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Ian F. Fergusson
*Congressional Research Service*

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

**Abstract**
[Excerpt] 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 mostly on trade disputes, and also on the ability of the two nations to continue their traditional volume of trade with heightened security on the border.

**Keywords**
United States, Canada, trade, border, security, commerce

**Comments**
**Suggested Citation**

Fergusson, I. F. (2011). *United States-Canada trade and economic relationship: Prospects and challenges* [Electronic version]. Washington, DC: Congressional Research Service.

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Congressional Research Service

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

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September 14, 2011

**Congressional Research Service**
7-5700
www.crs.gov
RL33087

**CRS Report for Congress**
*Prepared for Members and Committees of Congress*

# Summary

The United States and Canada conduct the world's largest bilateral trade relationship, with total merchandise trade (exports and imports) exceeding $429.7 billion in 2009. 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 2009, total merchandise trade with Canada consisted of $224.9 billion in imports and $204.7 billion in exports. In 2007, China displaced Canada as the largest source for U.S. imports for the first time, a trend that has continued since then. 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 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 the 2006 softwood lumber agreement are under arbitration, and Canada has sought WTO consultations over country-of-origin-labeling requirements. In addition, the United States has placed Canada on its Special 301 priority watch list over intellectual property rights enforcement issues. Canada has also vigorously protested the implementation of the "Buy American" provisions of the economic stimulus package.

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 mostly on trade disputes, and also on the ability of the two nations to continue their traditional volume of trade with heightened security on the border.

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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 9 times that of Canada in nominal terms and nearly 11 times as large 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.

In the past decade from 2001, the average annual real GDP growth rate has been slightly higher for Canada (1.9%) than for the United States (1.6%). Per capita average annual growth rates over the period have shown a similar, if anemic trajectory (0.82% v. 0.62%). Canadian per capita income, in terms of PPP, has remained relatively constant at around 84% of U.S. per capita income. The persistent per capita income gap has proven worrisome to Canadian policymakers as it raises questions about Canadian productivity and competitiveness.

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 larger as a percentage of GDP in the United States (76.9%-70.9%). 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 (27.2%-22.2%). Agriculture makes up the remaining 1.9% of the Canadian economy and 1.2% 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. Parliament consistently passed balanced budgets from 1997-2008, and Canada lowered its ratio of public debt-to-GDP from 100% of GDP in 1996 to 61.3% of GDP in 2008. Yet, deficit spending returned in the 2009 stimulus budget and public debt-to-GDP is now back to 84.0%. The United States has a lower ratio of debt-to-GDP, but it has been trending upwards, reaching 62.9% of GDP in 2010, after years of deficit spending.

[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 GDP comparisons because its measurement excludes exchange rate volatility and speculation.

**Table 1. Selected Comparative Statistics, 2010**

| Indicator | United States | Canada |
|---|---|---|
| GDP | | |
| Nominal PPP (billion US$) | 14,527 | 1,337 |
| Nominal (billion $) | 14,527 | 1,577 |
| Per Capita GDP | | |
| Nominal PPP ($) | 46,820 | 39,279 |
| Nominal ($) | 46,820 | 46,338 |
| Real GDP Growth | 3.0% | 3.2% |
| Recorded Unemployment Rate | 9.6% | 8.0% |
| Exports G&S(%GDP) | 12.7% | 29.4% |
| Imports G&S (%GDP) | 16.2% | 31.3% |
| Sectoral Components of GDP (%) | | |
| Industry | 22.2% | 27.2% |
| Services | 76.6% | 70.9% |
| Agriculture | 1.2% | 1.9% |
| Current Account Balance (% GDP) | -3.2% | -3.1% |
| Public Debt/GDP | 62.9% | 84.0% |

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

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 a relatively 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 affects economic dynamics. Canadian provinces have relatively more power vis-à-vis Canada's federal government than that of 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. Trade increased in 2010, after dropping in 2009 due to the global economic downturn. In 2010, total merchandise trade with Canada was $481.5 billion (a 12.1% increase from 2009), consisting of $275.5 billion in imports and $206.0 billion in exports resulting in a trade deficit of $69.5 billion.[2] In 2010, $1.3 billion in goods crossed the border each day. Trade with Canada represented 15.9% of U.S. total trade in 2010, with Canada purchasing 18.3% of U.S. exports and supplying 14.5% of total U.S. imports. 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 50.4% of Canada's imports of goods and purchased 74.9% of Canada's merchandise exports in 2010.

While the absolute value of trade continues to increase between the two nations, each nation's share of trade with the other has decreased in recent years. As a share of U.S. total trade, trade with Canada dropped from 20%-15% since 2003. Conversely, trade with the United States dipped from 74% to 63% of Canada's global trade in the same period.

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 2010, the comparable figure for Canada was 49.3%. Canada's goods exports totaled $386.0 billion in 2010, which represented 29.1% of Canadian GDP; Canada imported $390 billion from all destinations, 31.3% of its GDP. In 2009, Canada's merchandise trade balance fell into deficit for the first time since 1975 and this deficit persisted in 2010. Canada is relatively more exposed to the world economy and to the fortunes of other economies, foremost to that of the United States, than most other countries.

Autos and auto parts represent the top U.S. exports to, and second-largest imports from, Canada. Agriculture and construction machinery, computer equipment, general purpose machinery, aerospace product and parts, basic chemicals, pharmaceuticals and medicines, iron and steel, 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); pulp, paperboard, and paperboard mill products; aerospace products and parts; nonferrous metal and processing (ex aluminum); and basic chemicals.

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 40 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.

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

### Canada's Economic Stimulus Program

In January 2009, the government introduced a C$258.6 billion budget, which called for C$40 billion in stimulus spending and tax cuts for FY2009-2011. The stimulus consists of a package of income tax cuts, employment insurance (EI) benefit extensions, job retraining, 'hard' infrastructure spending, tax credits for home renovation, retrofits for social housing, and investments in First Nation's health programs.[3] In all, the C$40 billion represents a stimulus of about 1.5% of GDP in the first year and 1.1% in the second year. Increased spending represents approximately 72% of this package and tax cuts contribute the remaining 28%. The March 2010 budget allocated the remaining C$19 billion in stimulus.

