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March 15, 2000

U.S. Trade Deficit Review Commission
444 North Capitol Street, NW, Suite 706
Washington, D.C. 20001

Dear Chairman Weidenbaum and Commission Members,

I wish to provide the following comments for your consideration in the fulfilment of your mandate to report to the Congress and the President on the causes, consequences, and solutions to the United States' trade deficit, including the role played by specific bilateral trading relationships.

Canada is one of the world's most open economies, the largest trading partner of the United States, and an active participant with the United States in the World Trade Organization, the North American Free Trade Agreement (NAFTA), and the Free Trade Area of the Americas (FTAA) negotiations. Canada has a clear interest in strong and sustainable economic growth globally, and particularly in North America, as well as a major stake in a well-functioning international trade and payments system. In this context, I consider it opportune to share with the Commission our views on some of the issues under review.

The Commission will undoubtedly already have heard that trade deficits and surpluses are an inherent feature of the international trading system. Indeed, they are a necessary feature if trade and investment are to serve the needs of the global economy by, *inter alia*, channelling investment to the most profitable applications, helping to cushion shocks and accommodating, with the support of capital obtained abroad, growth more rapid than domestic savings permit. Accordingly, we view trade balance questions in the broader economic context, recognizing as well that economic principles would not support any attempt to balance trade by individual trading partner or by region. Indeed, in the case of bilateral trade balances, the issues are inherently political.

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Canada and the U.S. share the world's largest and most comprehensive bilateral trading relationship. This economic partnership has been mutually beneficial over many years, in particular since the entry into force of the Canada-U.S. Free Trade Agreement in 1989. It includes, *inter alia*, trade in merchandise, trade in services, the flow of income earned from investment, the movement of people, cross-border commercial presence, and the acquisition and sale of technology.

In recent years, a number of cyclical, structural and transient factors at the macroeconomic level have had significant implications for our trading relationship, including:

- the historically exceptional economic boom in the United States economy, in part attributable to structural factors such as U.S. leadership in information technology;
- the gains in wealth -- both in absolute terms and relative to the rest of the world -- experienced by U.S. consumers and companies from the combination of record equity market values, low inflation and a robust currency; and
- the bout of economic and financial instability in emerging markets in 1997-1998 which depressed commodity prices and disrupted global trading patterns more generally.

While Canada too has performed exceptionally well in recent years, our economic recovery took hold and strengthened later than in the U.S. and our dollar was buffeted by spillover effects from the aforementioned economic and financial crisis.

Against this background, I would note that the data show reasonable balance in overall trade between Canada and the United States. Canada has maintained a relatively stable merchandise trade surplus over the years; however, this surplus is small relative to the total two-way trade flow and is offset by other components of the bilateral current account. In 1999 (the most recent year for which full annual balance of payments data are available) Canada had a surplus on merchandise trade of about 11 % of total bilateral merchandise trade, a deficit on services trade of about 7 % of total bilateral services trade, and a deficit on investment income of about 47 % of total two-way investment income flows (by far the least balanced of all of these flows). These major components of the bilateral current account added up to a Canadian surplus of about 3 % of total current receipts and payments. Thus, while Canada sells more merchandise to the U.S. than we buy, we spend much of the proceeds in the U.S. to sustain our industrial capital, to acquire technology, or to buy financial or tourism services.

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Quite apart from the above points concerning the context in which merchandise trade balances are to be viewed, there are several rather technical issues which urge caution in taking trade balance figures at face value.

First, given the extent of integration on a North American basis of production in a number of high-value-added sectors, many products cross the Canada-U.S. border more than once as intermediate goods on the way to becoming final products - for example, steel may cross the border once as a commodity, a second time in the form of an auto part and yet again incorporated into an assembled automobile. Since the full value of a product is counted each time it crosses the border, the gross flows are larger than the value-added content of trade - and *the surplus/deficit figure on a gross-flows basis will be different than that on a value-added basis.*

Second, *country-specific trade balances may paint a different picture than balances based on the nationality of the firms doing the trading.* In this regard, the sustained growth in recent decades of two-way foreign direct investment has resulted in sales of foreign affiliates abroad rivalling the value of cross-border trade in the case of goods and substantially exceeding the value of cross-border trade in the case of services. Further complicating interpretation of balances in the case of services trade, companies often have the latitude to choose whether to deliver a contracted service from headquarters or from an office abroad and often have further scope to choose where to book the receipts. The incentives arising from consideration of taxes, costs, or simple convenience then determine how these transactions surface in our statistics.

