998-2004



Source: U.S. Bureau of Economic Analysis (BEA)

Canadian FDI Policy. Foreign investment has played a large part in the development of the Canadian economy. British and American capital was instrumental in building Canada's railways in the 19th century and in exploiting its resources in the 20th. Although Canada is generally open to foreign investment, certain restrictions do exist on some forms of FDI. Investment is monitored and some types of FDI are reviewed. "Significant investments in Canada by non-Canadians" are reviewed under the Investment Canada Act to insure "net benefit" to Canada. The review threshold for parties to the World Trade Organization (WTO), including the United States, is $223 million. All transactions involving uranium production, financial services, transportation services, or cultural business[18] must be reviewed. Net benefit is assessed on such factors as: effect on level of economic activity in Canada including employment; the degree or significance of participation by Canadians; the effect of productivity and technological development; the effect on

Figure 3. FDI Stock 1998-2004



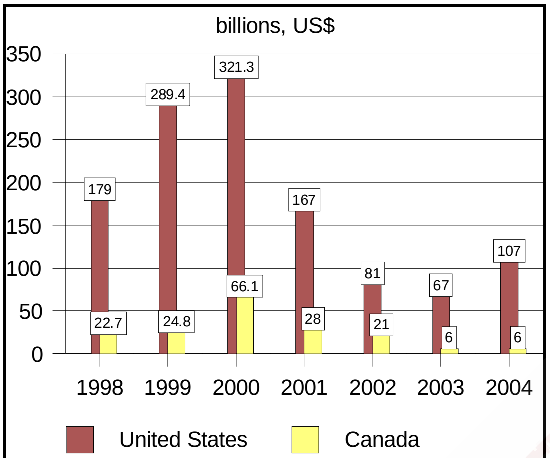
Source: BEA

[17] Industry Canada, *Trade and Investment Monitor 2004*, p.41.

[18] Cultural business refers to the publication of books, magazines, periodicals or newspapers; production, distribution, or sale or exhibition of film, video recordings, audio or video musical recordings; publication or dissemination of print music; or radio, television, cable, or satellite broadcasting.

competition; the effect on Canadian competitiveness on world markets; and compatibility with national, industrial, or cultural policies. No investment by a non-resident has been rejected under this authority, but in some instances investments have been altered pursuant to Investment Canada guidance.[19]

Figure 4. Inward FDI Flows from All Countries: 1997-2004



Source: Economist Intelligence Unit

The Canadian government has recently introduced legislation to provide for a review of foreign investment for national security concerns. Under the legislation (Bill C-59, which received first reading on June 20, 2005), any direct or indirect investment can be subject to additional review under the Investment Canada Act if it could be "injurious to national security," although that phrase is not further defined. An investment found to be "injurious" could be blocked or conditions could be placed on the transaction. Critics claim that the bill would introduce uncertainty into the investment process, at a time when investment in Canada is declining.[20] Others warn that diversion of resources through increased FDI such as Chinese investment in the oil sands could have political implications for U.S.-Canadian relations.

Disputes

Both the United States and Canada are considered to have relatively open and transparent trading regimes. Both are signatories to the World Trade Organization (WTO) and are bound together by the North American Free Trade Agreement. However, irritants in the relationship do exist and each party has issues with the way the other conducts the bilateral trade relationship. Some disputes have been adjudicated by WTO and NAFTA dispute settlement procedures and others have been the subject of regulatory actions by the United States or Canada.

Softwood Lumber. On April 27, 2006, the United States and Canada agreed to a deal that, if implemented, would resolve the longstanding softwood lumber dispute, perhaps the most intractable trade dispute between the two nations. The present incarnation of the dispute began when the Softwood Lumber Agreement (SLA) between the United States and Canada expired on April 1, 2001. This agreement, implemented in 1996, set a tariff rate quota on exports of softwood

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[19] C.D. Howe Institute, "A Capital Story: Exploding the Myths of Around Foreign Investment in Canada," p. 21.

[20] "Bill C-59: Foreign Investment Will Become Unpredictable and Politicized if Ottawa Caves into Vague National Security Concerns," *National Post*, July 19, 2005.

lumber to the United States from four Canadian provinces at 14.7 billion board feet per year and set fees for exports in excess of that amount. U.S. lumber producers contend that Canadian provinces subsidize their lumber industry by charging less than market value for lumber harvested in the form of stumpage fees and other practices. U.S. timber and environmental groups have also expressed concern about Canadian forestry management and clear-cutting practices and allege that such practices lead to dumping. The Canadian government has rejected these allegations and has demanded free trade in lumber. It has asserted that Canadian mills have modernized and are more efficient than U.S. operations.

The proposed deal would end all softwood litigation (see below) and return $4 billion of the estimated $5 billion in antidumping and countervailing duties collected since 2002 to the Canadian lumber industry. The remaining $1 billion would be split; half would go to U.S. lumber companies and the rest used for a joint North American lumber initiatives and other "meritorious initiatives," such as possible Katrina rebuilding efforts.

