1 TRADE POLICY AND ECONOMIC DEVELOPMENT

The truth is that, historically, free trade is the exception and protectionism the rule.

– Paul Bairoch, Economics and World History

The streets of Quebec City are an unlikely place to find police in riot gear. First settled nearly four centuries ago, its old quarter normally evokes a romantic, old-world charm that attracts thousands of tourists annually. But not from 20 to 22 April 2001. That weekend, its visitors included the thirty-four democratically elected leaders of the Americas as well as an estimated 35,000 demonstrators determined to impress upon the leaders their disapproval of globalization, freer trade, and international trade negotiations. In order to avoid a repeat of the debacle that had marred the third ministerial meeting of the World Trade Organization in Seattle eighteen months earlier, the police relied on a temporary fence built around the perimeter of the conference site. Their strategy worked. The official meeting was able to pursue its task without incident.

The protestors, however, also succeeded. As has become increasingly commonplace, television found the motley array of dissidents and their message more visually appealing and easier to report than the complex issues facing the leaders and their advisors. Unlike at Seattle, the leaders succeeded in adopting their communiqué and in giving renewed impetus to the quest for freer trade throughout the Americas. The protestors, not surprisingly, also claimed victory, and so the media reported. The goal of liberalizing international trade and investment and placing them on a more secure, rules-based footing seemed to be increasingly under attack, and the chances of ultimate success waning. Or was it?

Canadian antiglobalizers have been among the loudest voices protesting in Seattle, Quebec, Washington, Prague, and the many other places where leaders, trade ministers, or finance ministers gather to transact their business. Curiously, however, their claims and concerns have found but the faintest echo among most of their

Brian Gable, "Acronym Exhaustion," 17 April 2001.

fellow citizens. In the 2000 federal election, for example, Canadians gave the only party sympathetic to the claims of the protestors – the NDP – short shrift. For Canadians, the concerns of Seattle, Quebec, and elsewhere had been debated *ad nauseam* a decade earlier and proved wanting. Canadians had learned to accept that a country that derives an increasing share of its wealth from international commerce – the value of Canadian exports and imports of goods and services reached nearly 90 percent of the value of Canada's gross domestic product in the year 2000 – had much to gain from an open, well-ordered international economy. It was a lesson derived from more than two hundred years of experience, and driven home by the 1980s and 1990s. By the end of the 1990s, polling suggested that three out of four Canadians were satisfied that the international trade accords Canada had negotiated over the previous decades met their interests and concerns.[1]

The Trade Policy Challenge

Canadians could be forgiven, however, for not being familiar with the details of the charges and countercharges hurled across the fence in Quebec City. While not prepared to agree with most of the claims of the protestors, they did agree that the government should be more forthcoming in explaining the contours and purpose of international trade negotiations and their impact on Canadian and global developments. At the same time, governments could be forgiven for finding this a difficult task to discharge to the satisfaction of their critics.

Understanding the changes taking place in Canadian and global trade policy constitutes a challenge both to those who have a specialist interest and to those who have a general interest in gaining a better appreciation of Canadian trade policy and the issues involved. Stripped of its jargon and detail, however, trade policy is relatively straightforward. It is largely a matter of solving trade and investment problems within a framework of domestic and international rules as well as competing domestic and international political pressures. Ultimately, the solutions to these problems should increase national and global economic welfare. To achieve that end, governments pursue three basic objectives:

- improving access to foreign markets for competitive domestic producers and providers of goods, services, capital, and technology, by reducing or eliminating barriers to their exchange imposed by foreign governments
- maximizing national economic welfare by enhancing consumer and user access to competitive products at world prices, as a result of international competition and integration into the larger world economy
- establishing and preserving an effective, nondiscriminatory trade relations system based on transparency, due process, and the rule of law.

Market access is a business objective that seeks to maximize export, investment, and profit opportunities for domestic producers already able to compete on the international market; it has always enjoyed broad, popular support in the business community and elsewhere. Competition is an economic objective based on the ideas of neoclassical economics; it tends to raise suspicion and fear and can prove politically difficult to implement. An effective trade relations system is primarily a political and bureaucratic objective grounded in legal values; it also has enjoyed broad support because its successful pursuit provides the vehicle for fulfilling the other two.

