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The Canada - U.S. Free Trade Agreement: Implications for the Bilateral Trade Balance

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THE CANADA - U.S. FREE TRADE AGREEMENT: IMPLICATIONS FOR THE BILATERAL TRADE BALANCE

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I. INTRODUCTION

The Canada-United States of America Free Trade Agreement, ("FTA"), was signed on October 3, 1987,[1] after months of intensive negotiations, years of planning and decades of consideration.[2] The FTA

* OF THE ONTARIO BAR. CANADA

1. The official legal text of the FTA was signed by President Ronald Reagan and Prime Minister Brian Mulroney on January 2, 1988, and enacted by the United States House and Senate on September 14, 1988. H.R. 5090. *See* United States-Canada Free Trade Agreement, January 2, 1988, H.R. Doc. No. 100-216, 100th Cong., 2d Sess., at 297-1667 (1988) [Hereinafter "Legal Text"].

2. The FTA evolved under the leadership of Prime Minister Brian Mulroney, elected September, 1984. His Progressive Conservative Party government has made the FTA an issue of central importance. The so-called "Shamrock Summit" in Quebec City in March, 1985, between him and President Reagan marked the symbolic beginning of the present process. However, the former Liberal government under Prime Minister Pierre Trudeau laid much of the groundwork for the FTA. Under Mr. Trudeau, sectoral free trade was seriously discussed and the Royal Commission on the

became law in both countries in time to meet the January 1, 1989, implementation date originally provided for.[3] Canada and the United States share the world's largest bilateral trading relationship. In 1987, the value of bilateral merchandise trade approached US$130 billion.[4] The next largest bilateral trade flow, that between the U.S. and Japan, is almost a third smaller.[5]

From a legal perspective, the FTA represents the second free trade agreement the United States has negotiated. The first, the U.S. - Israel Free Trade Agreement, was signed in 1985.[6] Some elements of the two agreements are similar and certainly the U.S.-Israeli experience provided a reference for the negotiations.[7] From an economic perspective,

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Economic Union and Development prospects for Canada (the so-called "Macdonald Commission") was instituted. Moreover, long beforehand, the Reciprocity Treaty of 1854 and the Laurier-Borden election campaign of 1911 brought Canadian-American free trade to the forefront.

3. Passage of the FTA was quicker in the U.S. than in Canada. On August 9, 1988, the House of Representatives approved legislation (H.R. 5090) to implement the FTA by a vote of 366 to 40. Later, the Senate also approved implementing legislation (S. 2651).

In Canada, the FTA became one of the major issues in the November 21, 1988, federal general election which returned Prime Minister Brian Mulroney's Progressive Conservative government to a second majority government. Thus supported, Parliament's passage in December of Bill C2, An Act to Implement the Free Trade Agreement between Canada and the United States of America, came into effect January 1, 1989, after receiving Royal Assent on December 30, 1988.

4. *See* Horlick, "Transition in the U.S. Administration," *Canadian Competition Policy Record*, Vol. 9, No. 4, pp. 36-38 (Dec. 1988). All figures are in U.S. dollars unless otherwise indicated. The extent of bilateral trade may be measured in both Canadian and U.S. currency, in real or nominal terms, and in seasonally adjusted and unadjusted figures. The estimate of $130 billion is in U.S. currency, not seasonally adjusted and in nominal terms, as will be all bilateral trade figures in this article unless otherwise specified.

5. While the U.S.-Canadian trading relationship is the world's largest, the U.S.-Canada merchandise trade deficit is the second largest U.S. bilateral trade deficit after that for the United States and Japan. *See* F.N. PECK, PERSPECTIVE ON FOREIGN TRADE, (First Boston Econ. Dept. May 22, 1987). The latter merchandise trade deficit measured $59.8 billion in 1987 (not seasonally adjusted). U.S. CENSUS BUREAU REPORT, 1986.

6. Free Trade Agreement, Apr. 22, 1985, United States - Israel, in 24 ILM 653-87 (1985) (entered into force Aug. 19, 1985).

7. For example, in the area of trade in services, the U.S.-Israeli FTA involved a separate, non-legally binding declaration committing each country to a "best efforts" on the issue to achieve open access and accord national treatment. *See* Jansen, "The United States-Israel Free Trade Area Agreement: A Model for Canada?" *The Canadian Business Review*, Autumn 1985, pp. 24-27. The Canadian FTA also deals with services and goes beyond the Israeli FTA example in terms of scope and detail. The

the FTA will have enormous implications for future bilateral free trade negotiations in the rest of the world.[8] Moreover, it will have a great impact on the "Uruguay Round" of multilateral trade negotiations under the auspices of the General Agreement on Tariffs and Trade ("GATT").[9]

This article provides a framework for understanding the legal factors which will influence future Canada/U.S. trade relations if the FTA is eventually implemented.[10] The repercussions of the FTA are complex, as is the actual legal text, the subject of Part II. A number of its chapters deal with specific sectors, for example energy and automotive goods; others deal with issues transcending all sectors, such as tariff elimination. The Institutional Provision chapters affect sectors only in certain legal circumstances. For this reason they only have an indirect influence on bilateral trade balances; however, decisions concerning anti-dumping and countervailing duties will have a direct bilateral trade impact.

Part III of this article presents results of some major studies analyzing potential effects of the FTA. Two of the three studies indicate that free trade will worsen Canada's current account deficit with the United States. Two studies also predict a rise in overall Canadian exports. No study, however, directly focuses on the trade balance as an area of prime inquiry; nor does any study focus in great detail on subsidies.

From a U.S. perspective, the main irritant concerning Canadian trade is subsidies.[11] U.S. politicians have complained that the FTA does not address this issue.[12] There are many problems with this asser-

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Toronto Globe and Mail, Oct. 13, 1987, at B10.