The 2009 budget also marked a return to deficit spending for Canada after 12 successive budgets in balance or surplus. The 2009 budget contemplated a deficit of C$34 billion the first year, and predicted a total of C$81 billion in borrowing over five years before the budget is expected to return to surplus in 2013. The March 2010 Budget revised upward the 2009 deficit to C$53.8 billion, proposed a C$49.2 billion deficit in 2010, and envisaged the budget returning to balance in 2015 with a total C$158.4 billion increase in the national debt. In March 2011, the government introduced a budget that would return the country to surplus in 2014. The Harper government plans to return to budget balance by winding down the stimulus measures, targeted spending reductions, and identification of additional opportunities for administrative savings. The government has pledged not to raise taxes and not cut transfer payments to individuals or equalization payments to the provinces.[4] Opposition leaders have expressed skepticism that the budget could return to balance through economic growth and with the scope of spending cuts envisioned in the budget.

The return to deficit spending, while acknowledged as necessary by most of the political spectrum to combat the severe economic recession, was not undertaken lightly. Prior to the "austerity" budget of 1995, Canada had wracked up 27 straight years of deficit spending. At its peak in 1996, Canada's public debt represented 101.6% of GDP, and government sector spending reached 53.6% of GDP in 1993. Realizing this course was unsustainable, the Liberal government of then Prime Minister Jean Chretien and his Finance Minister Paul Martin embarked on a financial austerity plan using such politically risky measures as cutting federal funding for health and education transfers, applying a means test to those eligible for Seniors Benefits, and cuts in defense. A nationwide goods and services tax was introduced to help close the gap. Under this budget discipline, the government submitted a balanced budget in 1998 and a political consensus emerged not to resort to deficit spending, at least until 2009.

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.-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.[5]

## 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 (mostly 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.

[3] "Tories to Aggressively Implement Budget Spending Measures," *The Hill Times*, February 2, 2009.

[4] "Budget 2010 in Brief" http://www.budget.gc.ca/2010/glance-apercu/brief-bref-eng.html.

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

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 made up 15.6% of U.S. exports to Canada and 14.6% of U.S. imports from Canada in 2009 (see **Table 2**). 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. U.S. vehicles imports from Canada plummeted 27.6% to 1.2 million vehicles in 2009. U.S. vehicles exports to Canada fell 40.7% to 427,000 in 2008. One notable feature of this trade is the increasing composition of trade in so-called "new domestic" manufactures, foreign-owned companies with manufacturing and assembly plants in the United States and Canada. While the value of Canadian "Big 3" exports to the U.S. has declined 32% since 2000, the value of the primarily Japanese new domestics has increased by 45%, and in 2006 these new domestics made up 31.5% of Canadian imports into the United States. The value of Canada's imports of U.S.-produced new domestics has also increased by about one-third from 2000, and made up about 21% of the value of U.S. vehicle exports to Canada in 2006.[6]

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 had been due to the weak Canadian dollar, but that advantage diminished with the loonie's rise to parity with the U.S. dollar. Another major competitive advantage is Canada's national health system, which reportedly relieves Canadian automakers of approximately $1,400 in costs per vehicle.[7]

The global economic recession that has hit the U.S. domestic auto industry especially hard is also having an effect on Canada, especially Ontario. Approximately 20% of the plant capacity of the domestic Big Three (General Motors, Ford, and Chrysler) is located in Canada. The government of Canada and the Ontario provincial government have sought to match in proportion to production capacity the loans given by the U.S. government to General Motors and Chrysler. The Canadian authorities provided $4 billion in bridge loans to GM and Chrysler to match the $17.4 billion provided by the Bush Administration in December 2008. Following Chrysler's bankruptcy on April 30, 2009, the United States and Canada promised a $10.5 billion package of assistance based on a 3:1 ratio contribution: $8.08 billion from the United States and $2.42 billion from Canada and Ontario. In return, the U.S. government will hold 8% share of the restructured company and Canada and Ontario will own 2%. GM declared bankruptcy on June 1, 2009. Forty days later, it emerged from bankruptcy with the U.S. government owning 60.8% of the new company, Canada and the Province of Ontario taking an 11.7% stake, and the remainder owned by the United Autoworkers retiree trust fund and the former company's bondholders.[8] Ford, which also has extensive Canadian operations, did not ask either government for loans.

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[6] "Canada's Changing Auto Industry," by Francine Roy and Clerance Kimanyi, *Canadian Economic Observer,* May 2007, figures extrapolated from Table 2, p. 3.7.

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

[8] "GM Exits Bankruptcy," *Reuters*, July 10, 2009.

## Energy

Canada is the United States' largest supplier of energy—including oil, uranium, natural gas, and electricity—and the energy relationship has been growing.[9] Canada is the world's fifth largest petroleum producer, and its reserves are believed to be the third largest in the world only after those of Saudi Arabia and Venezuela; Canada's sources of oil include traditional and offshore wells and, increasingly, Alberta's oil sands.[10] In 2010, the value of U.S. petroleum and natural gas imports from Canada reached $82.2 billion from $63.7 billion in 2009. Canada provides 22% of U.S. crude oil imports and supplies 85% of U.S. natural gas imports.[11] Canada is particularly valued because it is considered a reliable source of energy, as it is not a member of OPEC. The two countries are also cooperating on the development of pipeline construction projects. China has shown interest in Canada's oil sector, and has recently bought stakes in the Alberta's oil sands projects. Canada also a net exporter of electricity to the United States, and the North American electricity grid is closely interconnected.

In 2005, oil and gas displaced motor vehicles as the United States' 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 is 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 to those held by Saudi Arabia.[12] Provisions of the FTA and NAFTA assure U.S. supplies of energy from Canada by prohibiting the imposition of minimal export prices or export taxes, and by restricting 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 2010, Canada imported $43.2 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 $12.5 billion of 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 import-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.

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[9] See CRS Report R41875, *The U.S.-Canada Energy Relationship: Joined at the Well*, by Paul W. Parfomak and Michael Ratner.

[10] U.S. Energy Information Administration (EIA), Country Analysis Brief: Canada, April 2011, http://www.eia.gov/countries/cab.cfm?fips=CA.

[11] U.S. International Trade Commission http://dataweb.usitc.gov.

[12] For more information on the oil sands, see CRS Report RL34258, *North American Oil Sands: History of Development, Prospects for the Future*, by Marc Humphries.

