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Redesigning Canadian Trade Policies for New Global Realities

Edited by Stephen Tapp, Ari Van Assche and Robert Wolfe

About this chapter

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Redesigning Canadian Trade Policies for New Global Realities, edited by Stephen Tapp, Ari Van Assche and Robert Wolfe, will be the sixth volume of The Art of the State. Thirty leading academics, government researchers, practitioners and stakeholders, from Canada and abroad, analyze how changes in global commerce, technology, and economic and geopolitical power are affecting Canada and its policy.

Chapter summary

The international trading system has grown more complex in recent decades. Globally integrated supply chains, foreign investment and cross-border portfolio holdings have introduced new and deeper economic connections between trading partners, blurring countries' geographic and economic borders. In Canada, relationships between trade policy and the interests of companies and citizens have become more nuanced as a result.

In this chapter, Emily Blanchard (assistant professor at the Tuck School of Business at Dartmouth College, United States) simplifies this complexity while reimagining the role of Canadian trade policy in the twenty-first century. She finds that while several long-standing policy tenets remain unchanged, global value chains (GVCs) bring new policy opportunities but also a few emphatic policy cautions.

GVCs require governments to update their approaches to tariffs, input trade, rules of origin and re-exporting, all of which are increasingly important as global production becomes more fragmented. Longer supply chains magnify the inefficiencies of trade barriers. When products cross more borders more often, tariffs — which apply to the total value of goods crossing borders, not to the incremental value added in each country — discourage production fragmentation, as the same product can encounter trade barriers multiple times along its journey. Blanchard says that Canada took a step in the right direction by removing tariffs on manufacturing inputs, but recommends that policy-makers consider going further by proactively removing the remaining import tariffs. This would reduce the regulatory and customs burden on Canadian businesses and customers and improve production efficiency.

GVCs allow countries to leverage a beneficial trade and investment cycle through regional and preferential agreements. And because some of the fastest growing emerging markets are also becoming most integrated into GVCs, Canada's best prospects for trade partnerships may be the rapidly growing economies of East Asia, Eastern Europe and Latin America.

However, Blanchard warns that Canada should pursue new trade and investment deals selectively and with due consideration of the potential costs of behind-the-border provisions (some of which have been criticized for challenging countries' sovereignty through overzealous investor and patent protections). She also notes that regional agreements could leave behind the countries that are currently outside of GVC networks, which could widen the gap between the integrated rich countries and peripheral have-nots. This could undermine multilateral efforts at the World Trade Organization (WTO) and inefficiently divert trade and investment. The global economy does not necessarily benefit from more trade preferences, which can create a "spaghetti bowl" of rules from overlapping deals. To guard against this outcome, Blanchard recommends that Canada maintain an active role in the WTO.

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Résumé de chapitre

Le système du commerce international a gagné en complexité au cours des dernières décennies. L'intégration mondiale des chaînes d'approvisionnement, les investissements étrangers et les avoirs en portefeuille transfrontaliers ont créé des liens nouveaux et approfondis entre partenaires commerciaux, estompant les frontières géographiques et économiques. Au Canada même, les rapports entre politique commerciale et intérêts des entreprises et citoyens sont désormais plus diversifiés.

Dans ce chapitre, Emily Blanchard (professeure adjointe à la Tuck School of Business du Dartmouth College, aux États-Unis) propose un cadre d'analyse de cette complexité tout en réinventant le rôle de la politique commerciale canadienne pour le siècle actuel. Même si plusieurs principes commerciaux restent inchangés, observe-t-elle, les chaînes de valeur mondiale (CVM) sont source de nouvelles opportunités mais appellent aussi de sérieuses précautions en matière de politiques.

Les CVM imposent aux gouvernements d'actualiser leurs approches en ce qui a trait à la tarification, au commerce des intrants, aux règles d'origine et aux réexportations, et l'importance de ces questions ne cesse de croître avec la fragmentation de la production mondiale. Car l'allongement des chaînes d'approvisionnement amplifie l'inefficience des barrières commerciales. Quand les produits franchissent plus souvent des frontières plus nombreuses, les tarifs — qui s'appliquent à la valeur totale des biens traversant les frontières et non à la valeur qui leur est ajoutée dans un pays — enrayent la fragmentation de la production puisqu'un même produit peut rencontrer plusieurs fois des barrières sur son parcours. Le Canada s'est engagé dans la bonne voie en abolissant les tarifs sur les intrants manufacturiers, explique l'auteure, qui recommande toutefois d'aller plus loin en supprimant résolument les autres tarifs sur les importations. Cela allégerait le fardeau réglementaire et douanier des entreprises et serait avantageux pour leurs clients, tout en améliorant l'efficience de la production.

Grâce à des accords régionaux et préférentiels, les CVM permettent aux pays de mettre à profit un cycle d'échanges et d'investissements qui se renforce sans cesse. Et comme certains marchés émergents en rapide croissance s'intègrent aussi de plus en plus aux CVM, les meilleures perspectives de partenariat commercial du Canada pourraient bien résider dans les économies en plein essor en Asie de l'Est, en Europe de l'Est et en Amérique latine.

