Submission from the Canadian Centre for Policy Alternatives to Global Affairs Canada's consultations on a possible Canada-China Free Trade Agreement

Scott Sinclair, Senior Researcher, CCPA

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Thank you for the opportunity to be part of your consultations exploring a possible Canada–China free trade agreement. The Canadian Centre for Policy Alternatives is an independent, non-partisan research institute with over three decades of experience analyzing Canadian trade and investment treaties. While we agree it is crucial for Canada to deepen economic, political and cultural ties with China, pursuing this goal through a typical bilateral free trade agreement (FTA) creates unacceptable risks for Canada, and particularly for Canadian workers.[1]

It is likely that an FTA based on Canada's standard template will reinforce rather than improve upon our currently highly imbalanced and deleterious trade patterns with China. It can also be expected to leave workers, especially those who are mid-skilled and without college education, worse off by further eroding Canada's manufacturing base, intensifying competition with lower-waged and poorly protected Chinese workers, and exacerbating domestic inequality. For these reasons, new and different approaches for engaging China (outside an FTA) should be explored.

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China is striving to escape the middle-income trap — the tendency for fast-growing developing countries to stall in the middle-income range[2] — by shifting its current manufacturing-based, export-led growth model to one that is more economically and environmentally sustainable, and driven to a much greater extent by domestic demand. If successful, this historic transition to a fully developed, high-income economy would benefit not only China but the rest of the world.

China is also actively planning for reduced rates of economic growth, and to supply a greater share of its internal demand in key sectors through domestic production, while building internationally competitive firms in a variety of high-tech and emerging sectors.[3] Even with lower rates of growth and higher levels of import substitution, the Chinese market is so huge that new opportunities for China's trading partners, including Canada, will be substantial.

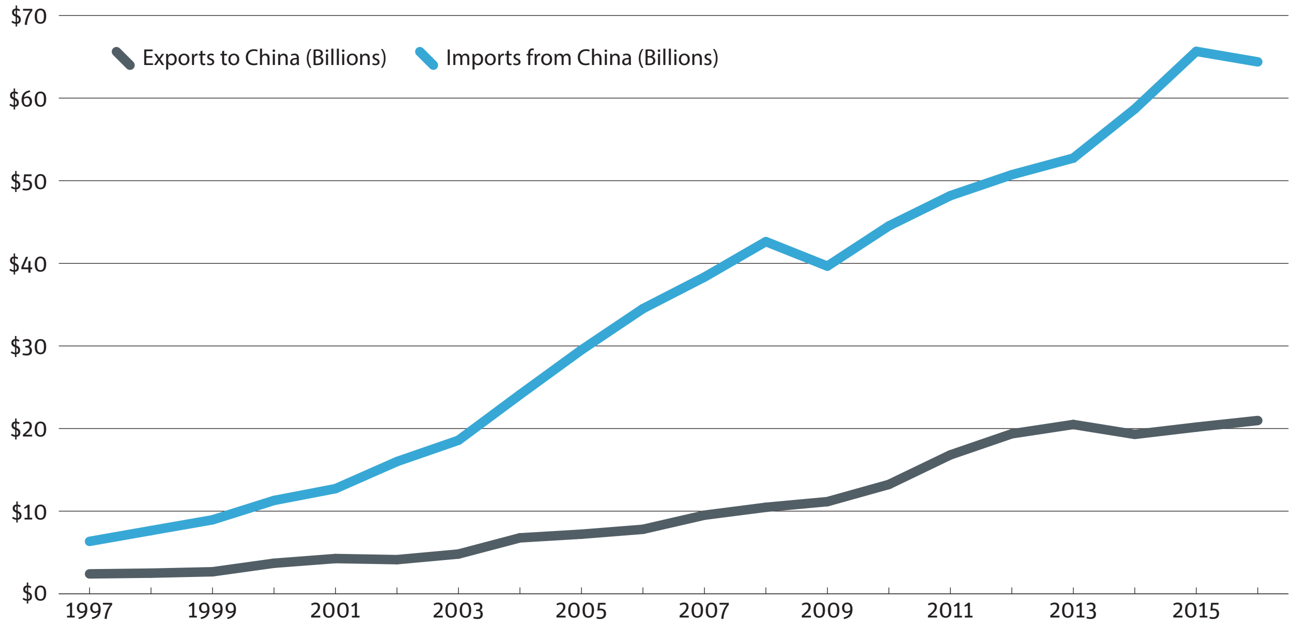
The risks associated with concluding a standard FTA arise from the following clear imbalances between Canada and China (elaborated on below) that should not be overlooked.

