CANADIAN TRADE POLICY:
A Brief History of the Evolution of Canada's Trade Policy

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Historical Antecedents: Mercantilism

From the 17th to the 19th century the trade policy that the newly formed nations-states followed is known as **mercantilism**. Mercantilism was more than an external policy towards trade, it was also an economic development policy. The objective of this policy was to boost the economic development of the nation-state by a) eliminating internal barriers to trade and substituting external tariffs on all goods that came in through the borders of the country. The purpose of tariffs, or taxes on the movement of goods was foremost the raising of revenue for the king's or the national treasury. There were no income or sales taxes back then, the main source of revenue was tariffs. The second objective of mercantilism was to encourage the export of goods at the expense of the import of goods so as to generate a trade surplus for the nation-state. Since gold and silver or "specie" as it was known was the international means of exchange, store of value and unit of account, in other words, money, a trade surplus meant that the state would accumulate gold. Since gold was money, it allowed the state to raise the revenue it needed to maintain and build up its army and expand its authority and territory at the expense of other states. Mercantilism was practiced by all the new nation states of Europe such as France, Spain, England and Holland, but it was the French and the Spanish that pursued it to the greatest extent possible. Two names stand out in the development and application of Mercantilism, Cardinal Richelieu and Colbert, the Finance Minister of King Louis XIV.

The Birth of Economics and the Rise of Economic Reasoning: Free Trade

The science of Economics was born with **Adam Smith**, who in 1776 published his famous book **The Wealth of Nations** . In this book, Smith, inspired by the rationalism of the era and especially Sir Isaac Newton's work, provides the first rational and therefore scientific explanation of what makes an economy prosperous. He discovers the laws of demand and supply, which like the laws of gravity helped explain what keeps the planets in balance, explained for the first time what keeps the prices of goods and services in balance, what makes them rise and what makes them fall and what makes them return to equilibrium. He found that competition is the mechanism most responsible for the creation of wealth, and to have competition you need free enterprise, i.e. people have to be given the freedom to pursue their own economic self interest, because it is in this pursuit that people will engage in enterprise, innovation and trade which will eventually make every one better off. Adam Smith understood that through competition, the self-interest of competing businessmen would be pitted one against the other and would result in a self-regulating, self-policing outcome where the main beneficiary would be the consumer. By extending this premise to trade between states, Adam Smith discovered that the competition was not only good within a nation but also good between nations as well and he developed the **theory of absolute advantage**, the first theory on trade that said that if you can buy a good for less money from another country than what it costs you to produce it in your own country, you are better off buying it from the other country instead of trying to make it yourself. Thus, Smith comes up with a rational analysis of why free trade is a better policy to follow than protectionism and autarchy, which is the essence of mercantilism. In the end, through free trade a nation state can create more wealth and accumulate more gold than through mercantilism.

Adam Smith was the first to develop a theory of international trade, but his theory had overlooked something that was left to be corrected few years later. In 1817, **David Ricardo** an English Jewish businessman and thinker, published his book **<u>Principles of Political Economy</u>**. In this book, Ricardo takes Smith's theory of absolute advantage, refines it and perfects it to its logical extreme. He proves that even if a country does not have an absolute advantage, free trade still makes sense as long as you have a comparative advantage. **Comparative advantage** means that what matters is not whether you can import a product for less than what it costs you to make it, but whether you can produce something else where you will make even more money, even if you still have the absolute advantage. In other words, even if you can still produce a product for less cost than the cost of importing it in your country, if you can use your limited resources to produce something else instead where you can create more value with your resources than the value created by the product you want to import, you still benefit from international trade. Simply, if a lawyer does the secretarial work better than the best legal secretary, it does not mean he should be his own secretary. If he can make more money practicing law than acting as a secretary, his time will be better served if he sticks to law and hires an employee to do the secretarial work, even if the employee can never be as good in this job as he could. The modern theory of free trade is based on the explanation that Ricardo gave in his book, which is a step up and an improvement over Smith's argument.

Change of Economic Policy in Britain: From Protectionism to Free Trade

The free trade theories of Adam Smith, David Ricardo and other economists and industrialists of the time had an enormous impact on British trade policy. Also, the gradual structural change being brought about by the industrial revolution, which had started in the 1770s in Britain, had created the preconditions for a change in trade strategy. The newly emerging middle class spearheaded by the leaders of the new ascending industrial business community, found that the existing status quo of economic protectionist policies and government regulation hampered their growth. These policies raised the cost of labour and raw materials to them while it made it harder for them to export their manufactured goods to other countries. They felt that since they were the most efficient producers of manufactured goods in the world that they had both an absolute and comparative advantage. Also the **corn laws**, a set of protectionist laws that were imposed in 1815, limited the importation of less expensive corn to Britain raised the cost of living for the ordinary worker which in turn pushed up the cost of labour. They felt that eliminating these laws would reduce the cost of living and lower wages and increase their competitiveness with other countries. This set of laws had been enacted in order to protect the interests of the land-owning class in Britain. By limiting the import of corn to Britain they maintained the price of corn high, which in turn made it profitable to cultivate the less efficient lands in Britain and therefore kept the rents that landowners charged to farmers high. A political economic struggle emerged between the established traditional land-owning class from which the ranks of royalty were filled and the newly emerging class of traders and now manufacturers, the business class. The gentry or landowning class favoured protectionism while the bourgeoisie –the precursors of the modern middle class- favoured free trade. The technological advancement that was taking place and fuelled the industrial revolution was undermining the status quo and changing the economic, social and political order of Britain. Ultimately, the new order prevailed and the British government led by Sir Robert Peel and the help of Lord Nelson repealed the corn laws on May 15, 1846. This was a defining moment in modern British history as well in the history of economics. It ended protectionism and ushered the era of free trade in modern history. It was also one of the key reasons why Britain went on to become a super power and rule the world for the next century.

Change of Winds: The Situation in British North America

Until the 1840s, the British government gave tariff protection to products imported from its colonies, whether from North America or elsewhere, what is known as the **British preferential system**. When London decided to phase out this protection and to adopt a free trade policy, the high price of Canadian products made it hard to find buyers in the international markets.

