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The Border Papers

U.S. Bilateral Free Trade Accords:

Why Canada Should Be Cautious About Going the Same Route

Danielle Goldfarb

In this issue...

The recent wave of U.S. bilateral free trade agreements will have relatively minor effects on Canadian interests. Ottawa should be cautious about pursuing a set of free trade agreements of its own.

The Study in Brief

Ottawa has expressed concern that the recent wave of U.S. bilateral free trade agreements dilutes Canada's tariff-free access to the U.S. market. This Commentary analyzes the effects of the U.S. bilateral free trade agreement strategy on Canadian interests. The U.S. agreements establish precedents and new rules without Canada at the table, and add to the "spaghetti bowl" of international trade rules. They may also undermine multilateral free trade efforts in which Canada has a large stake, and share Canada's duty-free access to the U.S. more widely. However, partner countries have economies marginal to Canadian interests and U.S. average duties are low to start with, so the overall effects of current U.S. free trade agreements on Canadian interests are likely to be relatively minor.

The government's strategy in this context is to complete already opened, but currently stalled, free trade negotiations — mostly with minor economies — and to open new free trade negotiations with select partners. While the political appeal of signing free trade agreements outside of North America is clear, this strategy is unlikely to result in large economic gains for Canada. Such accords will make the trading system more complicated, expending significant government resources for the prospect of a marginal benefit of which businesses may not even take advantage.

A better strategy would overwhelmingly focus on attaining secure, predictable access to the U.S. market, and providing continued support for the current WTO Round, including removing remaining tariff and non-tariff barriers, rather than continuing to protect certain industries at the expense of other industries' market access.

If policymakers are determined to proceed with free trade accords, Canada should try to engage large markets in comprehensive accords that reinforce multilateral efforts. Canada could use the negotiated U.S. agreements as a basis for striking its own deals. Where Canadian and U.S. interests coincide, and if countries with large economies are interested, Canada could carefully consider negotiating future agreements with the U.S. Then traders would face only one set of rules for Canada and the U.S. and Canada would be one of the few places where businesses can have free access to two large economies.

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In its 2005 International Policy Statement, Ottawa expressed concern that the flurry of recent U.S. free trade agreements is diluting Canada's once nearly exclusive access to the United States market. The federal government is responding in part by trying to negotiate a set of free trade agreements of its own.[1] Canadian policymakers should approach that route with caution.

This Commentary briefly discusses the implications for Canada of a trading system riddled by overlapping free trade agreements. It focuses in particular on the implications of the U.S. bilateral free trade agreement strategy for Canadian interests because of the overwhelming importance of the U.S. market for Canadian prosperity. It also considers the merits of Canada's available trade strategies in the face of U.S. and other bilateral trade accords.

The U.S. agreements spread Canada's duty-free access more widely, establish precedents and new rules without Canada at the table and possibly undermine multilateral and regional trade liberalization efforts in which Canada has a large stake. However, because these agreements are with marginal economies, the overall effects of current U.S. free trade agreements will be relatively minor to Canadian — and U.S. — economic interests.

Ottawa's current trade approach in this context is to complete already initiated free trade negotiations, while considering new opportunities. According to the International Policy Statement, the federal government plans to conclude stalled negotiations with the European Free Trade Association, Singapore, and four Central American countries. It recently opened negotiations with South Korea, and says it will open negotiations with the Caribbean Community, the Andean Community and the Dominican Republic. It is establishing a trade study with Japan that it hopes will lead to a free trade accord. And it is considering other targets (Sanford 2005; McKenna 2005). All of this is in addition to NAFTA and free trade agreements with Israel, Chile and Costa Rica.

The political appeal of signing bilateral free trade agreements outside of North America is strong; however such a strategy is likely to yield only marginal and declining gains relative to the high costs of negotiation and implementation. It will not reduce the risks posed by the U.S. approach, and might divert attention from more important priorities. Businesses have not responded in the past to initiatives to increase economic linkages outside of the U.S. and it is not clear that they will act any differently in the future.

Ottawa could pursue a better, more coherent strategy by focusing its limited resources in areas where payoffs to Canadian interests are likely to be greatest. The expected gains from global free trade will be much larger than from smaller accords and, as a result, Canada should maintain its support for the current round of World Trade Organization (WTO) negotiations and, to a lesser extent, for the stalemated Free Trade Area of the Americas (FTAA) process. Canada's limited influence over these efforts, however, makes it essential that the government

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1 The concerns about dilution of preferential access in the U.S. market and Ottawa's intended response are also captured in McKenna (2005).

concentrate its attention overwhelmingly on attaining secure, predictable access to the U.S. market.

If the U.S. pursues a free trade agreement with a large economy, Ottawa might carefully consider negotiating jointly with the U.S. to reduce overlapping rules and so that businesses in Canada will have free access to two large economies. If Ottawa intends to pursue its own bilateral free trade agreements, it should aim for large or otherwise strategically important markets and press for eliminating barriers to goods, services and investment, while not undermining Canada-U.S. multilateral or regional efforts.

Where We Are Now

This section explores Canada's trade and investment situation, national interests and recent trade policies.

Canada's Situation

Canada's relatively small domestic economy depends critically on international trade for its prosperity. Because of its gradual reduction of tariff rates during many years of multilateral trade liberalization, the country has a relatively open economy. Only a few sectors, such as dairy, textiles and shipbuilding, are still protected by high duties. Despite such an open economy, and the economic expansion of China and other Asian countries, Canada trades little outside of its immediate region. Table 1 highlights the inescapable fact that Canada's international trade is overwhelmingly directed to and from the U.S. market and that Canada's next largest export destination (Japan) accounted for just over 2 percent of Canadian exports in 2004. The limited available trade data indicate that Canada is not currently a significant part of supply chains outside of North America.[2]

Access to the U.S. market has been mostly tariff-free since the Canada-U.S. Free Trade Agreement came into force in 1989. Still, there are non-tariff barriers between Canada and the U.S. that reduce potential trade gains. Non-tariff barriers that remain include regulatory differences,[3] new security requirements, persistent trade penalties in certain sectors, and rules of origin.[4] Such barriers are inconsistent with the reality of a common economic space, with goods moving across the border in various stages of production. On average, one-third of

2 The traditional data do not capture foreign affiliate activities, so if such activities play a relatively more important role in Canada's activities outside of North America, then Canada's role in global supply chains may be understated. What is not in question, however, is the overwhelming importance of the U.S. market for Canadian trade.

3 The federal government intends to address regulatory differences through its Smart Regulation initiative, as well as through the Canada-U.S.-Mexico Security and Prosperity Partnership.

4 Origin rules are required in all free trade agreements and determine whether goods originate in the partner countries and are therefore eligible to enter duty-free. The rules complicate trade and may reduce companies' ability to compete globally by discouraging the use of non-NAFTA inputs even if those components are the lowest-cost ones. This is likely to become more important as companies draw increasingly on global components. NAFTA governments are working to simplify these rules.

