

Towards a Canada-USA “Deeper” Integration: A Computable General Equilibrium Investigation

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Abstract

The increasing convergence of the North-American Free-Trade Agreement (NAFTA) countries, and especially between Canada and the United States, combined with the events of September 11, 2001, have inspired some observers to suggest that Canada should ensure its access to the US market more than ever. Proponents of “deeper integration” argue that closer ties with the US will help Canada narrow the gap in living standards and economic performance vis-à-vis its major trading partner. This suggestion contrasts with the relatively modest impact of NAFTA on the Canadian economy as reported by Trefler (1999). A plausible reason often put forward for this modest impact is the “home bias” in trade. Though the explanation of the “home bias” is still somewhat a puzzle in economic literature, one school of thought suggests it be cost based: costs related to cross border trade are larger than may have been realized. To the extent that “home bias” is attributable to remaining non-tariff trade barriers, reduction of these costs as would be anticipated in an US-Canada common market scenario could have a significant impact throughout the economy.

A CGE model is constructed to estimate the economic impact of various proposed initiatives to advance Canada-US integration. The CGE model has 24 perfectly competitive sectors and eight regions: six Canadian regions, the USA and the Rest of the World. Non-tariff barriers are calibrated in the model based on gravity results on Canada-US trade (Anderson and Wincoop, 2001). In this paper the following scenarios of deeper integration are addressed: a) *Customs union* or the adoption of a common customs regime towards third countries. Potential gains to Canada from the removal of the existing rules of origin are also estimated. This experiment is conducted in the presence of border related non-tariff barriers or otherwise, b) *Common market with the US* or reduction of Non-tariff barriers to trade (NTBs): gradual reduction of NTBs (calibrated in our model) in Canada-US trade.