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Introduction: Canada's Interests in International Trade

by **ADAM FROST**

During the 1947 Duncan & John Gray Memorial Lecture then-minister of external affairs, Louis St. Laurent, outlined guiding principles for Canada's engagement with the world. In his address, he recognized that Canada could not maintain the standard of living Canadians had come to enjoy in isolation from the rest of the world. He said, "[we] are dependent on markets abroad for the large quantities of staple products we produce and cannot consume, and we are dependent on supplies from abroad of commodities which are essential to our well-being." This irrefutably remains true today.

Canada's ability to utilize its vast wealth of resources has afforded it the opportunity to become one of the most affluent and developed nations in the world, making the preservation of such ability of vital national interest.

However, trade in the 21st century is more complex than ever before. Technology allows for transactions between parties scattered across the globe to occur near instantaneously, and complicates the tracking and classification of many goods and services.

Moreover, global political developments and economic transformation are threatening the liberal world order built and protected by the United States since the Second World War. China's emergence as an economic juggernaut is shifting the global economic centre of gravity. Furthermore, reactionary domestic political forces within much of the western liberal democratic world, including the United States, question the value of continued support for the status quo.

Tectonic change is afoot.

In response, Canada is charting its path to navigate the challenges of 21st century global trade. Prime Minister Justin Trudeau's Liberal government is pursuing a progressive trade agenda as it seeks to modernize existing agreements, implement newly minted agreements, and explore potential future opportunities.

The lead package of this issue examines a multiplex of challenges and opportunities presented to those currently crafting Canadian trade policy. Geographically, it spans not only the management of relations with the United States and NAFTA renegotiation, but also the geopolitical considerations of bolstered engagement with Asia and the underappreciated opportunities present in Africa and South America. In addition to "with whom", this package also addresses the "how and why" of trade: the difficulty of adapting trade practices to the digital age and the costs, benefits and limitations of projecting Canadian values via trade relations.

In computer simulated and professional chess matches white consistently wins more often than not. The lack of first-mover advantage is a formidable deficit to overcome. Those who are not leading, are fated to play catch-up. The challenges facing Canada's policy-makers responsible for protecting and advancing our national interest via trade are legion. To optimally address these challenges, Canada is best served by being proactive at the forefront of negotiations. The benefits of cultivating a proactive posture are enticing, and the costs for failing to do so are avoidable. Canada must adapt to the dynamism of the global economic order, or fight to catch-up.

Adam Frost *is the Associate Research and Development Coordinator of the Canadian Global Affairs Institute.*

Canada-U.S. Trade: An Enduring Relationship, NAFTA or Not

by **DAVID J. BERCUSON**

Save for the Great Lakes, the border separating Canada and the United States is a political boundary and not a natural one. North of the U.S.-Mexico border, both Canada and the United States share continental geographical and physical boundaries and regions that run north-south. Before initial contact between European settlers and First Nations, the First Nations developed trade patterns and connections that were continent-wide. Historical evidence shows that First Nations of different parts of North America used trade goods from areas that were far removed from them. For the most part, the trade was conducted using the vast river network and Great Lakes of the continental interior.

When New France was settled in the early 17th century, French traders and explorers eventually organized a trade system that was based in Quebec City on the mouth of the St. Lawrence River, to New Orleans at the mouth of the Mississippi River, and which stretched north of Lake Superior to the Rocky Mountains in the far West. On the East Coast of the continent, the British colonies lay from the Florida boundary with the Spanish north to the Gulf of St. Lawrence (which included Nova Scotia and its major Royal Navy base at Halifax). Nova Scotia was long considered the 14th colony; it did not join the American Revolution due to the naval base and considerable British military presence.

When France was expelled from almost all of North America following the Seven Years' War (1754-1763) – also called the French and Indian War in the United States – Britain ruled North America up to the Spanish colonial empire in the West and trade continued to be continent-wide in its scope. It was only after the American Revolution concluded in 1783, and Britain withdrew from the United States, that a political boundary was thrown across much of the continent. Following that, efforts began on the part of the British North Americans and the Americans to define their interests and trade along east-west lines.

But even so, smuggling continued across the new border and the First Nations moved as they wished because the boundary was a settler-imposed barrier and not a natural one. For years after the Treaty of Paris, British troops and their First Nations allies continued to occupy territory belonging to the United States near Lake Michigan and treated the 1783 boundary as if it did not exist.

All this long history is important to bear in mind when examining the gradual integration of the economies of Canada and the United States. Slowly at first – and hindered on both sides of the border by considerations of national interest, politics, and the push and pull of metropolitan centres and their hinterlands – trade between Canada and the United States grew, hampered more by the political boundary than by any natural obstacle.