**Table 2. U.S. Merchandise Trade With Canada, 2010**

| Export Category | Amount billion $ (% change from 2008) | Import Category | Amount billion $ (% change from 2008) |
|---|---|---|---|
| Motor Vehicle | 20.6 (35) | Oil and Gas | 63.9 (25.2) |
| Motor Vehicles Parts | 19.3 (35.6) | Motor Vehicles | 36.5 (49.4) |
| Special Classification, NESOI | 7.7 (14.2) | Petroleum and Coal Products | 15.0 (15.7) |
| Agriculture/ Construction Machinery | 7.3 (26.9) | Motor Vehicle Parts | 11.9 (45.0) |
| Iron/Steel/Ferroalloy | 6.7 (52.4) | Nonferrous Metal and Processing | 10.3 (61.5) |
| General Purpose Machinery | 6.1 (18.2) | Pulp, Paper, Paperboard | 8.0 (9.2) |
| Basic Chemicals | 6.1 (20.0) | Returned/Reimported | 7.8 (3.9) |
| Petroleum / Coal Products | 5.7 (44.4) | Basic Chemicals | 7.5 (42.6) |
| Resin, Synthetic Rubber, artificial fibers | 5.7 (31.2) | Aerospace Products and Parts | 6.3 (-6.9) |
| Plastics Products | 4.9 (17.5) | Aluminum | 6.0 (30.2) |
| Oil and Gas | 4.6 (6.5) | Iron/Steel/Ferroalloy | 5.4 (53.6) |
| Engines/Turbines/ Power Transmission Equipment | 4.4 (22.0) | Resin, Synthetic Rubber, artificial fibers | 4.6 (32.0) |
| Aerospace Products/Parts | 4.4 (-8.3) | Special Classification, NESOI | 4.6 (-28.0) |
| Fabricated Metal Products | 4.1 (15.8) | Pharmaceutical/ Medicines | 4.4 (-13.2) |
| Pharmaceutical/Medicines | 4.0 (10.6) | Pesticides, Fertilizer, Agriculture Chems. | 4.4 (32.7) |
| Converted Paper Products | 3.9 (11.2) | Plastic Products | 4.1 (10.0) |
| Navigational, Measuring, Electromedical, and Control Instruments | 3.9 (13.2) | Other General Purpose Machinery | 3.6 (0.9) |
| Soaps, Cleaning Compounds, and Toilet Preparations | 3.6 (8.3) | Agriculture and Construction Machinery | 3.0 (10.6) |
| Waste and Scrap | 3.1 (16.1) | Sawmill and Wood Products | 3.0 (31.9) |
| Electrical Equipment, Components, NESOI | 2.9 (21.5) | Rubber Products | 2.7 (23.2) |
| All Other | 76.8 (-14.1) | All Other | 62.3 (9.8) |
| **Total** | **$206.0 (20.0)** | **Total** | **$275.5 (22.7)** |

**Source:** U.S. International Trade Commission. (Figures are NAIC-4, Domestic Exports and Imports for Consumption.)

**Note:** May not total due to rounding.

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.[13]

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. 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.[14]

## Trade Deficit

In 2009, Canada ran its first overall trade deficit since 1995. However, the U.S. trade deficit with Canada sharply narrowed to $20.2 billion from $74.7 billion in 2009 before increasing to 69.5 in 2010. As imports generally grew faster than exports in the free trade era, the bilateral trade deficit increased from 3.5% of the value of total trade in 1991 to 15.3% in 2005. In 2010, that ratio was 14.4%. (See **Figure 2**.)

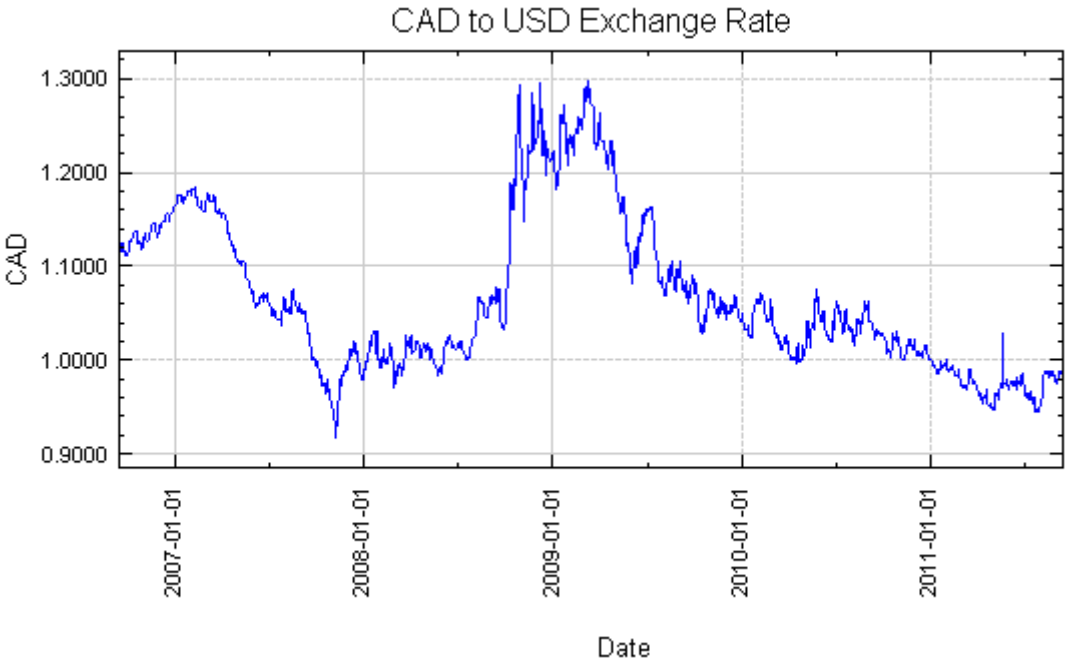
The persistent trade deficit with Canada has been blamed on many factors. Up until 2003, the deficit was attributed, in part, to the weakness of the Canadian dollar. The loonie had steadily depreciated in value in the decade prior to 2003. Worth approximately $0.84 at the time of the U.S.-Canada Free Trade Agreement in 1989, the currency briefly sank to $0.63 in 2002. Since then, the loonie has steadily appreciated and reached parity for the first time in 31 years on September 20, 2007 before peaking at an intra-day high of $1.10 on November 7, 2007. From that date, the loonie has crossed the parity line several times in relation to the U.S. dollar. However, from May 2008, the currency gradually declined, in part due to the end of the commodity and energy boom and the onset of the recession, to a low of $0.77 in March 2009. Since then, stronger commodity prospects and an earlier exit from recession has led the loonie to flirt with parity for much of 2010 to exceed the value of the U.S. dollar for nearly all of 2011.

[13] Wendy Dobson, "Taking A Giant's Measure: Canada, NAFTA, and an Emergent China," C.D. Howe Institute, September 2004.