- Both quantitatively and qualitatively, the current trade relationship with China is heavily imbalanced in China's favour. Canada's goal in any commercial negotiation must be to reset this pattern to the mutual benefit of both countries. A traditional-style FTA will only cement the existing pattern, to Canada's detriment.
- China's economy still involves a high degree of planning. Chinese authorities have industrial policy levers that are not available to Canadian governments. Canada could arguably learn some things from China's state-driven industrial policy, but these structural asymmetries between our two economies will be challenging to bridge in a typical FTA.
- China is a superpower. However painstaking Canada's negotiating strategy or skilled its negotiators, due to the vast power imbalance between the two parties, China will ultimately be the rule-maker and Canada the rule-taker in any one-on-one FTA negotiation.

The imbalanced Canada–China trade relationship

Canada's bilateral trade deficit with China has gone from $8.5 billion in 2001 to more than $43 billion in 2016 ($21 billion in exports, $64 billion in imports.) The trend to ever-higher deficits has slowed somewhat in recent years, but the imbalance per-

FIGURE 1 Goods Trade



Source Statistics Canada. CANSIM Table 228-0069. Accessed May 19, 2017.

sists (see *Figure 1*). Over the last three years, Canadian exports have grown by $1.7 billion while imports from China have grown by $5.7 billion.[4]

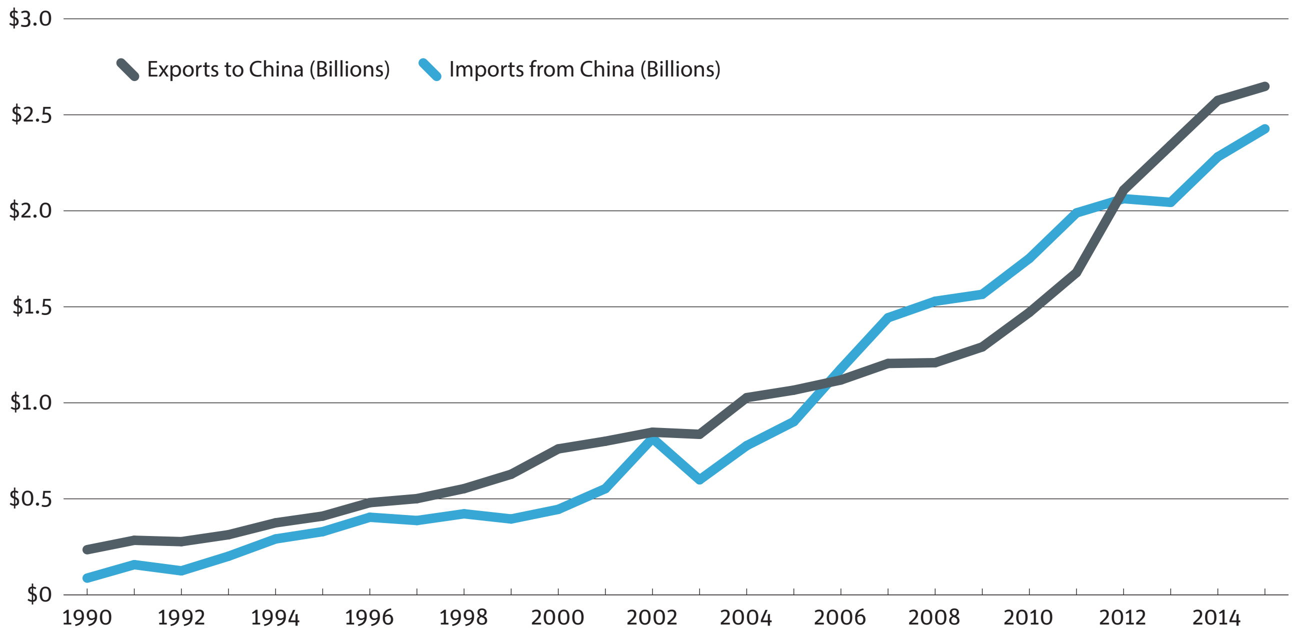
Canada's trade relationship with China is also qualitatively uneven. In general, Canada exports raw or semi-processed resources to China and imports higher-value-added manufactured goods. In 2016, Canada's top exports to China were pulp, canola, lumber, copper, soya beans, copper and coal. In the same year, China's top exports to Canada were phones, data processors, toys, electrical equipment and televisions.[5]

