Studies in

US-Canada Relations

FRASER america

April 2010

Skating on Thin Ice

American-Canadian Relations in 2010 and 2011

by Alexander Moens

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Contents

Executive Summary

Overview of Canadian-American relations

- the growth rate in US-Canada bilateral trade in the last decade has slipped far below that of the 1990s;
- trade in manufactured products has been without meaningful growth for several years;
- we have radically switched from an undefended border to a border that divides, discourages trade, and intimidates citizens;
- separate regulations and incompatible product standards combined with a complicated border is making North America less competitive in global production;
- there has been no concerted political effort to follow up on CUFTA/NAFTA despite the pressing need to establish accords on commercial regulation, product standards, and dissolving the remaining barriers to trade;
- Congress is increasingly open to protectionist political sentiment and some Congressmen are calling for a US withdrawal from NAFTA;
- various legislative and regulatory plans to reduce greenhouse-gas emissions threaten to disrupt Canada's most important export sector: crude oil products and an environmental crusade against the oil sands could begin to divert investment;
- very substantial unconventional gas finds could reduce Canadian natural gas exports to the United States, further dampening our exports;
- Canada's bilateral trade surplus is shrinking while our overall balance is moving towards deficit;
- given America's structural debt problems, American demand for Canadian goods will not recover as strongly in the short term as they did after the economic slow-down in the early 1990s;
- while defense and security relations have improved considerably with close cooperation in Afghanistan and the end of the Iraq controversy, the fact remains that Canada should participate in missile defense for North America if it wants to have a say in bilateral defense relations and that it should accept a continued military role in Afghanistan after 2011;
- Arctic security is a big concern for both countries but Canadian-American efforts at cooperation fall far short of the mark.

Cooperation between Canada and US has been poor

While cooperation between Canada and the United States has been poor, there are hopeful signs. In early February 2010, Prime Minister Stephen Harper and President Barack Obama reached a deal that opens the way for free trade and reciprocity in government procurement programs for public works. It should encourage free traders on both sides of the line to continue pressing for deeper economic cooperation.

This report explains that US-Canada relations are reeling from a double blow. The first blow came with the attacks by Al Qaeda on American soil, compelling the Americans to change their minds about our shared border. Although we share intelligence and electronic custom reports, the fact remains that we are essentially constructing a border that is reducing trade, investment, and tourism.

The second wave of trouble came in the wake of the financial crisis that started in late summer of 2008 and the ensuing recession of 2009. Washington's response to the economic challenge has been to feed various protectionist sentiments. We saw it in the "Buy American" provision. We also see it in the recent implementation of Country of Origin Labeling (COOL) on food products and newly emerging plans to apply COOL to ethanol-based fuel. The most devastating impact on Canada's trade would emerge if the United States should proceed with legislation aimed at carbon-dioxide emissions and so-called "dirty fuel" regulations. Given current uncertainty in the US political system on this issue, Canada must resist the temptation to move ahead with its own greenhouse gas measures.

While all efforts at diversifying trade are good, the rate of Canada's diversification from the American market is in fact modest. Canada's top economic interest remains unimpeded access to the US market. Post-9/11 structural changes on the border, the growing politics of protectionism in Congress, and the failure to usher in deeper Canadian-American economic integration togther pose a threat to Canada's vital long-term economic interests.

Canada and the United States need to pursue deeper trade integration in such areas as regulatory harmonization, common external tariffs on manufactured products, free trade in agricultural products, and an overall energy and environmental accord.

To do so Canada must engage the American polity. Canada needs to re-invent its pre-9/11 privileged status. The best way is for the two governments to formulate a unified regime to deal with a common security threat. Once the security regime is in place, the integrated dynamic of commercial exchange can flourish again as it did in the 1990s, leading to increased travel, deeper commercial interaction and assured future prosperity for Canadians.

Canada's government must explain to Canadians why it is important to have a single security strategy and deeper economic integration and that neither objective involves threats to Canadian sovereignty. If enough Canadians see their interest in a comprehensive security and market plan with the Americans, the Canadian government will ultimately find a willing ear in Washington.

Recommendations

- The two governments should negotiate a Beaufort Sea settlement in a set time frame or put it to outside arbitration or adjudication. They should also suspend the disagreement on the Northwest Passage and move towards a joint Arctic surveillance plan.
- Canada should continue negotiations with the United States for full reciprocity on public procurement at federal and sub-federal levels with the fewest mutually agreed exceptions possible.
- Canada should propose a single standards regime and bi-national inspection regime in the cattle and hogs industries and agree on national (single-market) treatment for Canadian (and American) beef and pork products, exempting these products from COOL labeling.
- In its most recent decision, *Citizens United v Federal Elections Commission*, the US Supreme Court ruled that the US government has no right to ban independent expenditures by corporations in candidate elections. Capitalizing on this new opportunity, Canadian stakeholders should explore through their US allies new lobbying opportunities for oilsands interests in Congressional election campaigns to forestall dirty fuel regulations and punitive carbon measures.
- Despite pressure from environmental groups and opposition parties to launch stand-alone Canadian targets for greenhouse-gas reductions, the Canadian government's plans to begin defining a cap-and-trade system by means of the Canadian Environmental Protection Act should not proceed ahead of any US action.
- Canada must avoid carbon measures that simply slow down growth. Rather, governments need to create the right incentives to encourage oil exploration and energy efficiency in the oil sands. Air injection, electro-thermal, and solvent assisted gravity drainage are new methods in the exploratory stage that offer higher quality oil, a smaller carbon footprint, and other environmental benefits.
- The Northern Gateway pipeline from Edmonton to Kitimat, British Columbia is currently in the review stage. It is scheduled to transport half a million barrels per day to West coast tankers that would then take it to US and Asian ports (Cooper, 2009). Speeding up the Northern Gateway project—not letting it fall victim to postponements due to open-ended environmental or native land reviews—is of key value to Canada.

Lack of progress since the Free Trade Agreement

Taking stock of Canadian-American relations at the beginning of a new decade gives rise to a gnawing sense of disappointment. Of course, relations between Canada and the United States are still among the best bilateral ties in the world, blessed with innumerable strengths and benefits for both sides. Disappointment comes from the realization of how much more the partnership could be and how we have made hardly any headway in the last 20 years. I argue below that we have lost ground and stand in danger of losing even more.

Unlike the European continent, which went from warring borders to no borders, Canada and the United States have slipped from an undefended border to a border that divides, discourages trade, and intimidates citizens. Instead of building a single economic market out of the 1989 free-trade agreement, American and Canadian governments have done nothing on a grand scale to help businesses work together more effectively. Separate regulations and incompatible product standards combined with a complicated border is making North America less competitive in global production.

On matters of defense and security, the record is also not good. Suspicion rather than a badly needed alliance hovers over the Arctic region. Canada avoids responsibility in refusing to assist in the defense against possible ballistic missile attacks on North America. Thankfully, the shared struggle to secure an accountable government in Afghanistan that can provide security for its people has allowed the two militaries to find their old synergy.

Canadian public attitudes towards the United States have improved in the last two years and Canadians remain strong supporters of cooperation on the border. The Canadian public's favorable rating of the United States rose nearly 15 points from 55% to 69% between 2007 and 2009 while the unfavorable rating fell from 42% to 28% (Wike, 2009). Seventy-three percent of Canadians support increasing the flow of people and goods across the border and 76% support a continental energy policy (Nanos, 2009). At the same time, Americans remain very favorably disposed towards Canada. In both 2009 and 2010, Americans scored Canada highest among 20 countries in favorability ratings. In 2010 Canada received a rating of 90%, followed by Great Britain at 87% and Germany at 80% (Saad, 2010, February 19).

Given the highly favorable public attitudes, cooperation between Canada and the United States has been unexpectedly poor: it has been paid little new attention and is reeling from a double blow to trade and security relations. The best that can be said of the current state of Canadian-American relations is that we are coping with this double whammy. Nevertheless, there are hopeful signs. In early February 2010, Prime Minister Stephen Harper and President Barack Obama reached a deal that opens the way for free trade and reciprocity in government procurement programs for public works. It should encourage free traders on both sides of the line to continue pressing for deeper economic cooperation.

First blow—9/11 and its impact on the border, commerce, and defense

The first blow came with the attacks by al-Qaida on American soil. The American attitude to our shared border changed dramatically. In the US-Canada 2001 Smart Border Accords and various discussions under the umbrella of the Security and Prosperity Partnership, the two countries have agreed on a host of cooperative security measures. Although we share intelligence and use biometrics, and electronic custom reports, the fact remains that we are essentially constructing a border framework reminiscent of the nineteenth-century nation-state: two separately sealed jurisdictions with multiple checklists on each side of the border. The border has become a security moat, a regulatory gate, and a commercial wall.[1] It is doubtful that we can run two integrated economies in this manner for long. The level of discouragement, irritation, just-in-case delivery, and towering paperwork may reach a point at which investors, professionals, and service industries will look elsewhere for places to do business, either at home or overseas. Government regulation at the border is likely to dampen the entrepreneurial spirit. Drops in tourism and cross-border travel are in part due to this thickening border (Yaffe, 2010).

Security costs, waiting times at the border, cost to truckers and traders for programs to facilitate secure and rapid passage are all up. In October 2008, 19% of Canadian respondents to a national poll felt that "it was a lot more difficult for Canadian exporters" to cross the border. In September 2009, that number was up to 26% of respondents (Bouzane, 2009). Border restrictions and waiting costs are especially costly for the integrated supply chain in manufacturing (Sands, 2009). The border is now a barrier to trade; this is true even for shippers who are enrolled in all the secure and trusted cargo and driver programs. Many of these find little return for their investment in secure border-crossing programs. Trucks and truckers enrolled in these programs find themselves in long waiting lines to get to their expedited lanes and are pulled over for inspection frequently despite their "secure" status (Conference Board, 2007).

A study of border traffic conducted in June and July of 2009 on three of British Columbia's border crossings of which one is FAST enabled (Free and Secure Trade Program) found low usage of FAST lanes by full trucks (12% on southbound and 1% on northbound). Most of the FAST users are empty

1 These terms, but not the argument, derive from Drache, 2008.

trucks, most likely because full trucks are subject to frequent inspections regardless of FAST status (BPRI, 2009).

The lack of dedicated lanes and customs officials as well as the elaborate menu of inspections by both border services has produced a costly uncertainty for business. Because Canada and the United States have a large number of differing regulations and product standards, employees of the two federal governments spend a lot of time at the borders enforcing their small commercial differences (NACTS, 2009: 18). Canada's manufacturing sector, until recently Canada's leading export sector, has been weakened by the thickening border. If the border costs continue to increase, integrated supply chains in manufacturing will be at risk. In other words, this trade, which represented more than half of all trade across the border in 2005, may begin to decline as investment is diverted to the United States. Nearly 50% of business respondents in a 2004 survey confirmed that border costs affect their investment strategy (Manley, 2005).

Lack of cooperation on North American defense

The American government floated the idea of a security perimeter after the attacks on September 11, 2001 but Canada rejected the overture (Jimena, 2004; Fortmann and Roussel, 2006). In hindsight, that was a costly mistake. Even though the US position itself was vague and perhaps only half-hearted, Washington's attitude has since hardened into a desire to go it alone. Soon thereafter, an opportunity was missed in defense relations. Despite recommendations from a bi-national task force for a more joint effort, the American and Canadian armed forces created new and separate military commands for the defense of North America. This was followed by the debacle on missile defense. After seeking Canadian participation for years, the American government finally decided to ask Canada formally when signals were sent that the Paul Martin government would look favorably on the request. A sudden Canadian reversal based on narrow political grounds has left Canada out of an important part of North America's defense. It may not be a priority for the Obama administration at this point but ballistic missile defense is American law and an on-going activity of the US military. North Korean and Iranian ambitions in this area are only increasing. Canada's absence from this file is a glaring hole in its bilateral defense cooperation. Because Canadian officers lack authority to be involved in missile interception, the only existing bi-national institution, NORAD, has begun to lose its core relevance as the tie between US Space Command and NORAD weakens (Fergusson, 2009: see especially p. 11).