8. For example, the United States signed a framework agreement with Mexico in November, 1987, to establish dispute settlement mechanisms for trade and investment and for pursuing liberalization in certain key sectors. These include textiles, steel, agriculture, technology transfer, electronic products, services and intellectual property. *See* Framework Agreement, Nov. 6, 1987, United States - Mexico, in 22 J. WORLD TRADE L. 109-11 (1988).

9. The Canadian FTA provisions on services could serve as a blueprint of the GATT negotiations in which trade in services are a high priority. The FTA will be submitted to the GATT in accordance with its status as a regional Free Trade Agreement as per Article XXIV. Both the European Economic Community and Japan are scrutinizing the FTA carefully. The Toronto Globe and Mail, Jan. 14, 1988, at B38.

10. See Appendix for framework table.

11. As a practical matter very few Canadian subsidies cause problems to U.S. producers. *See* Clark, *Subsidies in Canada - United States Free Trade*, 8 CANADIAN COMPETITION POLICY RECORD, Dec. 1987, at 35-38.

12. *See 20 U.S. Senators Ask for Guarantees on Canada Pact*, N.Y. Times, Feb. 24, 1988, at A33, col 1. A group of twenty U.S. senators, mostly from the western

tion. First, both countries employ countless subsidies. Moreover, for Canada, U.S. subsidies have generally only become a perceived problem in relation to agriculture.[13] For the United States, Canadian medical and unemployment insurance and welfare payments are often targeted as indirect subsidies, especially in seasonal industries. The FTA "addresses" the subsidy issue by maintaining existing U.S. countervail and anti-dumping laws and prohibiting agricultural export subsidies. These countervail and anti-dumping measures have sometimes been used to harass certain sectors of the Canadian economy.[14] Indeed, in Canada, one of the major criticisms of the FTA is that it offers no shield from such activity, beyond the agricultural prohibition and the impartial appellate review.[15] This criticism itself should be instructive for U.S. detractors who feel the FTA does not effectively prevent unfair subsidies.

II. Provisions of the Agreement

A. *Development*

The FTA document of October 3, 1987, emerged in the form of a Preliminary Transcript entitled simply: "Elements of the Agreement" ("Elements").[16] The Elements, which briefly state the principles agreed to under the FTA, were subsequently re-drafted in legal form. The "Free Trade Agreement" (the comprehensive "Legal Text"), was made public on December 10, 1987, and signed by President Reagan and

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states, signed a letter to President Reagan in February, 1988, referring to this issue. They proposed that U.S. tariff reduction exclude those areas involving subsidies the Senators feel the FTA does not address. These subsidies are alleged to occur in the Canadian natural resources sector. Concerns include transportation, Canadian wheat, plywood standards and stumpage fees. *See id.*

13. *See* Economic Council of Canada, Impact of Canada-U.S. Free Trade on the Canadian Economy (Aug. 1987). Table 8, *id.*, enumerates Producer Subsidy Equivalents in Agriculture for 1986. U.S. rates exceed Canadian rates for wheat, corn, rice, barley, cotton and pork. *Id.* at 44.

14. See Hart, *GATT Article XXIV and Canada-United States Trade Negotiations*, 1 Rev. of Int'l Bus. L. 315-55 (1987). Table 2, *id.* at 340, itemizes recent cases with comments on pages 346-47.

15. However, even an impartial appellate review may not be certain. Continued access to existing review may still be possible. *See* Clark, *Does The Canada-United States FTA Dispute Settlement Panel Really Replace Judicial Review?*, 8 Canadian Competition Policy Record, Dec. 1987, at 34-35.

16. External Affairs Canada, Preliminary Transcript Canada-U.S. Free Trade Agreement: Elements of the Agreement (October 4, 1987) [hereinafter "*Elements*"].

Prime Minister Mulroney on January 1, 1988.[17] Although both documents incorporate substantially the same agreement, significant changes and clarifications distingush the Elements from the Legal Text.[18]

B. *Contents*

1. *Overview*

The Legal Text of the FTA consists of a Preamble, twenty-one chapters in eight parts, and three series of exchanged letters.[19] It is the most comprehensive bilateral trade agreement ever negotiated encompassing both goods and services in agriculture, business travel and investment. The centerpiece of the FTA is Part Six, the Institutional Provisions. Its dispute resolution mechanism has emerged as the key to promoting enhanced access for Canada to the U.S. market.[20]

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17. EXTERNAL AFFAIRS CANADA, THE CANADA-U.S. FREE TRADE AGREEMENT (The International Trade Communications Group, December 10, 1987).

18. In particular the Legal Text, *supra* note 1, excludes a sectoral annex on the transportation services area which the Elements had proposed. *Elements*, *supra* note 16, at 21, para.3. Concerns expressed by the U.S. shipping and Canadian trucking industry contributed to this development. Canada's existing provincial laws ensuring that Atlantic fish species be processed in Canada was specified in the Legal Text, whereas it was not present in the Elements. *Legal Text*, *supra* note 1, art. 1203(c). The Legal Text included three important exemptions concerning investment: Canadian ownership restrictions on planned privatizations of Canadian federal or provincial Crown corporations; retention of current review thresholds for the uranium, oil and gas industries under the Investment Canada Act; and exemption of Investment Canada rulings on takeovers from the dispute resolution mechanism. Finally, Canada retains the right to discriminate in postal rates between domestic and U.S. magazines. *Legal Text*, *supra* note 1, art.1602(5) (Privatizations); *id.*, Annex 1607.3(4) (current review thresholds); *id.*, art. 1608(1) (dispute resolution exemption); *id.*, art. 2005 (cultural industries).