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

**Figure 1. Canadian Dollar per U.S. Dollar Exchange Rate**

2006-2011




**Source:** Federal Reserve Bank of New York, IndexMundi.com site.

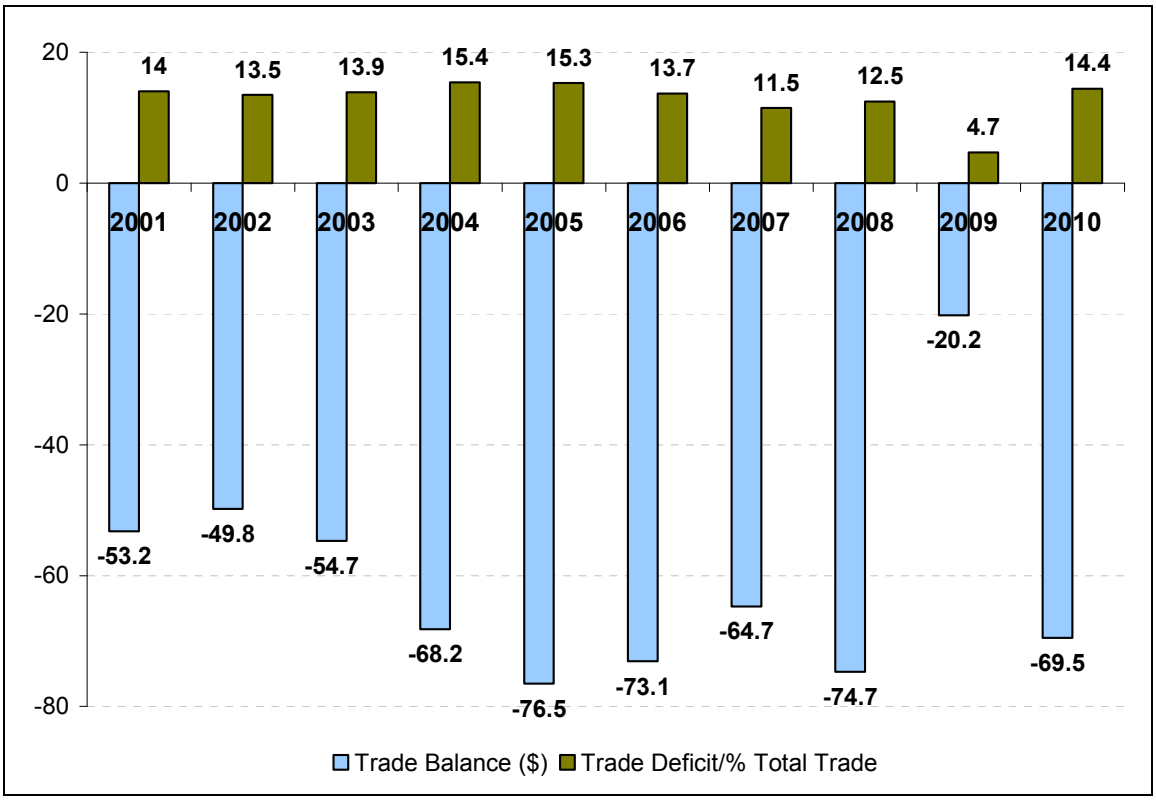
## Services

The United States also conducts a substantial services trade with Canada. In 2009, Canada remained the second-largest consumer of U.S. services, and dropped to the fourth-largest supplier of services to the United States after the United Kingdom, Germany, and Bermuda. That year, the United States exported $42.0 billion worth of private services to Canada and imported $22.0 billion, for a surplus of $20.0 billion. Private services exports to Canada accounted for 8.7% of U.S. private service exports overall; imports represented about 6.6% of total U.S. service imports. In 2009, U.S. service exports represented 56.6% of Canadian service imports, and Canadian service exports to the United States represented 52.3% of total Canadian service exports.[15] Commercial services made up 48.2% of overall two-way Canadian service trade in 2009 and travel and tourism totaled another 27.8%. Since 2004, Canada's overall service sector trade deficit has doubled from C$11.5 billion to C$22.6 billion; likewise, the service sector deficit with the United States also doubled from C$7.3 to C$15.6 billion. U.S. travelers accounted for 45.5% of Canada's travel and tourism receipts in 2009; Canadians spent 56.4% of their tourist dollars in the United States that year.[16]

[15] U.S. Bureau of Economic Analysis, *Survey of Current Business,* October 2010; Statistics Canada, Balance of International Payments—Fourth Quarter 2008, Table 18, available at http://www.statcan.gc.ca/pub/67-001-x/67-001-x2009004-eng.pdf.

[16] Statistics Canada, Balance of International Payments, Table 17, Table 60.