The Canadian economy changed substantially when the British Corn Laws were repealed in 1846, followed by the gradual repeals of the *Canada Corn Act* in 1849 and the preferential tariffs on timber in 1847 and 1848. Canada had depended mainly on British preferential tariffs until that time. The gradual shift in British trade policy from protectionism to free trade left the Canadian colonies exposed. They could no longer rely on preferential access to British markets, they had to find new markets. The expanding market to the south, was the logical and only alternative. It was during this time that Canada began turning to the United States as its commercial partner. This trend would lead to the **Reciprocity Treaty of 1854**.

On behalf of Great Britain and its British North American colonies, Governor Elgin signed a reciprocity treaty with the United States on June 6,

1854. This treaty eliminated customs tariffs. The agreement also governed the rights of American and British North American fishermen, raw materials, and agricultural commodities. The treaty was signed at an ideal time for United Canada and the other North American colonies, since Great Britain was phasing out its preferential system. The agreement with the United States gave the business class an outlet for its products. This shift was also reinforced by the undertaking of major railroad construction projects to connect Halifax, Nova Scotia and Portland, Maine to Montreal and from Montreal to Toronto and from Toronto to Windsor, Buffalo and Chicago. The plan was to make Montreal a gateway for trade between North America and Europe, whereby commodities from the U.S. Midwest would flow from Chicago to Montreal and from there to export markets in Europe while British manufactured goods would come into Montreal and then flow into markets in Canada and the United States. Montreal's legacy as a transportation and industrial hub dates back to this period and the fortunes made by the businessmen engaged in this activity are what made Montreal a major commercial and financial centre second only to New York. The **Grand Trunk Railway** (GTR) was launched in 1852, led to the construction of the Victoria Bridge in 1854, the longest bridge in the world at the time that is still in use today.

Canadian Colonies at a Cross Roads: First Steps Towards Nationhood

Although trade between the Canadian provinces and the United States increased substantially and was a boon to Canada, it was not to last. **The American Civil War** (1861-65) broke out in 1861 between the manufacturing states of the Northeast and the commodity producing states of the South. This civil war that lasted four years and ended in 1865 with the victory of the industrial northern states resulted in a major shift in United States trade policy. In the years that followed, American politicians -- pressured by the protectionist fervor sweeping the United States --demanded the treaty be abrogated. In 1865, the American government announced that the treaty would not be renewed, and it ended in 1866. The industrial interests of the Northeast did not want free trade with Britain, because their young manufacturing industries were not as advanced and efficient as the British were. While free trade with Britain suited the interests of the US South, because they could export their commodities without barriers to Britain and could import manufactured goods from Britain that were cheaper and better than the ones produced by the northern states of their country. Instead, the Northern states persuaded the US Congress to pass protectionist laws to raise tariffs on the British manufactured goods in order to make the goods produced in the United States more competitive and therefore foster the industrialization of the United States. Thus the plans of Canadian businessmen to become the bridge between Britain and the USA were derailed. They could no longer count on free trade with the United States on the one hand nor count on preferential access to the British market. They were left to fend on their own.

The end of the Reciprocity Treaty was a determining factor in the decision of politicians in United Canada to form a new type of partnership with the other British North American colonies. Since they could not count on free trade access to the South the next logical alternative was to rely on themselves, that is to build a Canadian market and a Canadian economy that would absorb all of the British dominions north of the U.S. border and forge a Canadian, northern alternative to the expanding U.S. market. Thus Canadian politicians led by the interests of Canadian businessmen, decided to unite all the Canadian provinces and territories and to create a confederation of provinces, which is Canada.

The Creation of Canada

In the spring of 1864, the provinces of Nova Scotia, New Brunswick and Prince Edward Island decided to meet in Charlottetown, P.E.I. to discuss the possibility of uniting to from a Maritime Union. In the meantime, the provinces of Upper and Lower Canada (what are known as Ontario and Quebec today) which had united in 1841 requested permission to attend the meeting of the colonies, in order to raise the larger subject of British North American union, something they saw as a solution to their economic difficulties. The meeting known as the **Charlottetown Conference**, September 1-9, 1864 proved a success and was followed by a second meeting in Quebec City known as the **Québec Conference**, October 10-27, 1864.

The Québec Conference was the second conference leading to creation of the Dominion of Canada in 1867. The Confederation project proposed in Charlottetown was on the agenda and, if the talks went well, a constitutional proposal would be drafted. In Charlottetown, the Canadian delegation had proposed the foundations for a new country: preservation of ties with Great Britain; residual jurisdiction left to a central authority; a bicameral system including a Lower House with representation by population and an Upper House with representation based on regional, rather than provincial, equality; responsible government at the federal and provincial levels; and the appointment of a governor general by the British Crown.

The Québec Conference took place from October 10 to 27, 1864, in a magnificent building that stood where the Château Frontenac is today. Delegates from all provinces except Newfoundland which sent an observer attended the Québec Conference as representatives of the colonies. Étienne-Paschal Taché was named chairman of the conference but it was **John A. Macdonald**, however, who dominated his Canadian colleagues, and even the rest of the delegates. Following this conference, the delegates from the colonies drafted a text known as the 72 Resolutions, or the Québec Resolutions. These resolutions were the basis for the **London Conference** held at Westminster Palace Hotel in December 1866 in London. This led to the creation of a new state, that of the **Dominion of Canada** on July 1, 1867 with John A. Macdonald as its first Prime Minister.

Another significant factor that led to the creation of Canada was the **fear of annexation** by the United States. Since 1850, William Seward, the American Secretary of State during the Civil War, had been an annexationist who felt that British North America (BNA) was destined to become part of the United States. As it became obvious that the North would emerge victorious there was a fear that American expansionism would rear its head and turn its eyes to the north.

In the Canadas and the Maritimes many thought that invading British North America would give the victorious Union army something to do. The possibility of annexation was even more real in the northwest of what is now Canada. In 1860 Seward praised the people of Rupert's Land for conquering the wilderness and creating a great state for the American Union.