19. The three series of exchanged letters pertain to the Standstill Agreement, the Implementation of the Harmonized System, and Plywood Standards. The Standstill Agreement has had important implications for Canada in relation to the U.S. 1988 Omnibus Trade Bill, Pub. L. No. 100-418, 102 Stat. 1107, and the potential effect on Canada of some of its provisions.

20. The goal of "secure" market access was to be attained by providing an exemption for Canada from U.S. Trade Laws. This goal was only attainable at too high a price (involving severe constraints on regional economic policy instruments). Hence, the policy trade-off of attaining "enhanced" market access was associated with the lesser negotiating result of an impartial review of U.S. trade law.

2. *Objectives and Scope*

Consistent with GATT, the FTA was designed as a regional Free Trade Agreement under Article XXIV.[21] As such, the FTA necessarily deals with "substantially all" of the bilateral trade between the two countries.[22] The FTA takes precedence over any existing trade agreement between them.[23] Its objectives include the elimination of barriers to trade in goods and services, the liberalization of investment, the facilitation of fair competition and the establishment of procedures to resolve disputes.[24] The principle of according national treatment to investments and to trade in goods and services is also explicit.[25]

3. *Trade in Goods*

Three sorts of issues are dealt with in this section. In the first set are provisions which may generally affect all goods: rules of origin, procedures for tariff elimination, import and export restrictions, technical barriers and safeguard actions.[26] The second set impinges only upon some sectors, either because of existing institutional factors or the nature of the provisions. Some examples are duty drawbacks, duty remission schemes and export taxes.[27] The final set outlines measures in four distinct sectors: agriculture, wine and distilled spirits, energy, and automotive goods.[28]

Central to the measures affecting all goods is the tariff elimination schedule. All tariffs in both countries will be eliminated for bilateral trade in one of three possible manners depending on the nature of the trade: 1) immediately, 2) in equal installments over five years, or 3) in equal installments over ten years.[29] Both countries negotiated the longest phase-outs on particularly vulnerable industries, with the ten-year

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21. Legal Text, *supra* note 1, art. 101.

22. It has been asserted that 80 percent of trade meets this threshold; however, there is no definitive precedent for this statement. *See* Hart, *supra* note 14.

23. Legal Text, *supra* note 1, art. 104(2).

24. *Id.* art. 102.

25. *Id.* art. 105.

26. *Id.* arts. 301-304 & Annex 301.2 (Rules of Origin); *id.* arts. 401 & 402 (Tariff Elimination); *id.* art. 407 (Import and Export Restrictions); *id.* arts. 601-609 (Technical Barriers); *id.* arts. 1101-1104 (Emergency Safeguard Actions).

27. *Id.* art. 404 (Duty Drawbacks); *id.* art. 407 (Duty Remission Schemes); *id.* arts. 408 & 2009 (Export Taxes; Continuation of 1986 Memorandum of Understanding on Softwood Lumber).

28. *Id.* ch. Seven (Agriculture); *id.* ch. Eight (Wine and Distilled Spirits); *id.* ch. Nine (Energy); *id.* ch. Ten (Automotive Products).

29. *Id.* art. 401.

phase-out applying to most agricultural products, textiles and apparel, softwood plywood, rail cars, steel, appliances, pleasure craft and tires.[30]

The rules of origin determine which goods will be accorded FTA status for bilateral trade. These rules apply if goods are "wholly obtained or produced" in either country.[31] To counteract the substitution of goods from third parties as domestic goods, a product must be sufficiently altered to change its classification under the Harmonized System of Tariff Classification.[32] Without reclassification, another provision demands that costs of materials and assembly constitute at least fifty percent of the value of the good.[33] In some cases, this requirement applies in addition to the reclassification test.[34]

There are important exceptions to the rules of origin. One which is of relatively greater benefit to Canada than to the United States concerns the apparel industry. Apparel made from offshore fabric will be given FTA status in quanta very advantageous to Canada.[35]

The Emergency Action provisions are especially important for Canada. The United States has frequently had recourse to safeguard actions under section 201 of the U.S. Trade Act of 1974,[36] or used them as a bargaining chip for trading partners to negotiate voluntary export restraints.[37] Under the FTA a transitional set of rules will apply to safeguard actions until 1998.[38] Until then, scheduled tariff reduc-

30. Among the industries listed, some in Canada are already quite competitive with their U.S. counterparts (e.g. steel); others include competitive subsectors (e.g. high fashion apparel). *See Free Trade in North America: Implications for Credit Risk: Broader Economic Considerations*, Bank of Nova Scotia Economics Dept., June 1987 at 15-16.

31. Legal Text, *supra* note 1, art. 301(1).

32. *Id.* arts. 301(2), 301(3), & Annex 301.2(3).

33. *Id.* Annex 301.2(4)(a) & 301.2(4)(b).

34. *Id.*

35. *Id.* Annex 301.2, rules 16-18. This includes provisions in Section XI of the rules concerning Textiles and Textile Articles: Other Made-Up Articles. In brief, Canadian exports of apparel made from offshore fabrics will exceed U.S. exports to Canada almost five-fold for non-woolen apparel and almost sixfold for woolen apparel. Restrictions on fabrics woven or knitted from offshore yarn will be set at equivalent levels in both countries.

36. 1974 U.S. Trade Act, 19 U.S.C. §§ 2101-2487 (1982).

37. This is the case in the Canadian steel industry. As the result of not being included in a § 201 action under the 1974 U.S. Trade Act, *id.*, Canada and the U.S. negotiated a Voluntary Export Restraint limiting Canadian steel exports unofficially to three percent of the U.S. market. In 1987 Canada introduced steel monitoring legislation as part of a scheme of self-compliance with the VER. *An Act to Amend the Export and Import Permits Act* (1987) c.16, Sects. 1-3.