The Canadian government would implement a supply management system for its lumber exports involving export taxes and quotas based on the price of lumber. If the price of lumber remains above $355/thousand board feet, no quotas or tariffs would be imposed. (Current prices are about $370 per board feet.) If prices fall below this threshold, each province could either choose to pay a sliding-scale export tax that would increase as the price falls, or pay a smaller tax along with agreeing to a market share limitation based on a province's share of total exports to the United States. Under the former, provincial producers would pay a sliding-scale export tax of 5% if prices fall below $350, 10% if prices fall below $335, and 15% if prices fall below $315. Under the hybrid methodology, each province has a share of the U.S. market. Thus, if the benchmark price falls below $355, each province's exports would be capped at its share of 34% of the U.S. market with an export tax of 2.5%, its share of 32% of the U.S. market combined with a tax of 3% at prices below $335, and its share of 30% of the U.S. market with a 5% tax at prices below $315.

The agreement would last for 7 years with an option of a two year renewal. Maritime provinces (which have private timber ownership) and other producers not engaged in the litigation would be exempt from the agreement. The agreement also provides for a surge mechanism if exports from a Canadian province exceed 110% of its allocated share. Conversely, if in two consecutive quarters third country exports to the United States increase by 20%, Canadian market share decreases, and U.S. market share increases, Canada is authorized to refund any export taxes collected in that quarter.

Before the agreement is finalized, all parties to the dispute must agree to its implementation. The deal was brokered by the United States and Canadian federal governments; it must also receive the approval of the Canadian provinces and the respective private industries. Canadian provinces must approve the deal because natural resources are a provincial jurisdiction in Canada. Each province has given its approval, with various degrees of enthusiasm. Producers involved in the litigation in each country must also sign on to the deal because they must agree to terminate pending litigation under the trade remedy laws of both countries. The U.S. Coalition for Fair Lumber Imports has supported the agreement, but Canadian producers have split. This agreement provides a framework for negotiations of a final accords. Continuing concerns by stakeholders on both sides of the border may be addressed in these negotiations.

Generally, proponents of the agreement view it as the best deal that could be obtained by negotiation. To proponents, the alternative was continuing litigation, with its inherent risk and uncertainty to each side. Through various restrictive mechanisms, U.S. producers would be able to avoid free trade in lumber with Canada, which, they maintain, continues to subsidize its producers through provincial ownership of Crown lands. U.S. producers would also able to keep about 10% of the duties collected by the U.S. government despite a Court of International Trade ruling that the Byrd Amendment did not apply to duties collected from NAFTA countries (see below). Canadian proponents point out that Canadian producers would get most (80%) of their antidumping and countervailing duties back. They contend that while trade is still managed, proceeds of an export tax would be retained in Canada, rather than paying antidumping and countervailing duties to the United States. Proponents in Canada also note that unless lumber prices drop below the $355 benchmark, there will be no restrictions on the U.S. market.

Opponents of the deal include consumers of softwood lumber, such as U.S. homebuilder and homebuyer groups, and Canadian opposition parties. The former claim that the deal will hurt consumers through higher prices for new homes and materials for renovation. Canadian opposition leaders have attacked the deal as a "sell-out"[21] to U.S. lumber interests. Some claim that the agreement scuttles that NAFTA dispute settlement process, which they believe would have provided Canada with an eventual victory in the dispute.

Regulatory and Legal Avenues. While the softwood lumber litigation has been put in abeyance by the proposed accord, it will not be terminated until a final agreement is reached. Duties will also continue to be collected pending the resolution of the negotiations. The following is an overview of the regulatory and legal tracks of the dispute.

The **regulatory track** of the dispute commenced on April 2, 2001, when U.S. lumber producers filed countervailing duty and antidumping petitions with the International Trade Commission (ITC) and the Department of Commerce (Commerce).[22] In its final determination, Commerce found that Canadian federal and provincial timber programs represented a countervailable subsidy of 18.79% (later reduced to 13.23% in January 2004, to 7.82% in July 2004, to 1.2% in July 2005, and to 0.80% in November 2005). Commerce also found that Canadian producers engaged in dumping of lumber and levied margins on companies ranging from 2.18% to 12.44% with the "all-other" rate set at 8.43%. Canada's Atlantic provinces have been exempted from these duties as timber stands in those provinces are generally

[21] New Democratic Party leader Jack Layton, in "Revised Deal Ends Lumber Dispute," *Toronto Star*, April 28, 2006.

[22] For detailed account of the extensive litigation undertaken concerning the softwood lumber dispute, please see CRS Issue Brief IB10081, *Lumber Imports from Canada: Issues and Events*, by Ross Gorte and Jeanne Grimmett.

privately held, but all types of lumber face duties in the remaining provinces including some products in which there is no comparable production in the United States. The ITC determined in May 2002 that the subsidies and dumping pose a threat of material injury to U.S. firms, thus allowing antidumping and countervailing duties to be imposed.