Bilateral trade in services is almost evenly balanced. But with two-way flows of $5 billion in services versus $86 billion in goods (2015 statistics, see *Figure 2*), it is not realistic to expect trade in services to counterbalance the lopsided trade in goods.[6]

In a groundbreaking study, MIT labour economist David Autor and his colleagues estimated that China's accelerated trade penetration in the U.S. following its entry into the WTO resulted in the direct loss of over one million U.S. manufacturing jobs between 2001 and 2007.[7]

Between China's entry into the WTO in December 2001 and the end of 2016, the U.S. lost 1,815,000 manufacturing jobs, reducing employment in that sector by 11%. Over the same period, Canada lost 594,000 manufacturing jobs, a 26% decline in

FIGURE 2 Services Trade



Source Statistics Canada. CANSIM Table 376-0036. Accessed May 19, 2017.

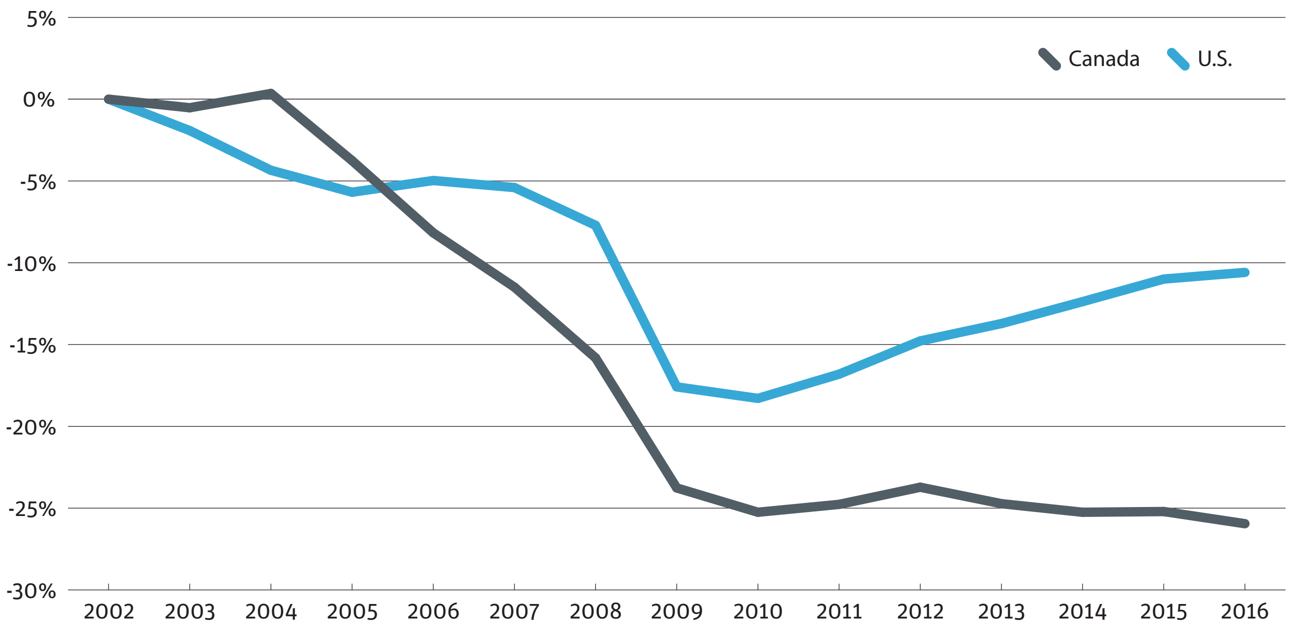
the sector. Significantly, the relative decline in Canadian manufacturing jobs since 2001 has been steeper than in the U.S. (see *Figure 3*).