By pursuing these three objectives, governments seek to influence directly the extent and nature of a country's foreign trade and indirectly a country's economic development. At its most basic, of course, trade is determined by the day-to-day decisions of individual consumers about what to buy, from whom, and at what price. Merchants, manufacturers, importers, and other private-sector firms respond to the cumulative impact of these decisions in their determinations about what to produce and supply. They, in turn, try to influence consumer decisions through advertising, product placement, and various other means. All of this takes place within a framework of laws and policies devised by governments to promote consumer safety, fair competition, environmental protection, and a host of other societal concerns and priorities. Trade policy instruments – tariffs, quotas, product standards, procurement preferences, and more – form an integral part of this framework of rules and regulations. Trade policy, trade relations, and trade negotiations are thus less about grand ideas and ideologies and more about the pragmatic working

out of very specific problems within the contours of existing political and economic realities, informed by the decisions and experiences of the past.

For a trade-dependent economy like Canada, a well-balanced trade policy is a necessary but not a sufficient condition for growth and prosperity. To be effective, trade policy needs to be complemented by other government policies, ranging from fiscal and monetary policies to competition and industrial policies. Increasingly, the line between these various policy instruments has become blurred, adding to the challenges faced by governments in their design and implementation of appropriate policies.

Over the years, trade policy has been one of the primary instruments used by Canadian governments to guide economic development. Generally speaking, minor changes in the deployment of trade policy instruments will lead to minor changes in exports or imports or industrial activity, while major changes may lead to more substantial changes. Over the years, most changes have been small and incremental despite claims to the contrary. Cumulatively, however, trade policy has been one of the most important policy instruments influencing Canada's economic development.

Historically, the Canadian economy has been open, small, export-led, and resource-based. Canadians have been price takers, that is, their economic activity has been much influenced by external factors. Exports have been an important engine of growth and, until recently, have been concentrated in resource-based products. Canadian trade policy, on the other hand, long tended to work against rather than with these characteristics of the Canadian economy. It sought to insulate the economy from outside influences and to encourage the development of industries capable of replacing imported products. There was a high degree of conflict in Canada between those policies that encouraged resource exploitation for export and those that encouraged import-substitution manufacturing. In other words, trade policy was more than a matter of economics; it was also an intensely political issue. Protection through high tariffs became inextricably tied to nationhood, a connection that was not broken until the end of the 1980s when Canada finally entered into an unrestricted reciprocity agreement with the United States, and the federal government told Canada's uncompetitive manufacturing sector to either adjust to global competition or lose its markets.

Ultimately, trade policy decisions involve choosing whether or not to give certain groups or individuals in society advantages over society in general – choices that require some understanding of the economic and political costs and benefits involved. The study of trade policy thus combines the analytical tools of both economists and political scientists. Since most decisions rely heavily on precedent and rules, a thorough understanding of the issues also benefits from the insights of lawyers and historians.

In trade policy, decisions to favour a domestic group often involve discrimination against foreign producers by imposing a tariff, a quota, a procurement preference, a higher product standard, or some similar measure. For example, in the 1950s,

the governments of industrialized countries concluded that domestic producers of textiles and clothing deserved a special degree of protection from foreign competitors – a decision that may have helped domestic producers, but discriminated against foreign producers and reduced economic welfare at home by increasing costs to consumers. Once domestic producers had become dependent on protection, they required more and more and developed a potent lobby dedicated to its maintenance. The choice then became not one of protecting one group in society at the expense of society in general but of breaking the spiral of protectionism by hurting one group (in the short term) while benefiting society in general. Most trade policy determinations essentially boil down to similar decisions to discriminate for or against the few.