Mais dans sa quête de nouveaux accords de commerce et d'investissement, prévient Emily Blanchard, le Canada doit se montrer sélectif et tenir compte des coûts potentiels des dispositions applicables « derrière les frontières » (dont certaines ont été critiquées pour la protection excessive de brevets et d'investisseurs, mettant en question la souveraineté des pays). Elle note aussi que les accords régionaux pourraient délaisser les pays non intégrés aux réseaux des CVM, creusant ainsi l'écart entre les riches nations intégrées et les pays périphériques démunis. On risquerait ainsi de saper les efforts multilatéraux de l'Organisation mondiale du commerce (OMC), en plus de détourner inefficacement le commerce et l'investissement. L'économie mondiale ne profite pas nécessairement d'une abondance de préférences commerciales, celles-ci pouvant créer un « salmigondis » de règlements provenant d'accords qui se recoupent. Pour empêcher ce résultat, l'auteure recommande au Canada de maintenir un rôle actif au sein de l'OMC.

Leveraging Global Supply Chains in Canadian Trade Policy

Emily J. Blanchard

For much of the twentieth century, trade policy was a relatively straight-forward matter of managing the flow of goods across borders. For the most part, Canada's national economic interests coincided with its geographic borders, and trade generally took the form of arm's-length exchanges of raw materials, commodities and final goods passing through customs. Generally speaking, the notion of a "Canadian" firm was tied to clearly delineated national production, trade and ownership patterns. What was good for Canadian firms was also good for Canadian workers, and cross-border intermediate input trade was relatively limited. A mercantilist understanding guided a simple approach to trade policy that emphasized multilateral tariff liberalization under the auspices of the General Agreement on Tariffs and Trade (GATT).

In recent decades, the trading system has grown far more complex. Globally integrated supply chains, inward and outward foreign investment, services trade and diverse cross-border portfolio holdings have introduced new and deeper economic connections between trading partners. Many Canadian firms — including some of the largest employers such as Magna International and Bombardier — are deeply integrated in global supply chains, with active networks of overseas affiliates. Others, such as Pratt & Whitney Canada, are major affiliates of foreign multinational firms. Most major exporters are also major importers of intermediate inputs. The upshot is that the relationship between trade policy and the interests of Canadian firms has grown more nuanced. Firms' profits, workers' interests and investors' returns all depend in different ways on a diverse landscape of local and foreign supplier relationships, affiliate locations and the degree of complementarity or substitutability between local and foreign factors of production.

In this chapter I provide some basic structure to this complexity and reimagine the role of Canadian trade policy in the twenty-first century. Many of the key policy tenets remain unchanged, including an emphasis on market liberalization and trade facilitation. At the same time, global supply chains carry new policy opportunities, as well as new (or more emphatic) cautions for Canadian trade policy, particularly vis-à-vis preferential trade agreements, the so-called tangle of bilateral agreements and regulations, and the ongoing role of the World Trade Organization (WTO).[1]

The subsequent discussion summarizes the key insights from current research on global supply chains and trade policy, and interprets these general lessons in the Canadian context. I argue that deeper and more complicated relationships between trading partners have increased the political opportunities for strengthening economic ties through selective regional and preferential trade agreements with certain trading partners, including the Comprehensive Economic and Trade Agreement (CETA) between Canada and the European Union, the proposed Trans-Pacific Partnership (TPP) and other core hubs in global value chains (GVCs) as identified in Canada's recent Global Markets Action Plan (GMAP). The arguments that follow are drawn from frontier research on the economics of trade agreements, and do not attempt to address the complex legal and political issues that are also of critical practical importance.

Trade Policy Implications of Global Supply Chains

To develop a clear understanding of how GVCs are changing the way governments approach trade policy and trade agreements, I begin with a brief look at the twentieth-century view of trade agreements as "shallow," tariff-focused market access solutions intended to correct inefficiencies from noncooperative trade policy choices (see, in particular, Bagwell and Staiger 2002). I then build on this basic understanding by identifying three key features of global supply chains and how they influence trade policy: international ownership; relationship-specific bilateral bargaining between specialized buyers and sellers; and supply-chain lengthening and value-added trade, which embed more border crossings into final goods production.[2] These three forces, I argue, have combined to shift political attention toward regional and preferential trade agreements at the expense of further multilateral talks.