While an overvalued Canadian dollar, technological change and other factors certainly played a role, it is reasonable to assume, especially given the U.S. evidence, that the manufacturing trade deficit with China has also had a major negative impact on Canadian manufacturing jobs.[8] Canadian economist Jim Stanford has estimated, "based on the average shipments per worker recorded in Canada's manufacturing sector, [...] that the bilateral trade deficit with China is equivalent to the loss of 125,000 Canadian manufacturing jobs."[9]

A standard bilateral FTA, which eliminates tariffs while significantly restricting governments' flexibility in important areas of industrial policy such as government procurement, performance requirements and foreign investment review, will simply reinforce these quantitatively and qualitatively imbalanced trade patterns, to Canada's detriment.

This has certainly been the experience to date under Canada's FTA with South Korea, the FTA partner whose industrial policy model and trade profile most closely approximate those of China. Korean merchandise exports to Canada have grown by 46% since the Canada–Korea Free Trade Agreement came into effect on January

FIGURE 3 Change in manufacturing employment since 2002



Source OECD. "Main Economic Indicators - complete database." Main Economic Indicators (database). http://dx.doi.org/10.1787/data-00052-en. Accessed May 22, 2017.

1, 2015. At the same time, Canadian exports to Korea have grown by just 3.5%, increasing Canada's trade deficit to $6.3 billion at the end of 2016.

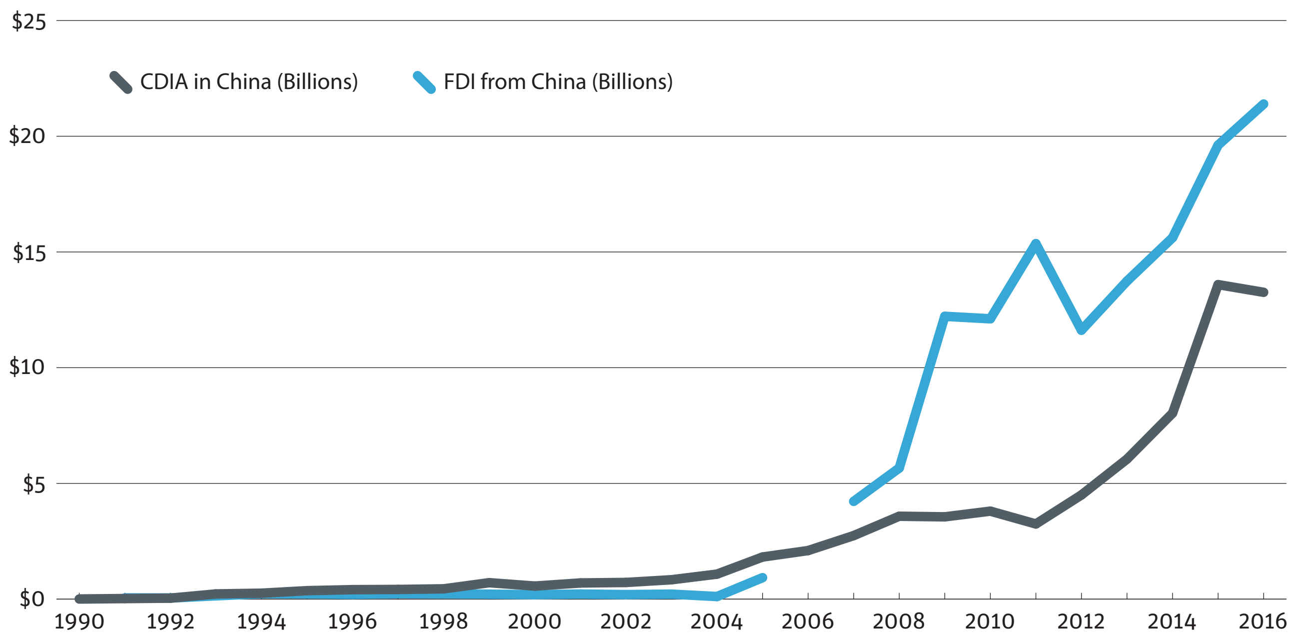
Qualitatively, Canada's trade pattern with Korea is very similar to what presently exists with China. Canada exports mainly unprocessed or semi-processed goods (minerals, fuels, aluminum, pulp and paper, and wood products) and imports higher-value-added Korean products (motor vehicles, electrical equipment, iron and steel, and plastic).[10]

Bridging asymmetrical investment and industrial policies

China remains an economy with a high degree of planning, where authorities at the national, provincial and local levels play an important role in industrial policy, financing and economic management. Chinese authorities actively employ industrial and trade policy levers that are not typically used by, or in some cases even available to, Canadian governments. This asymmetry heightens the difficulties of trying to engage with China through a traditional FTA template.