Table 1. *Canadian Trade and Investment by Country, Top Export Recipient Countries*

Country	Goods Exports to Country as Share of Total, 2004 (%)	Goods Imports from Country as Share of Total, 2004 (%)	Foreign Direct Investment (FDI) in Canada by Country as Share of Total FDI in Canada, Average, 2000-2004 (%)	Canadian Direct Investment in Country as Share of Total Canadian Direct Investment Abroad, Average, 2000-2004 (%)
United States	84.8	59.4	63.7	45.4
Japan	2.2	3.8	2.6	2.2
United Kingdom	1.9	2.7	7.8	10.1
China	1.6	6.8	0.1	1.5
Mexico	0.7	3.8	0.06	0.7
Germany	0.6	2.7	2.0	1.9
South Korea	0.6	0.2	0.1	0.2
France	0.5	0.3	9.2	2.1
Belgium	0.5	0.4	0.9	0.9
Italy	0.4	0.2	0.3	0.5
Netherlands	0.4	0.4	4.2	2.7
Australia	0.4	0.5	0.5	1.8
Norway	0.4	1.4	0.7	0.1
Hong Kong	0.3	0.2	1.2	0.7
Taiwan (Taipei)	0.3	1.1	0.03	0.0
Spain	0.3	0.4	0.1	0.4
Brazil	0.2	0.7	0.3	1.7
India	0.2	0.4	0.01	0.05
Indonesia	0.2	0.4	x	1.2
Saudi Arabia	0.1	0.3	x	0.05
Singapore	0.1	0.3	0.03	1.0

Note: Export shares exclude re-exports.

x = Suppressed to meet the confidentiality requirements of the *Statistics Act*.

Sources: Industry Canada Trade Data Online and Statistics Canada.

Canadian exports are imported and then re-exported as part of a more processed good or service (Cross 2002). Such intermediate inputs are subject to barriers each time they cross a border, multiplying the effect of even minor obstructions.

Outside of Canada's immediate neighbourhood, global tariff barriers have declined on average as a result of negotiations within the WTO and predecessor organizations. Canadian businesses have reasonably good access for industrial goods in developed markets, though providers of goods and services still face non-tariff trade and investment barriers, including technical and regulatory impediments.[5]

Foreign direct investment reinforces trade, as multinational companies, operating along global supply chains, set up subsidiaries that trade goods and services. While Canada has maintained its share of the rapidly growing global stocks of direct investment abroad, its share of inward direct investment has fallen steadily over the past 30 years (Hejazi 2004). As well, most two-way flows are with the United States rather than with other large markets that are important for global supply chains. For example, Canada's foreign direct investment in China represents only 1.5 percent of its total and China's direct investment in Canada represents a miniscule 0.1 percent of total direct investment in Canada, as Table 1 shows.

5 International Trade Canada's (2005) report on market access priorities catalogues remaining barriers.

Canadian Interests

Enhancing Canadian prosperity is a vital national interest because the well-being of its citizens depends on it. Canada also has an interest in a prosperous and stable world. As a result, Canada has a large stake in an open economy with barrier-free, secure, predictable, rules-based access to foreign markets, particularly to the U.S. Canada has a strong interest in participating in exercises that improve rules for simple, predictable, freer market access for goods, services, capital and people. It has a large stake in being at the bargaining table when such rules are created. Unlike the U.S., Canada's interests in trade policymaking are primarily economic rather than geo-political.[6] A broader trade deal with one set of rules is far preferable for Canada than being caught in an overlapping set of agreements with different requirements.

Canada has limited expertise and political energy to devote to negotiating and implementing trade accords. The country therefore has an interest in pursuing strategies that will yield large payoffs in terms of advancing its interests. Though multilateral negotiations are moving slowly, economic gains from multilateral trade liberalization will always be superior to those from preferential trade arrangements.[7]

Canadian Trade Policy

Gaining secure, predictable, rules-based access to the U.S. market motivated Canada's signing of the original free trade agreement with that country in 1988 as well as joining Mexico-U.S. negotiations that led to signing NAFTA in 1993. Canada's interest in common trade and investment rules that create predictability have motivated the country's historically strong support for multilateral trade liberalization and also for the FTAA process. That support for multilateralism and western hemispheric free trade continues, as does attention to securing access to the U.S. market. The latter includes the March 2005 announcement of the trilateral Security and Prosperity Partnership of North America and its related June 2005 progress report. It is still not clear how ambitious this initiative is or will eventually become.

During the 1990s and early years of this decade several countries or sub-regional groupings approached Canada to seek free trade agreements. As a result, Canada either opened, or publicly announced it was considering opening, negotiations with nine countries, adding to an incoherent and unfocused list that did not seem to coincide with major Canadian economic interests. Table 2 compares proposed and negotiated bilateral and sub-regional free trade

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6 According to the federal government, Canadian trade policy reflects the government's pursuit of three objectives: 1) prosperity through foreign market access, import competition, and two-way investment flows; 2) rules that provide fair and predictable conditions, and 3) support for broader political goals (DFAIT 2003).

7 This is because free trade agreements may both create trade that would not have existed otherwise and divert it from low-cost suppliers outside of the agreement to high-cost suppliers inside it. With global trade liberalization, no countries are excluded, so no trade can be diverted and trade creation benefits are spread over a wider domain than is the case with smaller accords.

Table 2: *U.S. and Canadian Bilateral and Sub-Regional Free Trade Agreements*

Country or region	United States	Canada
Andean Community (Bolivia, Colombia, Ecuador, Peru, Venezuela)	Negotiating with Colombia, Ecuador, Peru since 2004; Bolivia to be added later	Considering with all Andean countries since 2002
Australia	Yes, signed 2004	No, but Commonwealth preferences apply
Bahrain	Yes, signed 2004	No
Canada	Yes, signed 1988, superseded by NAFTA signed 1993	N/A
Caribbean Community (CARICOM)	No, but preferences apply under Caribbean Basin Initiative	Considering since 2001
Central America	Signed 2004 with Central America-5 (El Salvador, Guatemala, Honduras, Nicaragua, Costa Rica) and Dominican Republic	Negotiating since 2001 with Central America-4 (El Salvador, Guatemala, Honduras, Nicaragua); separate FTA with Costa Rica
Chile	Yes, signed 2003	Yes, signed 1997
Costa Rica	Part of Central America-5	Yes, signed 2001
Dominican Republic	Signed 2004 (joined Central America agreement)	Considering since 2002
European Free Trade Association	No	Negotiating since 1998
European Union	No	Negotiating "trade and investment enhancement agreement" since 2004
Israel	Yes, signed 1985	Yes, signed 1996
Jordan	Yes, signed 2001	No
Mexico	Yes (NAFTA), signed 1993	Yes (NAFTA), signed 1993
Morocco	Yes, signed 2004	No
Oman	Negotiating since 2005	No
Panama	Negotiating since 2004	No
Singapore	Yes, signed 2003	Negotiating since 2001
South African customs union	Negotiating since 2003	No
South Korea	In preliminary talks since 2005	Negotiating since 2005
Thailand	Negotiating since 2004	No
United Arab Emirates	Negotiating since 2005	No
United States	N/A	Yes, signed 1988, superseded by NAFTA, signed 1993

Sources: U.S. Trade Representative website and Department of International Trade Canada website.

agreements for both the U.S. and Canada. Outside NAFTA, Canada concluded only three agreements — with Israel, Chile and Costa Rica. These three countries together accounted for about 0.25 percent of Canadian goods exports in 1996 (before the agreements were signed), and they buy even less today (0.20 percent in 2004).