A twentieth-century view of trade agreements

At the most basic level, the role of any agreement is to create mutual benefit: all parties should gain, or at least not lose, from signing an agreement; this is what economists call Pareto gains. Thus, in the absence of an agreement, some inherent aggregate inefficiency must exist that an agreement would remove. In the context of trade policy, the economics literature has long identified a single source of pre-agreement inefficiency, the so-called terms-of-trade externality. The idea is simple: because large countries by definition affect world market-clearing prices, they do not bear the full burden of their import tariffs, but rather shift part of the tariff cost onto foreign exporters by depressing foreign export prices.[3] In the traditional national ownership context, any ill effects borne in foreign markets, by definition, are not internalized by the importing country that sets the tariff. Left to its own devices, therefore, a large country optimally would set its tariffs inefficiently high from the perspective of world welfare. Whatever a government's domestic policy preferences — which could imply a positive politically optimal tariff, especially if import-competing lobby groups are politically active — it always has an incentive to push the tariff even further above this politically optimal benchmark to exploit its market power at the expense of foreigners via the terms-of-trade externality.

From here, the potential for a Pareto-improving trade agreement is immediate. Because all large countries have the unilateral incentive to impose inefficiently high cost-shifting tariffs, a trading system that lacks treaties is characterized by a prisoner's dilemma driven by terms of trade: collectively and individually, all countries would be better off if they could commit not to increase their tariffs beyond the politically optimal level, but for strategic reasons, they are stuck instead in an inefficient situation where tariffs are too high. Bagwell and Staiger (1999) demonstrate that the twin pillars of the GATT — namely, reciprocity and most-favoured-nation (MFN) treatment — achieve this end. Reciprocity allows governments the means to make cooperative agreements to reduce tariffs in lockstep, thus expanding market access, while MFN ensures that pairs of countries cannot manipulate the terms of trade at the expense of excluded parties.

The Bagwell-Staiger understanding of trade agreements makes few assumptions about governments' underlying political objectives outside the implicit and crucial assumption of national ownership. Politically optimal tariffs can capture a broad set of possible domestic political machinations, and still the theory implies the following: in the absence of trade agreements, noncooperative tariffs would be too high; Pareto-improving agreement on tariffs would help governments cooperatively reduce tariffs and expand market access; and because the terms-of-trade externality is assumed to be the only source of international inefficiency, a "shallow" trade agreement over market access is sufficient to eliminate governments' incentives to manipulate trade policy at the expense of their trading partners.

For nearly a decade, the prevailing view in the economics literature was that the shallow integration mandate of the GATT and WTO, as embodied in the core principles of reciprocity and MFN treatment, was sufficient to exhaust the potential gains from multilateral trade negotiations. Economies such as Canada's need only participate actively in WTO rounds of negotiations to reap the rewards of global trade liberalization. More recently, however, this view has been challenged and recast in the context of foreign ownership, offshoring and global supply chains.

Trade liberalization through international ownership

Although conceptually distinct, global supply chains and international ownership frequently go hand in hand as part of the same deep economic integration phenomenon. In many instances, global supply chains embody foreign direct investment (FDI), and thus international ownership — although international ownership need not imply production fragmentation or vice versa. Consider, for example, new ventures (so-called greenfield FDI), joint ventures between foreign investors and domestic partners or virtually any type of cross-border merger or acquisition. All of these structures imply foreign ownership in one or more trading partners.[4] Even international portfolio diversification by individual investors or sovereign wealth funds transfers ownership across borders.

Whatever the source, the ultimate effect of international ownership is to muddy the distinction between national and foreign economic interests. The implied wedge between a country's economic interests and its geographic boundaries deals an immediate blow to the traditional "us-versus-them" mercantilist understanding of trade policy as a competition between foreign interests abroad and domestic interests at home. Intuitively, when domestic constituencies hold a direct economic stake in foreign export markets, their home government has less incentive to levy tariffs on imports (Kemp 1966; Jones 1967; Blanchard 2007). Indeed, at the theoretical limit where countries hold perfectly diversified international portfolios, all countries would have identical economic interests. Absent the potential for expropriation — an important caveat, which I discuss below — countries would unilaterally choose globally efficient tariffs.[5]

Cross-border ownership stakes thus might partially, or even completely, substitute for the traditionally understood roles of the GATT and WTO to increase market access cooperatively through reciprocal, nondiscriminatory tariff concessions. Indeed, if all countries were to hold sufficient ownership interests in their trading partners' export sectors, those overseas investment holdings could exactly offset the beggar-thy-neighbour cost-shifting externality that otherwise induces governments to restrict market access.

Moreover, this trade-liberalizing potential is not necessarily limited to international ownership stakes, but might also apply to outsourcing or offshoring activities more broadly. The key mechanism operates whenever constituents in the importing country are hurt directly by increased tariffs. Blanchard and Matschke (forthcoming) find strong evidence of a causal link between greater offshoring activity by US foreign affiliates and more generous US trade preferences on related commodities. The effect is big, too. The baseline results indicate that a 10 percent increase in affiliate sales to the United States leads to a roughly 4 percentage point increase in the rate of duty-free access under preferential trade programs; this corresponds to a 20 percent increase in the rate of preferential market access relative to the average. The complementarity between trade and investment, therefore, is not simply an academic possibility; it is relevant and influential in determining today's trade policy outcomes.

