Notes for Remarks to the Canada-China Friendship Association

Prospects and Obstacles to a Canada-China Free Trade Agreement

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It is an honour and a pleasure to address the Canada-China Friendship Society on a topic that is central to the future bilateral economic relationship between our two countries. I thank the Society very much for the invitation.

The possibility of a Canada-China free trade agreement (CCFTA) is very much in the air. The study commissioned jointly by the Canada-China Business Council (CCBC) and the Business Council of Canada (then the Canadian Council of Chief Executives) and co-authored by Laura Dawson and myself on the impact of a possible CCFTA (Dawson and Ciuriak, 2015) noted the various overtures that had been made to that point about such a next step – and demonstrated that there would be significant economic value to both countries from taking that step.

In my remarks this evening, I should like to elaborate on the value-added of a CCFTA against the background of an already-rich set of bilateral commercial agreements between Canada and China. Since Canada has been the hesitant party, I shall also outline what I believe to be the case for Canada committing to negotiations, and also the obstacles that Canada would have to overcome to make that possible.

The Age of FTAs – and much more

Ours is the age of trade agreements: bilateral and regional free trade agreements (FTAs); comparatively shallow and limited-ambition preferential agreements as well as deep and comprehensive economic partnership agreements; customs unions and single markets

But this only scratches the surface of the web of commercial agreements and treaties that have been developed to facilitate international commercial relations: these include agreements addressing double taxation, science and technology cooperation, movement of business persons, multiple-entry visas, youth travel, customs cooperation, patent office cooperation, "blue skies" air agreements, and others. Each has a claim to generating trade in one form or another. For example, the updating of the Canada-China Nuclear Cooperation Agreement paved the way for a sale by Canada to China of uranium from Saskatchewan.

Bilateral agreements are also complemented by many multilateral/plurilateral processes. For example, customs cooperation and facilitation of trade at the border, a topic addressed by FTAs, is also a core function of the World Customs Organization. It would be difficult for trade negotiators to make commitments that the responsible authorities for customs matters have not already made feasible through their own work programs. Similarly, the commitments elicited by

the Trans-Pacific Partnership (TPP) for *Good Regulatory Practices* repeat commitments that TPP parties have already made in the context of OECD and APEC programs on this set of issues. The World Bank's benchmarking exercise, *Doing Business*, has provided incentives to countries to streamline their procedures for trading across borders – and guidance on how to do that.

And of course, promoting trade tends to be a "whole of government" effort. Canada has a comprehensive program of economic diplomacy to promote exports:

- An expanding network of consulates and trade offices;
- a growing number of Trade Commissioner "boots on the ground";
- Export credit and financing facilities
- Trade promotion junkets ("Team Canada" missions)

When budgets are being allocated, each program makes the case for the valuable contribution it makes to Canada's exports and to investment promotion.

And government-led efforts only complement the web of sophisticated trade facilitation services provided by the private sector.

In short, Canada is very much engaged in the FTA game;[1] but FTAs are not the only game in town.

Dominoes and Discrimination

The current preoccupation with FTAs reflects some basic facts of economic life: first, trade is central to innovation and productivity growth; and, second, FTAs introduce discrimination into the trading system which sideswipes countries that abstain.

On the first point, modern trade theory and the empirical literature on which it is based and which it has helped to generate show that trade plays a key role in economic performance. Firms that enter into trade – either as exporters or as importers of intermediate inputs – tend to perform better than their peers on the key metrics of innovation and productivity. In the age of multinationals and global value chains (GVCs), which depend on low trade costs, not having an FTA with countries whose firms organize GVCs can result in a country being bypassed.

[1] At the bilateral/regional level, Canada has brought into force seven FTAs since 2009: these include agreements with the European Free Trade Association (EFTA), which entered into force in 2009, Peru (2009), Colombia (2011), Jordan (2012), Panama (2013), Honduras (2014), and Korea (2015). Canada has also concluded negotiation on three other FTAs, including the Comprehensive Economic and Trade Agreement (CETA) with the European Union, and the TPP with 11 parties circling the Pacific Rim. Canada has several other negotiations underway, including with India and the Caribbean community. At the multilateral level, Canada has signed (although it has not yet ratified) the 2013 World Trade Organization (WTO) Trade Facilitation Agreement (TFA) and the 2014 WTO Government Procurement Agreement (GPA). Canada is also engaged in the Trade In Services Agreement (TiSA) negotiations that are being held in Geneva; this negotiation has the eventual goal of becoming a WTO plurilateral agreement. The pace of signing new foreign investment protection agreements (FIPAs) has been even faster with some 11 entering into force since 2009, including the agreement with China that came into force in 2014 and 7 others signed since March 2014.