Canada has challenged each of the U.S. antidumping, countervailing duty, and threat of injury determinations before dispute settlement panels at the World Trade Organization (WTO) and before North American Free Trade Agreement (NAFTA) binational panels with mixed results. Binational NAFTA panels determine whether the Commerce and ITC determinations are consistent with U.S. law, while WTO Dispute Settlement considers the consistency of these determinations with WTO Agreements.

Subsidies. On Commerce's subsidy determination, the WTO Appellate Body has found that the U.S. determination that Canadian provincial stumpage fees provided a countervailable subsidy to Canadian loggers was consistent with WTO Agreements. It also upheld the cross-border comparison of prices to determine subsidization under certain circumstances, but remanded to Commerce to determine if certain sales represent "pass-through" subsidies. A compliance panel report of August 2005 found that Commerce has failed to conduct this analysis. In response to the earlier WTO decision, Commerce recalculated the subsidy slightly lower to 18.62% from 18.79%.

The NAFTA binational panel has affirmed that Commerce's determination that provincial stumpage programs are a countervailable subsidy are consistent with U.S. law. However, it found cross-border market comparisons and other provisions of the determination contrary to U.S. statutes. The NAFTA panel has remanded the inconsistent portions to Commerce for adjustment of the subsidy rates, and several remand decisions by Commerce have lowered the countervailable subsidy rate from 18.79% to a *de minimus* 0.80%. On March 17, 2006, a NAFTA binational panel affirmed the *de minimus* 0.80% subsidy, a level at which under U.S. law countervailing duties may not be imposed. On April 27, 2006, the USTR announced that it was filing a NAFTA Extraordinary Challenge Committee (ECC) appeal in response to this ruling, but it would drop the appeal if a final softwood lumber agreement was reached.

Dumping. The WTO Appellate Body has broadly upheld U.S. imposition of antidumping duties as consistent with U.S. WTO obligations. However, it faulted the methodology known as "zeroing"[23] in calculating the duties, and remanded the determination for recalculation. Commerce did recalculate with another methodology, which resulted in increased duties. Antidumping duties vary based on the producer, and specific rates now average 3.93% to 16.35%, with an "all-other" rate set at 11.54%.

[23] Broadly speaking, zeroing is a methodology to determine dumping margins under which exports shipped at prices above the calculated normal rate (i.e. not dumped) are given a zero value, rather than averaged with exports shipped at rates below normal prices in the calculation of dumping duties. This has the effect of increasing dumping margins.

A binational NAFTA panel has affirmed U.S. imposition of antidumping duties as consistent with U.S. law, but the panel found certain calculations of dumping margins such as "zeroing" as inconsistent with U.S. law. Two rounds of remands have lowered duties on certain producers and have revised the "all-other" duty to 8.85%, however the July 2005 remand raised the average dumping duty to 10.06% and the "all-other" rate to 10.52%.

Injury Determination. Under U.S. trade remedy law, an affirmative determination of subsidy or dumping must be coupled with a determination from the ITC that the domestic industry faces a threat of material injury. Unless this determination is made, AD or CVD duties cannot be imposed. Canada has challenged these affirmative decisions before the WTO and NAFTA.

A WTO dispute settlement panel found that the ITC threat determination was inconsistent with WTO obligations in February 2004. After the ITC reaffirmed its injury determination in November 2004, Canada requested a compliance panel to review this decision, and the panel upheld the U.S. determination on November 15, 2005. The Appellate Body reversed this determination in April 2006, citing an inadequate standard of review, but did not review the injury determination itself.

In August 2003, a NAFTA panel determined that the ITC's determination that softwood lumber imports constituted a threat of material injury to producers was inconsistent with U.S. law and remanded that decision to the ITC for further analysis. On two remands from the binational panel, the ITC reaffirmed its determination of material injury. On August 31, 2004, the NAFTA panel determined the evidence provided by ITC was not sufficient to find material injury and ordered the ITC to make a final determination invalidating its material injury determination, which the ITC did in September 2004. The United States appealed this determination to the ECC in November 2004, and a decision was rendered on August 10, 2005, which upheld the findings of the NAFTA panel.

The U. S. position is that the duties can continue under the above-mentioned November 2004 injury determination (reaffirmed in response to WTO dispute settlement) and that the previous determination challenged by Canada is no longer in effect. However, Canada has emphasized the primacy of the NAFTA panel's decision and expects the duties to be withdrawn and refunded. It is also challenging the implementation of the November 2004 determination in the U.S. Court of International Trade. This decision is due in June 2006. The Canadian government and press have expressed strong disapproval at the U.S. decision, and some have called for retaliation against the United States. On September 13, 2005, the Coalition of Fair Lumber Imports, a U.S. producer group, filed a case before the U.S. Court of Appeals in Washington D.C. challenging the constitutionality of the NAFTA Chapter 19 dispute settlement process.