Both America's Arctic policy and the Harper government's "Canada First" defense policy lack concrete proposals for more and deeper Canadian-American cooperation on Arctic security, something that should be a priority for both countries (White House, 2009; Fleming, 2008). Both nations are short on icebreakers. Both nations face ambitious Russian claims to the natural resources under the Arctic seabed. Canadians must not be left by their government to wonder whether the United States is a friend or rival in the Arctic. The key issues for Canada in the Northwest Passage are environmental enforcement, which the US strongly supports, and maritime security surveillance, which should be a shared continental effort. Sparring over mineral rights and fishing in a disputed zone in the Beaufort Sea has gone on too long.

Recommendation

The two governments should negotiate a Beaufort Sea settlement in a set time frame or put it to outside arbitration or adjudication. They should also suspend the disagreement on the Northwest Passage and move towards a joint Arctic surveillance plan.

Cooperation in Afghanistan

The major positive development in the defense relationship materialized in 2005/2006 and has continued thereafter. Both Canada's defense build-up and the robust deployment in Kandahar Province have brought back a strong military relationship with the United States that had been faltering. Admiral Mike Mullen, chairman of the Joint Chiefs of Staff, related to General Rick Hillier an earlier conversation Mullen had had with former Secretary of Defense Donald Rumsfeld: "We had written Canada off as a serious military player, a serious contributor, to anything that was going to happen around the world … Now you guys are at the forefront of everything positive. It's absolutely incredible" (Hillier, 2009, 488). Adding to Mullen's sentiment, Obama's National Security Adviser, General James Jones, called Canada "a charter member" of the effort in Afghanistan (Alberts, 2009).

The Harper government intends to abide by the parliamentary motion that ends Canada's combat mission in 2011 and has so far ruled out any major military task afterwards. But, as Obama's new strategic decision of early December 2009 provided a 30,000-troop boost and a call for more NATO troops, pressure for a continued Canadian commitment may rise. It is wise for any Canadian government to keep flexible options on the table so as not to lose the enormous positive capital gained in relations between the two countries on the Afghanistan file.

The Obama administration has floated the proposal for some 500 Canadian military personnel to train Afghan soldiers in the Kabul area after 2011 (Ibbitson, 2010). This request takes into account Canada's domestic political constraints and should be seen as an opportunity to continue to play a helpful role. A complete withdrawal of Canadian forces would be an unnecessary slight to Obama's efforts that could cost Canada goodwill in other areas of bilateral relations.

Second blow—2008 market meltdown and protectionism

The second blow to bilateral relations between Canada and the United States came in the wake of the financial crisis and recession that started in the late summer of 2008. Washington's response to the economic challenge includes some protectionist elements that, as usual, are not meant for Canada but end up having the most severe impact on Canada.

American Recovery and Reinvestment Act

The $787 billion stimulus program[2] (American Recovery and Reinvestment Act) passed in early 2009 included a Buy American provision that excludes Canadian steel, iron, and manufactured products in as much as $260 billion worth of projects at state and municipal levels (Austen, 2009).

The talks for obtaining a Canadian exemption in return for American access to Canadian projects at the provincial and municipal level began in August 2009 and bore fruit in February 2010 in a deal that exempts Canadian firms from most of the Buy American exclusion at the state and municipal level. In return, Canadian provinces and territories have agreed to sign the World Trade Organization's Agreement on Government Procurement. During the Uruguay round of the WTO negotiations (1996), a free-trade provision for procurement at sub-federal levels was negotiated but, unlike 37 US states, none of the Canadian provinces have thus far agreed to participate.

The deal is not perfect as most US contracts have already been allocated and both countries continue to have "carve-outs": health care and social services for Canada and mass transit and highways for the United States (Ivison, 2010). Still, this agreement is an important step towards reciprocity and free trade in the procurement markets. First, it is a win for free trade as Canadian companies get to bid on US projects and vice versa with only a few exceptions. Both countries get the benefit of greater economies of scale and more cost-effective public works. In addition, this mutual procurement policy recognizes that in many industries Canada and the United States form an integrated chain of supply. With supplies no longer obstructed from crossing the border, this mode of joint production will be reinvigorated with a new burst of energy. Canadian businesses stand to gain and taxpayers on both sides of the border should expect more efficient use of each tax dollar spent. Finally, this agreement creates a precedent for reciprocity in the future. The

2 The revised cost estimate of the stimulus bill in 2010 is $862 billion (CBO, 2010).

Buy American provision is set to become an example for future American programs. Congress has already requested similar restrictions in the next stimulus bill called the Jobs for Main Street Act (McKenna, 2010). Thus even if the deal does not net a lot of gains at this point, it may well avert future protectionist action against Canada.

Recommendation

Canada should continue negotiations with the United States for full reciprocity on public procurement at federal and sub-federal levels with the fewest mutually agreed exceptions possible.

Country of Origin Labeling

A second protectionist measure has hit the food and agricultural sector. The implementation of Country of Origin Labeling (COOL) on food products was sped up by the Democratic Congress and Obama's Secretary of Agriculture, Tom Vilsack, and has contributed to a decline in Canadian pork exports in 2009 and has also pushed down Canadian beef prices. The measure is strongly defended by Congressmen from South Dakota and Wyoming, whose interest in defending US beef seems to be the main driver. Canadian hog exports to the United States were down 30% in 2009 as a result of lower US demand, a high Canadian dollar, and COOL rules instituted early in 2009. Canadian hogs in recent years have made up about 7% of the US market. The value of these exports in 2008 was $482 million (Krauss, 2009). Many American food companies consider the paperwork involved in the COOL requirement so burdensome that they simply do not bother buying Canadian products.

Building on this idea and Iowa's interests in protecting its corn-based ethanol fuel from Canadian grain-based ethanol, a bill has been tabled in the US House of Representatives that requires COOL labeling on motor vehicle fuel. The intent appears to be to discriminate against ethanol production in Canada. While such a label would be in violation of the NAFTA treaty, this may not be enough to stop the bill (Chemiak, 2010).

Recommendation

Canada should propose a single standards regime and bi-national inspection regime in the cattle and hogs industries and agree on national (single-market) treatment for Canadian (and American) beef and pork products, exempting these products from COOL labeling.

Cap-and-trade and "dirty fuel"

A third area of potentially very significant protectionism has arisen in relation to the controversial issue of carbon-dioxide emissions and low-carbon fuel standards. The Obama administration's plan for a "new energy economy" includes a cap-and-trade system to reduce carbon-dioxide emissions. The current version before the House (Waxman-Markey) aims to reduce greenhouse-gas (GHG) emissions by 17% of 2005 levels by 2020; the version before the Senate (Kerry-Boxer) aims at a reduction of 20%.

Republican resistance against cap-and-trade measures may well prevent any bill from passing in 2010. However, Obama's energy advisers as well as many leading Democrats in Congress are all strongly committed to GHG reductions and are likely to make their move again if political opportunity arises.

If a cap-and-trade bill such as Waxman-Markey should become law, Congress will also impose tariffs or levies at the border for "trade-exposed industry" products from jurisdictions with lower GHG emissions standards in order not to put American companies at a comparative disadvantage (Rennie, 2009). Needless to say, both Canada's manufacturing sector and its energy sector would be hit hard by any levies unless Canadian carbon reductions are aligned with American standards.

A fully integrated bi-national cap-and-trade system is another possibility but would require a new start by both governments since there would have to be agreement on free allowances and adjustments, and would impose a single-allowances trading system. Most likely, Mexico would also want to be included (Bramley et al., 2009).

With good sense and prudence, the Canadian government is trying to make sure Canadian rules will be as similar as possible to the American regime. Anything less will necessarily produce market distortions (Alvarez, 2009). The sensible preference is to partner with Washington in a "continental framework" in which the two greenhouse-gas regimes are as close as possible (Ivinson and Akin, 2010). Even though punishing carbon is bad public policy based on shaky science in this author's view, Ottawa would stand to lose greatly in terms of exports by being outside the American regime. However, even if Canadian carbon measures were in line with American emission cuts, small regulatory differences could still expose Canadian industry to American trade action. Given the history in Canadian-American trade, this is no idle threat. While the Canadian government seeks to harmonize and align CO_2 reductions with the United States, it also wants to keep the power to set internal regulations according to Canadian parameters. This is understandable for many reasons. For example, most Canadian electricity generation (hydro) is without emission while most American electricity generation (coal) is high in emissions. The Waxman-Markey bill is a spectacle of rent seeking: full of free permits rather than permits for auction. Many Canadian sectors would ask for similar free allowances. However, a "separate but equal" system would considerably raise the chance of trade action from the United States (Prentice, 2009). If Canada should choose to give exemptions or lower emission standards to the oil-sands industry just as the US intends for its coal-fired electricity plants, trade action by the United States could not be ruled out (CBC, 2009). Wanting both to keep control over Canadian adjustments and to align with the American system poses a quandary for Canadian policy makers.

Given the strategic value Canadian oil exports represent (19% of American oil imports), one would expect special consideration. However, that is not how Congress works. Canada cannot assume that Congress will deal strategically with a foreign interest unless American stakeholders in industries integrated with Canadian oil exports such as refineries, oil drilling equipment, or investment firms lobby strongly on behalf of their Canadian interests. Concentrated Canadian lobbying and diplomatic efforts to rally this interest will be of key value over the next two years.

Western Canada's oil-sands have been singled out for concern over CO_2 emissions, especially by environmental groups and in the media despite the fact that the oil-sands generate just 5% of Canada's emissions (Morgan, 2009). When calculated in a holistic fashion—from wells to wheels—the extraction from oil-sands does not emit significantly more carbon dioxide than conventional oil. It certainly does not exceed by much, if any, the oil America imports from Venezuela and Mexico. GHG emissions per barrel of oil produced from the oil-sands have fallen 33% since 1990 and modest carbon levies are used by the Alberta government for research and development to reduce greenhouse gases in the industry. However, if the extraction and upgrading of synthetic oil is treated as an isolated energy-production sector, its carbon footprint is more significant. The International Energy Agency estimates that most exploration and extraction of oil-sands emits 20% more carbon dioxide than producing conventional oil (O'Neill, 2009). Others put it between 7% and 21% (Conference Board, 2010). Jumping on this bandwagon, 11 US states are considering a specific levy on oil-sands imports because of this higher carbon footprint, dubbing it dirty fuel (McCarthy, 2010). The Waxman-Markey Bill contained a provision that would have prohibited the US federal government from using fuel derived from Canadian oilsands. Extensive lobbying by oil firms led to its removal (Casey-Lefkowitch, 2009). California's low-carbon fuel standard adopted in 2010 mandates a 10% cut from the 2006 standard by 2020 (Kasler, 2010).

Recommendation

In its most recent decision, *Citizens United v Federal Elections Commission*, the US Supreme Court ruled that the US government has no right to ban independent expenditures by corporations in candidate elections. Capitalizing on this new opportunity, Canadian stakeholders should explore through their US allies new lobbying opportunities for oilsands interests in Congressional election campaigns to forestall dirty fuel regulations and punitive carbon measures.