A key factor behind the recent scramble to enter into FTAs to avoid being bypassed was the slow death of the Doha Round; the beginning of the end was in the mid-2000s when key WTO Ministerial meetings failed to advance the negotiations; the Round effectively expired in the December 2015 WTO Ministerial at Nairobi, when the differences amongst the parties were not papered over.

The FTA scramble can be readily understood when seen through the lens of the domino theory of trade negotiations (Baldwin, 1995; Ciuriak, 2010), which says that, once the major economies sign bilateral preferential agreements, other countries will feel competitive pressure to follow suit. The quintessential example of this is the Korea-US FTA (KORUS). In this case, the negotiations were stuck on beef and autos. The signing of the Korea-EU FTA quickly led to KORUS being pushed through only weeks later; the United States was not prepared to see the EU gain a competitive advantage over its firms in the important Korean market. The Korea-Canada FTA followed shortly after.

But while FTAs have been the flavour of the past decade due to this self-reinforcing trend, they are NOT a path to global free trade. The preferences that FTAs create must be limited to qualifying firms. This is accomplished through rules of origin (ROOs) which determine which products have access to tariff-free entry into partner countries' markets. ROOs are costly to administer and to comply with. Moreover, for trading firms (especially SMEs), complying with the ROOs of multiple FTAs can be difficult – for example, a Canadian firm organizing its supply chain to satisfy the ROOs of a Canada-EU FTA may not be able to meet the requirements of the ROOs of the TPP. Multiple FTAs thus create a spaghetti bowl of rules that complicate the trading environment, even as they reduce barriers to trade between specific partners.

FTAs also create constituencies against expansion. Preferences are valuable to the parties that negotiate them in part because they discriminate against third parties. By the same token, bringing new parties into an agreement dilutes the existing benefits for the incumbents. It is not surprising therefore that "docking clauses" of FTAs (provisions that anticipate additional parties joining the agreement) have rarely been used.

The TPP and its rival, the Regional Comprehensive Economic Partnership (RCEP) negotiation, represent attempts to consolidate a web of existing agreements while liberalizing the bilateral trading relationships among the parties that are not yet subject to FTAs. Their success has yet to be proven; however, it is possible that such "mega-regional" FTAs could serve as a more effective half-way house between the WTO Round that failed and the proliferating FTAs that dominate the current trade agreement landscape.

For Canada, with NAFTA long in the fold and the CETA and TPP newly signed, China is the major outstanding country with which Canada does not have a signed agreement. India and the Association of East Asian Nations (ASEAN) represent attractive but relatively minor future possibilities. China represents the major bilateral prize in the current FTA sweepstakes for Canada.

Why China?

Given Canada's hesitation in fully engaging China, it is useful to briefly review the arguments for such a deeper engagement. There are several – and not necessarily centred on the sheer size of the Chinese economy.

China as an innovation economy

China is changing: emerging from the cocoon of the old, largely rural, labour-intensive, low-skilled, command-control economy is a young, urban, high-skilled, knowledge-intensive economy. This economy has rising intellectual property standards and features a massive expansion of the stock of knowledge assets: China now issues about one million patents per year, vs. 600,000 per year in the United States. To be sure, infringement rates are still high, but there is also very intense internal litigation over intellectual property (IP) rights. China is learning to play the IP game.