There are, however, two important qualifications. First, import-competing or "tariff-jumping" horizontal FDI would have no such effect. In fact, economic theory suggests the opposite: ownership in foreign import-competing sectors only sharpens governments' incentives to restrict market access through tariffs.[6] Thus, it is only vertical, or offshoring, types of foreign investment and ownership that create a potential trade-investment complementarity, whereby more investment in export-oriented operations overseas induces the investing country's government to expand market access, and thus trade.[7]

A second complication comes from the potential for preferential agreements. Although preferential agreements can allow governments to harness the trade-liberalizing potential of international ownership, they also exacerbate the potential exclusion of nonsignatories. Moreover, to the extent that international ownership is the result of FDI, preferential agreements induce both trade and investment diversion at the expense of excluded countries.

Expropriation, bargaining and behind-the-border policy changes

A second key feature of global fragmentation is that it expands the scope for opportunistic governments to manipulate behind-the-border (BTB) policy instruments, such as regulatory standards related to health, environment and safety concerns as well as licensing requirements. Global fragmentation of production and ownership sharpens the incentives for BTB policy manipulation in two ways.

First, and most directly, foreign ownership of domestic firms or resources introduces the potential for implicit expropriation by host country governments via BTB manipulation. When international investment is sunk in the short run — or when foreign investors earn above market returns in the host country — the potential for rent extraction from foreign investors might induce rent shifting through domestic policy changes.[8] Expropriative policy changes need not be explicitly trade related: new taxes, technical barriers, regulations or permit requirements could be used to shift profits from foreign investors to the host government or to domestic firms or workers.

Second, lengthening global supply chains can introduce opportunistic BTB policy changes even in the absence of international ownership. Antras and Staiger (2012a,b) demonstrate that when buyers and sellers trade in highly specialized intermediate inputs — the kind of transactions that have become more common as global production has become more fragmented — transaction prices are often determined by bilateral bargaining, rather than by traditionally understood market-clearing conditions. The authors show that the bargaining process can be opportunistically manipulated by governments of both countries through trade policy and BTB policy changes. Intuitively, governments can use policy tools to increase their own firms' bargaining power by manipulating the commercial policy landscape. Cooperative agreements over traditional market access mechanisms thus might prove insufficient to reach globally efficient outcomes.

Unfortunately, it is far easier to recognize the potential for BTB policy manipulation than to mitigate it in practice. Although protections under the WTO's Agreement on Trade-Related Investment Measures (TRIMs) are almost certainly insufficient, broader investor-state dispute settlement provisions present their own problems, as many nation-states, including Canada, are aware.[9] The key questions for Canada are which design features for investor protections are necessary and which have the potential to backfire, and whether these protections should be negotiated within the existing bilateral investment treaty structure, embedded in preferential trade agreements (such as chapter 11 of the North American Free Trade Agreement, NAFTA) or moderated at the multilateral level via the WTO. A number of recent papers — see, for example, Baldwin, Evenett and Low (2009); Blanchard (2013); Staiger (2011); and Staiger and Sykes (2011) — highlight the importance of bringing BTB and other nontariff measures to the multilateral table. They stop short, however, of offering specific suggestions for the WTO due to the complex legal foundations on which deeper negotiated commitments would have to rest. These questions remain an important topic for future research, particularly for legal scholars.

Supply chains, value added and taming the tangle

A third complication arises from the supply chains themselves. Blanchard, Bown and Johnson (2014) point out that supply chain trade in intermediate inputs — even absent foreign ownership or bargaining relationships — alters governments' incentives to manipulate prices via trade policy. When a country's production of final goods embodies value-added inputs from its trading partners, changes in tariffs generally will pass through at least partly to the foreign value-added producers. Depending on the underlying political economy, production processes (including input-output linkages) and market structure, increased trade in value added relative to gross trade might dampen a government's incentives to increase tariffs beyond globally efficient levels.

Moreover, longer supply chains magnify the inefficiencies of existing trade barriers. As global supply chains increasingly stretch around the world to incorporate more border crossings, individual trade barriers, whether tariffs or nontariff measures, might be applied to the same final product multiple times without carefully synchronized rules of origin or value-added tariff rules. Even in a scenario with careful rules of origin and free trade, the bureaucratic and time cost of border crossings can substantially raise the final price of a good. Greater fragmentation of global supply chains essentially increases the effective rate of protection, even if tariffs and other trade costs remain unchanged.[10] Further, to the extent that border costs induce trade or investment diversion, one can expect global fragmentation to magnify these problems.