While various plans are under way to capture and store some of the carbon dioxide generated in oilsands production, the cost estimates for doing so are quite high. The cost of sequestering carbon dioxide are currently estimated at between $40 and $160 per tonne (McBean, 2009). Storing carbon is still in its early stages and not without risks. Higher levies on oil-sands as well as sequestration costs will be borne by the producers rather than the consumers as world oil prices are not set by Western Canadian producers. Producers face the potential of both higher costs (sequestration) and more discounting as a result of dirty-fuel regulations on heavy oil. Being frustrated by meager results in Copenhagen, green advocates seem keen to stir up media frenzy about the oil-sands, sensing that industry and government are divided on how to defend this sector. While it is hard to imagine divestment in the oil-sands at this point in time, punitive climate-change legislation is a danger to Canada's largest export industry (Cooper, 2010).

Recommendation

Despite pressure from environmental groups and opposition parties to launch stand-alone Canadian targets for greenhouse-gas reductions, the Canadian government's plans to begin defining a cap-and-trade system by means of the Canadian Environmental Protection Act should not proceed ahead of any US action.

Western Canadian crude is not easily sold elsewhere as refining capacity outside the United States for this heavy oil is limited. A slow down or reduction in oil-sands production as a result of carbon measures would have a major impact on Canada's export earnings. In 2008, total proceeds from exports of crude oil products to the United States totaled $71.9 billion or 16.9% of total merchandise export earnings (table 1). In 2008, total surplus on energy products for Canada was $80.6 billion (DFAIT, 2009).

Table 1: Canada's trade in crude oil and petroleum products with the US (billions of real 2002CA$)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total exports	12.5	14.5	26.2	23.3	25.2	27.8	32.2	38.4	45.5	48.7	71.9	41.7
Total imports	2.1	1.4	1.7	1.7	1.4	1.5	2.1	3.1	3.5	4.2	7.6	4.1
Net trade balance	10.4	13.1	24.5	21.6	23.7	26.3	30.2	35.3	42	44.5	64.3	37.5

Source: Industry Canada, 2010.

Recommendation

Canada must avoid carbon measures that simply slow down growth. Rather, governments need to create the right incentives to encourage oil exploration and energy efficiency in the oil sands. Air injection, electro-thermal, and solvent assisted gravity drainage are new methods in the exploratory stage that offer higher quality oil, a smaller carbon footprint, and other environmental benefits.

The best Canadian policy on carbon emissions is caution and delay: caution, because the public-policy issue of global warming may not be supported as strongly by scientific evidence as its early advocates would have us believe (Lomborg, 2001); delay, because the American political agenda on limiting carbon emissions remains in flux. Canada introduced its plans for a carbon-offset trading system on June 10, 2009 (MacDonald, 2009). Canada should not commit itself to higher targets for reductions in carbon emissions than the United States or set them in stone until American targets are clear and decided. When the Obama administration notified the United Nations of its target to reduce its greenhouse gas (GHG) emissions by 17% of 2005 levels by 2020, Canada did the same. Adjusting Canadian targets down from 20% to 17% was a realistic assessment of the American direction with respect to regulating emissions of greenhouse gases.

The Senate victory of Massachusetts Republican Scott Brown has led to speculation that no energy bill will be passed in 2010. Significant gains by Republicans in the 2010 Congressional elections may allow the US political process a second chance to consider what, if anything, should be done. "Climategate" and the weakness of the international agreement reached in Copenhagen have reduced the political influence of advocates for carbon levies in the American political landscape. A combination of greater energy efficiency and conservation, and the use of natural gas for transportation and nuclear energy for electricity generation offers better CO_2 reductions without cost to GDP growth.

Meanwhile, the Obama administration has other options to advance its green agenda that could be less costly to Canada's trade. In December 2009, the US Environmental Protection Agency (EPA) added carbon dioxide as an air pollutant and has thus paved the way for regulatory control over emissions should Congressional legislation fail to pass. In addition, Obama will raise the Corporate Average Fuel Economy (CAFE) standard and make it a national standard. Canada will join the US in using the standard as of January 1, 2011. Creating a single market standard between our two countries will result in a net gain for Canada's trade position in the automotive sector.

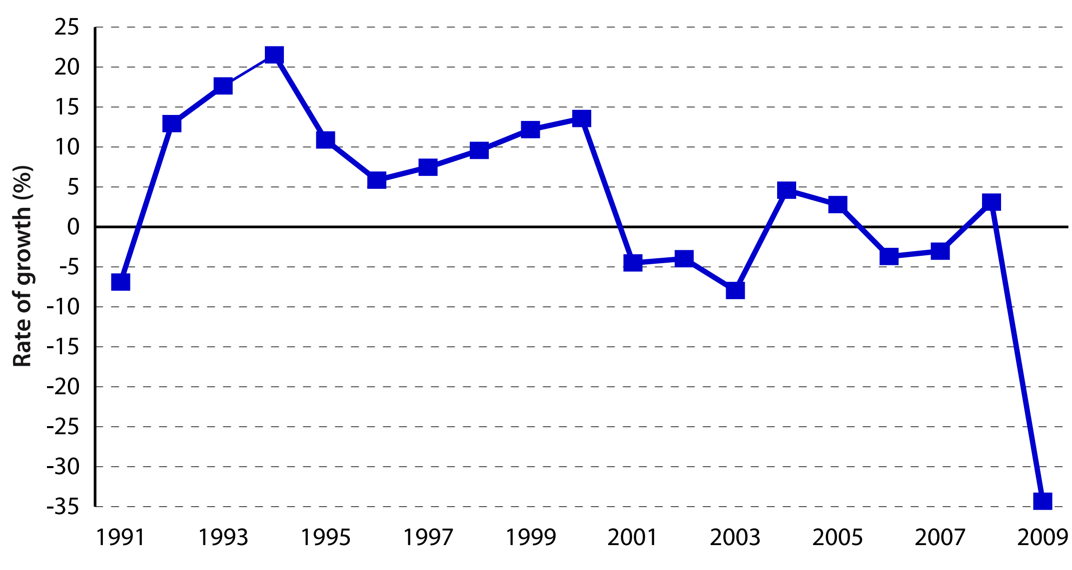
US Energy Facts

- 85% of energy used in the American economy is derived from fossil fuels. Wind power is less than 2% of US energy production (*Economist*, 2009).
- Solar power in the US today costs 3.5 to 4 times the price of conventional power. Additional costs would be incurred from having to build new transmission lines and to deal with reliability (Burnett, 2009).
- According to the Environmental Protection Agency, Waxman-Markey would cost on average $1,100 per household per year by 2050 and would lead to one tenth of a degree cooling by 2110. Projected impact on "climate change" is 0.05 degree Celsius by 2035 and 0.2 degree Celsius by 2100 (Kreutzer et al., 2009).
- As a result of aggressive rent seeking by US business and labor groups, Waxman-Markey gives away 85% of the $C0_2$ permits (Feldstein, 2009).
- Global energy use will increase almost 50% from 2006 to 2030. Oil is expected to still constitute 30% or more of the world's energy in 2030. CO_2 emissions from growth in oil consumption in developing nations will more than undo CO2 reductions in North America (Yergin, 2009).

Trade trends

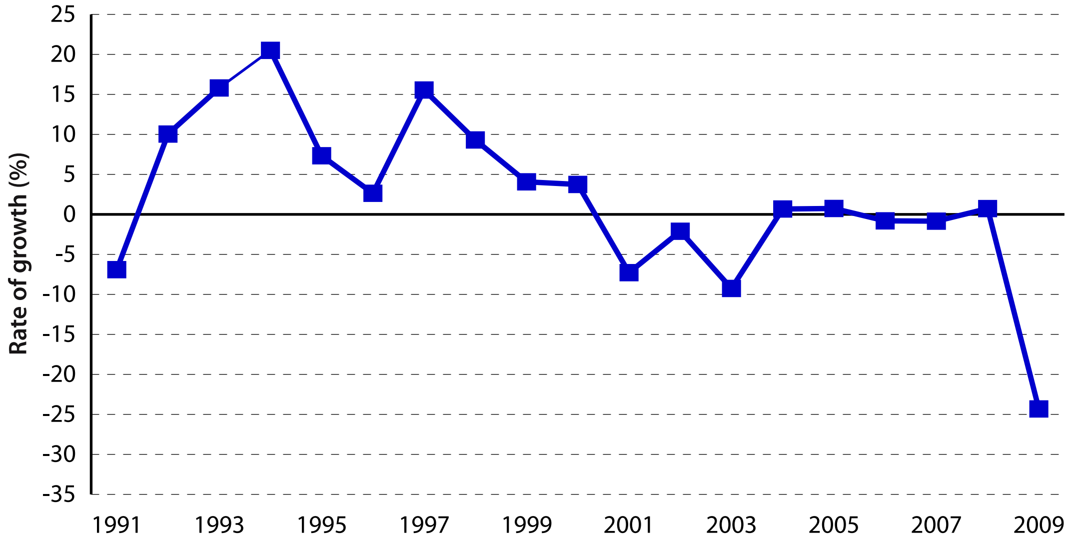
The strong growth in the 1990s of Canada's overall merchandise trade with the United States has not been sustained over the past 10 years (figures 1–3). Canadian exports have declined slightly more than Canadian imports. Overall, Canadian trade with the United States in 2008 (67.8% of total trade) was down by 5.3% from 2005 (DFAIT, 2009, 39). Trade between the United States and Canada in the last five years shows a weakening trend in most manufactured products exports and a gain in energy and minerals exports (figures 4 and 5). The year 2009 is an outlier as a result of the major economic turbulence that caused a drop in the level of trade for nearly all categories. Trade in manufactured goods, including transportation, chemicals, and equipment, has been declining since 2005. Of the 21 different manufacturing sectors in Canada, only four showed tiny increases (DFAIT, 2009).

Figure 1: Growth rates for Canada-US merchandise exports, 1991–2009



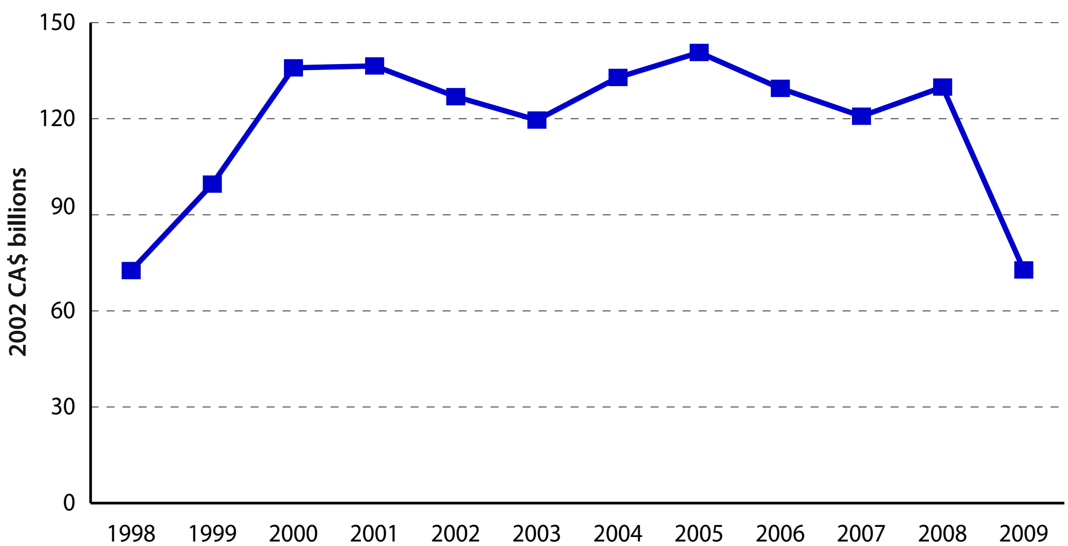
Source: Industry Canada, 2010; calculations by authors.

