

## **I Introduction**

Let me take a slightly different perspective than other speakers have this morning; my view is that the Canada-US relationship, while long-standing and deep, is not uni-dimensional nor uni-directional leading unambiguously towards deeper integration: the relationship can be characterized more as a modular house with some rooms quite closely tied into one another and some fairly clearly cut off, generally for good reason and likely to remain so.

I am going to focus on what we know about this complex relationship and what we do not know and then end with several comments for you to think about as we look ahead.

## **II What We Know**

One always starts a Canada-US economic discussion by stating that this trade/investment relationship is the largest in the world - covering both goods and services, the movement of ideas/technology and know-how, as well as of persons - that is, of professionals on a short-term basis as well as of visitors. We often then go on to highlight the fact that the US is responsible for some 20% of Canadian GDP or, conversely, that Canada contributes about 2% to US GDP; we also highlight the fact the trade with the US comprises the largest component of each provinces' trade and that trade with Canada forms the largest component of trade for 39 of the 50 states in the US - all pretty impressive, especially from the perspective of this province.

But we must be careful ... trade numbers in particular are just general indicators; while they record the movement of goods and, less accurately, of services, they represent less-and-less the way business is organized in today's world; that is, they do not capture fully the fragmentation of production and thus the growth of intermediate goods and services as an essential element of the regional and global value chains.

We also know that the direction, the pattern, and the intensity of trade can be explained by economic theory - by comparative advantage, by distance, and by growth performance. Thus it is no surprise that most of Canada's external economic activity will be with our next-door-neighbour, and indeed that it peaked during a time when the US economy was performing so well during the late 1990's and earlier this decade. The benefit of this neighbourhood relationship has been obvious over the years; the cost however, is that Canada, the smaller partner, is subject to the occasional "disruptive shock" such as 9/11 and its aftermath; these shocks are beyond Canada's control and have characterized Canadian economic history over the past two centuries or more.

A third factor that is part of our known current reality is the generally good state of the world economy - - - for the first time in decades, there has been a world-wide convergence of growth; just as the US has entered into a sub-par period of economic activity, others (Japan, most of the European Union member states, India and especially China) have filled the gap. This world-wide activity, including by the way most of Africa as well, has helped maintain satisfactory growth in trade-dependent economies such as Canada, at least to date. The only serious fly in the ointment, and it is a worry, is the fact of the current US current account deficit, the resolution of which will require over time either more US exports and/or fewer US imports. As its largest

trade partner, Canada inevitably will be affected by the correction of this deficit negatively - the only question is by how much and over what time frame.

A fourth and related factor now well known to all of us is what my colleague at CIGI, John Whalley, refers to as "global swirl", the growth of China, India and other so-called emerging economies that is shifting global power away from the industrialized, "developed" West and forcing changes in our economic structure away from manufacturing in particular. While we do not know the full extent and speed of this change in global tectonics, we do know that China this year will become the world's third largest economy and will have increasing demand over a long period of time for much of what Canada specializes in - resources and financial services.

Lastly, we know - even through many in our governments, the manufacturing sector, and the Conference Board do not agree and thus sound on occasion unnecessarily pessimistic - that Canada economically is doing really quite well - we have an excellent macro-economic record, a satisfactory micro-economic performance that does require further work, and an almost fully-employed work-force - - - Canadians know and feel this despite all the pessimistic chatter.

### **III      What We Do Not Know**

Being a typical, two-handed economist, I must also emphasize what we do not know or at least what we do not fully understand before we rush to any judgments or worse pronouncements, especially about how our economy will evolve in relation to that of the United States.

One uncertainty, of course, relates to the external value of the Canadian dollar; by most calculations, our dollar is now close to the upper end of its range - far too high with respect to relative labour costs, somewhat too high with respect to the consumer price index compared to those of other countries, and even a little high with respect to relative capital costs. But if the current, significantly higher level of the Canadian dollar is maintained for any period of time, Canadian businesses will be able to begin on a more concerted basis to actively substitute capital for labour as happened in the US over the 1990's - with consequent improvement in our measured productivity while at the same time forcing many changes in our labour market, particularly in the manufacturing sector.

A further uncertainty are the prospects for US growth: with a large fiscal deficit, with the historically high current account deficit referred to above, with the sub-prime housing issue, and with major overseas military commitments, the US at best will not be able to maintain its impressive growth rates of the past decade. Since growth of one's trading partner is the major factor in the amount of trade activity undertaken, this longer-term likely US slowdown will clearly influence Canada's trade performance, lessening the share of our total trade with the US over time. We can in fact already see this trend.

Also not known, although some interesting research is presently underway by a number of institutions, is the impact of the increased cost of security on international trade and investment. The cost of international trade has declined over the past one hundred and fifty years because of lower transportation and communication costs; will higher costs due to increased security at land and sea borders reverse this direction over time? If so, smaller countries such as Canada could be

damaged - investment and resulting trade could increasingly be directed to, or based in, larger economies to avoid increased border costs. Early evidence, most recently by the Conference Board, suggests, however, a minimal impact; we need, nevertheless, a longer period of observation; including an in-depth survey of how business practices across borders have changed, before we can come to any definitive conclusions. What I call techno-nationalism, that is, protecting and/or limiting the export of sensitive technology, will also be part of this equation and will have to be assessed to determine the impact on the likely volume and direction of trade and investment in the future.

We also are not certain about the long-term impact of the increased relative price of energy; although the output per unit of energy is much higher than was the case twenty years ago, the longer-term implications of permanently higher energy prices for both producers and consumers have yet to be analyzed, in particular the impact of higher sustained energy prices on the poorer members of our society who have benefited over the past decade from low-priced imported consumer goods from China and elsewhere. This favourable impact of the newly-emerging economies could well change because of higher energy costs in the years ahead, upsetting further the social contract between labour, capital and government. More generally, the longer-term impact of rising resource prices combined with resource technology improvements affecting this sector in particular will have a major longer-term impact on this country - - - as in the late 1960's and 1970's, we are benefiting at present from very favourable terms-of-trade because of high resource prices. Nevertheless, we have seen the terms-of-trade reverse themselves in the past as they will undoubtedly do in the future.

Finally, we are not clear about the importance of head office functions in our contemporary world of increasingly fragmented production and distribution. Who makes research, development, commercialization of innovation, production, sales and after-sales service decisions and where are they made? Does location of the headquarters matter? Does it vary by sector? What about business-related services - do so-called clusters have a significant influence, a particularly important question for Toronto and south-western Ontario? More generally, does the nationality of ownership of assets matter?

#### **IV      Conclusions**

So, in your day-to-day management of programs and policies, even the most domestic ones, international economic policy and developments do matter: notwithstanding globalization, we continue to live in a world of nation-states with enormous control - - - although no longer a monopoly - - - over information and policy - two key elements of governance.

But we understand increasingly that the global commons matters - climate change, migration, disease, competition - all these and other matters affecting global governance are relevant to the activity of the public sector both at the supra-national, national, regional, provincial/state and local levels. Cooperation at every level of government, in a world still characterized by personal and national self interest, is a key objective to maintain orderly social and economic progress.

Thank you.