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Macroeconomic Perspectives of Canada-U.S. Trade Agreements

*by Carl Beigie**

I **approach** the Canada-U.S. relationship as an economist. I give a lot of speeches and almost every questioner begins by saying "well, I'm not an economist" and brags about that fact. Well, I do not apologize for being an economist, it's an interesting perspective. There are, however, other perspectives, which I respect. But the one that gives me the most difficulty is the perspective of the political scientist concerned about sovereignty, independence, and uniqueness as goals which have value within a country.

My approach, after a great deal of reflection on this issue, is to argue three things. First, uniqueness must be based on something other than sheltered inefficiency. Second, a well-reasoned economic agreement with the United States could improve Canada's economic performance and thus its ability to achieve effective political sovereignty. And third, I believe the proper strategy for Canada is to pursue, simultaneously, the following: a) improved management of the domestic economy; b) a carefully constructed formalization of the Canada-U.S. relationship; and c) the pursuit of further progress through the GATT framework of multilateral trade and investment liberalization.

When I was asked to speak here, it was still the case that there was some interest in a sectoral approach to Canada-U.S. trade. However, I have always thought that the sectoral approach, especially a sectoral approach using the AutoPact as a prototype, simply will not work politically. There is not enough time nor is there the political patience in Washington to accommodate the deeply held fears of Canadians. Fears that would give rise to different forms of safeguard requirements for almost any industry sector that you would choose to negotiate on.

In my view, Canada should pursue the bilateral approach. And in order to succeed, the bilateral approach will require comprehensiveness. Now, it may be possible to have differentiation in the approach, for the transitional adjustment problems that Canada would particularly face in a bilateral agreement. But that should be among groups of sectors—like the competitive, nearly competitive and basket-case sectors of the Cana-

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dian economy. That is all I can see that is practical in terms of the sectoral approach to a bilateral agreement.

That is not the focus of my remarks, it is just the starting point for looking at the Canada-U.S. issues. I have always had a sense that Canadians are narrow-visioned in terms of their approach to Canadian problems in an international context. My focus concerns the macroeconomic environment, with particular emphasis on exchange rates and interest rates, within a broad international context. My concern is that the world economy is badly out of balance. I deal with these issues on a day-to-day basis, and the process of redressing the imbalance that has arisen is going to take a very long time. That redressing has probably begun, but in a manner that is going to generate mounting tensions in the trade area over the next year or two.

I must first give some background for my remarks. The 1970's will go down in economic history as the period of the Great Inflation. Imbalances were created that, from an economic perspective, were strikingly similar to the imbalances created in the global economy during the Great Depression. Because of this Great Inflation of the 1970's we had no alternative but to provoke a recession in order to bring about a change in the course of the world economy.

I am going to mention three elements of what I would regard as the U.S. economic, or macroeconomic, approach under Mr. Reagan. The first of these approaches is the monetary discipline practiced by the Federal Reserve, which provided the brake to the Great Inflation beginning in late 1980. The second element consisted of the tax cuts, at both the individual and corporate levels, and defense spending increases that exceeded the reductions in non-defense expenditures. The climb out of recession, which was provoked by the introduction of a very tough monetary policy, could have been extremely long and labored if some country had not provided a strong dose of demand stimulus.

The non-inflationary growth surge, which began in late 1982 and continued through 1984, was essential to the recovery of the global economy from the 1981-82 recession. But it was possible only through foreign financing of a large portion of the United States' internal budgeting deficit. The U.S. macroeconomic strategy meant three things:

1) High inflation-adjusted interest rates—what are called real interest rates. (U.S. interest rates would have been higher were it not for the foreign funds inflow that was attracted to the United States.)

2) A very strong United States dollar, which came about as a result of the foreign capital influence. (This was a period in which the United States dollar won a reverse beauty contest. The economic fundamentals in the United States were not all that glowing, but everything else was so ugly that the United States looked relatively attractive.)

3) A very significant deterioration in the United States international investment position. (I do not know whether it is true statistically that

the United States became a debtor nation early in 1985, but the way trends have been established in the trade sphere, the U.S. will definitely be so very early 1986.)

What these developments have produced is the situation that the United States is, has been, and will continue to be very vulnerable to a number of factors. First it is going to be very vulnerable to higher inflation when the dollar stops rising. I think the dollar has now seen its peak; it will not go back to its previous highs again. As a result of the dollar stopping its rise, the United States will lose the offset to inflation that was brought about through declining prices of foreign currencies and imports which the United States counted upon during this period.

The second vulnerability of the U.S. economy is higher interest rate differentials. I stress the word differentials—it is not sufficient to just look at levels in interest rates. The United States is vulnerable to a situation in which it will have to attract foreign money as soon as the dollar loses the magnetic value which attracted foreign currencies in the past. And the only way to induce capital inflow when the magnetism decreases is through having interest rates higher than alternative interest rates available to the foreign investor.

How do I know that? I live in Canada. Throughout our history, we have constantly needed to be alert as to what our interest rates were in relationship to alternative interest rates for the investor. When the dollar becomes less attractive we are going to have to watch that interest rate differential.

The third vulnerability is to the potential for a sharp fall in the U.S. dollar when an attractive alternative emerges. I do not think gold will be that attractive alternative. Nor do I think the yen could be that attractive alternative, because of the highly controlled Japanese financial market. But, if one or more of the European currencies became extremely attractive in an international financial sense, then there is potential for a very sharp and sudden fall in the United States dollar.

The important issue at the present is whether the countries with strengthening currencies (*e.g.*, the mark) will be as quick to reduce their interest rates as they were to raise them when the currencies weakened. If the Europeans take an attitude that basically says "what we want is a strong currency," and they pursue that instead of quickly lowering their interest rates, then the United States will have to raise its interest rates in order to establish a positive differential.