In the election of 1864 the Republican Party used annexation as a means to gain support from Irish Americans and the land-hungry. In 1865-66 annexationism was a factor in the American abrogation of reciprocity. An annexation bill introduced by General Banks was passed in the United States House of Representatives in July of 1866. It intended that the United States acquire all of what is now Canada.

Whether based in reality or not, the fear of annexation played a definite role in the achievement of Canadian Confederation and in shaping its constitution. Seeing the horror of war that resulted from the divisiveness of American federalism, the Fathers of Confederation decided that Canada should have a stronger federal government than the one south of the border.

A New Vision for a New Country

The newly formed Dominion of Canada consisted of the southern parts of present-day Ontario and Quebec plus the maritime provinces except Newfoundland. The northern part of Quebec, Ontario and Manitoba belonged to the **Hudson’s Bay Company** and was known as Rupert’s Land named for Prince Rupert, first governor of the company. This was a territory that spanned over most of the **Canadian Shield**. Under the charter granted in 1670 to the company by Charles II, the region comprised the drainage basin of Hudson Bay. The area embraced what is today the provinces of Ontario and Quebec North of the Laurentians and West of Labrador; all of Manitoba; most of Saskatchewan; the southern half of Alberta; the eastern part of Nunavut Territory; and portions of Minnesota and North Dakota in the United States. In 1870 the newly-created Dominion of Canada bought the territory from the Hudson's Bay Company for £300,000 which retained certain blocks of land for trading and other purposes. Thus it became part of Canada.

In the years that followed the creation of Canada in 1867, the remaining British colonies of North America joined the Canadian Confederation, namely

Manitoba in 1870, British Columbia in 1871, Yukon in 1898, Alberta and Saskatchewan in 1905 and eventually Newfoundland in 1949.

It can be seen from the above historical overview that economic factors were instrumental in the formation of Canada. The Colonies that made up the British North-American region were too small and divided to withstand competition with a united, strong and growing continental size economy as the United States. When the British Preferential System ended and was replaced by a free trade policy, it left these provinces more exposed and vulnerable. While, the business community of Canada preferred to have free trade with the United States, what was then called reciprocity, it didn't come to pass when the USA turned inwards, more aggressive and more protectionist following the Civil War. Thus when the USA abrogated the reciprocity treaty, the Canadian provinces were left with no alternative but to form their own bloc. Canadian businessmen were in awe over the success their American counterparts had in expanding westwards, in expanding their population through the settlement of the western states and through the expansion of their markets for manufactured goods. As the US moved West and expanded the population base there, the businessmen and manufacturers of the Northeast grew richer and richer, making fortunes from the establishment of railways linking the West to the East, from exploiting the cheap resources of the West while selling them US-made manufactured goods from the East. The Canadian business community and political leadership had to come up with a new vision, a new plan and new economic strategy.

Canada's New Economic Strategy: The National Policy

The strategy that emerged during those formative years can be outlined as follows:

1) Create a new and united country that would span the entire British-controlled territory North of the United States. The new country would be a confederation of provinces but with a strong federal or national government. The new federal government would be in a stronger position to borrow money on international capital markets and carry the debt and finance the major railroad, canal and infrastructure projects of the new country. It would also be in a better position to manage the economic affairs of the region and negotiate on behalf of the region with the USA and other countries. The new country would issue a new currency that would unite the fragmented economies of the various provinces and territories.
2) Create a new internal market spanning the entire length of the country, from the Atlantic to the Pacific Ocean. This internal market would be augmented by the addition of the Western provinces of Manitoba, Saskatchewan, Alberta and British Columbia to the West and Yukon and the Northwest Territories to the North and Rupert's Land over the centre. The internal market would also be augmented by opening the

country's borders to European immigrants, who would slowly expand the country's population base, increasing the labour force, the production of resources for export and increase the internal demand for manufactured goods made by industrialists in central Canada, i.e. Ontario and Quebec.

3) Create a commodity producing and manufactured goods consuming hinterland in the West just like the Americans had done south of the border. This hinterland would provide the economic opportunities to the business community of the East just as it had for the Americans.

4) But to make this plan viable, the new country would also need to create a transcontinental transportation infrastructure linking the Atlantic East to the Pacific West. This is what led to the launching of the **Canadian Pacific Railway** (CPR), which was launched in 1881 and completed in 1885. The CPR was Canada's first cross-country rail link and it united the new nation and opened up the Canadian West to settlement. It provided a low cost means of moving commodities produced in the West to markets in the East and outside Canada while providing a low cost means to move manufactured goods from central to western Canada.

5) Eliminate tariffs on the trade between provinces and replace it with a common external tariff, like a customs union. Establish high external tariffs to match the ones that the United States had imposed on its trade with Canada. Since Canadian exports to the United States were subject to high tariffs, Canada had no other choice but to do the same, i.e. set high tariffs on the exports of American goods to Canada. The new high tariffs would also provide protection for the Canadian manufacturing industry and would stimulate the industrialization of Canada, just as it was doing for the United States.

This was the broad outline of Canada's new industrial and nation-building strategy, and is known as the **National Policy**, which was more or less put in place during the 1867-1879 period. Since tariffs and trade strategy were an important part of it, we can say that it also formed Canada's first trade policy. This policy was to serve as the backbone of Canada's economic development as well as trade policy over the next one hundred years. By creating an East-West economic and political axis, it created a single market, it settled the West, it encouraged industrial development, and forged a national economy. It also provided an alternative to the East-West axis that had been built by the Americans south of the border. It was to prove to be Canada's "manifest destiny".

Canada's Century: Boom, Depression and Post-War Prosperity

In the years that followed, Canada's economy faced many challenges and experienced many opportunities. By and large, the national economic strategy served the needs of the country well and led to unprecedented levels of prosperity. When Canada's first census was conducted in 1871, Canada's population numbered 3.7 million. By 1911, it had doubled to 7.2 million, by 1951 it had doubled again to 14.0 million, and again by 1991 to 28.0 million. The opening up of the prairies expanded enormously Canada's agricultural capacity and with the settlement of the land by large numbers of immigrants and the development of new varieties of wheat suitable for cultivation in these new lands Canada emerged as one of the major producers of wheat in the world. Canada's vast forest resources were opened up as well and Canada started exporting huge amounts of timber and lumber while it developed its pulp and paper and newsprint industries. Canada's vast mineral resources started being developed as well with the discovery of nickel, oil and gas. Large infrastructure projects in railroads, canals, ports and bridges reduced transportation costs while the opening of the Panama Canal, opened up new markets in the Eastern seaboard for British Columbia's lumber. Canada's exports expanded greatly, especially after 1900 and by 1929 accounted for 27% of Canada's GDP.