On a more optimistic note, Baldwin (2006) and Baldwin, Evenett and Low (2009) articulate a potential counterweight via the political process. They argue that multinational firms with long supply chains suffer most from the tangle of complex regional and bilateral agreements and asynchronous rules of origin. To the extent that these firms have a voice in the political process, their advocacy to tame the tangle might induce their governments to simplify and reduce trade barriers unilaterally. Baldwin (2010) makes a different argument with a similar conclusion: as fragmentation splinters old political alliances between upstream and downstream industries, or dramatically shifts the pattern of comparative advantage along the global value chain, developing countries' governments might gradually abandon long-standing infant-industry industrialization strategies, unilaterally lowering their tariffs on upstream industries in particular. Indeed, Canada pursued exactly such a policy when it unilaterally lowered its input tariffs in 2010.[11]

Again, there is a caveat: if governments' efforts to reduce and simplify trade barriers focus only on trade partners with whom their multinational firm constituents are already involved, then countries outside the global supply chain network might be left behind entirely. This would worsen the discrepancy between the highly integrated "have" countries and the peripheral "have-nots." Canada and other developed countries should be particularly aware of this potential asymmetry when designing trade preferences for developing countries in support of broader aid and development objectives, such as so-called aid for trade and other preferences under the generalized system of preferences or through bilateral agreements.[12] This brings me to the next issue: how global fragmentation affects the view of preferential trading arrangements as stepping stones or stumbling blocks to freer multilateral trade.

Regionalism and global supply chains

Global supply chains, foreign investment and regionalism are deeply intertwined. Preferential trade agreements foster deeper economic integration between signatory countries, just as stronger economic ties sharpen the impetus for greater policy coordination through deeper regional agreements. NAFTA (like its predecessor the Canada-US Free Trade Agreement) is a quintessential example of how economic integration can lead to a preferential agreement, which can further deepen supply chain connections. Unfortunately, although preferential agreements can serve as an important lever for harnessing the trade-liberalizing potential of international investment and GVCs, they can raise important concerns, too.

Consider the following thought experiment. A Canadian-owned firm, XYZ Corp, sets up a manufacturing facility in Thailand that produces shoes to sell to consumers in Canada. The investment is an example of export-oriented offshoring. The intuition I set forth earlier suggests that the Canadian government would want to improve market access for XYZ Corp's foreign affiliate. (If XYZ Corp were to lobby a receptive government, then the effect would be stronger, but such pressure generally would exist as long as the Canadian government had an interest in XYZ Corp's profitability, even if only for tax revenue considerations.)

In an unrestricted trade policy environment, the Canadian government would want to expand market access for only XYZ Corp's foreign affiliate, but national-treatment rules prohibit discrimination at the firm level. Under such rules, but in the absence of MFN treatment, the Canadian government would have to offer preferential treatment for all shoes from Thailand — but at the narrowest possible product definition that includes XYZ Corp's shipments. Since MFN treatment rules out such discretionary treatment at the country-product level, the only opportunities to exploit the trade-liberalizing potential of XYZ Corp's offshoring investment would be either through a preferential arrangement (under GATT article XXIV or Enabling Clause Generalized System of Preferences exemptions to MFN) or by reducing the MFN tariff on shoes for all trading partners. Given the number of MFN trading partners worldwide, it is unlikely that MFN tariff reductions would follow from offshoring investment in just one trading partner.[13]

Turning instead to preferential agreements, recall that GATT article XXIV exemptions for free trade agreements (FTAs) in principle oblige signatories to remove "virtually all trade barriers for virtually all goods." In practice, however, many preferential agreements leave substantial barriers to trade for protected industries, which might make free trade deals easier to sign. (Moreover, agreements with smaller countries, such as Thailand, would be unlikely to have a significant impact on domestic import-competing industries, making them easier to ratify.[14]) The crucial question, then, is whether the extent of ownership and supply chain integration in the host country is sufficient to induce an FTA given the institutional constraints. If it is, there is a new reason for host countries (often small and developing countries) to seek foreign investors and global supply chain relationships from large trading partners: doing so might earn them a preferential trade agreement and improved market access for local exporters.

Two important cautions arise. First, preferential trade deals increasingly incorporate strong BTB protections that multinational firms typically favour, but they might be more problematic for investment host countries. For example, investor-state dispute settlement under NAFTA's chapter 11 has met with mixed reviews. To the extent that multinational firms are important actors in trade policy determination and strongly favour deeper policy integration and BTB protections, the rapid rise in observed and potential global fragmentation should accelerate the momentum behind more and deeper preferential agreements. If potential investment host countries compete for foreign investment and preferential trade agreements by signing BTB protections or investment subsidies that are otherwise welfare reducing, world welfare might fall.[15]

Second, preferential agreements might undercut multilateral liberalization. If fragmentation or foreign investment spurs greater policy liberalization through preferential agreements, and if those agreements further deepen economic ties as supply chains spread across signatories' borders, then the cycle of improved market access and increased fragmentation might continue. At the same time, however, the same mechanism could lead to substantial trade and investment diversion; just as some trading partners might experience ever-greater economic integration through a trade-investment complementarity, other countries might be left out entirely.