The Canada–China Foreign Investment Promotion and Protection Agreement (FIPA) provides a cautionary tale in this regard. Both parties to the treaty exempted

FIGURE 4 Investment Position



Source Statistics Canada. CANSIM Table 376-0051. Accessed May 19, 2017.

most existing non-conforming investment measures, but these were far more extensive in China than in Canada. As Osgoode Hall law professor Gus van Harten has pointed out, even though the formal obligations undertaken by Canada and China were similar, the practical impacts of (post-establishment) national treatment and (backward-looking) most-favoured-nation treatment were lopsided.[11] The result is a highly imbalanced situation in which the FIPA left China's pre-existing industrial and investment policies largely intact while essentially locking in Canada's far more liberal policies and open investment environment.

For example, Canada maintains the ability to review growing Chinese investments in Canada to ensure that they are of net benefit and, where called for, to apply performance requirements and other conditions to ensure that expected benefits are actually realized (see *Figure 4*). However, under the terms of the FIPA, Chinese investors will benefit from the raising of Investment Canada's threshold for reviewing investments (from $600 million to $1.5 billion), a step taken to implement the recently concluded Canada–EU Comprehensive Economic and Trade Agreement (CETA). Unfortunately, giving up the ability to review Chinese investments below this high threshold makes it is less likely that such investments will ultimately prove to be of net benefit to Canada.

At the same time, the FIPA's investor–state dispute settlement (ISDS) mechanism grants Chinese investors in Canada new rights to sue for damages when Canadian policies and regulations violate the treaty's broadly worded investment protections. The possibility of investor–state claims and their potential chilling effect on Canadian policy are always serious concerns. These concerns are magnified by the concentration of Chinese foreign direct investment in the natural resource sector, which has been the target of a large portion of disputes under NAFTA.[12]

Canada should consider a new model which dispenses with ISDS and avoids probably fruitless efforts to rein in and restrict China's industrial policy tools, including control over its state-owned enterprises. A more pragmatic approach would be to accept that China's successful industrial policy plays an important role in its continuing efforts to become a fully developed, high-income and environmentally sustainable economy.

Canada, while remaining vigilant against unfair competition harmful to Canadian interests, can learn from certain of China's industrial policies. China's basic mindset — that strategic government intervention and support can play a key role in shifting to more desirable, higher-value-added activities, and in securing a greater share of domestic benefits from participating in global supply chains — has clearly been helpful, from a developmental perspective, to this point.[13]

As an alternative to a traditional FTA with China, Canada might consider a sectoral approach focused, for example, on developing ambitious strategies to co-operate in achieving both countries' urgently needed transition to renewable energy. Such a strategy would benefit both countries and the global environment. This is an area where China has already made enormous strides, which Canada could learn from and contribute to. A successful co-operative model in renewable energy could be built on and extended to other sectors.

Acknowledging the Canada–China power imbalance

China is a superpower while Canada is not. However carefully Canada prepares for one-on-one comprehensive free trade talks, due to the vast power imbalance between the two parties China will ultimately have far greater power to set the rules and determine the necessary tradeoffs.

Rather than immediately forging ahead with an overarching FTA, Canada and China should focus on areas of clear mutual benefit. This could avoid putting Canada in a situation where it is has little choice but to make damaging concessions or compromises to secure a final deal, or risk a serious setback in bilateral relations by walking away.

A broader rules-based agenda involving China can still be pursued through multilateral fora, such as the World Trade Organization, the UN Sustainable Development Goals agenda or the Paris Agreement on Climate Change, where the participation of many countries counteracts the power imbalance between Canada and China. These international venues allow a middle power such as Canada to play a more creative and constructive role.