In the meantime Canada's manufacturing sector expanded greatly. Concentrated in the provinces of Ontario and Quebec or Central Canada, manufacturing activity expanded greatly helped by the protection afforded by the tariffs, as well as the opening up of the West. Montreal and Toronto became the economic and metropolitan centers of the country, with Toronto being the industrial center and Montreal the commercial, transportation and financial center of the country. Iron and steel products, automobiles, pulp and paper, newsprint, textiles, furniture, construction materials, oil refining, electricity generation were among the many industries to develop and grow in importance.

But the road to development was by no means smooth. The early years of Confederation saw the "Great Depression of the 1870s", disappointing immigration flows and slow growth. Then starting in 1896 Canada experienced an economic boom of enormous proportions, which lasted more or less until 1929. World War I was also an opportunity for Canada. It stimulated the industrial and resource development of the country while it enabled Canada to step aside from the shadow of its former colonial master, Britain and to gain a seat on the table in the Versailles negotiations in Paris in 1919. By shedding a disproportional amount of blood for its size in the fields of France, Canada had gained recognition as an independent state, as a power to be respected.

When the **Great Depression** of the 1930s came, however, Canada found itself in desperate straits. The boom that had preceded the 1929 crash gave way to a bust. Canada had borrowed huge amounts of money mostly from Britain and had invested heavily in its infrastructure and industrial development. International trade collapsed during the Depression years as countries raised tariffs, depreciated their currencies and followed import substitution strategies. The demand for Canada's commodities, especially wheat and forest products took a big hit. Commodity prices collapsed as well. The country, which had grown to be dependent on exports for nearly a third of its GDP was affected disproportionately compared to other countries that did not depend on trade as much, or had not borrowed and invested so heavily on the development of their export industries. Canada's GDP fell by 30% between 1929 and 1933 and the unemployment rate surpassed 20%. Even worst, industrial production in Canada (which does not include the government or service sectors of the economy) faired even worse. Between 1929 (1929 = 100.0) and 1932 the index of industrial production plunged to 58.0, which along with the U.S.A. and Germany suffered the largest drops of all industrial countries. Canada's real GDP did not recover to its pre-1929 levels until 1939, a full, ten years later.

Between 1930 and 1933 Canada raised its tariffs substantially as other countries were doing in response to the Depression, and led by the United States, which in 1930 passed the **Smoot Hawley Act** (1930) that raised tariffs by 53%. The main reason for raising them was to preserve employment in the protected industries. But a secondary reason was to create a bargaining advantage with other countries whereby preferred entry into other markets could be obtained for Canadian products. In 1934 the U.S. Congress passed the **Reciprocal Trade Agreement Act** (1934). This law gave the President authority to negotiate bilateral tariff-reduction agreements of up to 50% with other governments. In the 1932-36 period Canada entered into bilateral trade agreements with the United States to reduce tariffs, of which the most important were the Ottawa Agreements of 1932 and the United States Trade Agreements of 1935 and 1938.

The Great Depression of the 1930s was the result of many factors. Amongst them were the economic and political vacuum that resulted in Central and Eastern Europe from the defeat of Germany, the break-up of the Austro-Hungarian and Ottoman Empires, the creation of many new states in central and Southeastern Europe and the Russian revolution. But even more important were the collapse of the gold standard in 1914, which led to high inflation and exchange rate instability, high interest rates and financial and banking crises. Britain tried to restore the gold standard in 1925 but by 1931, it was forced to abandon it and allowed the pound sterling to depreciate. The United States, which had emerged after WWI as the world's biggest creditor nation lacked the experience that Britain had as the world's central banker. After having lent huge amounts to Germany and other countries in the 1920s it raised interest rates that induced a flight of capital out of Europe, which precipitated the collapse.

The worse of the Depression occurred from 1930 to 1933, from 1934 the economy begun a gradual recovery which brought economic activity back to 1929 levels in 1939. Then, World War II breaks out in Europe, and a new period of economic expansion begins. By the end of 1942, the economy was operating at full capacity and the unemployment rate had plunged to 1.7%. Canada's economic circumstances benefited greatly from the war in Europe. Europe's loss proved to be Canada's gain. But unlike the boom that followed the First World War during the 1920s, this one was to last a very long time. Canada's economy went on expanding at full throttle through the 1940s, 1950s and 1960s. By the early 1970s, economic prosperity in Canada had reached unprecedented levels. Per capita GDP in Canada had risen so much that it ranked only second to the United States. Prime Minister John A. Macdonald's National Policy had proved a resounding success. It had enhanced the economic and political integration of Canada by constructing a national railway system binding the country from East to West, by opening the great agricultural prairie region in the West, by encouraging immigration and settlement of the West and by stimulating industrial development with a high tariff to discourage imports and encourage domestic production. Canada's independence and status in the world had been guaranteed by a national economy strong enough to offset the North-South attraction of its enormous neighbour. When Canada celebrated its centennial in 1967, with Expo 67 taking place in Montreal, the mood in the country was jubilant. Never before had the self-confidence of the nation been so high. The 20^{th} century had indeed proven to be Canada's century!