China has long followed a multi-pronged strategy of technology acquisition:

- Home-grown, following the principles of "introduction, digestion, absorption and re-innovation";
- Attracting inward FDI with technology transfer strings attached; and
- Outward, technology-seeking FDI: Lenovo's acquisition of IBM's personal computer manufacturing business and CNOOC's acquisition of firm capabilities through its acquisition of Nexen are primary examples. A twist on this model is Huawei's tapping into foreign knowledge networks with over 20 R&D centres worldwide.\

China' Fortune 500 firms

Modern trade economics focuses on the role of the firm. A country's ability to trade depends on having firms that are capable of participating in global trade. China stands out amongst emerging markets in terms of the number of global firms that it has spawned in its modernization drive. In the latest Fortune 500 rankings, China-based firms account for almost 100. That's a fair share on a population-weighted basis (China accounts for about 20% of the global population), but it is above-average on a GDP basis (China accounts for about 15% of global GDP), and it is a spectacular figure for a country that is not yet a fully-fledged member of the club of advanced countries.

Chinese firms are now also entering the list of most innovative companies in the world, including moving up the lists of top recipients of US patents. The focus on state-owned-enterprises is backward–looking; firms are the "software" of a market economy, and China is a spawning ground for firms that are capable of playing on the global stage.

China's Educated Workforce

China expects to soon have 200 million community college and university graduates in the workforce; by comparison, the United States has about 120 million. These numbers are

significant. The rise of the US economy to pre-eminency was powered by the broad base of literacy and numeracy that it achieved. Today's BA is yesterday's high school diploma. China has reached more than critical mass on that score. But there is not just quantity, there is quality: Shanghai took first place on the 2012 Program for International Student Assessment (or PISA) for mathematics, reading and science. Every population has its distribution; and the tail of China's distribution of highly educated individuals features individuals who will become household names in due course as entrepreneurs and innovators.

China's Economic Policy

Not every emerging market is destined to successfully manage the challenges of growth and development. In China's case, it is a good bet that it will.

China's economic policy is feeling its way forward. Macroeconomic management has been cautious. When large current account surpluses emerged in the mid-2000s, China managed its exchange rate to gradually reduce them. China is now engineering a shift to internally-driven growth, which is evidenced by the declining share of trade in its GDP. There are hiccups (dumping of excess steel on the global market; its mis-calculation on rare earth elements) and China has less macroeconomic stability than its national statistics would suggest – observers of the Chinese economy track indicators such as rail freight and electricity usage, which show greater ups and downs than do the headline GDP numbers. However, China's economic policy managers have managed to keep China's economy on a growth path while managing important transitions.

China is "learning by doing" in economic management – and one distinct advantage that it has it that it is not wedded to the supply side policies that have put western economies into stag-deflation: if something works, China rolls it out; if it doesn't it pulls it back. We saw that with the floating of the "Red Chips" – the listing of China's reforming state-owned enterprises on the stock exchanges. When the initial round flopped because of poor accounting and disclosure, the issues were pulled back and additional reforms initiated. The name of China's macroeconomic management game is pragmatic experimentalism. So far it has proven to be broadly successful.

China is also showing an increasing level of ambition in its FTAs, which reflects growing understanding of these agreements. The RCEP will be the test bed for China's FTA leadership. Importantly in the FTA area, China has the wherewithal to "underwrite" these agreements by offering valuable economic concessions to its partners; in return, China obtains non-economic benefits – for example, New Zealand obtained valuable preferential concessions for granting China "market-economy status" for anti-dumping/counter-vailing duty cases – New Zealand's exports to China soared.

China as an "economic power"

China has long been referred to loosely as an "economic power", but rarely have the metrics of economic power been clearly articulated. In a paper in 2004, I suggested the following four

criteria. To be an economic "power" – that is, to be able to use economic clout to leverage gains in other areas – a country must have the following characteristics:

- Vital destination market for global firms
- Source of critical technology
- Provider of an international currency
- Organizer of "clubs"

Until recently, China was not a "power" by these metrics. In the early 2000s, China's domestic market was still small and its imports were heavily weighted to goods coming in for re-export after processing. It was a supplier of cheap labour, not vital technology. Its currency, the RMB, was not internationalized at all, let alone serving as a vehicle for international exchange. And it was joining clubs organized by others, not sponsoring its own. These were my conclusions at the time (Ciuriak, 2004).