Third, *bilateral trade statistics are distorted by transhipment to third countries.* The extensive use of U.S. transportation facilities for Canadian trade with third countries makes the transhipment issue of broad relevance in the analysis of our bilateral trade data. Of particular note in a NAFTA context, the very substantial discrepancies between Canadian and Mexican statistics on Canada-Mexico trade undoubtedly reflect the passage of goods through the U.S.; *ipso facto*, these discrepancies will find an echo in the U.S. bilateral trade data as well.

From the Canadian perspective, we look beyond balances to gain a sense of the value of the trading relationship that we have in North America. A few words are in order on this point.

Our mutual achievement under the FTA and NAFTA has been to build larger and more dynamic markets for firms in each country, with major gains in productivity and consumer choice across a range of manufacturing industries. Total trade among the three NAFTA partners increased by 75% between 1994 and 1998, stimulating strong economic growth and contributing to record employment levels in all three NAFTA countries. Our exports to third parties also have become more competitive from the ability of our producers to source some of the inputs from each other's economies at lower cost than available domestically. Investment flows have also been dynamic: between 1994 and 1998, the stock of direct investment into Canada from the United States increased by 32%, to US$99 billion, while Canadian investment into the United States has increased by 49% to US$85 billion.

Moreover, account must be taken of the benefits that a country derives from imports -- in the final analysis, a country exports in order to earn the foreign exchange needed to buy goods and services produced elsewhere more efficiently or more cheaply than would be possible domestically. In economic terms, the welfare benefits from trade derive from imports - an important consideration along with the benefits of trade associated with exports (creation of jobs, efficiency gains from increased economies of scale and so forth).

Finally, to the extent that concerns about trade deficits arise from specific sectors, communities or individuals that have been negatively affected by increased competition due to liberalized trade, we recognize that it is cold comfort to suggest that we look at the current account as a whole or other aspects of a booming economy. These concerns are very real, in both political and economic terms, and governments do need to respond appropriately. For example, the Canadian government used its existing programs to ease the burden of adjustment on particular sectors at the time the Canada-U.S. FTA was implemented. In addition, ongoing retraining programmes funded by the federal and provincial governments have been important means to meet these concerns.

In conclusion, the fact that the U.S. is the world's most successful economy is not unrelated to the fact that it is also one of the world's most open economies. As I have set out above, we believe that the benefits from trade go far beyond what might be inferred from examination of trade balances. Accordingly, we encourage the United States not only to 'stay the course' in its commitment to open markets but indeed to reinvigorate its leadership of trade policy both globally, through the WTO, and regionally through the FTAA. This latter initiative is of particular mutual interest, with its promise to extend the demonstrable benefits of the FTA and NAFTA to the rest of the Americas, a region with nearly 500 million people, 50 million of whom will be middle and upper income earners, a GDP of US$2 trillion, and a large untapped potential for expansion of trade through greater market access, stronger disciplines and protection for foreign investment, and enhanced rules and dispute settlement procedures.

Thank you for the opportunity to share our views with the Commission. I trust that you will find our contribution useful for your study. I look forward to reading your report once it is made public.

Yours sincerely,

Raymond Chrétien

Raymond Chrétien
Ambassador

Encl: 1

Major Components of the Canada-U.S. Current Account

	Sum of Major Components[1] of Canada's Current account with the U.S. (in billions of US$)	Canada's Goods Trade Balance with the U.S. (in billions of US$)	Canada's Services Trade balance with the U.S. (in billions of US$)	Investment income balance (in billions of US$)
1994	$ 2.53	$ 18.59	$ -5.93	$ -10.12
1995	$ 5.75	$ 24.17	$ -5.90	$ -12.52
1996	$ 11.46	$ 30.89	$ -6.27	$ -13.16
1997	$ 2.04	$ 22.43	$ -5.82	$ -14.57
1998	$ 6.96	$ 24.18	$ -3.32	$ -13.90
1999	$ 20.35	$ 40.71	$ -3.20	$ -17.16

1. Only major components of Canada's current account were included in the calculation of these figures (i.e. the totals exclude current transfers).