Three other negotiations have stalled. Canada launched free trade negotiations with the European Free Trade Association (Iceland, Norway, Switzerland and Lichtenstein) in 1998 and with Singapore and the Central America-4 countries (El Salvador, Guatemala, Honduras and Nicaragua) in 2001. The European Free Trade Association and the Central America-4 negotiations are stalled over Canada's unwillingness to lower shipbuilding and textile tariffs, respectively. The reasons for the delay in completing the Singapore agreement have not been made public. Canada is apparently holding out for an agreement commensurate with the U.S.-Singapore free trade accord (Box 1 examines the U.S.-Singapore agreement and selected other U.S. agreements). In the 2005 International Policy Statement, Canada committed resources to concluding these agreements soon, though the government has not yet scheduled any official negotiating rounds. These three groupings accounted for less than three-quarters of a percent of Canadian exports in 2004, though this does not include services or sales by foreign affiliates, nor does it reflect potential future exports.

At the same time, Canada has been formally considering three other free trade agreements since the early 2000s. None have advanced. One is with the Caribbean community (CARICOM), which Prime Minister Paul Martin committed to begin negotiating by the end of 2005, and the others are with the Dominican Republic and the Andean countries. According to International Trade Canada's website, the country's stated rationale for pursuing these arrangements is that they could strengthen peace and democracy, contribute to development within the Western Hemisphere and provide added impetus for the FTAA. Taken together, these three potential partners accounted for less than 0.5 percent of Canadian exports of goods in 2004.

Though there is no publicly available information on human and financial resources devoted to these agreements, it is clear that analyzing, negotiating and implementing them is resource-intensive. Canada likely devoted numerous resources over the last number of years to these nine agreements with countries that together accounted for only 1.4 percent of its goods exports in 2004.

In addition to completing the agreements already opened, Ottawa now intends to pursue a new series of free trade agreements. In response to South Korea's request, Canada began negotiations in July 2005 on a free trade accord with that country.[8] Canada is also conducting a trade study with Japan that Ottawa expects will "serve as a stepping stone to additional bilateral efforts and to realizing the full potential of our economic relationship with Japan" (Government of Canada 2005), meaning that Ottawa hopes it will lead to free trade discussions. As Table 1 shows, the two countries together represent destinations for less than 3 percent of Canadian goods exports, though this does not take into account their roles in global supply chains.

8 The Canadian auto and shipbuilding sectors are protesting.

The federal government is pursuing tools other than free trade agreements to advance other bilateral interests. Officials are putting together an emerging markets strategy to capitalize on opportunities in China, Brazil and India, though the complete substance of this initiative is not yet clear. Ottawa is also working on a Trade and Investment Enhancement Agreement with the European Union (EU), which will address more than traditional market access issues, but likely be much thinner in substance and scope than a comprehensive free trade agreement.

Overall, to an outside observer, except for the focus on Canada-U.S., multilateral and regional efforts, Canada's general trade strategy in recent years appears unclear and unfocused.

The Trading System and Proliferation of Free Trade Agreements

Canada's strategy should be evaluated in the context of the proliferation of free trade accords globally. Such agreements have multiplied in recent years, with Japan, China and the U.S. as the largest countries to pursue numerous accords. Many countries — even those that traditionally supported multilateralism — are making these accords the centerpiece of their trade policies.

Countries have signed over 300 free trade agreements and other preferential agreements,[9] more than half of which were completed between 1994 and 2004 (Consultative Board 2005, p. 21). In general, free trade agreements eliminate tariffs among members, while parties to the accord may still charge duties to non-members. The various arrangements differ considerably in scope, product coverage and the degree to which they have actually been implemented. Some liberalize significantly; others are friendship gestures with little substance.

Mexico has signed over 10 bilateral and sub-regional free trade agreements in addition to NAFTA, including one with the European Union. It is also in the process of negotiating an accord with Japan and has signaled its intention to apply for associate membership in MERCOSUR (Brazil, Argentina, Uruguay and Paraguay). Chile has free trade agreements with the U.S., Canada, Mexico, Korea, Central America and the European Free Trade Association, and is negotiating accords with China, India, New Zealand and Singapore. The EU has more than 25 arrangements (Kerr 2005), including free trade agreements with countries in Eastern Europe that are not already members, as well as Africa, Asia and Latin America. The EU has said it will not sign new free trade accords during the WTO Doha Round, in contrast to the U.S. and Canada.

China's recent free trade agreement with the Association of Southeast Asian Nations (ASEAN) — Singapore, Malaysia, Indonesia, Philippines, Brunei Darussalam, Cambodia, Laos, Myanmar, Thailand and Vietnam — has spurred a wave of free trade agreement talks in Asia. Japan recently signed agreements with Singapore, Mexico, the Philippines and Malaysia and is currently in talks with Indonesia, Thailand and ASEAN. Singapore had already signed a number of its own free trade accords, including with the U.S., Australia and the European Free Trade Association. India is also actively engaged in preliminary free trade talks

9 In addition to free trade agreements, other preferential arrangements include customs unions, common markets and unilateral preferential treatment granted to developing countries.

with other countries in Asia and is negotiating with MERCOSUR (Crawford and Fiorentino 2005). South Korea has targeted 50 countries for bilateral free trade accords and is negotiating with countries such as Canada, Mexico, India and Japan and with sub-regional groupings, such as ASEAN. China began free trade talks with Australia in May 2005 and, according to Antkiewicz and Whalley (2004), is having preliminary discussions on possible free trade accords with India, Chile, Singapore, South Africa and the Gulf Cooperation Council.

The U.S. Free Trade Accords

While Canada and Mexico had almost exclusive tariff-free access to the U.S. market in the 1990s under NAFTA, that has now changed. In the last few years, the U.S. has aggressively pursued a series of bilateral and sub-regional free trade accords. It has been able to do that because in 2002, Congress gave the President the authority — called Trade Promotion Authority — to negotiate trade agreements that Congress can vote up or down, but not amend.[10] The U.S. strategy marks a significant departure from historical U.S. policy in which preferential agreements were exceptions to the U.S. approach of treating all trade partners equally (Weintraub 2004).

The U.S. has completed new agreements (Table 2) with: Chile, Singapore, Central America-5 and the Dominican Republic,[11] Australia, Morocco and Bahrain. Negotiations are under way with 12 more countries: Panama, three of the Andean countries (Colombia, Peru and Ecuador), Thailand, the five nations of the Southern African Customs Union, of which South Africa is the largest, as well as the United Arab Emirates and Oman. Washington is also in preliminary talks with South Korea, and is considering bringing Bolivia, an observer at the current U.S.-Andean talks, into an Andean agreement at a later date.