**Figure 2. Merchandise U.S. Trade Deficit with Canada**



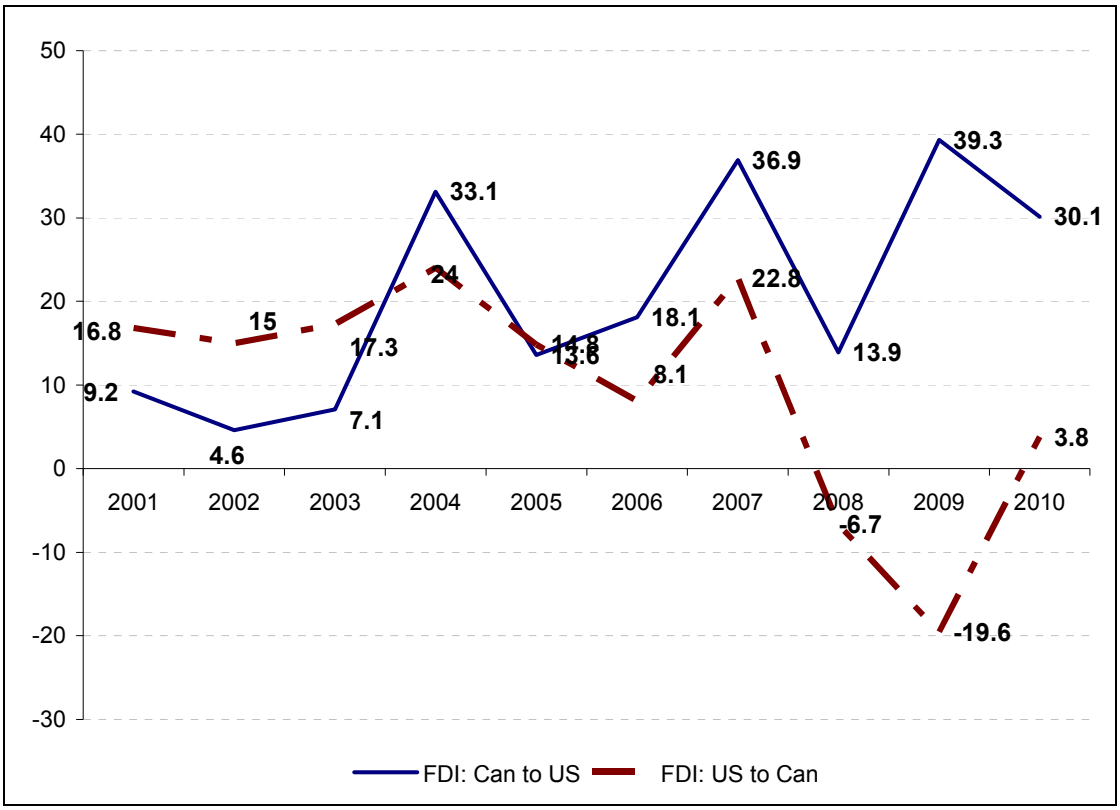

**Source:** U.S. International Trade Commission.

## Investment

The U.S.-Canada economic relationship is characterized by substantial ownership interests in each nation by investors of the other. The United States is the largest single investor in Canada with a stock of $296.7 billion in 2010, a figure representing 7.6% of U.S. direct investment abroad (DIA). U.S. investors accounted for 54.4% of the stock of foreign direct investment (FDI) in Canada in 2010, down from 64.1% in 2004.[17] Manufacturing, finance/ insurance, and mining/energy are the three largest categories of U.S. FDI in Canada. Canada had a prominent (though not the largest) FDI position in the United States at $206.1 billion, 8.8% of the total FDI stock in the United States in 2010, yet the United States is the most prominent destination for Canadian DIA, with a stock of 40.5% of total Canadian DIA that year.

[17] BEA, *Survey of Current Business*, July 2011; Department of Foreign Affairs and International Trade Canada, *State of Trade 2011,* http://www.international.gc.ca/economist-economiste/performance/state-point/state_2011_point/2011_6.aspx?lang=eng&view=d.

**Figure 3. FDI Flows 2001-2010**




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

Canada is also highly dependent on FDI. In 2010, FDI represented 35.6% of Canada's GDP, and Canadian DIA represented 39.1% of GDP,[18] both figures up from about 20.0% in 1995. Flows of FDI, which stagnated during the global economic slowdown and actually resulted in net disinvestment in the United States by Canadians in 2008, began to increase again in 2009.

## Canadian FDI Policy

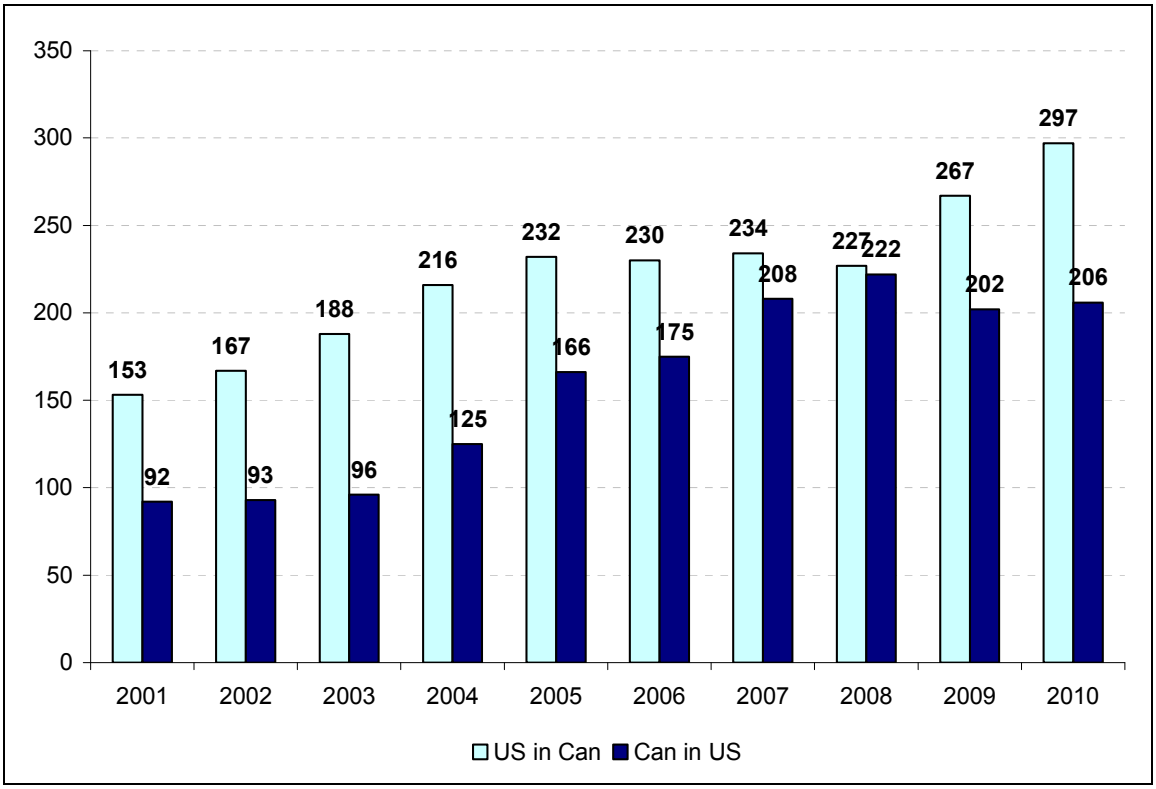
Foreign investment has played a large part in the development of the Canadian economy. British and American capital was instrumental in building Canada's railways in the 19th century and in exploiting its resources in the 20th century. Although Canada is generally open to foreign investment, certain 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 C$312 million. All transactions involving uranium production, financial services, transportation services, or cultural business[19] 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

[18] Economist Intelligence Unit, Country Data Series.

[19] 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.