38. Legal Text, *supra* note 1, art. 1101(1).

tions resulting in serious injury may be addressed by suspending the phase-outs.[39] After 1998 bilateral safeguards will no longer be allowed; nor will global safeguard actions be permitted to "sideswipe" either party unless imports from the party are substantial, generally more than ten percent, and contribute importantly to the serious injury.[40]

Import and export restrictions will be employed in accordance with GATT principals.[41] Certain existing restrictions will remain, including provincial laws governing the export of unprocessed fish in Canada's five eastern-most provinces.[42] New restrictions, necessary for supply management or support in both countries' building, control log exports, shipbuilding, and agricultural imports.[43]

The provisions which deal with only some sectors include duty drawbacks, duty remission schemes and export taxes. Duty drawbacks, the refund of custom duties on import components used in the manufacture of exported goods, will end for all third-country material used in bilateral trade in 1994, except for citrus products and apparel.[44]

No new duty remission schemes, which tie the refund of import duties to production, export, or employment performance requirements, may be introduced after U.S. congressional approval of the FTA.[45] All programs will be terminated by 1998.[46] The present automotive program is subject to different treatment.[47] Export taxes will be prohibited unless they apply equally to domestic consumption.[48] Also, the 1986 Softwood Lumber Understanding is exempt from this prohibition.[49]

In four distinct areas sector-specific proposals are outlined. In agriculture a host of specific proposals are included. Direct export subsidies on agricultural products in bilateral trade will be prohibited.[50] For wine and distilled spirits, distribution systems and practices will be ac-

39. *Id.*

40. *Id.* arts. 1101 & 1102.

41. *Id.* art. 407.

42. *Id.* arts. 407 & 1203(c) (Miscellaneous Exceptions: Unprocessed Fish Exports).

43. *Id.* arts. 407, 1203(a) & 1203(b) (Miscellaneous Exceptions: Log Exports); *id.* art. 710 (International Obligations: Agricultural Programs); and *id.* art. 1202 (Protocol of Provisional Application: Shipbuilding).

44. *Id.* art. 404(8).

45. *Id.* art. 405(1).

46. *Id.* art. 405(2).

47. *Id.* art. 405(2) & 405(4).

48. *Id.* art. 408.

49. *Id.* art. 2009 (Continuation of 1986 Memorandum of Understanding on Softwood Lumber).

50. *Id.* art. 701.

corded national treatment.[51] As to energy, a wide-range set of important proposals has been put forward. Most important are the import and export restrictions and the method for price setting.[52] Finally, a full complement of provisions concern automotive goods, including retention of the AutoPact provisions and extension of certain duty-free treatment to other manufacturers.[53]

4. *Government Procurement*

This Part effectively opens most sectors of government procurement above a certain threshold to competition from either country.[54] The coverage extends only to goods or to services incidental to their delivery.[55] Certain government departments and agencies in GATT countries are exempt, as they are not included in the GATT code.[56]

5. *Services, Investment and Temporary Entry*

With the provisions regarding services, investment and temporary entry, the FTA breaks into new territory for a bilateral agreement. The services chapter provides that a limited right of national treatment is extended to each country in the other's territory.[57] This right is circumscribed by limitations as to, inter alia, health, consumer protection, and "equivalent different" treatment.[58] Many aspects of the provision of a service are encompassed: the establishment of a commercial presence, the use of distribution systems, and the production, sale, distribution, marketing, delivery and purchase of a service.[59]

These provisions affect the "covered services" set out in Annex 1408. Some notable exceptions are medicine, dentistry, law, and many

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51. *Id.* arts. 801-808.

52. *Id.* arts. 902 & 904. Article 902 (Import and Export Restrictions) affects price decisions; article 904 (Other Export Measures) outlines the export restriction allowable in situations of short supply.

53. *Id.* art. 1002 (Waiver of Customs Duties) & Annex 1002.1 (Canadian manufacturers qualifying for waivers of customs duties).

54. *Id.* art. 1304.

55. *Id.* arts. 1301 & 1304; *id.* Annex 1304.3, gen. note 2.

56. *Id.* Annex 1304.3.

57. *Id.* art. 1402(2).

58. *Id.* art. 1402(3). Under "Equivalent Different," one party may treat the other country's persons differently than its own only for a purpose specified in the Legal Text, *supra* note 1. The other party must be notified in advance and the treatment must be "equivalent in effect to the treatment accorded by the Party to its persons for such reasons."

59. *Id.* art. 1401(2).

health, education and social services which are largely government-provided in Canada. Three services are regulated under the FTA by both the general services provisions and the more specific sectoral annexes to the chapter: architecture, tourism and computer services, and telecommunications network-based enhanced services.[60]

The investment provisions of the FTA are among the most important for the long-term future of the current account balance. The implications for corporate ownership and future dividend flows as well as general capital flows cannot be underestimated.[61] Canada's explicit foreign investment review will be limited in its application to U.S. investors.[62] National treatment will apply to the establishment of new businesses, as will higher thresholds for the review of direct or indirect acquisitions of existing businesses except for Canada's oil, gas and uranium industries.[63]

Direct acquisitions will be reviewable only if assets exceed Cdn$150 million by 1992.[64] Indirect acquisitions will not be reviewable after 1992.[65] Neither provision will apply to cultural industries such as publishing, film, recordings and music.[66] Moreover, provisions concerning expropriation will apply to oil, gas and uranium, but not to cultural industries.[67] Limitations on performance requirements as a condition for permitting investment will not be allowed except for oil, gas and uranium.[68]

The United States does not presently have explicit federal regula-

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60. *Id.* Annex 1405, Sectoral Annexes.

61. Even with the increase in review thresholds for direct acquisitions to Canadian $150 million by 1992, about 75 percent of total non-financial assets in Canada now reviewable will still be subject to review. However, the magnitude of such assets is sufficiently large that changes in ownership which influence bilateral dividend and interest flows should also affect the current account.