Implications for Canada

From the research I have summarized so far, policy-makers should take away three main messages. First, they should adopt a supply chain mindset. Second, they should selectively leverage preferential agreements. And third, they should recognize the global externalities that are implied by existing trade policies.

Policy lesson 1: Adopt a supply chain mindset

Both within and outside the realm of trade agreements, policy-makers should consider the implications of specific rules and legislation in the context of global supply networks. Global supply chains change the way governments should think about tariffs, rules of origin, input trade and the implementation of rules regarding re-exports. All of these will prove increasingly important as global production becomes more fragmented across borders, with ever-narrower slices of the global value chain performed in each country.

Taking a step back, the supply chain mindset provides an opportunity to reimagine the way trade taxes are treated more broadly. From a theoretical standpoint, rather than the status quo tax approach that applies tariffs on the total (gross) value when goods cross international borders, it would be more efficient and fairer to apply tariffs on the value that was added by the country during that stage of production. Imposing tariffs on gross, rather than on value-added, trade implies a de facto tax on fragmentation, which in turn weakens countries' abilities to exploit comparative advantage over narrow pieces of a GVC. This effect could prove particularly harmful for those of the smallest developing countries that have a comparative advantage toehold for just a sliver of a GVC. In practice, however, value-added tariffs might prove impossible to implement. A more provocative but serious proposal is to consider the unilateral elimination of tariffs altogether, which would reduce the regulatory and customs burdens faced by Canadian firms and consumers, and would eliminate once and for all the implicit discrimination against globally fragmented production and the potential asymmetries in market access afforded to Canada's trading partners (see, for example, Ciuriak and Xiao 2014). An encouraging policy step in this direction was Canada's announcement in 2010 that it was removing its tariffs on manufacturing inputs and machinery and equipment unilaterally by 2015.

Policy lesson 2: Leverage preferential agreements selectively

Preferential agreements can serve as an important lever for harnessing the trade-liberalizing potential of global supply chains. Canada is increasingly active in this arena. Before 2003, Canada had negotiated just four FTAs: NAFTA, and bilateral FTAs with Chile, Israel and Costa Rica. The years between 2003 and 2008 were a period of calm, which was followed by the rapid conclusion of eight new FTAs in six years (2009 to 2014). The largest of these deals involved a major trading partner — the European Union (CETA); one was with the European Free Trade Association (EFTA, consisting of Iceland, Switzerland, Lichtenstein and Norway); and bilateral deals were concluded with Peru, Colombia, Jordan, Panama, Honduras and South Korea. Currently, 11 more agreements are under negotiation. The most high-profile is the TPP; other notable negotiations involve bilateral talks with India and Japan. Exploratory discussions are also proceeding with Thailand, Turkey and South America's Mercosur customs union.[16]

Canada's active pursuit of these agreements notwithstanding, in thinking about these agreements there are two caveats. First, Canada's most natural FTA partners might be not the closest geographically, but the most integrated in terms of investment and supply chain trade. According to the traditional twentieth-century understanding of trade policy, it makes sense to conclude trade agreements with countries with which Canada's gross trade flows are the highest. So-called gravity studies of the pattern of trade flows demonstrate that gross trade is most energetic among geographically proximate trading partners. Ergo, the traditional view holds that regional trade agreements among neighbours would be the most desirable.

Although this broad logic still applies, today's complex terrain of supply chain linkages calls for a more nuanced view based instead on value-added trade patterns. Johnson and Noguera (2014) demonstrate that integration via trade fragmentation is still greatest among neighbours, which suggests that geographic proximity still counts as important for FTAs. Crucially, however, the authors also find that the fastest-growing emerging markets are also rapidly becoming the most integrated into global supply chains. Based on these considerations, some of Canada's best prospects for enhancing trading partnerships might be the rapidly growing, highly fragmented economies of East Asia, eastern Europe and Latin America (such as China, Thailand, Vietnam, Hungary, Romania, Turkey, Chile and Brazil).

Turning to data, one can glean additional insight from Canada's current FDI and value-added trade patterns. Unsurprisingly, the largest single recipient of Canada's outward direct investment abroad (as a percentage of the total stock in 2013) was the United States (41 percent), followed by the European Union (27 percent). In 2011, roughly 11 percent of Canadian direct investment was directed to Caribbean nations.[17] Value-added trade relative to gross trade — a widely accepted measure of global supply chain integration (Johnson 2014) — shows similar patterns. For example, US value added is highest in final goods production in Canada (relative to other countries) and vice versa.[18] It is important to acknowledge that endogeneity — in other words, that foreign investment and global supply chains depend on trade agreements, just as agreements depend on these measures of economic integration — might drive some or most of these patterns.