Geo-political rather than economic factors largely explain the U.S. choices (See Box 2 for U.S. criteria for signing free trade accords). For example, the U.S. signed free trade agreements with Bahrain and Morocco and is negotiating with Oman and the United Arab Emirates as part of a larger effort to democratize the Middle East. The country moved quickly to an agreement with Australia based on that country's support for the war in Iraq, and backed away from one with New Zealand after it did not support the U.S. position. The U.S. is trying to isolate Brazil, its antagonist over key aspects of the FTAA, by offering trade accords to most Latin American countries except those in MERCOSUR. Strengthening efforts to control drug traffic alongside promoting stability and democracy, rather than economic considerations, dominate U.S. motivations for the trade arrangements with Central America and the Dominican Republic (Salazar-Xirinachs and Granados, in Schott 2004).

With regional and multilateral negotiations lagging, and willing partners lining up at the U.S.'s door, that country is unlikely to stop signing bilateral trade

10 This authority was extended automatically in June 2005 until June 2007 when neither the House nor the Senate adopted a resolution opposing the move.

11 The House of Representatives ratified the Central America-Dominican Republic agreement by a slim margin in July 2005. It passed the Senate earlier.

Box 1: *Selected U.S. Free Trade Agreements*[a]

Australia

The U.S.-Australia agreement, which came into effect in 2005, is the first U.S. free trade pact with a developed country since the Canada-U.S. free trade agreement. Australia is unlikely to see major overall benefits because the two countries are geographically distant, the agreement has exemptions, and both countries were relatively open to each other for manufactures before the free trade agreement. U.S. duties on sugar and some dairy products will not be eliminated at all. Tariffs on textiles and some other items will also be phased out over 10 years, similar to the length of phase-out periods under the Canada-U.S. agreement and NAFTA. Unlike NAFTA and the other new U.S. deals, at Australia's insistence its agreement does not permit investor-state suits in the event of disputes. The U.S.-Australia deal is also the first to include specific provisions for pharmaceuticals, requiring Australia to increase the transparency and accountability of its Pharmaceutical Benefits Scheme, a move intended to benefit U.S. pharmaceutical companies.

Singapore

Trade in goods was largely duty-free before the U.S.-Singapore agreement and both countries are relatively open to investment so large trade effects are unlikely. The U.S.-Singapore agreement is, however, important for its precedent-setting effect, since it is the first comprehensive bilateral U.S. free trade deal with an Asian country and is regarded as a prototype for U.S. accords in the region (Weintraub, in Schott 2004). The U.S. placed considerable emphasis on services including financial, telecommunications and professional services (architects, engineers and accountants). The deal also goes beyond NAFTA and the WTO in a number of areas including investment, competition policy, intellectual property rights, e-commerce and cooperation on customs procedures. It further includes labour and environment provisions.

Chile

The U.S.-Chile free trade accord goes beyond the WTO and NAFTA and is more comprehensive than the Canada-Chile free trade accord. It applies to a larger number of products, and unlike Canada's agreement, it includes standards and intellectual property provisions [b](WB and IBRD 2005). Intellectual property provisions limit the grounds for allowing compulsory licensing of medicines and effectively extend the 20-year term of drug company patent monopolies by five years. Under the U.S. agreement, Chile must also phase out its agricultural price band system — which adjusts tariffs to defend either a floor or ceiling price. The agreement includes labour and environment provisions and the U.S. also requires Chile to limit its use of capital controls.

[a]For a more thorough overview of U.S. free trade accords, signed or proposed, see GAO (2004).

[b]The Mexico-Chile free trade agreement also includes provisions in these areas.

agreements, at least until 2007 when the President's Trade Promotion Authority expires, and as long as the recent battle in Congress over the Central America-Dominican Republic agreement does not deter the U.S. or partner countries from proceeding. The only western hemispheric countries not lining up to sign a U.S. accord are the MERCOSUR countries, Venezuela, Cuba, and the small Caribbean Basin nations that already receive extensive trade preferences in the U.S. market. The queue of countries seeking to enter free trade negotiations includes Egypt,

Box 2: *U.S. Free Trade Agreement Selection Criteria*

In 2003, then-U.S. Trade Representative Robert Zoellick outlined criteria for selecting early free trade agreement partner countries. They were:

1. Congressional guidance;
2. U.S. business and agricultural interests;
3. U.S. special product sensitivities;
4. Level of seriousness of the country to undertake a comprehensive, pro-reform free trade agreement, including highest-level government involvement to product follow-through on negotiated commitments, the country's micro- and macro-economic reform record prior to negotiations, and the level of skill of the negotiating team (most important);
5. Level of cooperation with U.S. goals and adoption of a problem-solving approach in WTO and FTAA;
6. Ability of the free trade agreement to stimulate regional integration;
7. Ability of country to employ the free trade agreement negotiations to catalyze its own economic reform and development program;
8. Role of the free trade agreement in supporting civil society via its labour and environmental provisions and its effect on human rights and the level of openness in society;
9. Level of cooperation in U.S. national security and foreign policy interests;
10. The need to counter preferential agreements struck by others;
11. Need to have a balance among the regions of the world;
12. Need to have free trade accords with both developed and developing countries, and
13. Limited negotiating resources of U.S. and others.

The U.S. selects current free trade agreement partners based on six similar considerations:

1. Country readiness;
2. Economic or commercial benefit;
3. Benefits to the broader trade liberalization strategy;
4. Compatibility with U.S. interests;
5. Congressional and private sector support, and
6. U.S. government resource constraints.

Source: GAO (2004).

New Zealand, Pakistan, the Philippines, Sri Lanka, and Taiwan (Schott 2004), as well as Indonesia.[12]

Implications of U.S. Bilateral Accords

Because of the importance to Canada of access to the U.S. market and officials' concern about possible erosion of Canadian preferences in the U.S., this section focuses on the possible effects of the U.S. agreements, while briefly discussing the larger implications of a trading system burdened by overlapping free trade agreements.

12 The U.S. is unlikely to propose deals with central or eastern European countries that are waiting to join the EU.

Canada: A Spoke to the U.S. Hub

One of the consequences of the U.S. signing numerous bilateral agreements is that it creates a hub-and-spoke arrangement. Under such a system, the hub country — the U.S. — has duty-free access to all the spokes — countries with which the U.S. has signed free trade accords — while the spokes lack duty-free access to each other.

This is the type of hub-and-spoke arrangement that Canada sought to avoid when it signed NAFTA, enabling it to remain in the U.S. hub during the 1990s. If, instead of Canada joining the Mexico-U.S. free trade negotiations, the U.S. had signed a separate agreement with Mexico, the U.S. would have been a hub with Canada and Mexico as spokes. Both would have been at a disadvantage relative to the U.S. because they compete with it, but without having duty-free access to low-cost imports in the other spoke, as the U.S. hub would (Wonnacott 1990). The hub would have had improved access to the two spoke markets and could have bought duty-free, low-cost inputs from both, making it more attractive to all countries as an investment destination, and therefore making the spokes relatively less attractive.[13]

The recent signing of numerous U.S. free trade deals effectively puts Canada in the position of being, jointly with Mexico, one of many spokes to the U.S. hub, rather than in that hub. When the U.S. hub now looks out over the domain of its bilateral agreements it sees duty-free access to all partner countries, including duty-free access to low-cost components from these spokes. As a result it may be somewhat more attractive to foreign investors. When Canadians or potential investors in Canada view this same configuration, they see duty-free access to the U.S. and Mexico, but a labyrinth of trade restrictions in other markets. And as the U.S. hub adds new bilateral free trade agreements, each pre-existing spoke loses some of the value of its preference in the hub market because the hub's duty-free access is now available to a larger group of countries.