62. Legal Text, *supra* note 1, art. 1607 & Annex 1607.3. This term includes an individual who is a U.S. national or permanent resident, a U.S. government (federal or state) agency, and an American controlled entity not controlled by Canada under the Investment Canada Act, S.C. 1985, c.20, as per subsections 26(1) and (2).

63. Legal Text, *supra* note 1, art. 1602(1).

64. *Id.* Annex 1607.3(2)(a)(i)(E).

65. *Id.* Annex 1607.3(2)(a)(ii)(D).

66. *Id.* art. 2005. Cultural industries of any size will remain reviewable under the *Investment Canada Act*, *supra* note 62. However, tariff reductions will apply to cultural industries and they may be subject to divestiture at fair market value pursuant to review of a U.S. indirect acquisition. Art. 1607(4).

67. Legal Text, *supra* note 1, combined effect of arts. 1605, 2005 & Annex 1607.3(4).

68. *Id.* Annex 1607.3(4).

tions on foreign investment analogous to those of Canada.[69] The FTA provides that if future screening is instituted by the United States, Canada will be exempt.[70] Given the growing trend of foreign investment by Canada, this provision could prove crucially important to Canada's current account balance.[71]

The rules concerning temporary entry for business persons facilitate entrepreneurial activities such as creating markets, increasing sales and providing after sales service.[72] Reciprocal access will be granted to those who qualify under one of four classes: business visitor, trader and investor, professional, or intra-company transferee.[73]

6. *Financial Services*

The FTA provides that a limited form of national treatment be accorded financial institutions in each party's territory. For both countries the timeliness of the FTA provisions is significant as their adoption coincides with the current atmosphere of financial deregulation in both countries.[74]

There are four main, specific changes. Predominantly foreign U.S. Schedule B banks are to be exempted from their present sixteen percent limitation on domestic assets;[75] however, the million capital threshold for closely held financial institutions remains.[76] The twenty-

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69. However, the U.S. Omnibus Trade Bill, *supra* note 19, has provisions which include disclosure requirements for foreign investors. Whether or not these are adopted now, the increase in foreign investment in the U.S. has been so pronounced recently that future Administrations may be faced with the same pressures.

70. Legal Text, *supra* note 1, art. 1602.

71. The differential between Canada's small but growing level of investment in the U.S. and the large present level of U.S. investment in Canada, and the future for it that the FTA implies, will be central to the determination of current account effects. Total Canadian direct investment abroad has apparently exceeded foreign direct investment in Canada in recent years. The Toronto Globe and Mail, July 24, 1987, at B1.

72. Legal Text, *supra* note 1, art. 1502 & Annex 1502.1, schedule 1.

73. *Id.*

74. In Canada the process of financial deregulation has occurred at both the federal and provincial level. *See* Kennett, "Regulation of Fiinancial Institutions," *Canadian Competition Policy Record*, Vol.9, No.2, at 15-16 (June 1988). While Canadian banks are federally regulated, securities firms are subject to provincial control. Since the securities activities of banks involve both levels of government, considerable wrangling has occurred as to the leadership role in the process. *See* McNairn, "One-Stop Shopping for Financial Services," *Canadian Competition Policy Record*, Vol.9, No.4, at 20-21 (Dec. 1988).

75. Legal Text, *supra* note 1, art. 1703(2).

76. *Id.* This provision in the *Bank Act*, S.C. 1980-83, c.40, as amended, remains operative because there is no preference now shown on the basis of nationality.

five percent aggregate foreign ownership rule applying to Schedule A banks, will not apply to U.S. persons;[77] however, the individual shareholder's ten percent maximum remains.[78]

Canadian banks and affiliates will be able to underwrite Canadian federal, provincial and municipal securities in the United States, and Canadian banks will be accorded the same rights as U.S. banks with respect to future changes in U.S. banking legislation.[79] Significantly, the FTA does not govern provincially regulated Canadian financial institutions, such as many trust companies, securities firms and credit unions. Provincial ownership restrictions in these institutions remain.[80] Also, dispute resolution concerning financial institutions will remain as a consultative process between the Canadian Department of Finance and U.S. Department of the Treasury.[81]

7. *Institutional Provisions*

The institutional provisions of the FTA are the centerpiece of the document and the focus of most analyses.[82] Throughout the course of the FTA negotiations, the goal of secure market access and the institutional arrangements surrounding each party's countervailing, anti-dumping and safeguard actions have been at the forefront of consideration. The goal of *secure* market access gradually evolved into *enhanced* access as the bargaining process continued.

The dispute resolution procedure encompasses four pathways. Three forms of adjudication are available for disputes not concerning private parties in countervail and anti-dumping cases. First, in the event of a safeguard action by either party, if a dispute arises concerning the imposition of a bilateral measure in the transitional period, the inclusion of a party, or the quantum of compensation in a global action, recourse may be made to the new Canada-United States Trade Commission ("CUSTC").[83] If the CUSTC cannot resolve the dispute through consultation, the issue may be referred to an arbitration panel under its auspices.[84]

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77. *Id.* art. 1703(1).

78. This provision in the *Bank Act*, *supra* note 76, remains operative because there is no preference shown on the basis of nationality. Legal Text, *supra* note 1, art. 1703.

79. Legal Text, *supra* note 1, art. 1702(3).

80. *Id.* art. 1701.

81. *Id.* art. 1704(2).

82. *Id.* art. 1801(1).

83. *Id.* art. 1802(2).

84. *Id.* art. 1806.