Figure 2: Growth rates for Canada-US merchandise imports, 1991–2009



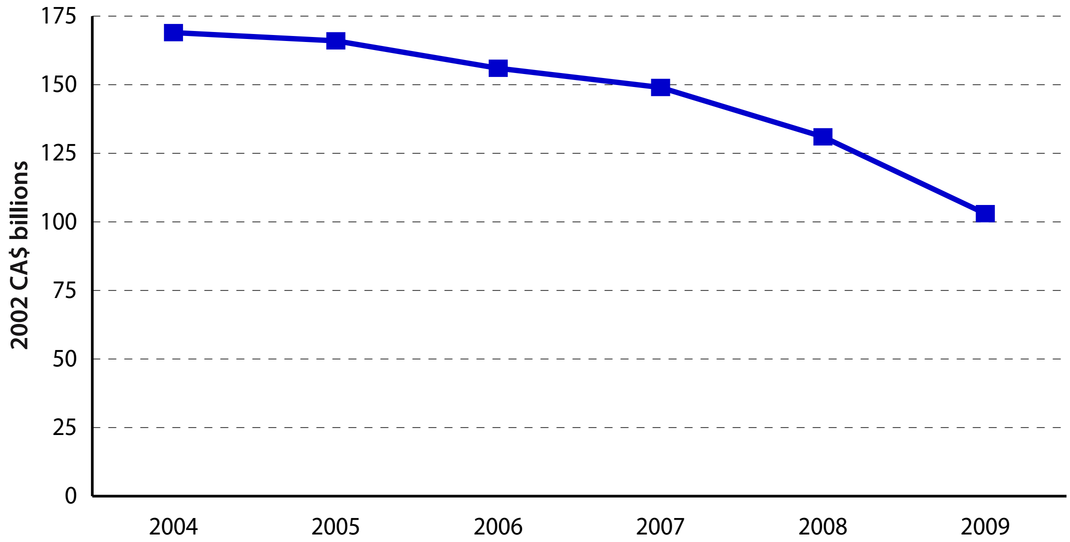
Source: Industry Canada, 2010; calculations by authors.

Figure 3: Canada-US net merchandise trade, 1998–2009



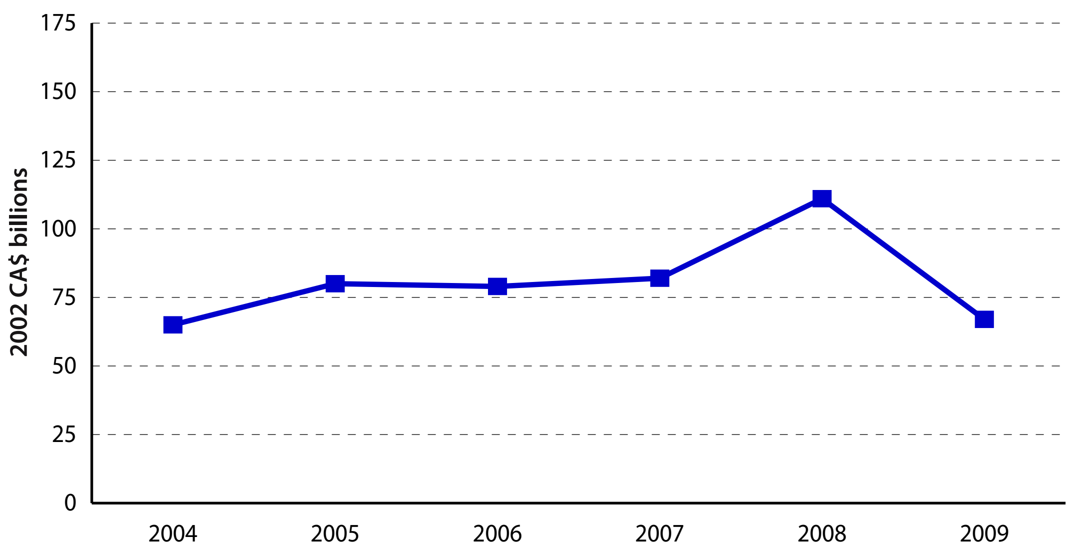
Source: Industry Canada, 2010.

Figure 4: Canadian manufactured products exports to the US, 2004–2009



Source: Industry Canada, 2010.

Figure 5: Canadian energy and mineral exports to the US, 2004–2009



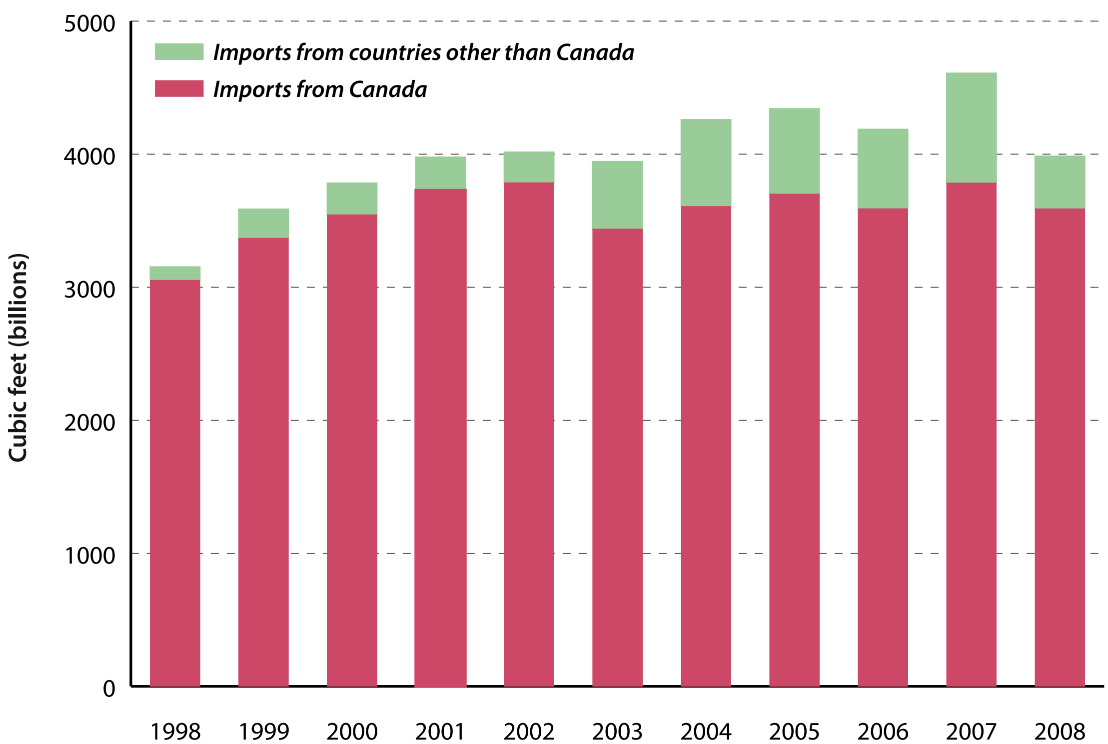
Source: Industry Canada, 2010.

Natural gas exports and unconventional gas

Canadians and Canadian businesses are hoping that the economic recovery in the United States will restore strong export earnings. While there appear to be good opportunities for Canadian businesses, for example in the banking sector, several other current trade trends do not bode well for growth in trade between the United States and Canada. Given the strong growth in nonconventional gas reserves being discovered in the United States, the Canadian natural-gas industry will face increasing challenges in exporting natural gas to the United States over the mid- to long term. Canadian exports of natural gas to the United States in 2008 totaled 4,048 billion cubic feet and were worth $40 billion (USDOE, 2009; Morrissey, 2009). However, as figures 6 and 7 reveal, gas sales to the United States, which peaked in 2002, have reached a plateau (USDOE, 2009). In 2008, gas sales equaled 7.5% of export earnings.

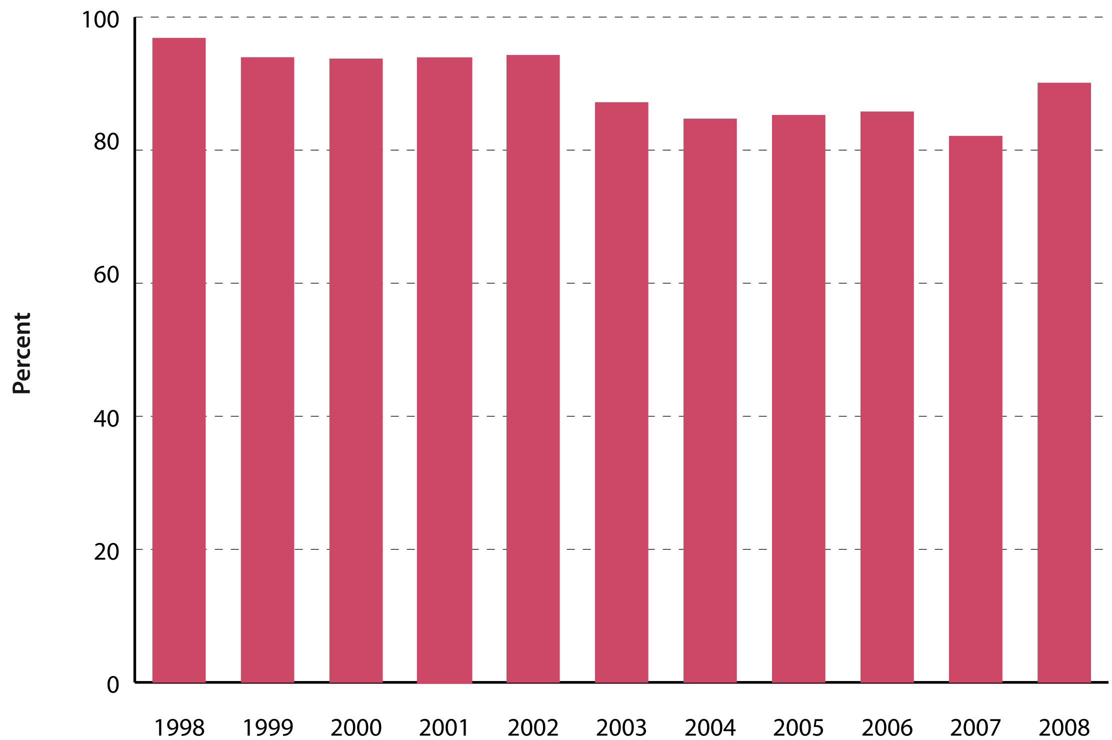
Recent technological breakthroughs in the exploration of unconventional gas (shale, coal-bed methane, and tight gas) in both Canada and the United States bring good news for Canada because conventional gas reserves are dwindling fast. At the same time, gas exports to the United States will be faced with a more competitive environment as US shale-gas reserves are very large and US gas production may offset Canadian imports. Proven and

Figure 6: Imports of natural gas from Canada and other countries by the United States, 1998–2008



Source: US Department of Energy, 2010.