Adding in non-U.S. arrangements makes matters more complex. In addition to being part of a spoke in the U.S. context, Mexico is simultaneously a hub in its own hub-and-spoke arrangement, having signed agreements with many other countries, some of which, such as Chile and Singapore, are hubs of their own. That makes Canada and the U.S. together one spoke with Mexico at the hub, with challenges similar to the U.S. arrangement, though the Mexican economy is relatively less important than the U.S. economy and Canada still has duty-free access to the key U.S. market under the Mexican hub-and-spoke arrangement. A world of overlapping hubs and spokes is much less desirable for Canada than a system in which all countries have the same access globally.

A Spaghetti Bowl Trading System

Overlapping bilateral free trade agreements complicate international trade and undermine the transparency and predictability of the trading system (Crawford

13 The proliferation of bilateral investment treaties also creates hub-and-spoke arrangements that make investment in the hub market more attractive (Eden and Li 2004, p. 57).

Table 3: *Economic Size of, and Trade With, U.S. Free Trade Agreement Partners (Including Prospective Partners)*

Partner countries	GDP, 2003 (in $billions)	Total Trade* Between Between U.S. and Partner as Share of Total U.S. Trade, 2004 (%)	Total Trade* Between Canada and Partner as Share of Total Canadian Trade, 2004 (%)
Negotiated			
Canada	1168	19.1	N/A
Mexico	877	11.3	2.2
Singapore	128	1.5	0.2
Central America-Dominican Republic	117	1.5	0.2
Australia	726	1.0	0.4
Israel**	145	0.9	0.1
Chile	101	0.4	0.2
Jordan	14	0.1	0.01
Morocco	62	0.05	0.03
Bahrain**	11	0.03	0.00
In negotiations or about to begin			
Thailand	200	1.1	0.3
Colombia, Ecuador, Peru	232	1.0	0.2
South African customs union***	224	0.4	0.1
United Arab Emirates	99	0.2	0.1
Panama	18	0.1	0.02
Oman**	28	0.03	0.01
Prospective			
South Korea	847	3.2	1.1
Taiwan**	395	2.5	0.7
Philippines	113	0.7	0.2
New Zealand	107	0.2	0.1
Pakistan	96	0.2	0.1
Egypt	115	0.2	0.1
Sri Lanka	26	0.1	0.02
Bolivia	11	0.02	0.00
Indonesia	292	0.6	0.2

Sources: World Bank World Development Indicators 2004, U.S. International Trade Commission dataweb, and Industry Canada Trade Data Online.

*Total trade is the sum of imports and domestic exports.

**2002 GDP figures are used for these countries as 2003 data were unavailable.

***Figures are for South Africa only, which represents the predominant share of the South African customs union.

and Fiorentino 2005). Each new accord creates another set of rules, hindering trade in intermediate goods and detracting from Canada's interests in a simple, predictable trading system. This leads to what trade economist Jagdish Bhagwati calls the "spaghetti bowl" of preferential trade agreements.[14]

Under multiple bilateral trade agreements, many tariff rates are applied to many trading partners. Each agreement also has its own set of origin rules and U.S. accords, in particular, have highly restrictive origin rules.[15] The U.S. free trade agreement with Singapore includes over 200 pages on origin rules alone. With overlapping rules and tariff rates, businesses and governments must devote more

14 For a picture of the messy spaghetti bowl of overlapping free trade accords signed, proposed, or under negotiation in the Americas and Asia, see Devlin and Estevadeordal (2004).

15 The origin rule complication does not apply to such dimensions as services and investments that are addressed in recent U.S. and other free trade agreements.

resources to figuring out, applying and enforcing them. If the rules are overly complex or restrictive, companies may pay the tariff rates non-free trade agreement partners are subject to in order to avoid origin rules altogether, forgoing the benefit of tariff-free access entirely.

Marginal Effects on Canada's Preferred Access to U.S.

Canadian officials are concerned that "the competitive bilateralism of the U.S. in pursuing a host of new free trade agreements means our preferred access under NAFTA is being, to some extent, eroded" (Government of Canada 2005). However, the effects of current U.S. accords on Canada are likely to be marginal. As U.S. trade expert Schott (2004) notes, current U.S. agreements will likely bring only temporary economic advantage to the chosen countries — mostly by disadvantaging other developing nations — and minimal advantage to the U.S.

One reason the agreements are likely to matter little for Canadian interests is that the Canadian and U.S. economies essentially operate within a common economic space, especially for trade in goods. The new U.S. arrangements are with countries outside of the immediate neighbourhood of the United States. Though distance is now a less important consideration for trade, it still matters. For example, Australia's tariff-free access to the U.S. market for goods under the 2004 Australia-U.S. agreement does nothing to reduce the significant cost of shipping goods from that country to the United States. Canada still has the enormous benefit of proximity to the U.S. and an already highly integrated economic relationship. As well, just because governments agree to eliminate trade barriers it does not necessarily mean that their businesses will shift trade patterns in response.

In addition, the U.S. has generally signed agreements with economically marginal countries. Table 3, which shows GDP for the U.S. free trade agreement partners, and U.S. and Canadian trade with the selected countries, demonstrates that the current and prospective U.S. partners are relatively unimportant by these measures.[16]

Most countries on the list have relatively minor trade and investment relationships with the U.S., compared with Canada and Mexico, and most of them are also small in terms of GDP, with Australia and South Korea being the exceptions. Current trade figures do not necessarily indicate potential future growth, though even if trade between the U.S. and its new free trade partners increases significantly, volumes are unlikely to come anywhere close to Canada-U.S. trade.

Partner countries and the U.S. also invest little in each other relative to two-way Canada-U.S. investment. For example, U.S. direct investment in Canada is triple that of its stake in Singapore, which is the highest among U.S. non-NAFTA free trade partners.

16 New U.S. trade agreements may result in minimal trade losses for Canada. For example, Choi and Schott (in Schott 2004, p.192) estimate that if the U.S. signed a U.S.-South Korea free trade accord, Canada's exports of agricultural food and raw materials would fall in the short-run, all else equal.

Future agreements may also have only marginal effects because few large economies are both willing and able to engage in free trade discussions with the U.S. If the country does manage to find a viable and desirable major partner economy, the resulting hub-and-spoke arrangement could weaken Canada's competitiveness and investment attractiveness, though this appears unlikely in the near term.