But that is changing:

- As I have noted, the trade share of GDP is falling as China's internal market integrates; the transition is far from complete, but China is becoming an essential final consumption market for global firms. This was long recognized as inevitable, which explains the early entry in the flood of FDI into China over the past decades.
- Chinese technology is already being "tweaked" in some cases in the West as "re-innovation"; this will only grow as China's innovation economy matures.
- The term "Redback Rising" was coined in financial markets to denote the rising role of the RMB in international exchange. The RMB Hubs that China is promoting, which will facilitate China-bound trade will serve to gradually build the role of the RMB as an international currency.
- China is sponsoring economic initiatives. The RCEP is formally ASEAN-led, but it is up to China to make that agreement happen. The Asian Infrastructure Investment Bank (AIIB) and the Silk Road and Silk Belt initiatives are significant attempts by China to shape the external environment for its global economic participation.

Canada's Engagement with China

If we list the many updated/upgraded agreements, Canada's engagement with China has been more hot than cold:

- The foreign investment protection agreement (FIPA) and updated agreements on double taxation, air transport, long-term visas, science and technology cooperation, patent office cooperation, and the aforementioned nuclear cooperation agreement.
- The expansion of Canada's consulate network in China
- High-level visits (including provincial trade missions)
- And edging towards an FTA through the 2012 "complementarities study" and Chinese statements opening the door, if Canada wants to walk through.
- The RMB trading hub is up and running in Toronto.

However, Canada's engagement has been lacking in conviction:

- Canadian tariffs were increased on Chinese imports when China was removed from Canada's General Preferential Tariff (GPT)
- Ambivalence about Chinese FDI, which coloured CNOOC's acquisition of Nexen

Accordingly, Canada is falling behind competitors in the Chinese market as China expands its network of FTAs (including with Australia and New Zealand, which have similar economies to Canada in many respects). This means that Canada is "leaving money on the table" when it comes to trade with China:

- The complementarities study (2012) highlighted many offensive interests in China: Agriculture, clean-tech, machinery and equipment (especially mining equipment), resource management, services (in particular infrastructure management), textiles (especially engineered materials), transport infrastructure, and aerospace.
- McKinsey (2014) identified a similar list: Agriculture, clean-tech, natural resources, services (include education and finance), transportation, infrastructure, and aerospace.
- Canada's Agri-food Alliance (2013) documented a number of non-tariff barriers in China that an FTA could address.
- Dobson (2012) outlined a range of mutual in interest in her "China Roadmap".
- Burney et al. (2012) highlighted government procurement and improved IP protection in China as important goals for Canada that could also be addressed in the context of an FTA.

To summarize, there is a compelling list of reasons for Canada to take the next step in economic relations with China:

- Bilateral trade preferences are highly valuable in China; growth in per-capita income in US$ terms will continue to be very strong, even as real GDP growth slows, because of convergence of Chinese prices towards purchasing power parity.
- China has the fastest-rising urban population in the world and features a large, economically active cohort that is young, educated and tech-savvy.
- Improved economic relations with the world's largest new source of FDI, of firms anchoring GVCs, East Asia's fulcrum for production webs, and the world's next major innovation lab

A Canada-China Free Trade Agreement

The economics

The Australia-China FTA provides an example of a feasible way forward for Canada and China. Australia is the most comparable economy in the world to Canada; it has similar offensive and to a lesser extent similar defensive interests. The China-Australia FTA (ChAFTA) is lightly WTO+ in the rules regime (e.g., for example, it features mutual recognition agreements on conformity assessment bodies) and it is asymmetric in services – China's liberalization is to be decided later. It would not be the most ambitious FTA and some areas of a Canada-China FTA would need to

reflect Canada-specific interests (e.g., canola) that were not covered in the ChAFTA. The bottom line, however, is that there is a template.

Modelling a Canada-China FTA on the basis of the ChAFTA suggests that there would be significant trade-driven gains

- exports to China would increase by CAD 7.8 billion,
- imports from China would increase by CAD 7.4 billion,
- Canada would obtain a real GDP gain of 0.137% (China: 0.016%)
- Canada would also obtain a welfare gain of about CAD 5.8 billion, in 2015 Canadian dollars (China: CAD 5.5 billion).

These impacts are relatively modest but compare well to Canada's gains from the TPP. Importantly, the level of impact reflects realistic "as negotiated" assumptions rather than ambitious assumptions that assess potential gains.