Byrd Amendment. The disposition of the softwood lumber duties already collected has become another impediment to the resolution of the lumber dispute, and they have become embroiled in a separate dispute over the Continued Dumping and

Subsidy Offset Act of 2000 (CDSOA, known as the Byrd amendment).[24] Under the Byrd Amendment, anti-dumping and countervailing duties are disbursed to the industries filing the actions, rather than the Treasury. Canada was among the countries that successfully challenged the CDSOA at the WTO. Canada began imposing $14 million in retaliatory duties, authorized by the WTO, in the form of a 15 percent surtax on imports of U.S. live swine, ornamental fish, oysters, certain cigarettes, and certain fish items on May 1, 2005. The Deficit Reduction Act of 2005 (P.L.109-171) repealed the Byrd Amendment, but allowed the distribution of antidumping duties collected on imports before October 1, 2007. On another legal front, the U.S. Court of International Trade (CIT) ruled in April 2006 that antidumping duties collected from Canada and Mexico could not be distributed to firms under the Byrd amendment because the Byrd language did not specifically refer to Canada and Mexico, a requirement under NAFTA implementing legislation.

Beef. On May 20, 2003, a case of bovine spongiform encephalopathy (BSE) or 'mad-cow' disease was detected on an Alberta farm, which was quickly quarantined. Concerns about the food supply caused the United States, Mexico, Japan, and others to close their borders to Canadian live animals and beef products. On August 8, 2003, the U.S. announced that it would begin to phase out the ban for boneless sheep and lamb meat, and for boneless meat from cattle under 30-months. Mexico announced a similar phase-out on August 11, 2003.

The process for reopening the border to live animals began with a USDA rulemaking proceeding initiated in November 2003. During a visit to Canada in December 2004, President Bush reportedly assured Prime Minister Paul Martin that the border would be reopened to Canadian live cattle. The USDA published a final rule on January 4, 2005 that allows for importation of ruminants from minimal-risk regions. Canada's regulatory system has been deemed to qualify for minimal-risk designation for live cattle and bison under 30 months of age and sheep and goats under 12 months. This rule was challenged in U.S. District Court by the Ranchers-Cattleman Action Legal Fund (R-CALF) and a preliminary injunction preventing the implementation of the final rule was granted on March 2, 2005. The 9th Circuit Court of Appeals overturned this ban on July 14, 2005. On July 18, 2005, the first live cattle were shipped across the border from Ontario to New York state.[25]

While the lifting of the ban disappointed U.S. rancher groups such as R-CALF, other American agriculture organizations were pleased with the ruling. Processors, who had been facing losses as more processing facilities were established in Canada, supported the ruling as other cattlemen saw this measure as leverage to reopen the Japanese and other markets which have been closed to American farmers since the

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[24] For background on the Byrd Amendment, please refer to CRS Report RL33045, *The Continued Dumping and Subsidy Offset Act ("Byrd Amendment"),* by Jeanne J. Grimmett and Vivian C. Jones.

[25] Congress Daily, July 19, 2005.

discovery of a BSE case in Washington state. Export Development Canada estimated that the total cost of the ban to the Canadian economy about $6 billion.[26]

Corn. In December 2005, Canada placed antidumping and subsidy duties on unprocessed grain corn from the United States. These determinations, a 26% average dumping margin and an 18% weighted subsidy average, were imposed by Canada on March 15, 2006, and reflect a preliminary combined determination of C$1.65/bushel in effect since December 2005. However, on April 19 the Canadian International Trade Tribunal ruled that these imports of U.S. grain corn have not caused nor threatened to cause injury to Canadian domestic producers. The absence of an injury determination, as in U.S. law, means that Canadian customs may no longer collect duties and must refund those already collected. Prior to this decision, the United States requested consultations with Canada on the preliminary injury determination, a step in launching WTO dispute settlement action.

Intellectual Property Rights (IPR). As in previous years, the U.S.Trade Representative placed Canada on its Special 301 watch list for intellectual property rights protections in 2005.[27] The watch list, the mildest category of rebuke, indicates that the listed trading partner "merit[s] bilateral attention to address IPR problems." The United States urged Canada to implement the World Intellectual Property Organization's Copyright treaty[28], which has been signed but not ratified. It expressed concern that a Canadian court declared that those using peer-to-peer software to download digital media did not infringe on copyrights and on proposed legislation on technological protection measures and Internet service provider liability. The United States also expressed concern about trade in pirated and counterfeit goods in Canada, as well as the transhipment and transiting of such goods. The United States urged Canada to adopt tougher border security measures to crack down on this trade, including allowing for the seizure of pirated and counterfeit goods. USTR is conducting an out-of-cycle review of Canada during 2005 to monitor Canada's progress on these issues.