Canadians; the effect of productivity and technological development; the effect on competition; the effect on Canadian competitiveness on world markets; and compatibility with national, industrial, or cultural policies. On November 3, 2010, Industry Minister Tony Clement announced that it would use the Investment Canada Act to block the attempted takeover of Potash Corporation of Saskatchewan by BHP Billiton, the Anglo-Australian mining corporation. It marked only the second time a proposed takeover by a non-resident has been blocked outright, but in some instances investments have been altered pursuant to Investment Canada guidance.[20]

**Figure 4. FDI Stock 2001-2010**




**Source:** BEA.

In 2007, the government began subjecting acquisitions by foreign state-owned enterprises (SOE) to additional scrutiny to assess whether they meet the "net benefit" test. The additional criteria include whether the SOE adheres to Canadian standards of corporate governance and whether the Canadian business acquired will continue to have the ability to operate on a commercial basis. In 2009, Parliament approved an amendment to the Investment Canada Act to allow for review of transactions potentially "injurious to national security." The Industry Minister may order such reviews of either proposed or implemented transactions if they raise national security concerns. If the review does not resolve the concerns, the Federal Cabinet would be able to block such transactions, or order the divestment of an implemented transaction. Neither the act nor the implementing regulations define "injurious to national security."[21]

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

[21] Peter Franklyn and Peter Glossop, "Regulation of Foreign Investment in Canada," in *Doing Business in Canada*, April 2010, pp. 15-18, http://www.osler.com/uploadedFiles/News_and_Resources/Publications/Guides/ (continued...)

## 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 reached an agreement to resolve the long-standing softwood lumber dispute, perhaps the most intractable trade dispute between the two nations.[22] This agreement, however, has now become the subject of arbitration between the two countries. The 2006 agreement was signed in Ottawa on September 12 by USTR Susan Schwab and Canadian Trade Minister David Emerson. The agreement was implemented on October 12, 2006. This follows a summer in which the Canadian government of Prime Minister Stephen Harper enlisted support for the agreement among Canadian provinces and among what he called "a clear majority" of the Canadian lumber industry.[23] The Canadian Parliament approved legislation implementing the agreement on December 14, 2006.

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 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 SLA ends all antidumping and countervailing duty litigation 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 was split; half went to U.S. lumber companies and the rest was used for a joint North American lumber initiatives and other "meritorious initiatives," such as possible Katrina rebuilding efforts.

The Canadian government implemented a supply management system for its lumber exports involving export taxes and quotas based on the price of lumber. Under the agreement, if the price of lumber remains above $355/thousand board feet, no quotas or tariffs would be imposed. If prices fall below this threshold, each province could either choose to pay a sliding-scale export

(...continued)

Doing_Business_in_Canada/DBIC_2009_April.pdf.

[22] For more information, see CRS Report RL33752, *Softwood Lumber Imports from Canada: Issues and Events*, by Ross W. Gorte and Jeanne J. Grimmett.

[23] "Canadian Softwood Industry Support Enough for Deal to Proceed," *International Trade Reporter*, August 24, 2006.

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 lasts for seven years with an option of a two-year renewal. Both governments and their respectively industries reportedly have expressed interest in renewing the agreement past its October 13, 2011 expiration.[24] Maritime provinces (which have private timber ownership) and other producers not engaged in the litigation are 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 third country exports to the United States increase by 20% in two consecutive quarters, Canadian market share decreases, and U.S. market share increases, Canada is authorized to refund any export taxes collected in that quarter.

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 noted that unless lumber prices drop below the $355 benchmark, there will be no restrictions on the U.S. market. While prices were above that level around the time the agreement was proposed, subsequently, lumber prices have fallen dramatically. With lumber prices around $270 on the date of implementation (October 12, 2006), and have fallen further since due to the housing industry collapse, the full 15% export tax has always been applied.

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 attacked the deal as a "sell-out"[25] 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.

[24] "U.S., Canada Back Two-Year Extension of Softwood Lumber Agreement," *Inside U.S. Trade*, August 4, 2011.

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

## Arbitration

In April 2007, the United States requested consultations with Canada on various aspects of the agreement. The United States sought clarification of several forest sector assistance programs providing grants, loans, and tax credits by the Canadian federal government and the provinces of Quebec and Ontario. The United States has also expressed concern about the administration of the surge mechanism, claiming that Canada has not adjusted its export level triggers to reflect actual consumption in the United States market. If Canada had done so, the United States claims, additional export taxes would have been collected from lumber producers in British Columbia and Alberta, provinces subject only to export taxes, and the quota would have been lowered for provinces using the mixed quota-export system (Ontario and Quebec). On August 13, 2007, the United States made a formal request for arbitration on the export tax-quota issue and submitted its first written arguments on October 19. On March 4, 2008, the London Court of International Arbitrators agreed with the United States that Canada had not adjusted the trigger (surge) levels in a timely manner, disagreeing with Canada's contention that the adjustment triggers were intended to take effect on July 1, 2007, rather than January 1 of that year. However, the arbitrators also decided that the western provinces that collect only export taxes did not have to adjust their trigger volumes based on a reading of the SLA. Because of this, Canada did not have to collect an extra $75 million in export taxes from B.C. and Alberta. The arbitrators, whose ruling is final, rejected the U.S. position that such adjustments had to be made regardless of whether the provinces used the export tax or export tax and quota option.[26]

To cure the breach for the failure of Canada to operate its adjustment mechanism from January 1, 2007, the parties again resorted to arbitration. On February 26, 2009, LCIA decided that Canada must impose an extra 10% ad valorem tariff on Eastern Canadian shipments until C$68.26 million) is collected as compensation. After failing to 'cure the breach' within the time allotted by LCIA (March 28, 2009), Canada offered C$46.7 million ($36.66 million)—the amount the United States claimed as its industry's loss—directly to the United States. In response, the United States levied 10% tariffs on affected softwood shipments to raise the amount of compensation ordered by the LCIA. Meanwhile, Canada has sought arbitration over its offer to cure the breach.[27]

In January 2008, the United States also requested arbitration over six provincial forest sector assistance programs in Quebec and Ontario, programs that the United States believes contravene the anti-circumvention provision of the SLA. In January 2011, the LCIA found certain of these programs breached the SLA, and Canada began imposing additional charges on lumber from Quebec and Ontario for the duration of the agreement.

Also in January 2011 the Administration sought arbitration under the SLA over certain timber grading practices in British Columbia. They claim that the BC government has been classifying an increasing amount of its cut as salvage Grade 4 lumber and charging less for it than better grades, resulting in a subsidy for Canadian timber processors. Canada attributes this increase to an infestation of mountain pine beetles, but U.S producers dispute this, claiming that BC has

[26] "Softwood Lumber Arbitration on Surge Provisions Yield Split Decisions," *Inside U.S. Trade*, March 7, 2008; "Canada, U.S. Continue to Disagree Over Arbitration Ruling on Softwood Lumber," *International Trade Reporter*, March 6, 2008.