Second, in the event of a dispute concerning interpretation or application of the FTA, the CUSTC may, upon the agreement of both parties, refer the dispute to binding arbitration.[85] Third, where no such agreement is reached, the CUSTC shall refer this dispute to an arbitration panel which will make a non-binding recommendation.[86]

Perhaps the most important form of dispute resolution is the binational panel to review anti-dumping and countervail actions. Three different aspects are involved. The panel will review decisions of the U.S. Department of Commerce and International Trade Commission ("ITC") and the Canadian Department of National Revenue and Canadian Import Tribunal ("CIT") upon the request of a private party who may require its respective government to convene the panel.[87] This is the single most important concession won by Canada in the FTA negotiations. It will save cost and time for private parties and contribute to impartial application of each country's existing laws.

Both parties have bolstered this initiative not only in a preventative but also in a forward-looking manner involving potentially drastic sanctions. Binational review may be requested for proposed changes to either party's countervailing duty and anti-dumping law.[88] If the panel's findings are not heeded, the other party may institute retaliatory action or terminate the FTA.[89] As well, both countries are committed to implementing a substitute system of anti-dumping and countervail law within seven years.[90] Failure to adopt such a system may also allow termination of the FTA.[91]

III. ECONOMIC SECTORS AND THE LEGAL TEXT

A. *History of Bilateral Balances*

The United States has registered a merchandise trade deficit with Canada since 1976 and a current account deficit since 1983. The table below[92] provides a historical summary of both the bilateral current ac-

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85. *Id.* art. 1806(1)(b).

86. *Id.* art. 1806(1)(a) (Safeguard Compulsory Arbitration); *id.* art. 1806(1)(b)(Interpretation and Application of Binding Arbitration); *id.* art. 1807(2) & 1807(8) (CUSTC Decision Based on Panel Recommendation).

87. *Id.* art. 1808(1). The right of private individuals to such review is between the respective private individual and relevant governments. It is not included in the FTA itself.

88. *Id.* art. 1901.

89. *Id.* art. 1903(3)(b).

90. *Id.* art. 1906.

91. *Id.* art. 1906.

92. *See* "Macroeconomics and Global Economic Analysis: U.S. Trade and Pay-

count and trade balances.

Table I: BILATERAL CURRENT AND MERCHANDISE TRADE ACCOUNTS
(billions of U.S. dollars, balance of payments basis, not seasonally adjusted).

	1987	1986	1985	1984
Current Account	-5.6	-2.6	-5.7	-3.8
Merchandise Trade	-11.6	-13.3	-15.0	-14.6
Non-Merchandise Trade	6.0	10.7	9.3	10.8

As the table demonstrates, the U.S. non-merchandise trade surplus does not offset the merchandise trade deficit and, therefore, a current account deficit results. Canada has traditionally depended upon the U.S. for capital inflows to help meet domestic investment requirements.[93] This is reflected in the non-merchandise trade surplus, a composite of the large U.S. surpluses in dividends, interest payments, travel and business services. U.S. residents provide the largest market for Canadian bonds although their share in international holdings has declined from fifty-five percent in 1982 to forty-four percent in 1986.[94]

Canadian policy makers have come under increasing pressure to narrow the spread in interest rates between Canada and the U.S. in order to dampen the rising dependence upon foreign borrowing to finance Canada's current account deficit.[95] Thus, although Canada has a current account surplus with the U.S., Canadian interest rate policy is eroding this position.[96] An offsetting trend is the rising direct investment by Canadians in the United States, investment which has grown

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ments," *Bank of Nova Scotia Economics Dept.*, Sept. 1988.

93. However, Canadian direct investment abroad has actually exceeded foreign direct investment in Canada in recent years. The Toronto Globe and Mail, July 24, 1987, at B1.

94. This is primarily due to a shift toward Japanese financing. Canada increasingly relies on Japanese investors to finance government sector requirements. In 1986 they held Cdn$26.2 billion of $107.0 billion in Canadian government bonds. Japanese equity and direct investment remains relatively small. *See* Smith & Brown, "Treasury Report: Special Edition - Japanese International Investment, Implications for Canada," *Bank of Nova Scotia Economics Dept.*, Aug. 28, 1987.

95. *See* Mackness, *Probing the Outer Limits of Deficit Financing*, CANADIAN BUS. Q., Mar. 1987, at 22-27.

96. This view is quite controversial in Canada. The Bank of Canada believes that the present interest rate policy is in Canada's best interest. *See* Mackness, "Defending the Canadian Dollar," *Policy Options*, Vol.8, No.4, May 1987, at 1.

by about twenty percent per year for the past decade.[97] In 1975 Canada had invested Cdn$5.6 billion in the United States, less than twenty percent of U.S. investment in Canada; by 1985 Canadian investment had risen to Cdn$35.5 billion, or about sixty percent of U.S. investments in Canada.[98]

Underlying Canada's persistent bilateral trade surplus is the large difference in relative exchange rates in Canadian and U.S. currencies. The relatively low value of the Canadian dollar has contributed to a great extent to Canada's trade surpluses. This has lowered effective overall costs in selling products to the United States and has offset the general tendency of higher per unit labor costs and lower productivity gains in Canada.

Canada's merchandise trade exports to the United States are mainly in five areas, given here in descending order of importance: vehicles and vehicle parts, metals and minerals, pulp and paper, lumber, and crude petroleum.[99] Therefore, Canada is predominantly a net exporter of raw and semi-finished commodities. These exports share several common traits: they are capital intensive, requiring high levels of investment; they respond to cyclical shifts in demand; and they are highly sensitive to world prices for both input and output.

B. *Importance of Bilateral Balances*

An assessment of numerous recent studies purporting to deal with the economic effects of free trade reveals that almost all of them focus on the employment impact of the FTA.[100] Few have dealt with the general issue of sectoral trade balances and none has made a detailed estimate of future Canada/U.S. trade and current account balances. Some macroeconomic models have included the FTA in scenarios projecting the level of Canadian exports, imports and capital flows; however, none has examined the trade balance as the prime issue.