Encouraging greater respect for human and labour rights

A final fact that cannot be overlooked is that China has an authoritarian government. While Canada must recognize the limits of its ability to modify China's behaviour, it must not turn a blind eye to human rights abuses in the pursuit of stronger commercial relations. That said, self-righteousness is rarely helpful, and Canada must recognize that its own human rights record, with respect to First Nations in particular, is far from sparkling.

But no matter one's perspective on this issue, there is strong evidence a traditional FTA cannot improve human rights and may worsen inequality. Even the strongest supporters of deeper trade liberalization increasingly accept that the distributional impacts have been negative. In Canada, the share of labour income has recently fallen to new lows and wages have consistently lagged behind productivity growth. Certainly, any formal trade and investment pact must encourage greater respect for labour and trade union rights, and include strong enforceable obligations binding both countries.

In recent years, real wages in China have begun to rise and labour unrest is growing. Nevertheless, weak labour protections, including the failure to respect collective bargaining rights and to allow for independent unions, artificially lowers wages. The resulting unfair export competition has played a role in undermining wages and working conditions of mid-skilled and non-college-educated workers in developed countries, including Canada. Any bilateral trade pact must address this serious issue by ensuring the ratification of and respect for basic labour rights as defined by the International Labour Organization and including enforcement mechanisms with effective penalties.[14]

Notes

1 The author wishes to acknowledge the support of the following CCPA colleagues. Stuart Trew edited this brief, Hadrian Mertins-Kirkwood prepared the charts and Tim Scarth formatted the document.

2 The Economist. “The Middle-Income Trap.” March 7, 2012. http://www.economist.com/blogs/graphicdetail/2012/03/focus-3.

3 Richard Kozul-Wright and Daniel Poon. “Learning from China’s Industrial Strategy.” *Project Syndicate*. April 28, 2017. https://www.project-syndicate.org/commentary/china-industrial-strategy-lessons-by-richard-kozul-wright-and-daniel-poon-2017-04.

4 Trade Data Online. Industry Canada. Accessed: May 29, 2017. http://www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/Home.

5 Trade Data Online. Industry Canada. Accessed: May 29, 2017. http://www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/Home.

6 As Jim Stanford argues, “the idea that services exports by Canadian firms can somehow make up for the flood of merchandise imports coming in from China is not credible. The scale of merchandise imports, and its one-way nature, is a completely different order of magnitude than our relatively balanced and modest services trade.” Jim Stanford. “The Stylized Facts of Canada-China Trade.” The Progressive Economics Forum. August 29, 2016. http://www.progressive-economics.ca/2016/08/29/the-stylized-facts-of-canada-china-trade/.

7 David Autor, David Dorn and Gordon Hanson. “The China Syndrome: Local Labor Market Effects of Import Competition in the United States.” *American Economic Review*. 2013.

8 Andrew Jackson. “Canada-China trade agreement no deal for middle class, blue collar Canadians.” *Globe and Mail*. May 9, 2017. https://www.theglobeandmail.com/report-on-business/economy/economic-insight/canada-china-trade-agreement-no-deal-for-middle-class-blue-collar-canadians/article34934243.

9 “Based on the average shipments per worker recorded in Canada’s manufacturing sector, I estimate that the bilateral trade deficit with China is equivalent to the loss of 125,000 Canadian manufacturing jobs.” Jim Stanford. “The Stylized Facts of Canada-China Trade.” The Progressive Economics Forum. August 29, 2016. http://www.progressive-economics.ca/2016/08/29/the-stylized-facts-of-canada-china-trade/.

10 Trade Data Online. Industry Canada. Accessed: May 29, 2017. http://www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/Home.

11 Gus van Harten. *Sold Down the Yangtze: Canada’s Lopsided Investment Deal with China*. James Lorimer and Company. May 2015.

12 Scott Sinclair. “NAFTA Chapter 11 Investor-State Disputes to January 1, 2015.” Canadian Centre for Policy Alternatives. https://www.policyalternatives.ca/publications/reports/nafta-chapter-11-investor-state-disputes-january-1-2015.

13 See Richard Kozul-Wright and Daniel Poon. 2017.

14 Ed Broadbent. “Let’s make human rights central to a new NAFTA.” *Globe and Mail*. May 5, 2017.

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