Winds of Change: Foreign Direct Investment in Canada and the Rise of Economic Nationalism

One of the unintended but welcome consequences of the National Policy was that it attracted huge amounts of foreign direct investment (FDI) into the country. American companies found that the tariff wall made the price of their exports to Canada uncompetitive. At the same time the allure of a vast country, rich in natural resources and with a rapidly expanding English-speaking population and markets right next to them made Canada a most attractive destination. American companies starting mostly in the 1920s, begun making direct investments in Canada by setting up Canadian subsidiaries designed to produce and sell their products in the Canadian market. If it was costly to export their way into the Canadian market, then why not build subsidiaries or buy out existing Canadian firms. FDI inflows from the United States started mostly in the 1920s, they slowed down during the Depression, but it was after the Second World War during the 1950s and 1960s that they reached their peak. By the late 1960s, the United States had not only become Canada's largest foreign direct investor, but the process had gone so far that the majority of Canada's mining and oil and gas industry had fallen in US hands and nearly half of the manufacturing sector as well.

This wholly unexpected development of the National Policy proved a big opportunity for Canada, but also a challenge. On the one hand, it brought in badly needed capital which Canada as a young developing country badly needed, especially after the Depression years and the decline of Britain as an economic super-power. It also brought in technological and managerial know-how that was too costly to develop on its own. This technology and organizational transfer proved extremely beneficial for Canada. Canadian authorities welcomed the inflow of American capital with an openness to foreign investment rare in the modern world. It not only stimulated the economic development of the country, but it also helped finance Canada's new social programs such as public pensions, employment insurance, social assistance, universal healthcare (“medicare”) and regional economic development.

On the other hand, foreign direct investment created new challenges for Canada. First, was the issue of foreign ownership and control of Canada’s economy. Allowing U.S. firms to buy huge swats of control over Canada’s economy meant that as a country, we were relinquishing our economic sovereignty to the Americans. If more and more of the economic decision-making is done by foreigners, how could we retain control over our country and our destiny. Second was the fact that the typical US-owned Canadian subsidiary was structured to produce a wide range of products but in limited quantities, sufficient to serve the small Canadian market. This created a high cost structure that reduced the international competitiveness of Canadian manufactured products and kept domestic prices high. Third, was the fact that the typical US-controlled firm did little research and development (R&D) activity in Canada, and most of the high-level managerial, product-development, marketing and financial decisions were made in the United States by the parents of these companies. Worst of all was the fact that US subsidiaries did little exporting to third countries. Why should they, the whole idea was to access the Canadian market by circumventing the Canadian tariff. The business model of the typical US subsidiary was import-substitution by locating and producing for the Canadian market.

This development eventually led to a backlash in Canada. As Canada’s economy expanded and prospered and as it acquired new confidence, more and more Canadian thinkers started questioning the rationale of this policy. Economic nationalists like **Kari Levitt** argued that Canada’s economic development benefited the foreign owners of capital more than Canadians, and that these investments perpetuated Canada’s status as a “hewer of wood and drawer of water”. She coined the term **“branch plant”** economy to describe the picture that emerged. It led her to say that Canada had become “the world’s richest underdeveloped country”. The issue was politicized because it arose at a time of newfound confidence in Canada, when Canadians started feeling as a nation and when Canada’s new flag was unveiled by Prime Minister **Lester B. Pearson** in 1965. It was also a time when there was an increasing awareness of the presence and role of the multinational corporation, of American dominance and extraterritorial influence over the world economy, rising dissatisfaction over America’s involvement in the War of Vietnam, pretty similar to the current anti-globalization sentiment. At issue, though not always explicitly stated, was not as much the high degree of foreign ownership in Canada’s economy, but the fact that the overwhelming percent of foreign ownership was American, and this created too much dependence on our neighbour to the South which kindled fears of unwanted integration with the United States, similar to the fears of U.S. annexation in the 1860s.

In response to the rising nationalist economic sentiment and concerns over American ownership of Canada's economy, the Canadian government of **Pierre Elliott Trudeau** launched a Royal Commission of Inquiry to study the issue and to recommend policy action. In 1972, the commission published its findings in a report titled "Foreign Direct Investment in Canada" also known as the "**Gray Report**". The Gray report underscored the issues that might be created over the high degree of American ownership of Canada's resource and manufacturing sectors and confirmed the tendency of U.S. subsidiaries in Canada to replicate the full range of products produced by the parent firm, at significantly higher cost in the smaller Canadian market. It also confirmed Kari Levitt's notion of the "truncated firm" as a malign result of the foreign direct investment, itself the result of the import-substitution strategy of the high tariff engendered by the National Policy. The truncated firm is a branch plant that fails to perform the full range of corporate activities associated with a normal firm such as local decision-making and local board of directors, research and development, marketing, advertising, financing, investing, strategic planning and of course exporting. It was also revealed that branch plants curtailed the freedom to make decisions by local managers while it limited their career development and rise to higher levels of management.

In response to the new challenge created by the foreign ownership issue, the Canadian government set up the **Foreign Investment Review Agency (FIRA)** to screen all major new foreign direct investments undertaken in the Canadian economy and to bargain for more benefits for Canada. At the same time, most U.S. –owned firms responded to the nationalist demands rather positively. They tried to become good Canadian "corporate citizens". Boards of Directors, share-ownership and management were "Canadianized" to some degree and Canadian subsidiaries were given greater autonomy. Disagreements focused more on the means of achieving the goals of greater autonomy and to share the benefits with Canada, rather than the goals themselves. American firms seemed to accept Canada's sensitivity and concern on this issue. At the same time a new approach was tried with considerable success. It was to grant the Canadian operations of US-owned firms "**world product mandates**". This meant that Canadian subsidiaries were given the authority to select a product, specialize in its production for distribution and sale on the world market, not just for the Canadian market, and often in competition with the same product being made by the parent company in the United States

At the same time, the Canadian government sought to balance American FDI in Canada by attracting more FDI from other countries. This approach proved successful more out of luck than out of trying. By the late 1960s, Europe's post-war reconstruction had come to an end and Europe had emerged as an economic super-power to rival that of the United States. As Europe became self sufficient in capital, more and more European firms started making foreign direct investments in Canada as well. Although Britain had always been a significant investor in Canada, it became a bigger player while European based firms from

France, Holland, Switzerland, Sweden, Italy and eventually Germany started investing big amounts in Canada by the 1970s and Japan by the 1980s. Thus, the stock of foreign direct investment in Canada became more diversified and less dependent on the United States, which by that point started experiencing economic difficulties of its own following the financial drain of the Vietnam War, the loss of competitiveness vis-à-vis Europe and Japan and rising current account deficits and inflation.