In some respects this is not surprising. The final trade and current

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97. The Toronto Globe and Mail, July 24, 1987, at B1, col. 1.

98. *Id.* By 1987 cumulative Canadian foreign direct investment in the United States ranked fourth behid investment from the United Kingdom, the Netherlands, and Japan. *Canadian Free Trader*, No.9, at 76 (Sept. 1988).

99. THE ECONOMIST, October 10, 1987, at 61.

100. This is not only true of these three major reports by the Economic Council of Canada, the Conference Board of Canada and the Department of Finance but of many others as well. For example, the British Columbia Federation of Labor in January, 1988, predicted the FTA would involve an employment loss of 60,000 positions in British Columbia during the 10 year phase-in. The Toronto Globe and Mail, May 2, 1988, at A2.

account balances arise from the interaction of many underlying economic factors. Most studies focus on assessing the underlying factors and make only general statements at best about the trade and current account balances.[101]

From the perspective of both politicians and the public, this may seem strange. Both groups are conditioned to consider the trade balance as an economic indicator of prime importance. The U.S. financial community eagerly awaits the announcement of the monthly trade balance to assess underlying economic conditions in order to implement market strategy.[102]

To a certain extent the trade balance has become an overemphasized statistic. It should be seen within the context of the overall balance of payments system. The trade balance and the balance on services, income and transfers comprise the current account.[103] The current account interacts with the system of external financing to balance in each time period.[104] A current account deficit may be financed by borrowing and drawing down international reserves.[105] In this way trade flow complements investment and financial flows and, although significant, is not central.

Nonetheless, the trade balance represents a great deal of information. A persistent deficit implies some long-term structural problems. Such problems may be developing in both the U.S. and Canadian economies.[106] The principle of free trade between any two nations is a positive step to alleviate these problems, but free trade will not necessarily

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101. For example, important studies by the Office of the U.S. Trade Representative (released November 1987), and Imperial Oil Ltd. (released March 1988) make not mention of the bilateral trade and current account balances. The trade and current account balance can be predicted only by making specific assumptions about a host of factors including income and price elasticities of consumers, economies of scale in plant and equipment, investment decisions and many other factors set on the world market, such as commodity prices and, to a lesser extent, interest rate policy.

102. The U.S. trade balance along with the U.S. budget deficit and the viability of U.S. bank loans to less developed countries have become three of the most high profile factors whose fluctuations can significantly affect U.S. equity markets. *See* Little, "The Malady Lingers On," *Report on Business Magazine*, December 1987, at 22.

103. *See* Samuelson & Scott, *Economics*, Fifth Canadian Edition, 1980, at 694.

104. Whether trade flows are the driving force in the international economy and financial flows a by-product of secondary importance is a moot point. However, this is probably the majority opinion. *See id.*

105. *Id.* at 696-97.

106. A case in point is the Australian economy, a developed country with chronic current account deficits which have undermined its creditworthiness in the international economy. This has forced the Australian government to take drastic fiscal action. *See* Mackness, *supra* note 96, at 3.

dampen the U.S. trade deficit with Canada.

C. *Existing Studies*

Three major studies, all generated by reputable, high-profile Canadian institutions, deserve attention despite their primary focus on issues other than the trade balance. The Economic Council of Canada ("ECC") released a study dated August, 1987, entitled *Impact of Canada-U.S. Free Trade on the Canadian Economy.*[107] Utilizing a macroeconomic model assessing short and medium term implications, its authors state that for Canada, free trade "will worsen the current account balance (net exports) and increase Canada's dependence on foreign savings."[108]

The observation is qualified as a comparison with what would have occurred between 1987 and 1995 in the absence of the FTA.[109] It is also qualified in terms of the assumptions it makes about the FTA, specifically allowing for no phase-in period for tariff elimination. This assumption, the ECC admits, would change immediate results.[110] It should be noted that this study was released before the FTA became public.

This observation is only one of a host of conclusions concerning free trade, most of which are positive. It is based upon specific assumptions regarding the level and structure of trade protection including relative tariffs, non-tariff barriers and government procurement practices; monetary and fiscal policy, firm pricing behavior; productivity gains from scale economies; and rationalization in business investment.[111]

The Conference Board of Canada performed its own simulations of the impact of the FTA.[112] Like the ECC, the Conference Board predicts a deteriorating Canadian current account deficit.[113] It projects that by 1997 long-term capital inflows from new corporate bond issues and net direct investment will be fifty-five percent higher than in a non-

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107. ECONOMIC COUNCIL OF CANADA, IMPACT OF CANADA-U.S. FREE TRADE ON THE CANADIAN ECONOMY (August 1987).

108. *Id.* at 84.

109. *Id.*

110. *Id.* at 72.

111. *Id.* at 23.

112. FRANK, ADJUSTING TO FREE TRADE: WHAT DO THE NUMBERS TELL US? (The Conference Board of Canada, Mar. 1988).

113. *Id.* at 16. The Conference Board predicts a higher Canadian current account deficit under the FTA in 1997 than would be the case in a non-FTA environment (Cdn\$2.8 billion versus Cdn\$1.2 billion).