Underlying most decisions to discriminate – whether domestically or internationally – is scepticism about the efficacy of markets and the price mechanism on the one hand, and faith in the beneficial effect of government regulation and controls on the other hand. Most of those decisions, however, are not based on economic concepts and analysis but on noneconomic instincts and biases. David Henderson, an economist with long experience in government, notes, "More than two centuries have passed since the publication of Adam Smith's great treatise, *The Wealth of Nations;* and trained economists are now well established, not just in universities and research institutes, but also in business enterprises, civil services, and the councils of presidents and prime ministers ... Yet DIYE [do-it-yourself economics] has not become a curiosity of the past ... Ideas and beliefs which owe nothing to recognized economics textbooks still retain their power to influence people and events."[2] He concludes that economics must be one of the few academic disciplines in which the professionals have failed to drive out the amateurs and in which "prescientific" notions continue successfully to influence serious opinion.

Because trade policy decisions often affect foreign interests, trade policy is an arm of diplomacy and may involve international negotiations and rule making. Again, the basic concepts in diplomacy and rule making are simple, even if they too have become the craft of professional experts. Negotiations involve making mutually satisfactory bargains by finding ways and means to satisfy often-conflicting objectives, while rule making concerns the establishment of precise standards that will govern future decisions, thus promoting predictability and stability. Years of negotiating and rule making have created a body of international rules that now limit the choices available to governments in deciding whether or not to favour one interest over another. The basic concept underlying these rules is the presumption that nondiscrimination is better than discrimination, whether domestically or internationally.

Trade policy can be divided into two branches – foreign and domestic. Foreign trade policy is concerned with access to foreign markets and the successful exploitation of those markets, while domestic trade policy is concerned with import competition on the domestic market. Ideally trade policy and international negotiations should seek to achieve a balance between foreign and domestic priorities, a balance

that ensures gradual movement toward more open and more secure trading conditions in order to increase domestic and global economic welfare. In practice, however, these ideals are often tempered by political and other realities.

In order to make significant progress toward their foreign trade policy objectives in a negotiation, the partners need to frankly assess current practices and often be willing to make serious adjustments to their domestic policies. This is more likely to happen when the partners share a common view of the issues, when their economies are organized along similar lines, and when they are at approximately the same level of development. Trade-offs are less likely to be made when there is little ideological consensus, differing approaches to economic organization, and wide disparity in economic development among the players. Additionally, the greater the number of players involved, the more likely the benefits of more open access will be perceived as relatively diffuse and long term, while the payment may be seen as direct and painful, politically if not economically.

Inevitably, the question of sovereignty arises. Over the years, as nations have grown more interdependent and economic integration has intensified, the issues subject to international negotiations have expanded. Fifty years ago, trade negotiations principally revolved around tariff and quantitative restrictions, and the major concern was the extension of most-favoured-nation (MFN) treatment. Negotiators concerned themselves about what happened at the border and sought to end discrimination in the way countries treated foreign goods originating in different countries. Today, negotiations touch domestic laws and regulations and involve national treatment, that is, discrimination between national and foreign goods and services. Such negotiations can prove much more controversial.

Part of the problem, of course, is created by the rhetoric of politicians, when they suggest, erroneously, that *countries* trade with one another. Trade and production, however, are driven by the demand and imagination of *individuals* responding to market opportunities and desires. Government's role is to regulate the resulting flow of goods and services. Trade agreements do little more than reduce the scope for arbitrary and discriminatory regulations and for unproductive interference in market-based decisions. Concern about the impact of such agreements on sovereignty is perhaps overwrought and misplaced.

Indeed, it can be argued that every trade negotiation is an affirmation of sovereignty. The whole idea of entering into an international agreement is to impose the rule of law – one country agrees not to do some things and to do other things in particular ways, in return for other countries agreeing to do the same. The 1947 General Agreement on Tariffs and Trade (GATT) involved such commitments, as did the 1935 and 1938 bilateral trade agreements between Canada and the United States. In fact, these commitments strengthened Canada as a nation, because they made the country stronger economically and because trade and other matters came to be governed by agreed rules of international law, not by decisions made unilaterally in Brussels, Tokyo, or Washington.