In the early 1970s, Canada was confronted with three options for its future: 1) It could maintain the current status quo with the United States; 2) develop an even closer relationship with the United States, or 3) seek a “third option”, i.e. seek to diversify its economic relations away from the United States in order to reduce its vulnerability to it.

Under the nationalist administration of the Trudeau government Canada tried to explore the “third option”. Although many nationalist political leaders favoured it, it was a non-starter. The basic geopolitical positioning of Canada on the North-American continent and away from other regions, dictated that we could not go against the economic gravitational pull of the vast U.S. economy. Ninety percent of our population and economic activity is located within 100 miles of the US border. The vast US economy, although a potential threat to Canada’s economic independence was also an opportunity of capital proportions. There was a lot more to be gained by gaining better access to a market ten times the size of the Canadian. The linguistic and cultural affinity of the US, the shared European and English traditions, the low transportation costs of selling to the U.S. were major advantages. Secondly, Canada’s trade with Europe as a share of its total trade kept decreasing. In 1954, Canada sent 33% of its exports to and received 13% of its imports from the United Kingdom and other Western European countries. By 1984, Western Europe accounted for only 6% of Canadian exports and 9% of Canadian imports. By this time, around 80% of Canada’s growing trade was being done with the United States, in what had become the world’s largest bilateral trading relationship. Thirdly, with the formation of the European Economic Community (EEC) in 1957, and with the entry of Britain in the EEC in 1973, Europe turns more inward. European governments and businesses begin focusing on European economic and political integration on the European continent. Economic relations with Canada on a a different continent become secondary. In a sense, just as the shift of Britain from protectionism to free trade and the abolition of the Canadian system of preferences in the 1840s forced Canada to look to the United States for opportunities, the accession of Britain in the EEC in the 1970s put an end to any hope of any further economic integration with Britain or Europe for that matter. The only viable opportunity for Canada remained the United States of America.

On the other hand the day-today process of economic integration between Canada and the United States was well underway. As US firms Canadianized their Canadian subsidiaries, they also sought ways to rationalize their operations to lower costs and make them more competitive. There was no other industry where this process of rationalization and integration was well underway than Canada's automobile industry. The mutual advantages of economic integration were so obvious that they did not stop the nationalist administration of Lester B. Pearson from signing in 1965 the Canada-US Automotive Agreement, which was a sectoral free-trade agreement with the United States in the automobile industry, what is known as the "**Auto Pact**". In this agreement the two countries decided to abolish all tariffs and barriers to the movement of cars and automotive parts between them and form an integrated North-American industry. The Auto Pact proved to be resoundingly successful for Canada. American automobile makers took advantage of Canada's lower cost and more disciplined work force and expanded their Canadian production and built more plants in Canada. But the Auto Pact was also successful in that it served as a limited experiment on the feasibility and impact that free trade with the United States could have for the Canadian economy. The very success of this limited "sectoral" initiative was to pave the way in the late 1980s for the Canada-United States Free Trade Agreement (CUSFTA). On one hand it proved that free trade with the United States could be beneficial for Canada. On the other hand it also proved that fears of over-reliance on the United States were overblown. By placating the fears of nationalists, it made consideration of further integration with the United States more palpable and less contentious.

Winds of Change: Changing Global Environment

As Canadians were immersed in the discussion over issues of foreign ownership and control of their economy, major changes were taking place in the global environment, which brought along new threats and new opportunities. The first change had to do with reconstruction of Europe and Japan and their emergence as global economic powers. The economic ascendance of **Western Europe and Japan** and increasingly that of Southeast Asian countries, the so-called "**Asian Tigers**" meant that more and more of the goods consumed in both Canada and the United States came from abroad. These efficient producers posed a serious threat to domestic producers –whether Canadian or foreign-owned. Domestic producers started seeing their market share slip bit by bit, while FDI flows from these regions started to swell in North America. US multinational companies were no longer the only multinationals on the planet. Now, you increasingly saw multinationals from other countries, principally Europe and Japan.

The second change was the one brought about by the various rounds of multilateral trade negotiations initiated in 1947 with the signing of the **General Agreement on Tariffs and Trade (GATT)**. The various rounds of multilateral tariff reductions that were initiated in 1947, 1949, 1951, 1956 and most notable the Dillon Round (1960-61), the Kennedy Round (1964-67), the Tokyo Round (1973-79) and then the Uruguay Round (1986-93) reduced enormously the average level of tariffs and reduced considerably the barriers to international trade. The “Canadian Tariff” that had played such a big role in protecting Canadian manufacturers and fostering the industrial development of Canada had gradually disappeared. Canada no longer had the protection of this tariff, nor did the United States for that matter. Now the growing threat was no longer the United States, but imports from the rest of the world! Moreover, far from being concerned over the “branch-plant” effects of US companies in Canada, the more serious threat became the fact that in a world of no tariffs between Canada and the United States, there was no longer an economic motive to keep their plants in Canada. American companies could be better off closing them and serving their Canadian market through the export of goods produced in their larger and more efficient plants south of the border.

The third change came from the expansion in Canada’s social programs, which by then had created a major overhead burden on the Canadian economy. Such programs were affordable and posed minimal burden as long as the economy remained prosperous and kept growing, as it had in the 1960s and early 1970s. But that was not to be for long. The two oil shocks of 1973 and 1979 put an end to the “Canadian century”. Rising inflation, increased global competition and eventually high interest rates in the late 1970s and early 1980s brought this period of prosperity that started in the1940s to an end. The collapse of energy prices in the mid-1980s, were a most unfavourable development for Canada’s resource producing economy. Canada’s terms of trade deteriorated as income from the sale of our natural resources plunged while the cost of domestic production rose, the legacy of the inflation of the 1970s and the effect they had on raising wage costs in Canada. Now, the large social expenditure burden could not easily be maintained. It meant that either the Canadian government would have to raise taxes or cut expenditures. What the Canadian government dominated by Liberals chose to do was to increase government borrowing to maintain the high expectations that had been created during the prosperity of the 1960s. This led to a spiraling growth in Canada’s public debt, which rose from 23% of GDP in 1973 to over 100% in 1993.