The recent Global Markets Action Plan (GMAP) released by Foreign Affairs, Trade and Development Canada identifies 20 of Canada's trading partners as key emerging markets with broad Canadian interests, most with deep linkages in GVCs, including a few explicitly linked to resource extraction (principally mining). The GMAP explicitly targets trade facilitation for markets in which Canada has significant ownership or supply chain interests, a first-mover advantage or opportunities to develop infrastructure or talent. Canada is pursuing trade agreements with some, but not all, of these markets. Trends in value-added trade and fragmentation suggest that Canada might prioritize these potential partnerships with key emerging markets.[19]

The second caveat is that Canada should exercise caution concerning deeper integration clauses in any new FTAs and regional initiatives. In principle, powerful behind-the-border regulatory and investor protections increase efficiency by countering hidden protectionism and the risk of expropriation by investment host countries. In practice, however, these agreements have had unintended consequences, including challenging countries' sovereignty. Recent litigation by US-based Lone Pine Resources over Quebec's moratorium on hydraulic fracturing and the Philip Morris lawsuit against Australia's plain packaging tobacco laws make it clear that industrialized countries are not immune to such concerns (see, for example, Coy, Parkin and Martin 2014). Indeed, both CETA and the TPP have been publicly criticized for their overzealous investor and patent protections.

There is a case to be made for regularizing BTB protections multilaterally under the WTO umbrella, rather than through a complex interweaving of idiosyncratic clauses embedded in the next generation of FTAs. That said, many potentially relevant BTB policies extend into sensitive areas of national sovereignty, and might prove infeasible for multilateral negotiation. For instance, as Olney (2013) demonstrates, the potential for higher FDI flows has induced some countries to engage in a race to the bottom in labour market standards. There is a strong case for limiting such implicit investment subsidies through a multilateral agreement, but it is unlikely that governments would agree to limit their flexibility with respect to something as politically sensitive as local labour policies. More broadly, it is hard to envision multilateral cooperation on many BTB policy issues, including health and safety concerns, taxation and environmental controls.

Policy lesson 3: Recognize global externalities implied by Canada's trade policies

From a global perspective, more is not necessarily better when it comes to trade preferences and the so-called spaghetti bowl of free trade deals. There are both economic and geopolitical issues to consider. On economics, asymmetric trade preferences can lead to trade and investment diversion at the expense of excluded countries. On geopolitics, the proliferation of FTAs ultimately might undermine the role of the WTO. Canada should weigh each of these global externalities when forming its trade objectives. With that in mind, I suggest Canada's trade policy should minimize asymmetries in FTAs and aid-through-trade programs, and remain engaged in the WTO.

With respect to the first strategy, preferential trade liberalization that improves access to the Canadian market is good for the beneficiary trading partners. However, excluded countries might be hurt inadvertently by trade, investment and supply chain diversions that displace their exports or reduce their ability to attract foreign investment or lucrative supply chain contracts. Indeed, this issue is attracting increasing concern by the multilateral policy community, as evidenced by the emphasis of the *World Trade Report 2014* (World Trade Organization 2014).

To the extent that trade preferences are differentially afforded to countries that are initially more integrated with Canada, small initial advantages might become institutionalized via preferential trade agreements. A self-renewing cycle of trade and investment liberalization and integration could lead to substantial differences in the long run. Canada's trade policy, therefore, should weigh the gains from preferences afforded through bilateral FTAs and the aid-through-trade generalized system of preferences, against the potential cost of asymmetric treatment borne by excluded countries.[20]

Although the GMAP seems to identify the most economically advantageous set of countries to target for deeper integration, it is not clear that further proliferation of FTAs is, on balance, a good thing for the rest of the world. Indeed, looking at the GMAP's priority emerging markets, it is clear that the countries not identified as such are also the poorest and most economically vulnerable. Excluding developing countries in sub-Saharan Africa, for example, could worsen conditions for those already in dire economic circumstances. By the same token, Canada should take care not to be excluded from major regional trade agreements — although there seems to be little danger of this given NAFTA, CETA and Canada's ongoing engagement with the TPP.

With respect to the second strategy, to the extent that FTAs undermine future multilateral trade liberalization or divert political capital away from the WTO, the proliferation of free trade deals might prove extremely costly in the long run.[21] Even if multilateral tariff liberalization under the WTO has been tapped dry — which is not at all clear given that high tariffs remain in many developing countries and given the legacy of special and differential treatment — the WTO serves a number of crucial roles. These functions include the ongoing broadening of the WTO mandate to include trade facilitation, health protections (sanitary and phytosanitary), government procurement, investment protections (trade-related investment measures, or TRIMs) and intellectual property protections (trade-related aspects of intellectual property rights, or TRIPS). It is noteworthy that many of these goals — particularly those related to trade facilitation — are also identified as key priorities by the GMAP.

Perhaps of greatest practical importance for Canadian firms is the WTO's Dispute Settlement Body (DSB), where Canada is among the most active member nations. According to Newcombe (in this volume), Canada is the sixth most frequent respondent in DSB cases and the fifth most frequent litigator. Moreover, to the extent that the surveillance and transparency provisions embodied in FTAs are weak in practice, as Wolfe (also in this volume) argues, maintaining the institutional strength of the WTO might become increasingly important if the DSB remains the sole arbiter of trade-related disputes. To support the ongoing authority of the DSB, Canada should maintain or even increase its engagement with the WTO to the extent it can.