In May 2004, the Canadian Parliament enacted the Jean Chretien Pledge to Africa Act (Bill C-9). This legislation was designed to implement the WTO's 2003 Decision on the provision of lower cost medicines to address public health problems in developing countries. This legislation authorizes the Canadian government to authorize the manufacture of a generic drug by compulsory license for distribution to a developing country with insufficient or no manufacturing capability. Draft regulations implementing the legislation were published in November 2004, but a technical flaw in the act required that Parliament reapprove it, which it did on May 5, 2005. Critics claim that the bill contains too many restrictions, including a right

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[26] EDC Weekly Commentary, "Mad Cow Roundup," August 3, 2005. [http://www.edc.ca/docs/ereports/commentary/weekly_commentary_e_7574.htm]

[27] United States Trade Representative, 2005 Special 301 Report, [http://www.ustr.gov/Document_Library/Reports_Publications/2005/2005_Special_301/Section_Index.html]

[28] The WIPO Copyright Right treaty updates existing copyright protections for Internet and other electronic media.

of first refusal to patent holders to produce the drug, and lack of incentives for generics to produce the medications.[29]

Wheat. On October 23, 2002, the U.S. Commerce Department announced antidumping(AD) and countervailing duty (CVD) investigations on Canadian durum and hard-red spring wheat. U.S. petitioners allege that the Canadian Wheat Board (CWB), a state trading enterprise which markets grain produced by western Canadian farmers, subsidizes Canadian growers through loan guarantees and limits transportation costs by subsidizing railcars. These subsidies, U.S. producers contend, encourage dumping of Canadian wheat into the U.S. market at below-market prices. The Canadian government maintains that the practices of the CWB are fully compliant with the WTO and bilateral trade obligations, and it points to several U.S. investigations that it claims uphold their position. On August 28, 2003, the Department of Commerce's final determination found countervailable subsidies equivalent to 5.29% of the price of both durum and hard-red spring wheat. Final antidumping margins were determined to be 8.26% for durum and 8.87% for hard-red spring. On October 9, 2003, however, the ITC found that the alleged subsidies and dumping margins did not cause material injury or a threat of material injury on U.S. durum wheat producers. For Commerce's final dumping and countervailing duties to take effect, the ITC must make an affirmative determination of material injury or threat of material injury to domestic producers. The ITC did find material injury with regard to domestic hard-red spring wheat on October 3, 2003, thus allowing antidumping and countervailing duties of 14.15% to take effect on this product.

NAFTA panels were established in 2004 at Canada's request to examine the ITC final determination and Commerce's antidumping and subsidy determinations. In March 2005, one NAFTA panel remanded Commerce's determination on financial guarantee programs, while upholding Commerce's subsidy finding regarding provision of government railcars. Commerce recalculated its subsidy determination and lowered the subsidy rate from 5.29% to 2.54% (providing a combined AD/CVD rate of 11.4%). On June 7, 2005, another NAFTA panel determined that the ITC had failed to prove that material injury resulted from the importation of hard-red spring wheat. The ITC voted on October 5, 2005, that no injury exists.

Meanwhile, the United States challenged practices of the CWB at the WTO. On July 11, 2003, the United States secured the establishment of a World Trade Organization dispute settlement panel to examine the consistency of CWB activities with WTO rules. On February 10, 2004, the WTO panel found that, while the CWB did not violate the WTO provisions concerning state-trading enterprises, certain CWB practices did violate national treatment obligations[30] of the WTO. The United States announced on June 1, 2004 that it would appeal the panel decision. On August 30, 2004, the WTO Appellate Body upheld the panel's conclusion that the United

[29] "Chretien's Plan to Deliver Cheap Medicines for Africa Stuck in Uncertainty," *Canadian Press*, May 1, 2005; "Canadian Triumph Turns Sour," *Toronto Star*, May 9, 2005.

[30] National treatment refers to the WTO obligation to treat goods from other countries in a like manner to domestically produced goods.

States failed to prove its claim that the CWB sells its wheat under non-commercial terms.

Culture. Canada has long been concerned that its culture is in danger of being overwhelmed by that of the United States, which, in terms of population and GDP, is about ten times the size of Canada. Claiming a need to maintain its cultural identity, Canada has implemented regulations to promote Canadian ownership of film distribution; to encourage Canadian content in radio/TV programming; and to restrict the distribution of foreign magazines. The United States has challenged many of these restrictions, arguing that such laws are disguised protection that denies opportunities to U.S. firms. Canada had its cultural industries exempted from NAFTA, subject to extra U.S. retaliatory rights, and has resisted attempts to include cultural industries in WTO negotiations.

Security and Trade

The aftermath of the terrorist attacks on the United States on September 11, 2001 has increased scrutiny of the Canadian border as a possible point of entry for terrorists or for weapons of mass destruction. The potential for economic disruption caused by a terrorist attack on border infrastructure or as a result of a border closure is large. For example, the Ambassador Bridge that links Detroit and Windsor, Ontario is the largest trade link in the world, with more than 7,000 trucks crossing daily carrying goods worth more than $120 billion per year.