Figure 7: Imports of Canadian natural gas as a percentage of total US imports of natural gas, 1998–2008

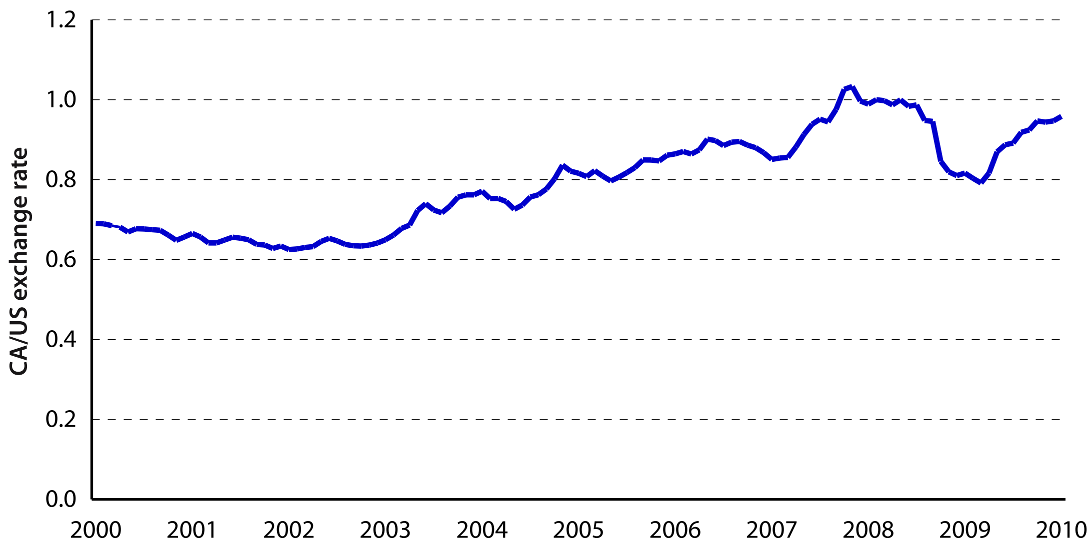


Source: US Department of Energy, 2010; calculations by author.

recoverable reserves have risen to 245 trillion cubic feet (Tcf) in 2008. The massive finds constitute 90 years' worth of US supply (Yergin and Ineson, 2009). Canadian gas exports formed 13.1% of American consumption in 2008. In an optimal scenario, Canadian gas companies would use their finds in non-conventional gas as a way to maintain their exports to the US while Canadian conventional supplies go down. At the same time, Canadian producers have a new opportunity to export gas to other areas of the world. In order to do so, the federal and relevant provincial governments need to speed up the approval process for the construction of Liquefied Natural Gas export terminals in British Columbia.

The seemingly endless regulatory and environmental approval process for natural-gas pipelines from the Canadian and American Arctic have made the commercial prospects for this gas to come on line more difficult as shale-gas exploration is rapidly expanding. Now that a federal review panel in Canada has given tentative approval for the Mackenzie line, the National Energy Board must approve the line as soon as possible and the federal and provincial governments must speed up the remaining process both for the landing of Alaska gas in Alberta and the Mackenzie line.

Figure 8: Canada/US dollar exchange rate, 2000–2009



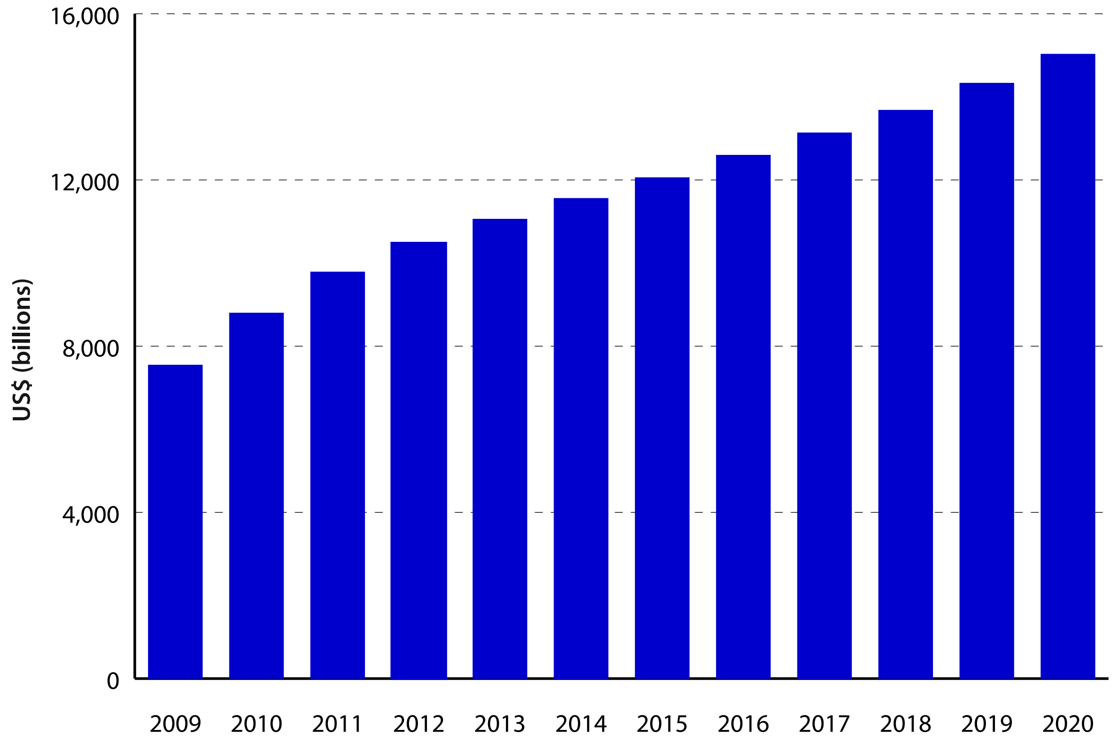
Source: Bank of Canada, 2010.

High Canadian dollar

Another challenge for future Canadian exports to the United States lies in the relatively high value of the Canadian dollar (figure 8). Canada has in the last two years been coping with a depressed market for exports as a result of slumping American demand and a high Canadian dollar. The Canadian dollar is likely to remain high in relation to its American counterpart, putting downward pressure on Canadian exports. The reason for the relatively high Canadian dollar is twofold: America's debt problems and rising energy and commodity prices driven by continuing strong global demand for energy and commodities, which are key Canadian exports. America's 2009 national budget deficit accounts for 11.2% of its GDP and its current debt is equivalent to 60% of its economy. Figure 9 shows that walloping debt projections for years to come (which are compounded by unfunded liabilities in Medicare/Medicaid and Social Security) will keep deficits high.

While promising a partial freeze in domestic spending in 2010 and tax increases on high-income earners, the Obama administration is also planning to add a $50 billion increase to the 2010 education budget and additional $100 billion for job creation. The recently passed health-care bill is expected to cost $940 billion over 10 years in new insurance coverage. At the same time, the Obama Administration points out that the bill will also entail several hundred billion dollars in cost savings. As a result, the 2010 deficit, which was expected to go down from the $1.4 trillion figure for 2009, is now expected to rise to $1.6 trillion in 2010 (Montgomery and Branigin, 2010).

Figure 9: Projected total US debt, 2009–2020 (US$ billions)



Source: United States, Congressional Budget Office, 2010.

US Debt and Economy

- The budget deficit for 2009 is estimated to be 11.2% of GDP as of August 2009, according to the Congressional Budget Office, the highest level since 1945.
- US national debt is projected to stay above 60% of GDP from 2010 until 2019.
- Government revenues are at 15% of GDP while expenditures are estimated to be 24.1% in 2010.
- Net interest costs as a percentage of government revenues had been under 10% in the first decade of this century but are now projected to reach 17% by 2019.
- Even with GDP growth rates of 3% to 4% from 2012 onward, given unfunded liabilities in major programs such as Medicaid and Social Security, US debt will continue to rise.
- The cost of borrowing and risk of inflation are expected to put upward pressure on US interest rates

Data based on CBO, 2009; Kadish, 2009; *Economist*, 2009; Sprott and Franklin, 2009.

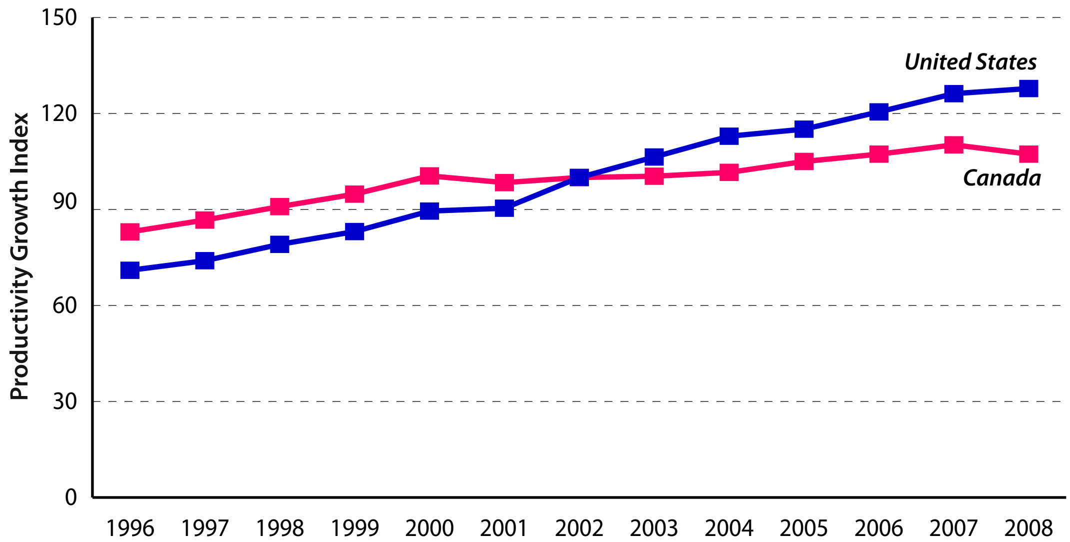
Challenges for the growth of Canadian exports to the United States in 2010/11

Several economic factors are coalescing in the near future that will pose challenges for robust growth in Canadian trade with the United States. In a reversal of trends, Canadians' real disposable income (RDI) has recently outpaced that of Americans. Since 2005, Canadian RDI has risen by 10% while US RDI rose by only 5%. At the same time, most analysts predict that by 2011 the Canadian dollar will equal US$1.05 as a result of large US deficits and a rise in energy and commodity prices. Most forecasters project increases in interest rates of 2% by 2011 (Scotiabank Group, 2009; Tal, 2009).

The United States is also expected to experience lower growth in demand because of persisting high unemployment rates. Close to double-digit unemployment rates are expected to persist through 2011. US employment in the last four years has essentially been flat. As a result of the housing and financial crises, there has been a 20% drop since 2007 in US household net worth. Taken all together, only modest annual GDP growth (2%–3%) is expected for 2010/11 (Scotiabank Group, 2009; Tal, 2009). Low Canadian productivity growth (figures 10 and 11) poses another challenge to Canadian export growth as it makes Canadian manufacturing less competitive within North America.