Conclusions

Canada's trade policy community faces both opportunities and challenges in responding to the rapid rise of global supply chains in the world economic landscape. Although GVCs offer the potential to leverage a trade-investment nexus via targeted regional and preferential agreements, those agreements embed controversial behind-the-border protections, and in the long run could threaten the primacy of the World Trade Organization.

Accordingly, I suggest that Canadian trade policy should include the following three strategic elements:

1) Adopt a broader supply-chain mindset, particularly when evaluating rules of origin, tariffs on intermediate goods trade and re-exports. Consider unilaterally eliminating tariffs altogether or, alternatively, for a broader set of industries.
2) Leverage preferential trade agreements, but selectively and with explicit awareness of the potential costs of deep behind-the-border provisions.
3) Mitigate negative global externalities of trade agreements by minimizing asymmetries in trade preferences and by maintaining an active role in the WTO.

By incorporating these approaches, Canadian trade policy would be well positioned to meet the challenges and would increase the benefit from global supply chains.

Notes

1. The term "taming the tangle" was coined by Baldwin, Evenett and Low (2009) in the context of trade regulations.
2. This part draws from Blanchard (2013), which reviews these arguments in the context of the WTO.
3. When a country imposes an import tariff, it causes its own demand, and thus total worldwide demand, for that imported good to fall. The world price of the imported good declines as a result of the reduced demand, and so the foreign exporters' profit margins shrink. The foreign exporters thus effectively bear part of the burden of the large country's import tax.
4. If the FDI is "vertical," it would be a source of both international ownership and global fragmentation; if instead the FDI is market seeking ("horizontal"), it might be considered international ownership, but not global fragmentation.
5. This point has been refined by Stockman and Dellas (1986), Devereux and Lee (1999) and Blanchard (2010).
6. Roughly speaking, import-competing investments abroad give a government an even greater vested interest in improving the terms of trade by increasing the relative price of goods that it both exports and, with horizontal investment, produces overseas directly.
7. Baldwin (2010) highlights an interesting caveat in the spirit of Kojima (1975): to the extent that inward FDI in a downstream import-competing industry increases its political influence, that FDI could induce tariff reductions on upstream industries although this would require the political impact of the downstream industry's growth to outweigh the political cost of being "foreign."
8. This argument is developed formally in the trade policy context in Blanchard (2009).
9. See Newcombe (in this volume) for a careful discussion of the issues surrounding investor-state dispute settlement in the Canadian context.
10. Miroudot and Rouzet (2013) calculate Canada's effective rate of protection before and after its unilateral removal of input tariffs in 2010.
11. See Miroudot and Rouzet (2013) for an impact analysis.
12. The active participation by multinational firms in the annual review of the US Generalized System of Preferences, as documented by Blanchard and Hakobyan (forthcoming), raises important questions about transparency and fairness.
13. In practice, however, a handful of industries are characterized by such widespread offshoring and supply chain fragmentation that perhaps they could induce multilateral liberalization. Indeed, the Information Technology Agreement (ITA), implemented in 1997, likely reflects this underlying mechanism.
14. Asymmetric agreements can be enormously important for a small developing trade partner (such as Thailand), and thus for the foreign multinationals located there, but of minimal political consequence for a larger, industrialized partner such as Canada.
15. In an earlier paper (Blanchard 2013), I formalize this argument, making an efficiency case for multilateral disciplines on investment incentives.
16. Some of these, however, are effectively dormant — for example, the Central American Four (CA4) agreement, in place of which Canada and Honduras concluded a bilateral agreement. Ongoing negotiations also include those with the Caribbean Community (CARICOM, consisting of 15, mainly

English-speaking, countries: Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, Saint Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago), the Dominican Republic, Morocco, Singapore and Ukraine. Two modernization agreements are also under negotiation with existing FTA partners Costa Rica and Israel.

17. Investment data are from Statistics Canada, CANSIM database, table 376-0051, April 2014 release. Note that the relatively high percentage of Canadian FDI to the Caribbean is not necessarily funding productive capital and plant, but instead might be attracted by low-tax jurisdictions, or “tax havens.”
18. 2009 World Input-Output Database (http://www.wiod.org/new_site/home.htm) and author’s calculations.
19. Among developed markets, the GMAP identifies the United States, the European Union, members of the EFTA, Australia, Japan and New Zealand as key strategic partners. Canada has completed or is negotiating trade agreements with all of them.
20. Fortunately, the Canadian generalized system of preferences does appear to be sufficiently “generalized” in practice that it raises relatively few concerns. Bilateral agreements, however, remain a central concern.
21. Research is divided on whether preferential deals act as stepping stones or stumbling blocks to further multilateral liberalization, but the balance of evidence seems to favour the stumbling-blocks view.

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