The cost of the border to carriers, manufacturers and governments in terms of delays and compliance has been estimated by one survey at $7.5 billion to $13.2 billion annually.[31] Using the survey's midpoint estimate, they estimate that costs related to transit time and uncertainty total $4 billion and trade policy related costs were estimated at $6.28 billion.[32] The total midrange figure, $10.3 billion, reflects 2.3% of cross-border trade in 2004. Another report claims that average processing times have increased 200% from 45 seconds in December 2001 to 2.15 minutes in December 2004. This report also claims that additional reporting, compliance, and delays add approximately $800 to the cost of every North American produced vehicle and that the border "threatens to become the greatest non-tariff barrier the world has ever seen."[33]

Action Programs and Initiatives. In order to address what became a threat of border disruptions, the two governments agreed on December 12, 2001 to a (now) 32-point Smart Border Action Plan consisting of 4 pillars: the secure flow of people,

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[31] George Jackson, Douglas Robideaux, and John Taylor, "The U.S.-Canada Border: Cost Impacts, Causes, and Short to Long Term Management Options." [http://www.fhwa.dot.gov/uscanada/ studies/taylor/costrpt_2003.pdf].

[32] Ibid.

[33] Coalition for Secure and Trade-Efficient Borders, "Rethinking Our Borders: A New North American Partnership," July 2005, [http://www.cme-mec.ca/pdf/Coalition_Report0705_Final.pdf].

the secure flow of goods, a secure infrastructure, and coordinated enforcement and information sharing. The pillar concerned with the flow of goods consists of initiatives on harmonized commercial processing, clearance away from the border, joint or shared customs facilities, enhancement of information sharing, container targeting at seaports, and infrastructure improvements. This initiative was updated in the NAFTA context by the Security and Prosperity Partnership of North America (SPP). The SPP was launched at a summit of the leaders of the three countries at Crawford, Texas on March 24-25, 2005. The first semi-annual report was released on June 27, 2005. The initial harvest of security results included border improvements, land preclearance measures, and joint port security exercises, many of which are follow-on to the 32-point Action Plan.[34]

The Free and Secure Trade (FAST) is a joint program implementing the harmonized commercial processing initiative. It is open to participants in the U.S. Bureau of Customs and Border Protection's (CBP) Customs-Trade Partnership Against Terrorism (C-TPAT) and the Canadian Border Security Agency's Partners in Protection Program. Participants of these programs undertake audit-based compliance measures to enhance security along the supply chain and receive certification as low-risk shippers. In February 2004, CBP reported approximately 2,800 companies were certified. The FAST program provides for dedicated inspection lanes to goods carried by approved lower-risk shippers, to goods purchased from pre-authorized importers, and to goods transported by pre-authorized drivers and carriers. FAST transit points are operational at 19 high-volume land ports of entry on the northern border.[35] In August 2005, CBP reported that 55,427 drivers enrolled in the program.

A complementary program to expedite the secure movement of people has also been established. The NEXUS program provides an identification card and dedicated traffic lanes to frequent travelers who have undergone security clearances on both sides of the border. The NEXUS is seen as especially important to minimize the disruption of cross-border trade in services, which relies on the free movement of skilled labor. NEXUS was operational in 11 high-volume border crossings and is utilized by 71,000 participants in December 2004.[36] A pilot program for an airport-based NEXUS program began in November 2004 at Vancouver International Airport using iris recognition biometric technology.

The 32-point action plan also called for increased monitoring and targeting of containers off-loaded at Canadian and U.S. ports in transit to the other nation. The U.S. Container Security Initiative (CSI) is designed to prescreen high risk containers entering the United States at overseas ports of departure. The program is working to develop security criteria to identify high risk cargo, to develop and utilize technology to pre-screen high risk containers and to encourage the use of secure containers. U.S.

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[34] "NAFTA Ministers to Review Proposals for Integrating Economies," *Inside U.S. Trade*, May 13, 2005.

[35] Smart Border Action Plan Status Report, December 17, 2004. [http://www.dfait-maeci.gc.ca/can-am/washington/border/status-en.asp]

[36] Ibid.

customs agents work alongside Canadian agents in the CSI ports of Halifax, Montreal, and Vancouver to identify cargo for screening. Canadian customs agents are stationed in the ports of Newark and Seattle-Tacoma. These agents have no enforcement power on the other country's territory; they serve in an advisory capacity.

The Canadian government has implemented a package of port security initiatives that included increased screening of marine traffic, "real-time" identification and monitoring of vessels in Canadian waters, radiation screening equipment for containers, and enhancements to portside Emergency Response Teams of the Royal Canadian Mounted Police. These initiatives respond to concerns within Canada that differences in port security were affecting the ability of Canadian ports to compete as entry points for goods eventually entering the U.S. market. The United States and Canada have also reached agreement on a program of increased screening and monitoring of railway shipments between the two countries. Under this program, railcar cargo detection equipment known as the Vehicle and Cargo Inspection System (VACIS) has been installed at seven rail crossings in the United States and one in Canada.

Land preclearance away from the border by U.S. and Canadian customs agents working in each other's territory remains a contentious issue. Although a jointly commissioned study has detailed the operational benefits of cross-border operations, several legal and institutional issues remain unresolved including land ownership, the enforcement powers of such agents, and their ability to carry firearms. This issue may also be complicated because of Canadian sensitivities about sovereignty. One pilot program to build joint border stations for small land border crossings sidesteps this question, however, as structures actually straddle the border at six small crossings. The SPP update announced a new preclearance site at the Thousand Islands crossing where Canadian operations would be relocated to Alexandria Bay, New York.