Another important reason the agreements will have marginal effects is that the value of duty-free treatment gained under a free trade agreement with the U.S. is low and declines over time. The difference between the rate that U.S. free trade partners pay (nothing) and the rate that all other countries pay (the U.S. Most Favoured Nation rate) is low on average, as a result of years of multilateral tariff reductions. The agreements also contain restrictive rules of origin that can dilute the potential gains from duty-free trade. Further, the U.S. extends duty-free treatment to some developing countries that do not reciprocate, and so duty-free treatment in the U.S. market is already widely shared. New U.S. free trade partners, therefore, gain only a small edge over non-free trade partners and that edge declines as the U.S. signs new agreements. As a result, existing U.S. free trade partners, including Canada, share their small duty-free advantage with many others.

Canadian officials also say they are concerned about Canada's ability to compete in markets where the U.S. and others have free trade agreements and Canada does not. The U.S. accords are unlikely to have more than a marginal effect on Canada's ability to compete in third-country markets because they are with minor, distant economies. Focusing on the U.S. agreements is appropriate, though a more comprehensive study could look at the effects of all free trade agreements signed globally on Canada's ability to compete in third country markets. Canadian businesses do not currently compete in a significant way in most of these markets, many agreements signed by other countries are full of exemptions, and it is not clear to what degree businesses will respond to them. So, the effects of these other agreements on Canadian trade and the ability of Canadian companies to compete in third country markets may not be that significant.

Setting Precedents

The U.S. agreements establish precedents on such issues as services liberalization, intellectual property rights and investor protection that the U.S. wants to advance at the multilateral level and in future bilateral agreements. For example, all of the U.S. bilateral accords ban trade-related investment requirements, such as those that demand that foreign companies use local components (WB and IBRD 2005, p. 101).

Canadian and U.S. objectives are similar in many of these areas, though they differ in others. For example, the United States seeks broadened intellectual property rights at the multilateral level, while Canada aims to ensure full implementation of current rules. If Canada is not among the negotiators when new rules are set, the U.S. strategy will not take into account Canadian interests unless they coincide with those of the U.S.

Potential Dangers to Multilateral Efforts

Washington says it is engaging in competitive liberalization,[17] or working to open markets bilaterally through free trade agreements, regionally through Asia-Pacific Economic Cooperation and the Free Trade Area of the Americas negotiations, and globally through WTO talks. Since progress on multilateral and regional liberalization is slow and difficult, bilateral accords may put pressure on non-partners either to join or conclude a broader agreement. If, as the U.S. Trade Representative argues, the U.S. strategy hastens multilateral and regional negotiations, this could advance Canadian interests. If the strategy instead diverts attention from larger negotiations or from strengthening Canada-U.S. relations, it could undermine Canadian interests. Evidence on whether bilateral accords contribute to or detract from multilateral or regional trade liberalization is mixed.[18]

NAFTA provides a good example of smaller free trade agreements leading to larger accords. That agreement set a precedent for the rest of Latin America to pursue bilateral and sub-regional free trade accords, as well as spurring interest in hemispheric free trade. Combined with the development of the EU, NAFTA also provided impetus to non-member countries to move forward at the multilateral level, spurring completion of the Uruguay Round. One reason that bilateral accords may encourage multilateral ones is that as each new country signs a trade agreement with, say, the U.S., the temporary advantage of duty-free access for existing U.S. partners is shared more widely, reducing its value and therefore reducing opposition to multilateral changes.

To be sure, there are a number of reasons that the U.S. accords could instead undermine regional and multilateral efforts. By their very nature, bilateral trade agreements give preference to some, and discriminate against others, running counter to the multilateral WTO principle of non-discrimination. Also, unlike in earlier periods, there are now fewer countries excluded from bilateral agreements, an action that might have encouraged them to advance a multilateral accord. Many developing countries already get preferential access in developed country markets and have signed their own bilateral arrangements (WB and IBRD 2005).

Moreover, Andriamananjara (2003) argues that the resources required for negotiating, administrating and ratifying bilateral agreements may divert attention from multilateral efforts. Arguably the recent U.S. preoccupation with the ratification of the Central America-Dominican Republic Agreement and the side deals involved in ensuring its passage may have diverted U.S. attention from multilateral efforts and reduced its credibility in the multilateral arena. Bilateral free trade agreements may also shift the focus from pre-existing agreements, such as NAFTA, though this does not appear to be the case currently. What is clear is that the U.S. bilateral, or sub-regional, free trade accords claim a disproportionate amount of resources relative to their actual economic impact. As Table 3 shows, U.S. bilateral partners to date, excluding Canada and Mexico, make up about 5.5

17 The term competitive liberalization also refers to the idea that a sequence of bilateral trade accords by the U.S. and the European Union in competition with each other for smaller regional markets can spur global trade negotiations.

18 For a review of this evidence, see WB and IBRD (2005), p.133.

percent of U.S. trade — while trade with the two NAFTA countries accounts for over 30 percent. According to GAO (2004) estimates, the U.S. agreements consume 37 percent of the travel budget of the U.S. Trade Representative (USTR) and 11 percent of USTR staff time, while pulling three-quarters of the negotiating teams from other agencies.

Also, in extensively pursuing bilateral agreements, the U.S. creates vested interests in free trade partner countries that want to maintain the exclusivity of their duty-free advantage, rather than share it more widely in a multilateral or regional agreement.[19] For example, the U.S. pursuit of bilateral agreements with many Latin American countries may have weakened support for a regional accord among those that have signed because they do not want neighbouring countries with which they compete to have the same duty-free access under a broader agreement. Theoretically, there should be pressure on such countries as Brazil and Argentina, which are excluded from U.S. free trade consideration, to support a regional agreement in order to avoid the increasing discrimination they would otherwise face in the United States and its partner markets. However, the U.S. strategy has not bolstered support of the regional process in those countries.

Also, the origin rules that each new free trade agreement introduces and that effectively protect businesses that compete with imports could also create or reinforce vested interests. Businesses in free trade partner countries might therefore be less likely to support a broader accord that eliminates origin rules.

Canada's Options

Canada can do nothing to reverse the considerable bilateral free trade agreements signed by the U.S. and others. In this context, what strategies are available to Canada, and do they advance or diminish Canadian interests? I consider several non-mutually exclusive options.

Support Multilateral and Regional Efforts

Multilateral trade liberalization would result in the greatest global economic gains, while hemispheric liberalization would be a second-best option, establishing one set of rules and eliminating distortions within the hemisphere. A multilateral accord avoids the extra costs of Canadian companies having to adjust first to duty-free treatment under new bilateral free trade agreements and then having to adjust again when that preferential treatment is undermined when Canada's free trade partner signs an agreement with another country. Multilateral liberalization is the only way to simplify international trade and reduce the hub-and-spoke distortions in the trading system brought about by the numerous overlapping free trade agreements. Multilateral and hemispheric efforts, if successful, advance Canadian

19 As discussed, however, U.S. tariff rates applied to non-free trade agreement partners are low, so the benefit of duty-free access is relatively small. Therefore, vested interests are unlikely to be as resistant to regional and multilateral efforts as they would be in a situation in which U.S. duty-free access was a greater advantage.

interests through rules-based, predictable, distortion-free, market access. They also give Canada a seat at the negotiating table in a forum that includes the U.S.