It was a striking feature of the free-trade debate in Canada in the 1980s, for example, that the opponents of free trade were able to convince many Canadians that a bilateral trade agreement posed a special threat to sovereignty. Few questioned that Canada enjoyed a defence relationship of extreme importance and complexity with the United States, or that it should strike bilateral agreements on subjects as diverse as migratory species, water quality, extradition, and mutual legal assistance, but it was an article of faith that a bilateral *trade* agreement carried with it unacceptable risks of absorption.

As the forces of global integration continue to place pressures on domestically oriented producers, values, and institutions, more issues will become candidates for international negotiation, and an ever-wider array of special interests will feel threatened by such agreements. But if governments are to address today's problems and influence tomorrow's decisions, they must of necessity deal with the issues raised by the real world, including controversies that arise out of traditional domestic policy making. Governments cannot ignore the protectionist effect of trade-remedy legislation, ownership restrictions, cultural support programs, or agricultural supply management and still hope to negotiate useful agreements. As a result, trade negotiations require that governments confront entrenched domestic interests that are prepared to make emotional appeals to sovereignty.

A further limitation on what can be expected from trade negotiations is imposed by the conventions of international trade bargaining. Trade negotiations seek to increase economic welfare by reducing discrimination, removing barriers, and providing greater scope for the operation of market choices, unencumbered by artificial barriers imposed by governments. They assume that the order and stability flowing from clear rules and equitable dispute settlement provisions are to be preferred to the rule of power. In short, both economic and legal maxims suggest that international trade agreements are mutually beneficial.

But international bargaining is often pursued on the basis of pre-economic and pre-legal concepts. Negotiations are frequently viewed as a zero-sum game – every concession granted by one side must be matched by a concession from the other side. While negotiators know that the removal of barriers and the establishment of rules make sense, in their hearts they are convinced that they must also maximize export opportunities and minimize import competition to satisfy their political masters, who are responding to the noneconomic ideas of their publics. From time immemorial, politicians have accepted the mercantilist maxim that the strength of the nation requires a positive trade balance, an ability to do without imports, and the promotion of strategic advantage over all other nations. British economic journalist Martin Wolf has called this process "mercantilist bargaining" and has suggested that, perversely, politics dictates that it is only through mercantilist bargaining that progress can be made.[3]

One of the factors that promotes mercantilist bargaining is the reality of international trade. International trade theory teaches that reductions in trade barriers

lead in most instances to a more efficient allocation of resources and to an increase in both national and global economic welfare. The gains realized are spread out thinly across the whole population, while the losses are concentrated among producers of the formerly protected goods and services and their employees. Beneficiaries of trade liberalization tend as a result to be much less vocal about their interests than potential losers, who are thus able to tilt the political balance against trade liberalization and require negotiators to demonstrate specific gains and losses in a mercantilist balance sheet.

Trade policy, therefore, involves the pursuit of some well-established principles of law and economics tempered by the realities of domestic and international politics. The constant interplay between principle and pragmatism is informed and influenced by the precedents of the past, which make the trade policy, laws, and practices of each country unique. Contemporary trade policy challenges can often be understood more clearly by examining their historical roots. Economic analysis may well demonstrate the fallacies of Europe's Common Agricultural Policy (CAP) or of Canada's system of supply management, but it will provide no more than a partial answer to those interested in negotiating solutions to the problems these programs pose for Europe's or Canada's trading partners. The historical origins of these policies also need to be studied. Understanding modern trade policy means grasping current political and economic circumstances as well as the historical development of the modern trade relations system and the place of Canada and its major trading partners in that system.

The Challenge of History

Canada has always been a trading nation. From earliest days, Canadians have relied for their livelihood on exports to bigger and wealthier markets. Those exports have been largely resource-based and often at very low stages of processing. Furs and fish, then wheat and forest products, and finally metals and minerals were sold on world markets in exchange for machinery, consumer goods, food, and other products not as readily or as cheaply available at home. Canada's colonial, imperial, Commonwealth, and sentimental ties to Britain and geographic ties to the United States ensured that the preponderance of the country's commercial relations would be with these two countries.