A related issue is the ability of the transportation infrastructure to cope with increased security measures. The aging condition and limited capacity of the land border infrastructure preceded the terrorist attacks on September 11, 2001. The Ambassador Bridge and the Detroit-Windsor Tunnel, which together carry 25% of total U.S.-Canada cross-border traffic, both opened in 1930. The Peace Bridge linking Buffalo NY and Niagara, Ontario was opened in 1927 and is 3 lanes wide. Approaches to the bridges, often city streets, have been criticized as inadequate to the commercial needs of the 21st century. This issue, in turn, affects the efficient implementation of security measures. For example, the FAST system provides for dedicated lanes at land border ports for expedited preclearance. However, these lanes will not provide a time saving if the FAST participant cannot access this lane due to congestion or delays at the points of access. The SPP program has targeted improvements on the Detroit/Windsor crossing to commence in the fall of 2005. The Surface Transportation Reauthorization Act (P.L. 109-59), signed by the President on August 10, 2005, reauthorized a coordinated border infrastructure program which funds border projects that facilitate cross-border vehicle and cargo movements (Sec 1303).

Prospects and Policy Options

Economic Integration. The terrorist attack of September 11, and its aftermath, have sparked a wide-ranging debate in Canada over its relationship with the United States, including the feasibility or desirability of furthering the process of North American integration. The extent to which the two economies are integrated was dramatized by the adverse impact that border closings had on trade flows after the terrorist attacks. While concerns in the United States over the U.S.-Canada border are focused primarily on border security and immigration issues, the debate in Canada has become much broader, encompassing such issues as the nature of sovereignty, the desirability and feasibility of further economic integration with the United States, and even the adoption of the U.S. dollar. This discourse is not unusual in Canada; questions concerning relations with the United States continually loom large in policy discussions. Such discussions are unusual in the United States, and at this point they are generally confined to the types of security measures described in the preceding section.

Certain aspects of increased cooperation with the United States on border and immigration issues have proved controversial to some Canadians. These questions generally have taken the form of resistance in some quarters to the notion of harmonization of U.S. and Canadian regulations. A segment of Canadian public opinion fears that, due to the wide disparity in population and economic power of the two nations, harmonization of customs and immigration regulations would inevitably lead to adoption of U.S. standards, and implicitly, the policies behind them. Moreover, according to this view, Canadian resistance to this harmonization could imperil the economic relationship with the United States. However, others contend that Canadian and U.S. regulations affecting the border are more similar than different and would be for the most part compatible. Hence, the scope of coordination in certain areas of border management may be acceptably encompassed by mutual recognition of each other's regulations.

Others in Canada believe the lesson from September 11 is that increased cooperation with the United States is both necessary and inevitable, given the reality of Canadian trade flows and economic interdependence. Yet, they believe such integration must be managed to assure Canada protects its interests and its sovereignty. Several economic options have received renewed attention in Canadian policy circles, from greater regulatory harmonization to more long-term options including a security perimeter, a *customs union*, a *common market*, or a *monetary union*. The latter also received attention due to the long-term slide of the Canadian dollar up to 2002. However, the appreciation of the Canadian currency by 30% against the U.S. dollar since has eclipsed such discussions. These concepts are not new, and they have been discussed in conjunction with "deepening" the North American Free Trade Agreement. Consequently, these discussions often involve Mexico as well.

NAFTA Plus. With the tenth anniversary of NAFTA in 2004 (and the 15th anniversary of FTA), there has been renewed discussion of ways to enhance cooperation between the three NAFTA partners. The concept of deepening NAFTA- "NAFTA plus"- has taken on added salience, in some quarters, since most of the gains resulting from tariff reduction of the agreement have been realized. In addition, FTAs negotiated by the United States and Canada with other trading partners have diminished the relative advantage of NAFTA. In addition, since the 2001 terror attacks there has been a perception by some in Canada and Mexico that continued economic access to the U.S. market is dependent on greater security cooperation with the United States. Former U.S. Ambassador Paul Cellucci notably said in 2003 that "security trumps trade" in the U.S.-Canada relationship.[37] This realization has led to many border initiatives described above. The Security and Prosperity Partnership (SPP), contains many initiatives that could lead to some measure of regulatory harmonization among the United States, Canada, and Mexico. In addition to calling for implementation of common border security strategies, the SPP initiates cooperation in energy, the transportation network, financial services, and standards harmonization. Ten Ministerial working groups were formed and were required to report after 90 days, and semi-annually thereafter. Reportedly, the scope of SPP activity is in the realm of regulatory changes, actions that do not require legislative activity.[38]

The initial report was released on June 27, 2005. The Prosperity component of the SPP intends to enhance competitiveness by developing proposals to streamline regulatory processes among the three partners, enhance detection and prevention of counterfeiting and piracy, and liberalize rules of origin. Sectoral initiatives on steel, autos, energy, air transport, and e-commerce are also envisioned. Quality of life cooperative initiatives on pollution, agriculture and food supply, and health issues were also launched. [39] Since the initial report, the United States and Canada have agreed to facilitate the exchange of information on infectious disease outbreaks, concluded an open sky agreement, and signed a memorandum of understanding on pipeline safety.