[27] "United States to Impose Customs Duties on Some Softwood Lumber from Canada," *International Trade Reporter*, April 7, 2009.

changed its grading procedures and is heating lumber prior to grading, resulting in greater cracks and defects.

Some members of Congress have criticized the enforcement of the SLA. For example, Senator Snowe has called for a licensing system to require that importers of Canadian lumber certify that shipments are entering in compliance with the SLA.[28] On April 17, 2008, U.S. Customs and Border Protection issued a final rule that prescribes the collection of certain entry data for lumber imports to the United States in order to monitor compliance with the SLA.[29] The 2008 farm bill (P.L. 110-246, Title III) requires the U.S. Department of Agriculture to establish a program for importers to declare on customs forms that their imports comply with the relevant softwood lumber import programs.

## Country of Origin Labeling

The 2002 farm bill required retailers to provide country-of-origin labeling (COOL) for fresh produce, red meats, seafood, and peanuts. The requirements for seafood were implemented on September 30, 2004, but COOL requirements for other products were delayed until September 30, 2008. The 2008 farm bill, The Food, Conservation, and Energy Act of 2008 (P.L. 110-246), reaffirmed this timetable and added goat meat, chicken, ginseng, pecans, and macadamia nuts as covered commodities. Canada claims the rule is a non-tariff barrier that has led to a steep drop in beef and hog shipments to U.S. processors. A final rule was issued on January 15, 2009, effective March 16, 2009. In November 2009, the WTO established a dispute settlement panel to hear challenges to COOL from Canada and Mexico, and a confidential interim report issued in May 2011 reportedly found that COOL discriminated against imported livestock and violated the WTO's Technical Barriers to Trade Agreement.[30]

## Buy American Stimulus Provisions

The Buy American provision of the American Recovery and Reinvestment Act of 2009 (ARRA, Sec. 1605, P.L. 111-5) states that no funds shall be appropriated for building projects or public works projects unless all the iron, steel, and manufactured goods are made in the United States. This provision was subject to three discrete waivers: (1) applying this policy would not be in the public interest, (2) the iron, steel, or manufactured products are not produced in sufficient quantities or of a satisfactory quantity in the United States, or (3) the inclusion of the applicable U.S. products would increase the cost of the overall project by more than 25%. The Senate added language to ensure that the provisions are applied in a manner consistent with U.S. trade obligations.

With regard to Canada, the United States has undertaken government procurement obligations under the World Trade Organization's (WTO) Agreement on Government Procurement (AGP) and under the North American Free Trade Agreement (NAFTA). The AGP is a plurilateral

[28] "Snowe Discusses Softwood Lumber Issues at Pleasant Valley Lumber Facility in Dover-Foxcroft," Press Release, March 17, 2008.

[29] "Entry of Softwood Lumber Products from Canada," 73 *Federal Register* 20782, April 17, 2008.

[30] "Mexico, Canada Prevail Over U.S. in WTO Country of Origin Fight," *Inside U.S. Trade*, June 3, 2011.

agreement that only binds those WTO members that agreed to undertake obligations under it. Furthermore, the AGP only applies to the sectors and the procurement agencies that the national government and sub-national agencies includes in its schedule of national commitments. NAFTA contains similar commitments on the national level, but excluded sub-national entities.

Both the United States and Canada have undertaken extensive obligations to open their government procurements at the national level under both agreements. Thus Canada firms may bid on ARRA-related federal procurement under the provisions of the AGP. Under the AGP, 37 U.S. states as well as other government entities such as the Tennessee Valley Authority and the Port Authority of New York and New Jersey have made commitments under the AGP. By contrast, Canada has not undertaken any government procurement obligations on behalf of its provinces. Likely for this reason, guidance from the Office of Management Budget implementing the Buy American provisions excluded Canadian firms from bidding on ARRA-financed contracts that are tendered by the states that are party to the agreement.[31]

The United States and Canada started negotiations to resolve this dispute over ARRA procurement access in August 2009. The resulting agreement, which became effective on February 16, 2010, waives the Buy American provisions for Canadian firms bidding for ARRA contracts tendered from seven federal programs in the 37 states that participate in the AGP until September 30, 2011. In return, Canada's provinces and territories will become signatories to the AGP, opening procurement opportunities to U.S. firms. This agreement will only affect procurement tenders yet to be awarded; this action will not reopen existing contracts. The agreement also commits the parties to begin negotiations reciprocally to expand commitments for market access in procurement between the two countries. The ability of Canadian firms to benefit from the immediate terms of the agreement may depend on the value of the stimulus projects that have yet to be awarded.

## Intellectual Property Rights

In 2011, the U.S. Trade Representative again listed Canada on its Special 301 report on intellectual property rights protections to the priority watch list for intellectual property rights protections.[32] The priority watch list indicates that the listed trading partner has problems with respect to IPR protection, enforcement, or market access for persons relying on intellectual property and that these problems merit "increased bilateral attention." In this designation, Canada joins such notorious IPR violators as China and Russia. The United States again urged Canada to implement the World Intellectual Property Organization's Copyright treaty, which has been signed but not ratified by Canada.[33] The United States also expressed concern about trade in pirated and counterfeit goods in Canada, as well as weak enforcement and relatively lax penalties for IPR. infringement. 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 by customs agents without a court order.

[31] Office of Management and Budget, "Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009, April 3, 2009. pp. 160-166.

[32] United States Trade Representative, 2011 Special 301 Report, p. 27, available at http://www.ustr.gov/webfm_send/2841.

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

The government introduced a new Copyright Modernization Act (C-32) in June 2010, which is intended to bring Canadian copyright law into conformance with the WIPO Internet treaties and allow for some format shifting and fair-dealing (fair-use) exceptions, but would prohibit the circumvention of digital protection measures. It would clarify the rights and responsibilities of internet service providers for infringement of their subscribers. While the business community and entertainment industries generally have supported these measures, opponents claim that any benefits derived from fair-use or format shifting are nullified by the prohibition on breaking digital locks.[34] This legislation died with the dissolution of the 40th Parliament in May 2011, but the Government is expected to reintroduce this legislation in the current session of the new Parliament.