In terms of sectoral impacts in Canada:

- Textiles and apparel would the sector most negatively impacted by expanded imports from China
- Canola and automotive exports would be the main goods sectors benefiting from the deal
- Business services and transportation services would be the main services sector benefiting from the deal, with improved binding of current market access serving as a key to the services impacts

All in all, the economic gains would be well balanced under such a deal, with the larger gains going to the smaller economy (Canada) as is usual in such analyses.

The geo-economics

In terms of the "geo-economics" (i.e., how the deal would impact on Canada's place in the global economy), the impact of the CCFTA on Canada would be on the same order of magnitude as the TPP (our point estimate is about 0.14% vs. 0.07% for the TPP), but without the rules-related issues that have made the TPP controversial in Canada.

Further, it provides Canada a way to engage China to help broker constructive solutions for China's trans-Pacific trade rather than being a policy taker – as happened in the TPP ROOs regime for automotive products, which was decided bilaterally by the United States and Japan.

Preferential access to China would enhance the global mandate of subsidiaries of multinational enterprises based in Canada.

There is also a less obvious reason for Canada to take the next step with China. As the FTA agenda runs into diminishing returns, the single most powerful policy initiative that Canada could take on the trade front would be the sweep away the remaining set of tariffs and preferences that constitute the legacy trade policy that Canada now imposes. But such bold moves by Canada unilaterally would be difficult to take politically, because the main beneficiary

of expanded trade with Canada would be China – given political sensitivities, Canada would likely need to have corresponding trade concessions from China. Accordingly, an FTA with China would pave the way for Canada to move beyond FTAs and start to forge a trade, innovation and industrial strategy that is better suited to take Canada forward than what is currently in place.

The geo-politics

Geo-politics is perhaps the greatest stumbling block and complicating factor for Canada in moving forward on its commercial engagement with China.

Simply put, the United States and China are engaged in a classic great power rivalry.

As concerns the United States, as Peter Petri and Wendy Dobson observe in a recent Globe & Mail op-ed, 8 US Secretaries of Defense voiced support for the TPP as part of the US "pivot to Asia"; this is not about trade. In official US policy statements, the TPP is characterized as a key instrument in a contest with China over who "writes the rules" for trade and investment in the Asia Pacific. In practical terms, there is less here than meets the eye – the rules of the road for trade and investment tend to be written by expert groups in various fora sorting out the technicalities in their particular issue areas, private sector players, and courts that take on pivotal cases. However, the message cannot be ignored.

For its part, China has signalled its military's technical capacity (the launch of a nuclear-powered aircraft carrier and submarine, a demonstration of its ability to target satellites, an active space program, cyber warfare).

The United States formally seeks to prevent the emergence of a "peer competitor"; China's trajectory made a "pivot to Asia" inevitable, viewed through the lens of realpolitik.

The history of great power rivalry is one of unmitigated disaster; it is not something to be wished for. It is in Canada's national interest to broker constructive solutions to the challenges that will confront the Asia Pacific region in the coming decades. Canada's bilateral economic relationship with the United States rivals any in the world. Having a strong, economics-based relationship with China can only put Canada in a better position to play such a constructive role.

The prospects

As I have mentioned, when one lists Canada's engagements with China as hot or cold, the list of hot is much longer; however, Canada has not moved with conviction on the opening that China has provided for an FTA.

China is patient; it is in China's interest to establish a deeper economic relationship with Canada and that offer is unlikely to be withdrawn.

Dealing with the geopolitics is difficult for countries that wish to be partners of both the United States and China. With the usual bluntness that one expects from Australians, Callaghan and Hubbard (2016) write: "For Australia and Korea, hitched economically to China but necessarily

sensitive to the United States' strategic concerns, the policy process that led to joining the AIIB was particularly *tortuous*."

I put the emphasis on "tortuous"; however, it was not impossible. A carefully crafted approach, informed by the US's West Pacific allies with interests in China, should be within Canada's grasp.

Conclusions

A Canada-China FTA is in Canada's national interest on multiple grounds:

- It provides a short-term economic dividend on the same order of magnitude as the TPP
- It provides, a gateway for Canada to trade policy options that might not be accessible absent trade concessions from China
- It provides a stronger position from which to broker geo-economic solutions to Trans-Pacific economic issues that will inevitably arise
- It provides a way to deal Canada into the Asia-Pacific grand game of geo-politics – and hopefully with an ability to help defuse issues and promote the win-win activity of business.

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