Much of Canada's trade policy, from its early pre-Confederation origins until well into the postwar era, was forged in reaction to policies pursued by these two world powers, policies typically adopted without any thought, positive or negative, about their possible impact on Canada. Throughout much of their history, Canadians sought a special place for their products in one or both of these two markets. Much of the history of Canadian trade policy, therefore, is a record of the changing priorities attached to commercial ties with one or the other. The quest for special status was complicated by the trade policy and attitudes in vogue in these two dominant powers as well as by noncommercial sentiments and considerations. The latter

"THE CREAKING OLD MILL"

Borrowing from Strube of the London Express, Dale again reverted to the theme of High Protection's effects. (Nov. 17, 1932.)

Arch Dale, "The Creaking Old Mill," 17 November 1932.

often flowed from the fact that Britain and the United States were major powers with worldwide interests, responsibilities, and influence, while Canada, rather self-consciously, worried about its self-image and identity. Only after the 1960s, with the decline in the United Kingdom's global economic role and the emergence of the United States as Canada's only major partner, did the government strike out across the Atlantic and Pacific in search of countervailing forces to the overwhelming influence of the United States.

For much of Canada's history, trade policy served as the basic building block in the country's industrial development. Tariffs and related instruments encouraged the growth of a domestic manufacturing sector, while trade negotiations provided access to foreign markets for Canada's resource producers. The result was a bi-furcated industrial structure, a heavy reliance on foreign capital, and an increasing dependence on trade with the United States. Dissatisfaction with both the means and the result led in the 1970s to efforts to foster different trade and production patterns. Their impact, however, proved meagre at best. In a democratic market economy, a century of economic development is not quickly undone and the forces of geography, business judgment, and consumer preference are not easily overcome.

Canadians have historically found it hard to accept that a resource-based economy without secure markets for its products, coupled with an inefficient, import-substitution manufacturing sector, provided a poor basis for sustained growth and development. In the face of spreading protectionism in the United States and in Europe, however, it was difficult for a small, trade-dependent country either to find ways to reduce foreign barriers to its exports or to resist the siren call for protection from its own manufacturers. What might make economic sense now did not necessarily make political sense then. Nevertheless, Canada's dependence on outside markets made the autarchic impulse of nationalism increasingly untenable. If Canadians wanted to continue to benefit from international trade, the economy had to become both more diversified and more integrated into the emerging international economy, on the basis of a trade policy that would provide business with predictable and stable access to wider markets. To that end, trade policy in the 1980s and 1990s achieved a level of public attention and concern that had been absent for more than fifty years. Responding to wrenching changes in the domestic and global economies, the federal government pursued a range of bilateral, regional, and multilateral negotiations aimed at both encouraging and rewarding adjustment to these changes. The implementation of the Canada-US Free Trade Agreement in 1989, the North American Free Trade Agreement in 1994, and the World Trade Organization Agreement in 1995 completed the quests of more than a century of international negotiations while simultaneously mapping out the contours of future negotiations.

Trade policy had for centuries been organized on the basis of the measures governments use at the border to define and defend national markets and national producers. Over the past half-century, as a result of successful negotiations among nation-states, a rules-based international trade order has become a universally accepted part of both intellectual and intergovernmental discourse. By the 1990s, however, the success of that order in integrating national economies into a global economy posed a new series of challenges suggesting the need for both a new trade policy and a new regime capable of extending concepts of national governance to an increasingly integrated global economy.

The full impact and implication of the global economic changes that are driving the demand for a new paradigm are, of course, not yet fully understood. Understanding these challenges will require a greater appreciation of the road Canadians have travelled over the past century and a half. It is more than a cliché that those ignorant of the past are bound to repeat its mistakes. The past informs the present and makes it both more intelligible and easier to accept. With a firm understanding of the past and a realistic appreciation of the present, the challenges of the future are less daunting.