# 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.[35] 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.[36] The total midrange figure, $10.3 billion, reflected 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."[37] However, a July 2007 study indicated that increased border security has not affected Canadian export volumes to the United States through most land ports, although the study found evidence that substitution between ports may have occurred.[38]

## Western Hemisphere Travel Initiative (WHTI)

A provision of the Intelligence Reform and Terrorism Prevention Act of 2004 (P.L. 108-458), the WHTI required all travelers from Canada and Mexico to present a passport or another form of secure documentation to enter the United States starting January 1, 2007, for air travelers, and

[34] "Bill Would Update Canadian Copyright Act To Respect Needs of Digital Age, Official Says," *International Trade Reporter*, June 10, 2010.

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

[36] Ibid.

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

[38] Conference Board of Canada, *Tighter Border Security and Its Effect on Canadian Exporters*, June 2007.

starting a year later for land passage. Currently, most land travelers enter with a driver's license or other form of government identification. While travelers could use existing passports to cross the border, estimates vary widely on how many citizens of each country hold them. In response, the Department of Homeland Security (DHS) and the Department of State (DOS) announced the establishment new form of identification known as the People Access Security Service (PASS) card. This card would resemble many current driver's licenses, but would contain a biometric identifier and provide documentation of citizenship. Concerns have been expressed by the Canadian government, by some business organizations on both sides of the border, and by some members of Congress that the measure will impede travel and trade on the northern border. Some fear that many border-area residents will not obtain the PASS card and will no longer make routine trips across the border as they do currently.

WHTI came into effect on June 1, 2009. The Department of Homeland Security (DHS) has been working with the Canadian government to develop a secure, alternative document such as a driver's license containing enhanced biometric information. Currently, such enhanced licenses are being issued by the provinces of British Columbia, Manitoba, Ontario, and Quebec, and by the states of Michigan, New York, Vermont, and Washington. In March 2011, the Government Accountability Office (GAO) reported a greater than 95 percent compliance rate with WHTI requirements in FY2010.[39]

## 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 four pillars: the secure flow of people, 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, TX, on March 24-25, 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.[40] The leaders met again in Cancun, Mexico, in March 2006, Montebello, Quebec in August 2007, and New Orleans, LA, in April 2008.[41] The Obama Administration has affirmed its commitment to continue past efforts on North American cooperation in meeting with neighboring leaders but under a different approach from the SPP framework.

Such cooperation may be continued on a bilateral basis through the Beyond the Border Declaration. This declaration, signed by the United States and Canada in February 2011, sets out a shared vision for perimeter security and economic competitiveness. The declaration pledges the two countries to agree to focus on improved information sharing and joint threat assessments; to develop infrastructure investment to accommodate continued growth in commercial and

[39] U.S. Government Accountability Office, *Border Security: DHS Progress and Challenges in securing the US Southwest and Northern Borders*, GAO-11-508T, March 30, 2011, p. 6, http://www.gao.gov/new.items/d11508t.pdf.

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

[41] For further information, see CRS Report RS22701, *Security and Prosperity Partnership of North America: An Overview and Selected Issues*, by M. Angeles Villarreal and Jennifer E. Lake.

passenger traffic; to work to integrate cross-border law enforcement operations; and to strengthen shared cyber-infrastructure.[42]

**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 (PIP) Program. Participants of these programs undertake audit-based compliance measures to enhance security along the supply chain and receive certification as low-risk shippers. Since 2003, CBP has validated over 6,900 companies in the C-TPAT program.[43] 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 21 high-volume land ports of entry on the northern border. According to CBP, more than 87,000 commercial drivers were enrolled in the program as of April 2008.[44]

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 utilized by 265,000 participants and was operational in 16 high-volume border land crossings, 8 airports in Canada, and 33 marine crossings by January 2009.[45] Also, according to CBP, the NEXUS card will constitute a valid form of identification for the WHTI.

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. 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

[42] Beyond the Border Declaration, February 4, 2011, http://www.whitehouse.gov/the-press-office/2011/02/04/declaration-president-obama-and-prime-minister-harper-canada-beyond-bord.

[43] U.S. Customs and Border Protection (CBP), Customs-Trade Partnership Against Terrorism: A Year in Review, January 31, 2008.

[44] CBP, Free and Secure Trade Factsheet, http://www.customs.gov/linkhandler/cgov/newsroom/fact_sheets/travel/fast/fast_fact.ctt/fast_fact.pdf.

[45] CBP, NEXUS Factsheet, http://www.customs.gov/linkhandler/cgov/newsroom/fact_sheets/travel/nexus_fact.ctt/nexus_fact.pdf.

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. However, negotiations to implement a pilot program at the Peace Bridge crossing at Buffalo-Fort Erie broke down in April 2007. A 2008 GAO report cited disagreements over arrest authority, fingerprinting practices, and the right of individuals to withdraw an application to enter the United States while at the preclearance station. The Obama administration reviewed this decision, but in August 2009 Secretary Napolitano announced that negotiations to construct a preclearance site adjacent to the Peace Bridge would not be reopened.

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 three 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. The FAST system provides for dedicated lanes at land border ports for expedited preclearance. However, these lanes will not save time if the FAST participant cannot access this lane due to congestion or delays at the points of access. The SPP completed a pilot program that attained a 25% improvement in border crossing times at the Detroit-Windsor gateway in December 2005, yet the aging and adequacy of the border infrastructure may affect whether such improvements are sustainable. The new Detroit River International Crossing (DRIC) south of the Ambassador Bridge between Zug Island on the Michigan shore and Brighton Beach, Windsor, received the approval of the Federal Highway Administration on January 14, 2009. The DRIC proposal is supported by the Canadian government, which believes the a new span should not be privately held. To this end, Canadian Transport Minister John Baird has offered to loan the state of Michigan $550 million to fund its share of the new bridge, the total cost of which is expected to be $5.3 billion. Incoming Michigan governor Rick Synder endorsed the construction of the bridge in January 2011 and a bill creating a bridge authority is awaiting consideration by the Michigan legislature. Meanwhile, the owner of the Ambassador Bridge, the principal opponent of the new crossing, has brought a North American Free Trade Agreement (NAFTA) investor-state dispute over his contention that the proposed rival bridge would divert traffic (and tolls) from his bridge.

# Prospects and Policy Options

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

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.[46] This realization has led to many border initiatives described above.

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

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.[47]

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.[48] 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. In June 2006, the three nations launched a North American Competiveness Council, which is made up of business leaders from each nation who will examine proposals and provide recommendations to improve the competitiveness of North American business in global markets.

## 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.

## 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

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

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

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 likely would be small.

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