I will pursue this issue with a somewhat different perspective than is commonly heard in the United States. As an economist, I have not the slightest doubt that, in the period since late 1982, the United States did not give, but received "aid" from the rest of the world. The real transfer of resources, through the trade deficit which the United States was running in that period, was very substantial. (Canada contributed to this U.S. aid, but it received aid from the rest of the world on balance. We had a modest current account surplus during this period because we were shipping capital—mainly to the United States.)

The process of restoring a better world economic balance through non-inflationary growth would have been assisted by two things:

First, the use of the "aid" received by the United States to significantly boost domestic investment in modern, internationally competitive capital equipment. This is the third element of Reaganomics, an element not very well understood in the Canadian economy. What Mr. Reagan did more than anything else, in terms of a positive contribution to the world economy, was to significantly increase the role of the market place in the allocation of resources within the United States economy.

The second point that would have assisted the process to an effective global re-balancing has not happened and in my judgment, will not happen. The United States had a serious responsibility to reduce the United States internal budgetary deficit in line with its movement toward effective full employment. I have no objection to the fact that the United States effectively conducted policy to receive "aid" from the rest of the world. My objection is that the United States, and the whole fundamental logic of what Mr. Reagan was doing, required him to move quickly—as the United States moved to a significant reduction in the unemployment rate—toward a reduction in the internal budgeting deficit. If this had happened, then success could be measured by a future in which there would be a slower rate of U.S. import growth.

As the United States slid down from a robust expansion after the recession, it provided the locomotive for the rest of the world's economy. That cannot continue forever, and what should have happened was the United States locomotive would have slowed down and let the rest of the train catch up with it. The United States should have slowed significantly its rate of import growth.

If it had used that "aid" it received from the rest of the world to effectively increase its investment potential on international competitive terms, then the United States would have been able to have an expansion in its exports of internationally competitive products and services. And the combination of the slower growth in imports into the United States with an expansion of exports, as the rest of the world increased their growth rates, would have resulted in a much improved trade balance for the United States and a fairly limited general depreciation of the United States dollar. There was no reason for a large U.S. dollar depreciation if all of these things had happened appropriately.

What would have happened under this scenario I am trying to paint? There would have been a very steady improvement of the United States' internal budgetary position which would have freed output in the United States to aid the development process abroad. In other words, after receiving the "aid" the United States would have been in a stronger position in the late 1980's and 1990's to return the "aid." Then, a particular economy (European or Canadian) could have undergone a fairly substantial restructuring, resulting in modernization and enhanced competitiveness. And, this would have resulted eventually in a U.S. budgetary surplus.

This is what has to happen eventually, before the economy of the world is going to be back in better shape—the restoration of a strong U.S. international investment position. The United States has no business, in a world that is as imbalanced as ours, in being an increasingly large net-debtor nation. This is not concerned with the protectionist arguments in the United States. It is concerned with the morality of taking from the rest of the world to improve one's own position on a steady basis.

That is where things should have been. And I am greatly concerned that the opportunity is going to be missed. The dollar has weakened suddenly with the lag in foreign interest rate response—the Europeans are going to let their currencies get much stronger before they move on interest rates. There is a failure to cut the budgetary deficit. In the face of rising unemployment in the United States, Congress will be much less willing to go into a deficit cutting action if the economy is weak.

There will be a tendency to seek a lowering of interest rates in this environment by permitting an excessive rate of money supply expansion. This is precisely what the Federal Reserve is doing now. They are concerned that if the economy softens too much, the Congressional action on the deficit will be held off. Mr. Volker is running extremely serious risks of increasing the money supply too rapidly and mitigating, not wiping out, the progress that has been made around the world on reduction in the inflation rate, which should be permanent.

Furthermore, this attempt to lower interest rates through more rapid money supply creation will be self-defeating before very long. The market will pick up on it quite quickly and interest rates will be rising in the not-too-distant future. The bottom line is that missing the above mentioned opportunity will result in a further rise in pressures for protectionism in the months and years ahead.

Thus, I would argue that the failure to follow through on the logic of the second element of Reaganomics (temporary stimulus of the economy through tax cuts and expenditure increases) and the failure to follow through and get the budget deficit down as the economy strengthens, could jeopardize sustained adherence to the first principle—monetary discipline.

Furthermore, it could lead to difficulty in terms of continued performance on the third element of the Reagan program, which is, essentially, increasing the flexibility and the competitiveness of the United States' economy. If President Reagan is forced, by political reasons, to give into Congressional pressures for protectionism, it will significantly deprecate the whole foundation of his approach to the world economy.

If my concerns are well-founded, we are headed for another world economic down turn, this time led by the United States. Canada will experience a serious weakening in its growth because of a cut back in the major engine of that growth in recent years—exports to the United States. This weakness will be aggravated by a tough budget coming in the latter part of May (1985) from the current Government, which feels it has an obligation to the business and investment community to bring a reduction in the budgetary deficit at this time.

From a macroeconomic perspective, while the spirit of a North American trade accord exists, the longer it takes to put forward a detailed agenda for negotiation, the greater the likelihood that general macroeconomic difficulties will sour that spirit. The comprehensive approach must be launched quickly if it's to have a chance to succeed this century. If we wait to dot all the *i's* and cross all the *t's*, the possibility of an agreement will lead nowhere.

Sectoral agreements are simply impractical in the environment I foresee. Functional agreements may still be feasible as a fall-back, if we cannot get a serious comprehensive agreement, but the longer we wait the less meaningful those functional agreements are likely to be. I respect very much the process of discussion and debate and education. I am participating in a lot of groups such as the one at this conference. The fact of the matter is, if we have not done our homework yet, if we spend too much time debating what by now should be obvious, it may be too late.

Thank you very much.