As we stand at the beginning of a new century, the salient features of the Canadian economy, when placed in their global context, suggest the need for urgent attention to a range of critical economic policy choices. Canadians now enjoy one

of the highest standards of living in the world, while occupying the second-largest piece of global real estate with less than half of 1 percent of the world's population. Nevertheless, these features are in some ways liabilities as Canadians face the much more competitive and integrated global economy of the new century. If Canadians are to adapt their economy to the challenges of the new century, they will need to look again to trade and related economic policy choices. Making the right choices will require a clear understanding of the choices made in the past and of the influence these choices have exercised on Canada's economic development.[4]

The pages that follow treat an economic issue – trade – but they are not a contribution to the economic history of Canada as that subject is usually understood – the application of economic analysis to historical phenomena.[5] This study attempts to make a contribution to the history of ideas and public policy. It seeks to provide a better appreciation of the nature of Canadian trade policy and the contribution trade policy has made to Canada's current economy and its place in the global economy.

Much of the writing about these issues in Canada over the past few decades has been too much influenced by current political and economic ideas and values; governments, in making and implementing policy, react to contemporary pressures and realities on the basis of a rather limited series of choices. Governments do not have 20/20 hindsight, nor can they anticipate the views of later critics. When Prime Minister John A. Macdonald, for example, decided to pursue a National Policy, he was responding to the reality of a small and not very successful economy that had suffered the rebuff of first the United Kingdom and then the United States. He was looking for a policy mix that would help to develop the Canadian economy and at the same time create incentives for the United States to take Canadian reciprocity overtures seriously. Similarly, efforts by Liberal governments in the 1940s and 1950s to open the economy to greater competition and to enhance export opportunities reflected their continuing preoccupation with depression and global war. As Judith Goldstein points out in her study of the role of ideas and institutions in the evolution of American trade policy, "American trade policy has been very 'sticky'; the creation of rules and procedures to enforce a particular economic strategy at one point has acted as a constraint not only on current behavior but also on the range of options available to future entrepreneurs. In particular, laws have remained in force long after the economic conditions and political interests originally underpinning them have changed. Old statutes have constrained newer policies by giving standing to particular claims for protection from foreign goods. They have also affected the fundamental constitution of social interests."[6]

Generals often end up preparing for and fighting the previous war. Politicians similarly find themselves analyzing the last depression or renegotiating the last trade agreement. The gap between changing realities and the policy responses to them can sometimes be quite cavernous. While we will never be able to foretell the future, our ability to understand the present and to prepare for the future can be significantly enhanced by a better understanding of the past.

2 THE OLD MERCANTILISM

To found a great empire for the sole purpose of raising up a people of customers may at first sight appear a project fit only for a nation of shopkeepers. It is, however, a project altogether unfit for a nation of shopkeepers, but extremely fit for a nation whose Government is influenced by shopkeepers.

– Adam Smith, The Wealth of Nations

Canada's beginnings lay in dashed hopes and broken dreams, its destiny in unimagined wealth and promise. European adventurers, in search of gold and spices and a new passage to the fabled treasures of the East, found instead a vast and sparsely populated land of lakes and forests. They stayed to fish, hunt, trap, and otherwise exploit its untold riches and thus bequeathed an even richer and longer-lasting legacy than they had imagined in their wildest fantasies.

The commercial policy that initially nurtured and guided the development of this wilderness of the North reflected the political organization and prevailing economic doctrines of the day. It was the king and his nobles who decided and adventurers and merchants who acted. Together they made an empire. Progress, however, was painfully slow. The romantic schoolroom history familiar to generations of North Americans obscures the fact that for more than a century after the first European contacts with the Americas, the territories that eventually became Canada and the United States remained at the periphery of European civilization, of interest to no more than a few explorers and religious zealots. What economic and other activities took place there were regarded as a net drain on the king's purse with little prospect of long-term gain. In 1758, the last year of French rule in Canada, fewer than 60,000 Europeans occupied a territory far larger than all of western Europe. In order to survive they had to import some eight million livres worth of provisions and were able to export only two and a half million livres worth of fish, furs, and lumber. Local taxes (mostly customs duties) made only a small dent in the expense of maintaining local government and a military garrison.

The French and English courts found it hard to take the discoveries across the Atlantic seriously. Between the pioneering voyages of Columbus and Cabot at the