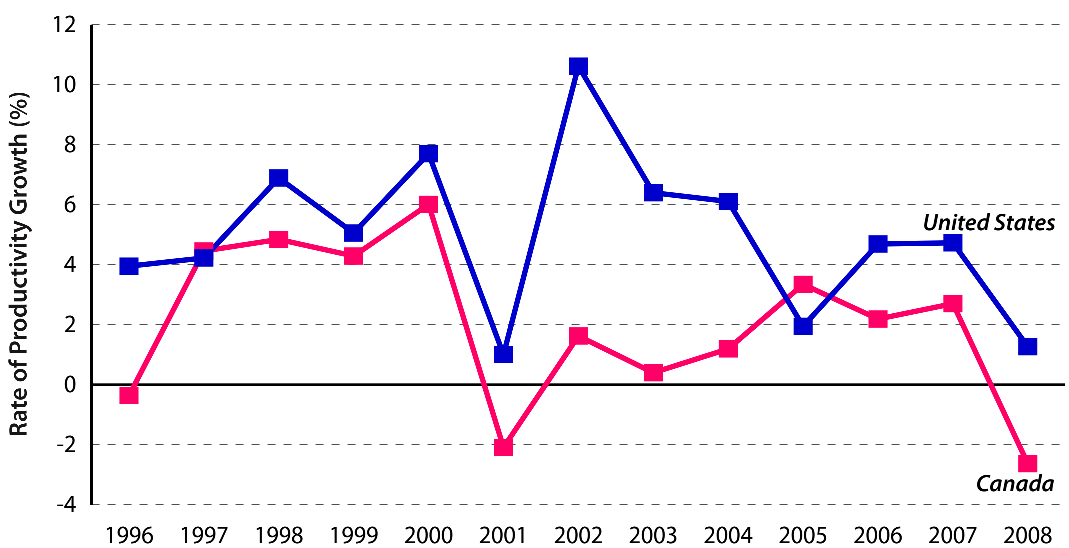
The perfect storm of costly border delays, potential carbon levies, decline in gas exports, a high Canadian dollar, weaker American demand, and persistently lower Canadian productivity rates, suggests that the outlook for growth in trade with the United States is weak. Given that Canada's only major trade surplus in the last 20 years has been with the United States and that it runs a consistent trade deficit with the rest of the world, Canada's trade account ledger, which switched to a negative balance in 2009, may be slow to recover (figures 12 and 13). Though Canada's trade in services is still modest compared to merchandise trade (about 10%), it runs a consistent deficit with both the United States and the rest of the world.

Figure 10: Canadian and US output productivity growth index, 1996–2008 (base year 2002)



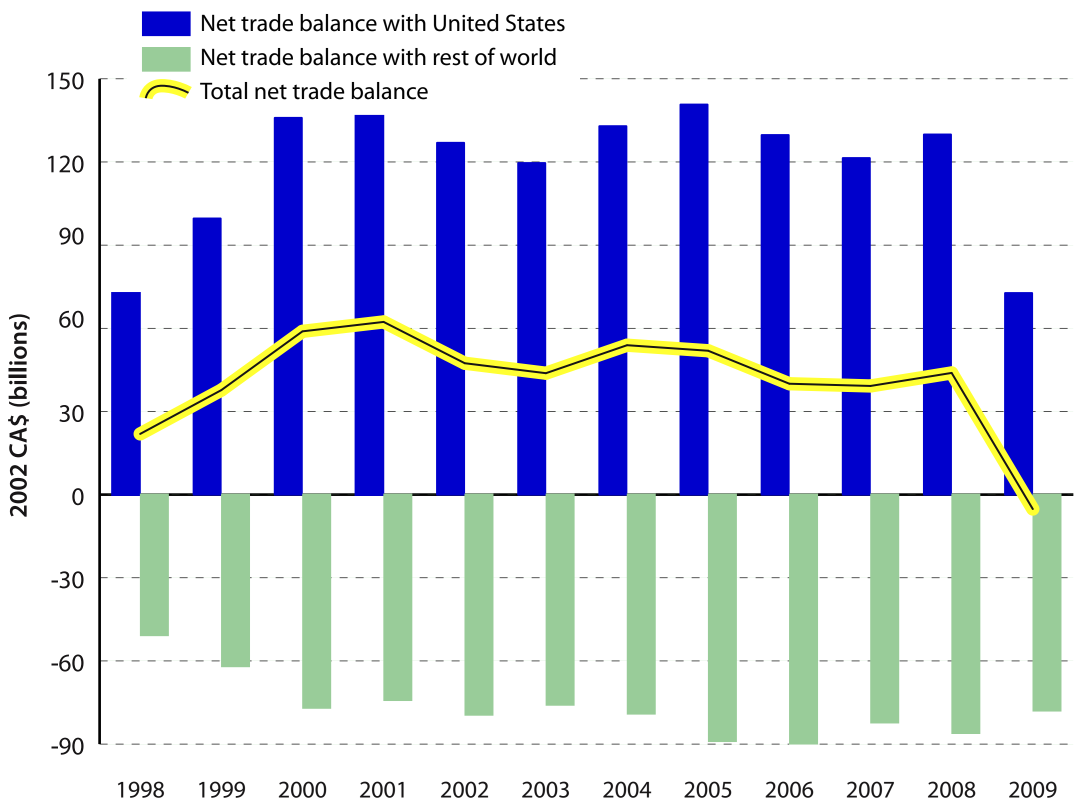
Sources: United States, Department of Labor, Bureau of Labor Statistics, 2010.

Figure 11: Canadian and US rates of output productivity growth, 1996–2008 (%)



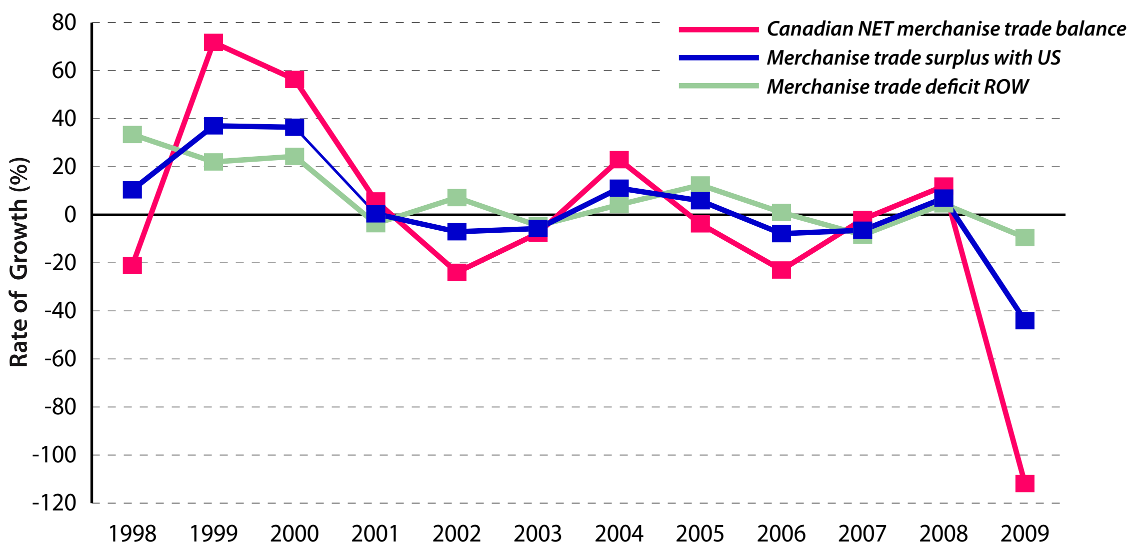
Sources: United States, Department of Labor, Bureau of Labor Statistics, 2010.

Figure 12: Canadian net merchandise trade balance with the United States, 1998–2009 (2002 CA$ billions)



Sources: Industry Canada, 2010; calculations by author.

Figure 13: Growth rates of Canadian net merchandise trade balances, 1998–2009



Sources: Industry Canada, 2010; calculations by author.

The unproductive political relationship

Not too long ago, Canada and the United States had one of the most successful periods in bilateral relations when Brian Mulroney and Ronald Reagan negotiated an enormously successful free-trade deal, reached agreements (like the Acid Rain Accord) that solved a variety of bilateral problems, and deflected major collisions on East-West relations. No major advancements were made in the bilateral relationship after the ratification of NAFTA in 1994—a lost opportunity for deeper bilateral ties—while the period from 2001 to 2006 was mainly characterized by protracted disputes. The disagreement over Iraq in 2003—which John Manley called "more than an irritant" (Manley, 2009)—and the drawn-out disputes on softwood lumber and "Mad Cow" disease (BSE) created an atmosphere in which both sides felt aggrieved on different issues without any satisfactory resolution. It is quite normal for highly interdependent countries to have multiple disagreements but it is harmful for a close relationship such as that between Canada and the United States to have these unresolved and festering for too long.

The resolution of the dispute over softwood lumber in the Softwood Lumber Agreement of 2006 brought closure to a major irritant but its sliding scale of levies (as the price of lumber falls, the levy rises) has left the Canadian lumber industry (especially in the West) in tatters as the US housing industry declined shortly afterwards, taking lumber prices down with it (Hajdu, 2010). Likewise, the resolution of the dispute over BSE ("Mad Cow" disease) came two years after the first border closure. Canadian cattle and beef markets have never fully recovered.

Security and Prosperity Partnership

The Security and Prosperity Partnership was launched in 2005 by the United States, Mexico, and Canada to increase harmonization in both border security and commercial regulations. The initiative was innovative in that it sought direct talks among officials at the technical level. It produced modest outcomes. It eliminated NAFTA's Country of Origin regulations on several manufactured goods, finalized an open-skies agreement on air cargo, and harmonized security procedures for containers carrying hazardous materials. However, discussions floundered in 2008 as a result of Congressional skepticism and popular mistrust. Critics argued that the three governments were negotiating secretly to establish a single supranational North American Union. Though false, this allegation was believed by a large segment of both the American and Canadian public (Council of Canadians, 2008) and lack of leadership by Canada and the United States has allowed protectionist and nationalist sentiment to turn the public against the process. Canadian nationalist lobbies and New Democratic Party (NDP) made it a political albatross for any Canadian government to pursue publicly (Moens, 2008; Sands, 2005). If the Obama administration does not launch a new initiative, the precedent of the "failed" Security and Prosperity Partnership (SPP) will raise the level of political difficulty for any future engagement. Better yet, for Canada—though politically difficult for Washington—is the option of two separate bilateral discussions between Canada and the United States and Mexico and the United States. Unhindered by Mexico's border and economic problems, Canada would be able to make progress more quickly.

The perception among the Canadian public is that Canada remains vulnerable to US trade actions against Canadian imports. This is not to say that the NAFTA panels have not resolved disputes—they have—but the Canadian perception is that, when it comes to big ticket items, lumber or BSE for example, the system often fails to deliver. Strident criticism of the NAFTA accord in the 2008 Democratic primaries further rattled Canadian confidence. The Canadian government could not simply assume that the NAFTA or WTO process would be able to protect Canadian interests if its energy or manufacturing sectors were to be discriminated against by green energy legislation or regulation in the United States. That is why the February 2010 deal on reciprocal procurement access is so important to the Canadian-American trade dynamic. It is the first positive signal for trade that suggests a possible shift away from more protectionism.

A Snapshot of Canadian-American Cooperation

The rough qualitative assessment below of yearly ups and downs in Canadian-American relations shows how improvised the relationship remains (these points do not include ongoing disputes).