Unable to finance its social programs and uncertain over the continued growth of its economy, Canadians lost their confidence and economic nationalism declined. The Liberal government’s **National Energy Policy** of 1981, whereby it tried to share the windfall gains of high oil prices more equitably within Canada while limiting foreign investment in Canada’s oil and gas industry proved the last straw. It was a policy designed on the economic reality of the prosperous 1960s, which by the 1980s had given way to falling energy and commodity prices and increased insecurity engendered by an intensifying global competition and a shifting of competitiveness away from North America towards Europe and now Asia. Canada after a full century had gone by, found itself again at a cross roads. The National Policy of Sir John A. Macdonald had fulfilled its mission and brought Canada an un-herd of level of economic prosperity, but the policy could not last forever, because the circumstances that had made that policy viable had shifted dramatically by the end of the 1970s and early 1980s. With the economy in stagflation, i.e. high unemployment and high debt and with a spiraling public debt, a new plan, a new vision, a new strategy was needed.

In the meantime, circumstances south of the border in the United States were not any better either. The United States was being faced with the same global challenges as Canada while just as we were too busy patting ourselves on the back and spending heavily in one new social program after an other, the Americans were busy fighting the War in Vietnam and trying to pull themselves out of that fiasco and shouldering the responsibilities of fighting communism on the global stage. They too were much weakened by all these demands and they too were in search for a new policy direction.

A New Vision for the Future: Continental Integration

The bad turn in Canada's economic circumstances led to increasing dissatisfaction with the rule by the Liberals and the Progressive Conservatives, led by **Brian Mulroney** won a huge victory in the general elections of 1984. Although the Conservatives had opposed the idea of free trade in the election, when they came to office they quickly embraced the idea as a viable option to lead Canada into the next century. Mulroney's priorities were to rebalance public finances by slowing down the growth in social expenditures and restructuring the Canadian economy to make it more efficient in the face of increasing foreign competition. He dismantled the national energy policy and the Foreign Investment Review Agency (FIRA). He privatized public enterprises in order to reduce the degree and extent of government intervention in the economy and he restructured the federal manufacturers' sales tax, which was a tax on all goods levied on manufacturers in Canada. This tax was paid by manufacturers and was built in the price of industrial products, thus it was not visible to the consumer. This tax was a major handicap on Canadian exporters because it was charged just the same, whether the product was destined for export or for consumption at home. This was a significant innovation in Canada's trade policy, because unlike most countries that didn't levy a tax on their exports we were short-sighted enough to do so. The new tax that took the place of the old manufacturer's sales tax was named the **goods and services (GST**) tax and was a variation of the value added tax (VAT) being used in Europe and many other countries. He lowered the rate of the new GST tax to 7% from 9%, but he extended it to all services with the exception of food, medicine, education, banking and rents.

This was a much needed improvement in the federal sales tax system, in that it removed it from exports, thereby making Canadian exporters more competitive on the world market while by broadening the base of the tax he lowered it by two percentage points and linked it to the growing service sector of the economy which until then had not been subject to any tax. This removed the unfair treatment that goods were subjected to at the expense of services and created a level playing field for all products, irrespective of whether they were goods or services. It also linked the tax to the growing service sector of the economy, which over the years had been growing faster than the goods-producing sector and therefore ensured that tax revenues needed to lower the budget deficits would rise at a faster rate in the future.

The second and perhaps the greatest achievement of Brian Mulroney and his government, is that he had a clear understanding of the challenges facing the nation being an ex-business executive himself and he quickly seized the opportunity to propose a free trade deal with the United States of America which were then led by President **Ronald Reagan**. Since both of them were of Irish stock, both were conservatives, and both had an outgoing personality he struck an excellent relationship with his American counterpart. President Reagan quickly accepted, and negotiations were well underway, led on Canada's side by Simon Riesman. By 1988 a free trade agreement had been negotiated. The general election of 1988 was fought on this issue and was widely viewed as a referendum on free trade. Although a plurality of Canadian voters voted against the agreement, his party won an overwhelming majority in the polls, and the agreement was signed and came into effect on January 1, 1989.

Free trade and closer economic integration with the United States have been a recurring issue throughout Canadian history. The first choice of Canadian businessmen had always been free trade with the United States. In 1854 what was then Canada had signed a reciprocity treaty with the Americans, but it was they who abrogated the treaty in 1865. Bilateral free trade arrangements had been discussed in 1879, when the then government of John A. Macdonald before finalizing the Canadian tariff made a direct offer to the United States which was turned down. So did again the Liberal government of **Sir Wilfrid Laurier** in 1911, and McKenzie King in 1948. In 1965, Lester B. Pearson signed the Auto Pact, which rationalized the automobile industry on a bilateral basis. Canadian attitudes toward economic integration with the United States have always been deeply ambivalent. US direct investment in Canada, while welcomed for the economic benefits it brought, has been also widely perceived as a significant constraint on Canada's national autonomy and sovereignty and a threat to its cultural identity. Thus the Canada-US free trade agreement represents a major shift in Canada's trade and investment policy, from import substitution and domestic protectionism to outwardness and regional integration.

The Benefits of the New Economic Strategy

What was it that Canada hoped to attain by entering into the CUSFTA? As explained above, the National Policy of Canadian Confederation had by now run its course. It had built a nation by integrating all the Canadian provinces into a single market, with a single currency, and a common trade policy. It had settled the West and developed the country's vast mining and agricultural potential. It had fostered the industrialization of the country and developed a modern, secure and prosperous economy. Now the winds of change were different. The threats and opportunities lay outside Canada's borders. Increasing globalization and intensification of global competition had emerged as the new threats and opportunities. To sustain and enhance its prosperity now Canada had to look outwards. Successive rounds of multilateral tariff reductions had removed the rationale for import-substitution policies. Now Canada had to go out and meet the competition.