Security Perimeter. One approach envisioned by some U.S. and Canadian business leaders and policy advocates is to create a North American security perimeter. This proposal responds to U.S. fears of terrorism by removing the security functions from the border to the point of first contact of a good or person to North America. Thus, the container landing at the Canadian port of Halifax headed for the United States would be inspected in Halifax, not at the U.S. border, thereby avoiding delays at border choke-points. Pre-screening of passengers would also take place at the point of landing, not at the border. However, a completely seamless border for goods would also require standards harmonization or acceptance of the inspecting party's standards, information sharing on threat assessments, and trust in each party's screening procedures. It also makes the assumption that there are no terrorist threats indigenous to the North American security perimeter.

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[37] "Cellucci's Message," *National Post,* March 26, 2003.

[38] "NAFTA Ministers to Review Proposals for Integrating Economies," *Inside U.S. Trade,* May 13, 2005.

[39] Security and Prosperity Partnership of North America, Report to Leaders, June 2005, [http://www.spp.gov/spp/report_to_leaders/index.asp?dName=report_to_leaders]

Customs Union. Another step discussed in policy circles regarding the further integration of the North American economy is the creation of a *customs union*. Members of a customs union commonly eliminate tariffs among themselves, and erect common barriers against the rest of the world. Both the U.S. and Canada have already eliminated all tariffs between each other under NAFTA, and have similar, though not identical, tariff schedules with third countries. Because all customs duties would be paid at port of entry at the perimeter of the customs union, the need for customs agents on the U.S.-Canadian land border to collect revenue would be obviated. However, border agents also enforce immigration, sanitary and phytosanitary, and environmental laws. A customs union does not imply a harmonization or mutual recognition of each nation's regulations. Thus, a national presence at the border would continue to be necessary. It is also unclear in what form current trade remedy practices could be continued under a customs union. Such actions against third countries could continue relatively easily if both sides found it necessary; however, actions against each other would require the continued payment of duties at the border.

Common Market or Economic Union. Deeper integration of the North American economic space would imply some form of common market or economic union. A common market area would add free movement of labor and capital; thus, immigration and investment regulations would need to be harmonized or mutually recognized. In addition to a common tariff policy and free trade in goods and services, a common market would imply free movement of capital and labor. At this point, harmonization of certain investment and immigration issues would need to be agreed upon. A type of economic union approaching that of the European Union would also require harmonized or mutually recognized standards and regulations and perhaps some supranational institutions. Although the United States and Canada share many developed country level standards, this form of integration would still need to be meticulously worked out. For example, would the United States adopt the metric system to fulfill its obligations to harmonize standards? Could the two nations adopt common forestry prices and management policies and thereby help resolve the softwood lumber dispute? Would either nation allow supranational entities to overrule laws passed by Congress or Parliament? These questions illustrate the extent to which North American economic integration would affect the governance of the United States, Canada, and possibly Mexico.

Monetary Union. Another discussion recurrent in many Canadian policy circles is that of monetary union with the United States. This potential goal has been discussed in many forms. The Canadian dollar could be linked in value to the U.S. dollar; Canada could adopt the U.S. dollar; or a new North American currency (called the Amero by one proponent) could replace the U.S. and Canadian dollars, and perhaps the Mexican peso. Generally, talk of monetary union north of the border is strongest during times of relative weakness of the loonie vis-a-vis the U.S. dollar. The recent strength of the loonie has diminished such discussion, although the idea still has some proponents.

Those who support monetary union argue that it would force Canada to make the necessary structural adjustments that would make it more competitive with the United States. In other words, dollarization or a currency union would remove the ability to cushion adverse economic conditions through depreciation of the currency.

By tying the loonie to the U.S. dollar or by adopting the dollar outright, Canada would be making the unmistakable commitment to converge with U.S. macroeconomic policy. Then Canada would be able to reap the benefits of U.S. policy, which traditionally have been lower inflation, lower interest rates, and higher levels of growth than Canada has experienced. In addition, the savings in trade transaction costs would be significant for the volume of trade the two nations conduct.

Canadian opponents of monetary union contend that it would lead to an unacceptable loss of political and economic sovereignty. Monetary policy would be dependent on (or tied to) actions of the U.S. Federal Reserve. Thus, the Canadian government would be left with fewer levers to combat inflation or fight recession. In a monetary union in which macroeconomic convergence is reached, this point may not be important. To opponents of monetary union, however, the two economies respond differently to events, and thus need to utilize different adjustment mechanisms. Furthermore, with a population and economy smaller than some Federal Reserve districts, Canada's ability to influence U.S. monetary policy in a monetary union would be small.