Postive and negative in Canadian-American relations in 2009

Positive actions and measures *that [1] favor free trade; [2] exhibit rule-based behavior; [3] seek cooperative or integrated approaches to common or shared problems; [4] improve goodwill and public support for the US Canada relationship*	**Negative actions and measures** *that [1] inhibit or reduce free trade; [2] do not exhibit rule-based behavior; [3] seek national and separate solutions to mutual or shared problems; [4] reduce goodwill and public support for the US-Canada relationship*
Resumption of negotiation on a joint pre-clearance pilot project between Ontario and New York State. In a joint pre-clearance site, both countries agree to do customs clearing on one side of the border to reduce congestion (Alberts, 2009a).	Rising number of "green energy" subsidies in both Canada and the United States that distort trade; e.g., Ontario's Green Energy Act of 2009 stipulates that 25% to 50% of materials and labor for solar, wind, and transit vehicles must come from Ontario (Radwanski, 2009). The Waxman-Markey energy bill would provide up to $65 billion in allowances from 2012 to 2020 for state and local government energy efficiency programs.
Canadian compliance with softwood lumber case in the London Court of International Arbitration as the Court ruled that Canada had calculated its export taxes under the 2006 Softwood Lumber Agreement too low by $68.3 million (National Post, 2009, September 29).	28 US states and cities are planning to eliminate Canadian "dirty oil" from their fuel supply and 12 states are seeking protectionist barriers against Canadian hydro-electric power (green as green can get) in order to kick start their local clean-coal or other electric-power initiatives (Martin, 2009b).
Canada and the United States agree to recognize each other's labeling of certified organic food products and to give it national equivalence treatment (USTR, 2009).	The US pulp and paper sector has received subsidies of US$7 billion, distorting the market for forestry products. In response, Canada has offered $1 billion in subsidies to its paper and pulp mills (Hamilton, 2009).
The Canadian public's favorable rating of the United States rose from 55% to 69% between 2007 and 2009 while the unfavorable rating fell from 42% to 28% (Wike, 2009). Americans are very favorably disposed towards Canada: in both 2009 and 2010, Americans scored Canada highest among 20 countries in favorability ratings (Saad, 2010, Feb. 19).	US Country of Origin Labeling (COOL) on imported meat products.
Canadians support enhancing the flow of people and goods across the border by 73% and a continental energy policy by 76% (Nanos, 2009).	Governments in both countries have asked companies to submit bids for offshore gas drilling in the disputed zone of the Beaufort Sea along the Yukon-Alaska border. However, "both countries have also agreed on a moratorium on work in the disputed area," until a resolution is found (Boswell, 2009).
"ShipRider" program adopted in which the Royal Canadian Mounted Police and US Coast Guard engage in joint training, joint patrols, and enforcement operations, riding each other's vessels on waterways along the border.	Canada filed a diplomatic note of protest with the US Department of State in April 2009 over a unilateral fishing moratorium in the contested Beaufort Sea boundary waters.
Clean Energy Dialogue set up three US-Canada working groups for collaboration on energy research in the areas of clean engine technologies, advanced biofuels, and energy efficiency (Breese, 2009).	US Customs and Border Protection's new, so-called Importer Security Filing (also called the 10+2 rule) requires that importers and shippers must now submit 12 additional items of information on such things as manufacturer, country of origin of the goods, buyers and sellers' information, and data about the shipments destined for the United States.
	The US Trade Representative's office (USTR) put Canada on the priority watch list regarding copyright law. Canada still has to ratify the World Intellectual Property Organization (WIPO) Internet Treaties. USTR claims that Canada does not have sufficient copyright protection or enforcement and that it lacks adequate protection of intellectual property rights (Viana, 2009).

Canadian trade options

The uncertainty surrounding the bilateral relationship between Canada and the United States is spurring increasing calls for diversification within many sectors of the Canadian economy. For purely political reasons, Canadians flock to this option all too easily. As one experienced observer put it: "Whenever the US passes through tough economic times, there are murmurs in Canada that it has hitched its wagon to a falling star" (Burney, 2009, November 17).

Of course, diversification and trade with the United States is not an either-or question. Canada's strong growth in trade with the United States after the Canada-US Free Trade Agreement (CUFTA) did not come at the expense of trade with other areas of the world. Diversification versus deeper integration is a false tradeoff (Andresen, 2006): Canadian entrepreneurs have several trade options and should pursue these vigorously and Canadian governments must seek to create an environment that maximizes the benefits from free trade.

While there is still relatively little trade with the European Union, it has grown over the last ten years (table 2). Canada is currently negotiating a Comprehensive Economic and Trade Agreement (CETA) with the European Union. Though the estimated gains for both sides are modest, Canada stands to gain relatively more than the EU (European Commission and Government of Canada, 2008). Canada and India have also begun exploratory talks towards a free-trade agreement (Clark, 2009). Also, after finally realizing that the multilateral trade process was going nowhere, Canada is now "aggressively pursuing" bilateral trade deals with smaller partners (Senior DFAIT Official, confidential personal communication with author, October 8, 2009).

Canada's trade with China is still quite small (table 3) although, between 2003 and 2008, Canada nearly doubled both its exports and imports with China. While trade with both the EU and China equal just 10% of the volume of US-Canada trade, the average rate of growth in merchandise trade between 1998 and 2008 suggests that China is the outlier (table 4).

Table 2: Merchandise trade between Canada and the EU, 1998–2009 (2002 CA$ billions)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Exports	18.4	18.3	20.6	19.2	17.9	19.5	22.0	23.3	26.8	31.3	31.8	23.8
Imports	31.7	35.1	39.8	40.4	40.1	39.2	40.4	42.9	44.9	44.2	47.4	36.5
Balance	−13.3	−16.8	−19.2	−21.2	−22.2	−19.7	−18.4	−19.6	−18.1	−13.0	−15.6	−13.8

Source: Industry Canada, 2010.

Table 3: Merchandise trade between Canada and China, 1998–2009 (2002 CA$ billions)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Exports	2.7	2.9	3.9	4.4	4.1	4.7	6.5	6.7	7.2	8.5	9.2	9.1
Imports	8.4	9.6	11.8	13.0	16.0	18.1	23.0	27.6	31.6	34.4	37.4	32.0
Balance	−5.6	−6.8	−8.0	−8.7	−11.9	−13.4	−16.6	−20.8	−24.5	−25.8	−28.2	−23.0

Source: Industry Canada, 2010.

Table 4: Average growth rate (%) of merchandise trade balance with China, the United States, and the European Union, 1998–2008

China	United States	European Union
20.4	7.0	2.9

Source: Industry Canada, 2010.

Foreign direct investment

Recommendation

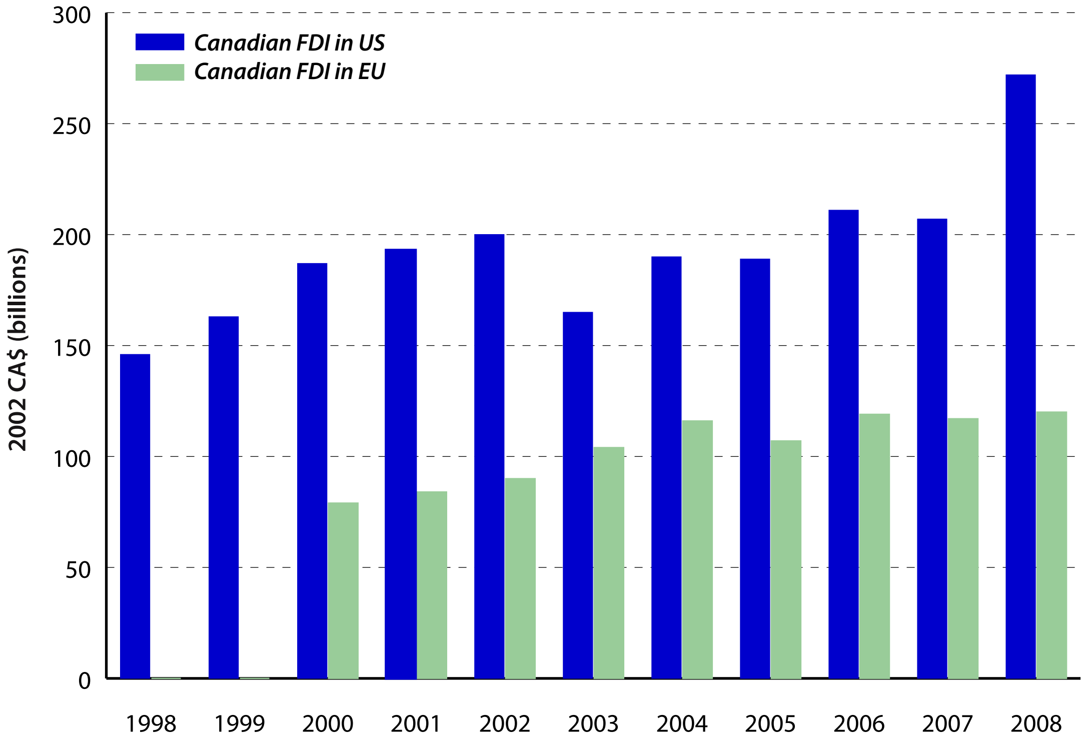
The Northern Gateway pipeline from Edmonton to Kitimat, BC is currently in the review stage. It is scheduled to transport half a million barrels per day to West coast tankers that would then take it to US and Asian ports (Cooper, 2009). Speeding up the Northern Gateway project—not letting it fall victim to postponements due to open-ended environmental or native land reviews—is of key value to Canada.

Canada's investment relationship with China is still tiny compared to Canada's foreign direct investment (FDI) in the United States and the European Union (figures 14 and 15). In 2008, Canadian FDI stock in the United States was over $250 billion and in the European Union, over $100 billion. In China, it just surpassed $3 billion.

The share of FDI in Canada from Asia/Oceana has risen from 4.8% in 2003 to 7.9% in 2008. Growth rates of FDI in Canada from Asia/Oceana outstrip growth rates of FDI in Canada from the United States. Chinese FDI stock in Canada rose from 0.1% in 2003 to 0.5% in 2008 (DFAIT, 2009). US FDI stock in Canada dropped from 63.7% of total FDI stock in 2003 to 58.2% in 2008. Figure 16 compares the growth rates for FDI in Canada from the United States, the European Union, and China.

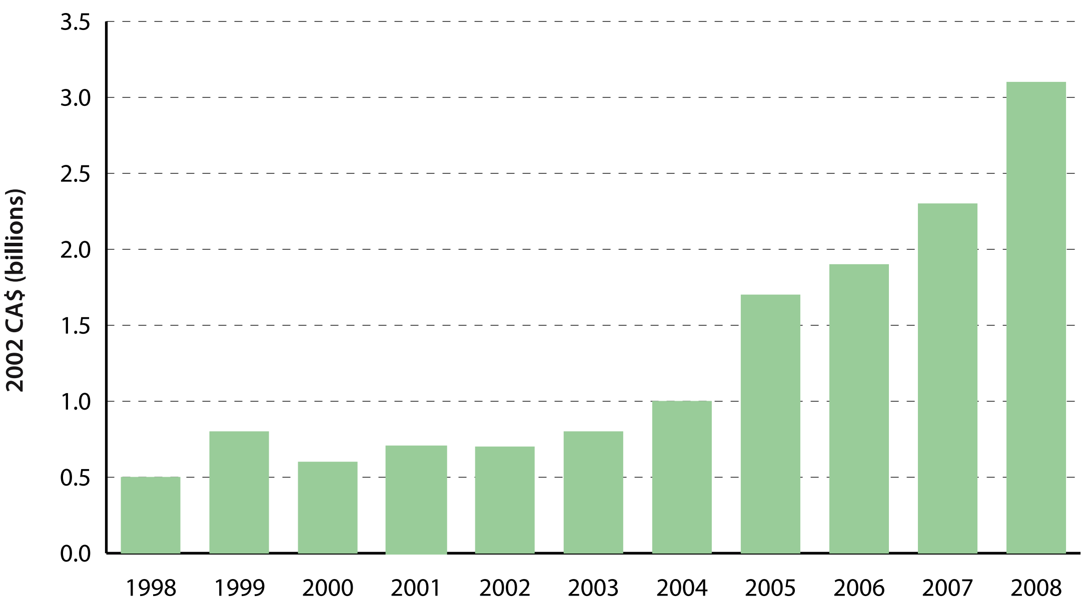
A similar relationship exists in terms of foreign direct investment (FDI) from the United States, Europe, and China in Canada (Figures 17 and 18). The American share is by far the largest, followed by the EU share, while China is just getting its toe in the water. The investment by PetroChina of $1.9 in the Athabasca Oilsands Corp., as announced in September 2009, was the first Chinese investment in the sector and was approved in December (Martin, 2009a).