FTA environment.[114] These inflows will accrue to different industry sectors in varying degrees. The Conference Board predicts no large investment increase in automobiles, mining and smelting, or energy, but sees a potential increase in financial services and some manufacturing.[115]

In terms of overall export levels, the Conference Board predicts a slight increase as compared to a non-FTA environment, from a compound growth rate of 3.2 percent without the FTA to 3.4 percent with it from 1987 to 1997.[116] It specifically predicts little change in trade in either automobiles or most primary products.[117]

The Canadian Department of Finance issued an analysis of the FTA in January, 1988. Entitled *The Canada-U.S. Free Trade Agreement: An Economic Assessment*, it has the advantage over the ECC study of having been released after the FTA became public.[118] Its medium term analysis suggests that Canadian exports will rise "in volume terms about 3.4 percent by 1993."[119] The report is silent on the trade balance issue. It reports that in the long term, once all effects of the FTA have worked through the system, the Canadian GNP will increase by 2.5 percent.[120] It also predicts a net increase of 120,000 jobs over the first five years of the FTA.[121]

D. *Evaluating Sectoral Effects*

The chart in the Appendix provides a basic framework for assessing the sectoral effects of the FTA on corresponding areas of the economy. The Conference Board of Canada predicts that tariff phase-outs included in the FTA will have little impact on trade in primary industries.[122] Instead it foresees the major influence to be on those secondary industries in which tariff protection is already high.[123]

Given the high volume of Canadian merchandise trade exports in

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114. *Id.* at 10.

115. *Id.* at 10-14.

116. *Id.* at 14.

117. *Id.*

118. Of the three major organizations whose studies are included in this paper the Department of Finance would be expected to most strongly support the FTA, given its public sector affiliation.

119. DEPT. OF FINANCE, THE CANADA-U.S. FREE TRADE AGREEMENT: AN ECONOMIC ASSESSMENT 38 (Jan. 1988).

120. Cdn$12 billion in constant 1988 dollars. *Id.* at 51.

121. *Id.*

122. FRANK, *supra* note 112, at 14.

123. *Id.* at 15.

the primary industries, the conclusions of the Conference Board with respect to tariff effects should have major implications for the trade balance. Of course, other important aspects of the FTA, especially the Institutional Provisions, will be important for primary industries. As well, investment flows will be altered by the new institutional parameters set by the Investment chapter.

On a sectoral basis the Conference Board predicts minimal trade impact in energy and agriculture.[124] Combined with its conclusions concerning only a slight direct investment impact in energy, mining and smelting, overall effects of the FTA may be small.[125]

Bilateral trade volumes in motor vehicles are the largest between both countries.[126] The magnitude of these volumes will impact heavily on determining the overall trade effect on secondary industries. The Conference Board does not foresee either important trade or investment changes in this sector. Indeed, it predicts widespread investment losses even in those sectors which now enjoy relatively high tariff protection.[127] However, the FTA could be moderately conducive to increased investment in the utility sector and financial services.[128]

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124. *Id.* at 18-21.

125. *Id.* at 10-11.

126. Of all bilateral sectoral effects, the automotive goods sector is potentially the most crucial to each country because of high trade volumes which approached $46 billion in 1986. Over one-third of bilateral trade occurs in this sector. Essentially, the benefits of free trade have already accrued to both countries in this sector. The Agreement on Automotive Products, Sept. 16, 1966, United States - Canada, 17 U.S.T. 1372, T.I.A.S. No. 6093 [hereinafter "Auto Pact"], has provided for a form of free trade since September, 1966.

The Auto Pact provided that new automobiles and original equipment parts would move duty-free subject to certain conditions. *See* Beigie, *The Canada-U.S. Automotive Agreement: An Evaluation*, Canadian-American Committee, 1970, at 46. Manufacturers had to maintain the ratio of Canadian car production to Canadian car sales (subject to a lower bound of 75 percent). Auto Pact, Art. 2(5)(ii)A. They were also required to maintain a level of Canadian value added in dollar terms on the production of vehicles in Canada equal to that in the 1964 model year. Auto Pact, Art.2(5)(ii)B.

These provisions meant that automobile companies in Canada had to assemble approximately the same number of cars in Canada as were sold there. Canada could be a net exporter, not a net importer, of completed cars to the United States. There were no limits on parts however. Auto Pact, Art. 2(5)(ii)A and B. As well, letters of undertaking were written by Canadian auto producers to the Canadian Government promising to increase Canadian value added by a percentage of the growth in sales.

127. FRANK, *supra* note 112, at 12.

128. *Id.* at 11.

IV. Conclusion

The FTA can have several important implications for the future of bilateral trade and current account balances. As demonstrated by this article, although in-depth research has been undertaken on many aspects of the FTA, a comprehensive sector-by-sector quantitative analysis of trade balances is still difficult to do. An analytical treatment will require quantifying the impact of the legal provisions of the FTA, a very complicated task. The Appendix helps relate the key sections of the FTA to standard economic classifications.

V. Appendix

Economic Classification	FTA Legal Text Relevant Provisions
Primary Industries	
Agriculture and Fisheries	Chapter 7
	Chapter 12, Article 1203 Unprocessed Fish Exp.
Forestry and Lumber	Chapter 20, Article 2008 Plywood Standards
	Article 2009 Softwood Lumber
	Chapter 12, Article 1203 Log Export Controls
Pulp & Paper and Printing	Chapter
Oil & Gas and Coal	Chapter 9
Mining and Non-Metallic Minerals	
Steel and Metal Fabricating	
Secondary Industries	
Food and Beverages	Chapter 8
	Chapter 12, Article 1204 Beer and Malt Beverages
Textiles and Clothing	
Motor Vehicles	Chapter 10
	Chapter 4, Article 405 Duty Remission
Machinery and Electrical Products	
Chemicals and Refineries	
Construction	Letter CMHC Plywood Standards
	Chapter 20, Article 2008 Plywood Standards

Utilities	
Services	Chapter 14
	Chapter 13, Government Procurement
	Chapter 15, Temporary Entry for Bus. Persons
	Chapter 17
	Chapter 20, Article 2004 Intellectual Property
	Article 2006 Retransmission Rights
	Article 2007 Print in Canada