While Canada is already relatively open, the country could solidify its ability to negotiate multilaterally by addressing such issues as supply management and high tariffs in certain sectors that leave it open to trade challenges. Canada could also take leadership in pushing for the elimination of MFN tariffs through the WTO, in order to eliminate the need for origin rules.[20] The prospects for the WTO Doha Round are clouded, however, and the FTAA is at an impasse. At the same time, Canada has limited influence over the outcome of either multilateral or hemispheric efforts.

Deepen the Canada-U.S. Economic Relationship

Canada could focus on removing remaining barriers to movements of goods and people between Canada and the U.S. Ottawa is already taking some steps in this regard under the Security and Prosperity Partnership of North America. A seamless Canada-U.S. border would enable Canadian businesses to compete more effectively in the face of increased global competition from large developing economies. Though this would not eliminate the U.S. hub-and-spoke system, it could mitigate its relatively small effects. Canada would then be in a position where it has greater, more secure, access to the U.S. market that goes much deeper than duty-free treatment. This strategy advances Canada's large stake in secure, predictable access to its largest trading partner, allocates government resources to accessing the world's largest market, and does not complicate the global trading system or undermine multilateral and regional efforts.

Seek Bilateral Free Trade Agreements

Canada could attempt to negotiate bilateral free trade agreements. This could include accords already started or under consideration, or agreements with new partners. With such an approach, Canada would add to the spaghetti bowl problem of overlapping origin rules, complicating the trading system further. Still, this process would establish Canada as a hub with access to the markets of a series of spoke countries. It would fail, however, to place Canada in the U.S. hub where it would have access to all U.S. spoke countries, though non-NAFTA U.S. free trade partners are all small markets at present.

Unless free trade agreements are with large markets, a bilateral accord strategy is unlikely to re-charge multilateral and regional initiatives in which Canada has a large stake, and could undermine them. It will also do nothing to gain Canada a voice in negotiations for any special rule-making that the U.S. might negotiate in its bilateral agreements. And negotiating bilateral free trade accords is extremely resource-intensive, so this type of strategy may divert focus and resources from Canada-U.S., multilateral or regional initiatives.

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20 With MFN tariffs at zero, there would be no difference between tariffs applied to free trade partners and those applied to non-members and therefore no need to have origin rules to establish whether goods qualify for duty-free access.

Such agreements are unlikely to result in large, permanent economic gains for several reasons. Canada does not currently have a significant trade or investment presence in any potential partner economies (Table 1). All prospective partners are outside of Canada's immediate region. Despite previous government attempts to increase Canada's economic linkages outside of the U.S., Canadian businesses have not taken advantage of available trade channels outside North America and it is not clear that they would respond differently with free trade agreements. As well, as discussed in the U.S. case, any advantage gained will be transitory and decline over time as that partner country negotiates duty-free access with another nation, and each successive trade accord will further undermine any advances. South Korea, for example, is simultaneously negotiating a host of free trade accords, including one with Canada, so any access to that market gained by Canada will be widely shared with others.

Canada's three free trade agreements with countries outside of its immediate region — Israel, Chile and Costa Rica — illustrate that free trade agreements do not necessarily translate into large trade gains. Since signing free trade agreements with Canada, exports to Israel grew by more than average Canadian exports; exports to Costa Rica grew by less than half the growth rate of overall Canadian exports, and exports to Chile declined by over 10 percent.

Nor is such a strategy likely to lead to large foreign direct investment gains. According to Hejazi (2004a), Canada's current foreign direct investment pattern is a result of a number of factors, such as poor research and develpment performance, relatively high Canadian taxes and possibly uncertain access to the U.S. market. New bilateral free trade agreements will do nothing to address those factors and boost investment.[21]

Because trade gains are likely to be small, costs of adjusting to changes from bilateral free trade agreements are also likely to be small. Still, Canadian companies and workers might ultimately have to bear a double cost of adjustment. If Canadian companies are not the most efficient suppliers of a particular product or service in a barrier-free world, but gain an advantage under a free trade agreement that enables them to become temporarily the most efficient, Canadian companies and workers will make related investments. Then, if the Canadian free trade partner signs a new agreement with a country with more efficient suppliers, or if regional or global trade barriers come down, and those Canadian companies and workers are displaced, they will have to bear larger adjustment costs than if Canada had not pursued the bilateral free trade agreement in the first place.

Some agreements will result in greater gains than others. An agreement that maximized potential trade gains would require simple origin rules and have to be

21 Investor protection agreements that Canada is pursuing with China and India may provide some additional certainty and may partly address Canada's interest in predictable conditions for investment attraction and investing abroad in a world of global supply chains and increasing trade in services, especially because a multilateral investment agreement is not part of the current WTO round. On the other hand, there is currently almost no two-way investment between China and Canada or between India and Canada (Table 1), and a bilateral treaty is unlikely to change the situation significantly. Discussing bilateral investment agreements and their pros and cons, however, is too large a topic to address in detail here and requires a separate analysis. Alexandroff (forthcoming) addresses some of these issues.

comprehensive by including all products and all areas, such as services, where the potential for gains is likely higher than for goods. For example, since Japan appears unwilling to liberalize agriculture in current bilateral free trade talks, it is unlikely that a Canada-Japan agreement would include agriculture, closing off a key area for possible large gains. Also, South Korea excluded rice from its free trade agreement with Chile and is likely to continue to do so in other free trade accords.

A comprehensive agreement would require Ottawa to eliminate supply management in the dairy and poultry sectors, as well as high tariffs in such sectors as shipbuilding and textiles where Ottawa has been reluctant to move in bilateral, regional and multilateral negotiations. If Ottawa persists in this stance, countries will be less willing to negotiate with Canada, bilateral negotiations will stall and any completed agreements will yield small gains relative to potential. Canada's high shipbuilding tariffs will be an issue during negotiations with South Korea, home to a large shipbuilding industry.

Agreements will result in greater gains if partners are significant in terms of economic size or their role in global supply chains, such as the EU, China, Brazil or India. In this case, Canada would be one of the only countries with duty-free access to both the U.S. and the other partner's key market, raising its relative investment attractiveness and possibly establishing a presence in a major market with strong growth potential. An agreement with China might also raise a whole host of political issues that Canada would have to consider.

It is not clear, however, why any significant economy would be interested in expending its resources to negotiate a free trade agreement with a relatively small economic unit like Canada, particularly when the country has failed to address the tough issues that derailed previous bilateral negotiations. Further, many of the larger countries are not interested in opening up to trade. As a result, Canada is limited to talks with the presumably small list of countries that may have an interest in negotiating with it. Even if a large economy signs a free trade agreement with Canada, it is not clear that businesses would respond because Canadian companies are currently not establishing large presences in these markets.