Figure 14: Canadian foreign direct investment (FDI, stock) in the United States and the European Union, 1998–2008 (2002 CA$ billions)



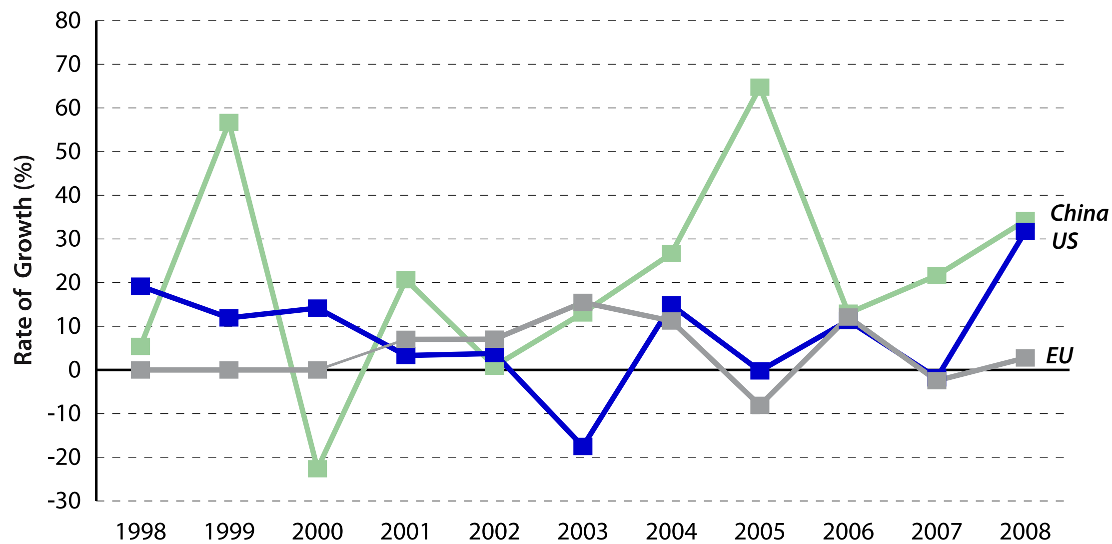
Source: Foreign Affairs and International Trade Canada, 2010.

Figure 15: Canadian foreign direct investment (FDI, stock) in China, 1998–2008 (2002 CA$ billions)



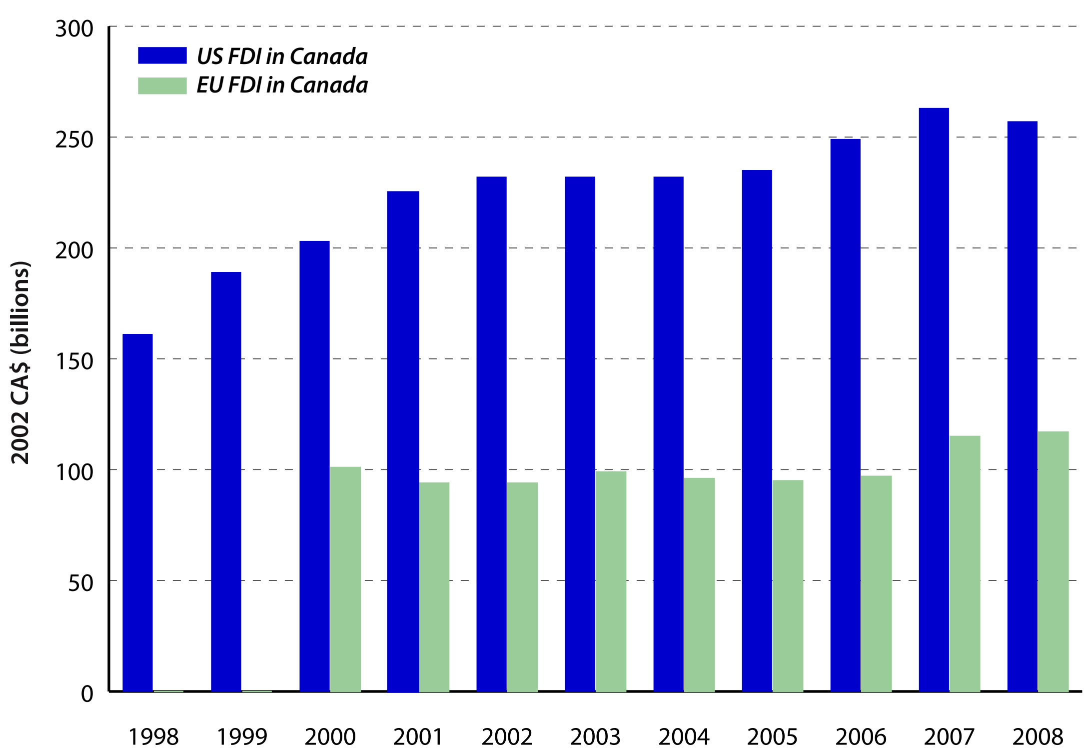
Source: Foreign Affairs and International Trade Canada, 2010.

Figure 16: Canadian FDI (stock) growth rates in the United States, European Union, and China, 1998–2008



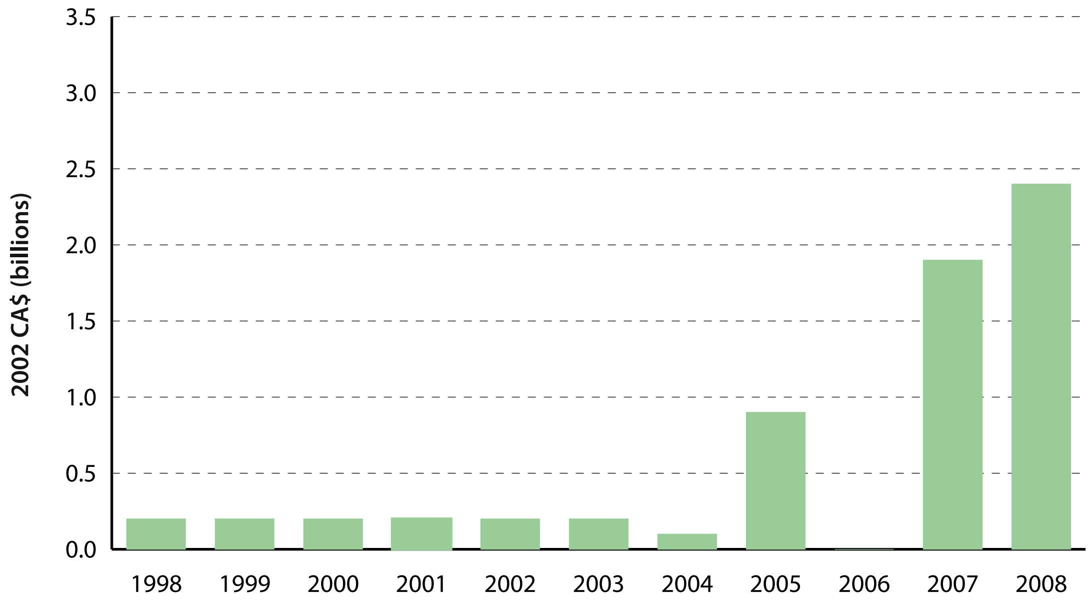
Source: Foreign Affairs and International Trade Canada, 2010.

Figure 17: Foreign direct investment (FDI, stock) from United States and the European Union in Canada, 1998–2008 (2002 CA$ billions)



Source: Foreign Affairs and International Trade Canada, 2010.

Figure 18: Foreign direct investment (FDI, stock) in Canada from China, 1998–2008 (2002 CA$ billions)



Source: Foreign Affairs and International Trade Canada, 2010.

Think big

Trade expansion outside North America and free-trade agreements are both good news. But Canadian businesses have always found ways to capitalize on American market opportunities and there is no reason that the 2008 financial crisis and the 2009 recession should put an end to this. At the same time, there are valid concerns that the bilateral relationship at the political level is failing to adjust regulatory and border regimes, thereby hindering the emergence of new trading patterns.

Canada's top economic security interest remains unimpeded access to the US market for Canadian exports and imports (Molot, 2003). The concern underlined in this report is that the post-9/11 structural changes on the border, the growing politics of protectionism in Congress, and the failure of the Security and Prosperity Partnership (SPP) to usher in deeper economic integration between the United States and Canada collectively pose a threat to Canada's vital long-term economic interests.

President Obama's willingness to negotiate a reciprocity deal on procurement is a welcome development that augurs well for his promise to be pro-free-trade. It also testifies to the importance of ensuring a positive Canadian-American political atmosphere, an objective the Harper government has pursued since 2006. Canadian business people still see opportunities in the United States but obstacles increasingly stand in the way. Many in Canada simply assume that the so-called BRIC countries (Brazil, Russia, India, and China) will make up any short-fall in trade between the United States and Canada but the historical record does not afford such a conclusion. There is a strong chance that Canadian long-term prosperity will be derived from renewed American prosperity.

The failure to pursue deeper trade integration between Canada and the United States in such areas as regulatory harmonization, common external tariffs on manufactured products, free trade in agricultural products, and an overall energy and environmental accord in the 15 years following the implementation of NAFTA has left Canada's future economic relationship with the United States undervalued. In order to overcome the public-policy obstacles that thicken the border and the outlook that regards protectionism as the best response to economic downturns, Canada must move closer to the American polity and market. Marrying America's security concern with Canada's need for a single economic market should have been Canada's number one goal as of September 12, 2001. Nearly ten years hence, reaching such a deal has become increasingly difficult, especially with most American politicians not focused on Canada. Still, it should remain Canada's number one objective in foreign policy.

The way forward toward deeper economic integration starts at the strategic security level. Canada cannot insist on its privileged trade status with the United States without recognizing the threat and sharing in the response. The United States cannot treat Canada like all other countries if these two North American neighbors are fully integrated in a North American security and defense framework, united against this new threat. Canada cannot ignore US safety requirements nor can it isolate itself from the consequences of American security policies (Barry and Bratt, 2008). Security threats are no longer around us as during the Cold War but between us. Canada must formulate proposals to overcome American concerns about the security of the flow of people in and out of Canada.

In the famous Ogdensburg agreement of 1940, the two governments gave voice to a common threat and closed the door on the separateness that had existed because of British colonial and American continental policies. To apply the lesson of Ogdensburg in our time, Canada and the United States must first of all come to terms with each other about the threats that face us.

After 9/11, there was considerable distance between the Canadian and American interpretations of the threat. The assessment of what was at stake was blurred by the Iraq question. With a bit more reflection and perspective, the two governments should be able to formulate a unified response. We face a totalitarian religious ideology in *jihadism* that aims to fashion society completely according to its dictates. This ideology uses every means possible to inch towards the goal of spreading its totalitarian values at the expense of our Western way of life. It uses migration, finance, indoctrination, terrorism, and civil war. While the threat is serious, it can be dealt with by a means of focused intelligence and counter-terrorism. There is no reason that it should divide our two societies or hamper our bilateral economic relations.

Once the two countries formulate a common threat assessment, they can focus on what common policies should govern both the American and Canadian territories. Once the security regime is in place, the integrated dynamic of commercial exchange can flourish again as it did in the 1990s, leading to increased travel, deeper commercial interaction, and assured future prosperity.

Canada's government must explain to Canadians what is at stake and what is on the table regarding a single security strategy and deeper economic integration with the United States. A shared security space and more market harmonization will require some shared responsibilities and some compromises but will not lead to political union or a supranational jurisdiction. Neither governments nor people are interested in such an outcome. Even in Europe, governments are beginning to learn that their peoples do not want to forfeit national sovereignty. If enough Canadians see their interest met in the plan, the Canadian government will ultimately find a willing ear in Washington.

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