But Canada was still a small country in terms of population, size of domestic market and size of firms. Canadian firms lacked the economies of scale, or the capital base or the international experience and sophistication required to compete successfully in the global environment. It needed a trade partner to do it together than go it alone. Of all the potential partners the only two options were Britain or Europe and the United States. Europe was not an option, since geographically it was part of a different continent. Besides, Europe had turned inwards at the difficult task of forging an economic powerhouse from its fragmented members, and had a long way to go in that road to consider integration with Canada. Canada had no other option than look toward the United States.

What were the advantages of teaming up with the United States. First, the allure of the US market, the largest unified, homogeneous market in the world, considered the envy of the world. Free trade for Canadian firms meant that they could now gain free uninhibited access to a market ten times the size of the Canadian. The potential for gain was much greater for Canadian firms that would gain access to a size ten times that of their domestic market than it would for the Americans, who would gain access in a market only a tenth the size of their own. Besides, the Americans had already established themselves in the Canadian market mostly though FDI and the Auto Pact. They didn't stand to gain as much as Canadians did by gaining unrestrained access into the US market.

Second, forging a trade agreement with the United States would go a long way towards assuring and guaranteeing future access and security in the US market. If the United States were to turn isolationist or protectionist as they had twice before in the 1870s and again in the 1930s, Canada would be much damaged from such a development.

Third, by signing a formal treaty with the United States and by introducing some kind of dispute settlement mechanism in the agreement, Canada could produce a large degree of predictability and reliability in its trade relations with the US and make it harder for our "super-power" partner to use unilateral or capricious actions against us. Now we could have a basis, a framework to hold them more accountable for their actions. In effect, a trade agreement helped level the playing field with the Americans, it curbed their propensity to use strong arm tactics against us while giving us a legal and moral basis to better defend our interests.

Fourth, the economic restructuring that would be required by the corporate sector would stimulate greater specialization, greater economies of scale and lower production costs which would make Canadian firms and by extension the Canadian economy more productive, wealthier and more able to meet the competition from the rest of the world that was heating up anyway. If this strategy could work, by restoring growth and prosperity for Canada's economy, it would also guarantee that the country's much-cherished social programs would be financially viable and expanded in the future.

The downside risks on the other hand had become small. There was not much more control that Americans could rest over in the Canadian economy, the protective tariff had melted away and Canadian firms were no longer sheltered, while international competition was increasing reducing the market share of Canadian companies and undermining the ability of the nation to maintain its social benefits that it had worked so hard to create.

From Bilateral to Trilateral Free Trade: NAFTA

Mexico had also pursued a protectionist and import-substitution policy since the Mexican Revolution of 1910 and the cross winds of global economic change had also caught up with Mexico. Without going into much detail on Mexico's economic experience here, Mexico had reached a cross roads similar to Canada. The 1980s debt crisis and the collapsing of the Mexican banking system had proven to be the last straw. The reformist government of President **Carlos Salinas de Gortari** decided to pursue a more outward economic policy and embarked on a road of economic restructuring and tariff reductions to open up the closed Mexican economy and make it more competitive. He also saw the benefits that could accrue for Mexico through closer integration with the United States. On the heals of the successful implementation of the CUSFTA he proposed to U.S. President **George H.W. Bush** Sr. that Mexico would like to enter into a similar deal with the United States. President Bush accepted his counterpart's offer immediately, and negotiations between the two countries begun in earnest.

This development caught Canadian authorities by surprise, because they had never contemplated such a possibility and felt threatened that if the US were to conclude a deal with Mexico, that would put Canada in a position of disadvantage because the United States could claim to foreign investors that investing in the US gave them also access not only to the Canadian market, but even the bigger Mexican market as well. Canadians would not be in a position to make the same claim. Moreover, if the United States were to negotiate similar agreements with other countries, a "hub and spoke" trading system would emerge in which the United States as the "hub" would have a locational advantage over any of the "spokes". This prospect, did not sit well with Canadian authorities.

At the time, Canada's trade and investment relations with Mexico were small. Canadian exports to Mexico were CAD $1 billion while Mexican exports to Canada were $1.7 billion. Canada was Mexico's 11th largest trading partner and Mexico was Canada's 17th largest trading partner. Although Canada had by 1989 built a significant presence in Latin America with total Canadian direct investment in the region of about CAD$8 billion, the amount invested in Mexico was only a fraction of the above, a mere $400 million dollars, while there was no significant investment by Mexico in Canada.

What would Canada hope to gain to become part of the deal with Mexico? First, was the hope that existing low levels of trade and investment could be increased to the mutual benefit of both countries. Second, was the need to rationalize North-American production on a continental basis and to make the region more competitive and stronger in the face of increased global competition. In the summer of 1990, the Canadian government conducted public hearings on whether Canada should participate in negotiations on a possible three-way deal with Mexico. But in September, of 1990, the Canadian government announced that Canada would seek to enter negotiations with the United States and Mexico. On February 1, 1991 the three countries announced that they would launch negotiations on a trilateral trade deal.

The reason that Canada decided to join the negotiations had less to do with the reasons mentioned above. It had more to do with defensive reasons. First, staying out of the deal would give the United States an advantage over Canada for attracting FDI from the rest of the world. Second, Mexico would gain the same advantage that Canada had just won with the CUSFTA by being able to claim that by investing in Canada you gain free access to the USA. Since Mexico's market was potentially much bigger than Canada's, it would grant Mexico competitive advantage over Canada. But the clincher was that the inclusion of Mexico in a North American trade deal would give Canada an advantage in having another medium sized player as a partner in dealing with the United States. By having each other the two countries could better join forces to offset protectionist measures in the United States. The United States would not be able to play one partner against the other, instead both partners working together stood a better chance in counteracting the more powerful United States.

The negotiations went better than expected and a new trilateral trade agreement was concluded, the **North American Free Trade Agreement (NAFTA),** which came into effect on January 1, 1994. This agreement created the world's largest trading block representing a $6 trillion economy and a population of 360 million at that time. Although NAFTA remains a free-trade area as opposed to a customs union, which is the EC, the amount of three-way trade exceeds even that taking place within the European Community (EC).

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Comments, feedback and discussion on this paper are welcomed and would be much appreciated by the author.

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