Negotiate Bilateral Agreements With the U.S., Accede to U.S. Agreements, or Start With U.S. Package as Default

Canada could try to negotiate future trade agreements jointly with the U.S. or consider adopting the terms of already signed U.S. accords.[22] For example, Canada has not been successful at concluding a Singapore or Central American free trade agreement. In the case of Singapore, Canada is holding out for an accord commensurate with the one negotiated by the United States. Rather than negotiate

22 I am grateful to Alan Alexandroff for suggesting this option.

separate agreements, Canada could try to accede to the U.S.-Singapore or the U.S.-Central America-Dominican Republic agreement, assuming the latter is ratified by Congress. Or, since South Korea has asked both Canada and the U.S. to negotiate free trade agreements, Canada could propose a Canada-U.S.-South Korea agreement.[23]

Such a strategy would bring Canada into the U.S. hub of the relatively minor U.S. hub-and-spoke system and could therefore have small, positive consequences for Canadian investment attractiveness. If the U.S. does pursue a trade agreement with a significant economy, being in the hub position could increase Canada's relative investment attractiveness. Businesses locating in Canada would then have access to both key markets with one set of rules of origin applied to the three countries. Negotiating jointly with the U.S. would also eliminate the inefficiencies associated with Canada and the U.S. each signing separate free trade agreements with the same partners, requiring importers and exporters to wade through the myriad requirements in each.

Because Canadian and U.S. tariff rates applied to third countries are already close and on average low in most sectors (Goldfarb 2003), negotiating jointly or acceding would not mean a loss of policy autonomy in most areas since Canada and the U.S. share similar objectives and tariffs are no longer a significant revenue source or instrument of industrial policy. The two countries' interests often coincide in multilateral and regional contexts. There are, however, a few sensitive sectors, such as sugar for the U.S. and dairy for Canada, where joint negotiations or accession would be more difficult. Any difficulties would be heightened with Mexico's addition because that country's average tariffs are much higher than those of Canada or the United States. Such policies as those the two countries extend to Cuba, as well as the application of trade penalties, would not have to be the same because free trade agreement partners may apply their own tariff rates to partners outside of the free trade zone.

Acceding to the current list of U.S. agreements is likely to yield relatively small gains for Canada, though it would require few negotiating resources to do so relative to pursuing separate Canadian agreements. It could also enable Canada to use the strength of the U.S. to its advantage, opening the door to negotiations with a country that might not consider negotiating with Canada alone and possibly achieving greater access than would be possible without the U.S.

Canadian and U.S. choices of free trade partners are unlikely to completely coincide. U.S. selection criteria are heavily weighted towards geopolitical interests, while Canadian criteria are likely to be more heavily influenced by economic concerns. It is also not clear if the U.S. and its partner countries would agree to Canada's inclusion in negotiations. Even if they did, though Canada would be at the table for any new rulemaking, it might not have much influence.

When Canada chooses to negotiate with the same partner the U.S. has already negotiated with, another related option is for Canada to use the already negotiated

23 A related option is for Canada to propose harmonizing all three NAFTA bilateral accords with Chile into one NAFTA-Chile free trade agreement with a common set of rules and obligations (Eden and Li 2004). Chile proposed a NAFTA-Chile free trade agreement after NAFTA was signed, but at the time, the President had lost the authority to sign trade accords and have Congress vote them up or down without amendment, limiting the U.S. ability to pursue this option.

U.S. accord as a basis or default option for its own free trade negotiation. This appears to be essentially what Canadian policy makers hope to achieve in Canada-Singapore negotiations, for example. This option would mean starting with a more comprehensive, ambitious package based on the NAFTA model and would be more likely to yield larger payoffs than if Canada started from scratch.

Recommendations

Ottawa should articulate a coherent strategy that sets out a short list of Canada's policy priorities and explains how they advance the country's overwhelming interest in secure access to the U.S. market and in a barrier-free, simple, rules-based trading system. This approach should focus limited resources in areas likely to yield substantive payoffs and should include federal and provincial domestic policies, such as education, tax and infrastructure, that affect Canadian competitiveness and investment attractiveness.[24] It should also recognize that governments can sign agreements but businesses ultimately make the decisions about where to trade and invest.

Some suggested guidelines:

1. Canada's overwhelming priority must be enhancing the Canada-U.S. economic relationship and eliminating barriers and unpredictability inconsistent with the reality of a common economic space.
2. Canada should maintain its support for the current WTO round and, to a lesser extent, the FTAA process. This should include removing remaining tariff and non-tariff barriers.
3. Canada should not pursue a series of marginal, resource-intensive bilateral free trade agreements likely to result in only small and declining rewards.
4. If Ottawa intends to pursue bilateral free trade accords, the government should:
   a. Select economically important partners, such as those with large markets and expected high growth rates, those that play important supply chain roles and those that could be strategically important for Canada's ability to compete in the U.S. market;
   b. Pursue agreements that will not undercut either the multilateral system or regional liberalization efforts, and
   c. Negotiate agreements that not only address barriers to goods, but also services and investment, and that have minimal, simple rules of origin requirements and few product exemptions;
5. In the event that the U.S. intends to pursue agreements with important markets, and if Canadian and U.S. interests coincide, Canada should evaluate the possibility of negotiating jointly with the U.S., or acceding to its arrangements in order to minimize use of scarce resources and reap the advantages of being in the U.S. hub. Another possibility is that Canada

24 See the WTO 2004 *World Trade Report* for a discussion of how domestic policies can undermine or reduce the benefits of good trade policy.

could use an already negotiated U.S. free trade agreement as a starting point for Canadian negotiations with the same country.

Conclusion

The U.S. has many new free trade agreements and continues to sign more. U.S. exporters now have duty-free access to new partner markets and Canada's duty-free access to the U.S. is more widely shared with other countries. Canadian policymakers should note that the U.S. agreements set rules and precedents without Canada being at the bargaining table, complicate international trade, and might weaken multilateral and regional liberalization efforts that are in Canada's interest. Still, the U.S. partners have relatively small economies and U.S. duty-free access is already widely shared and not worth much because the tariff rates for non-partners are already low. As a result, Canadian officials do not have to be overly concerned that the new U.S. accords will dilute the value of Canada's duty-free access to the U.S. market.

Ottawa should be cautious about jumping on the free trade bandwagon as the U.S. and so many other countries have done. Most bilateral free trade agreements with willing partners are unlikely to result in large economic gains for Canada. Such accords will make the international trading system more complicated and expend limited government resources for the prospect of a marginal benefit of which businesses may not even take advantage.

A sounder strategy would be to focus in areas likely to produce the largest payoffs for Canadian interests while minimizing risks and costs. Access to the U.S. market must be the overwhelming priority. This means removing barriers to flows of goods and people that are inconsistent with the highly integrated Canada-U.S. economic space. Canada should also maintain its support for the WTO Doha Round and the FTAA, to a lesser extent.

If policymakers are determined to proceed with free trade accords, Canada should try to engage large markets in comprehensive accords that go beyond reducing barriers to goods trade and that reinforce multilateral efforts. Such agreements would put Canada in the enviable position of being one of the only countries with free access to both the United States and other important economic powers, possibly making it a more attractive place to invest. And policymakers must have realistic expectations of the economic gains from such agreements and not lose sight of Canada's paramount area of interest — North America.

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