Until the mid-1840s, Canada – as a British colony – traded almost exclusively with the United Kingdom. British law, designed to hold the growing British Empire together, afforded tariff preferences to its colonies. Thus, Canadian timber could cross the Atlantic and be sold more cheaply in the U.K. than could timber from the nearby (to Britain) Baltic countries. That was true of timber, furs and other natural products that Canada produced, including foodstuffs. After the 1840s, the newly thriving British industrial economy was so far advanced over any rivals that the British came to believe that their factories ought to be able to access the cheapest raw materials possible. Thus arose the notion of free trade – the complete elimination of tariffs on any goods coming into the U.K.

In British North America, the U.K.'s adoption of free trade was a death knell to commerce. Suddenly, Baltic timber became cheaper than Canadian timber in the U.K. market. The nascent Canadian merchant class – ship owners, bankers, insurance companies, port administrators, warehouse owners, even small industrialists – found themselves desperate for new outlets for their products.

That was a key factor behind political unrest in Montreal and the issuance by much of that city's merchant class of the Annexation Manifesto of 1849, calling on British North America to detach itself from the U.K. to become part of the United States. The leaders of the Manifesto movement wanted free access to U.S. markets and were prepared to give up their British colonial identity to do so. The annexation movement was a failure, but the notion that Canada must seek U.S. markets and allow U.S. goods to enter Canada became a permanent factor of colonial politics thereafter. The British, fearing the loss of Canada, secured a 10-year trade treaty with the United States in 1854 – the Elgin-Marcy Treaty – which brought prosperity to many sections of the Canadian colonial economy. Most of the treaty's successes came from the growth of a trade of convenience – BNA communities traded with the closest American market and vice versa. However, the treaty did not last more than a decade when the Republican-dominated U.S. Congress decided in the midst of the American Civil War that it wished no special arrangements with a British colony, partly because official British policy was pro-Southern until the Battle of Gettysburg in July of 1863. Even though British liberals were abolitionist, the government allowed the Alabama, a Confederate commerce raider, to be built in a British shipyard and to sail into the North Atlantic where she conducted numerous raids against northern shipping. In addition, the Civil War congress was highly protectionist and that sentiment continued to rule until the early 20th century.

The Canadian search for markets was a key factor behind the Confederation movement in British North America from 1864-1867. The Canadian merchant class believed that unity of the British North American colonies would open up wider colonial markets by abolishing tariffs between them. But access to the U.S. market remained the winning prize for Canadian political leaders for decades.

Thereafter, the search by Canadian political leaders for an outlet for Canadian products in the United States manifested itself as a search for the re-establishment of reciprocity – at least in natural products. In the 1850s and 1860s, the Canadian commercial class undertook two steps that were designed to enhance trade with the U.S.: Canada adopted the decimal currency and Canadian railways adopted the standard rail gauge that would allow railway cars to move without effort from Canadian to American tracks and vice versa.

In fact, railway access to the United States was the Canadian merchant class's continuing ambition. In 1845, the St. Lawrence and Atlantic Railway was chartered in Maine to run from Portland to the border with Canada. Not long after, the Atlantic and St. Lawrence Railway was chartered in Montreal to meet the St. Lawrence and Atlantic at the border. Eventually, a rail line connected Montreal to Portland, in part ending Montreal's winter isolation when the St. Lawrence River froze over. The line was eventually absorbed by the British-owned Grand Trunk Railway which extended its western terminus from Windsor, Ontario to Chicago. That railway, therefore, ran from Portland, Maine to Chicago. Other railways followed and today there is an extensive network of railways connecting hundreds of points in Canada and the United States. The two major Canadian railways – Canadian Pacific and Canadian National – own thousands of miles of track inside the United States, stretching from the East Coast to the Midwest to the Gulf of Mexico. The rail network is a prime example of North American infrastructure that ties the economies of Canada and the United States together.

Two other examples of continental infrastructure are the networks of oil and gas pipelines and the electrical power grid that bring Canadian hydrocarbon energy and hydro power to much of the American northeast and the West Coast. The rail, pipelines and electrical transmission grid have become permanent features of the continental infrastructure binding the two national economies.

In Ottawa, Canadian governments after 1867 never gave up on attempting to gain reciprocity with the United States. When Alexander Mackenzie's Liberal Party occupied the government in Ottawa for a five-year term after the Pacific Scandal in 1873, efforts were made to entice Washington into a reciprocity agreement but the protectionist Republicans would have none of it. John A. Macdonald defeated Mackenzie in 1877, and he contrived the national policy tariff on manufactured goods. He was trying to protect Canada's growing industrial base from U.S. imports, but he made it clear that Canada remained very interested in reciprocity in natural products with the United States. Since Canada did little trade with the U.S. in manufactured goods, Macdonald's offer of reciprocity would have covered most of Canadian exports to the United States anyway.

In Canada the main result of the national policy tariff was to encourage American corporations to establish branch plants in Canada, thus avoiding the tariff. This was especially true in the Canadian auto industry where the McLaughlin Motor Car Company, founded in 1907, was purchased by General Motors, but similar results could also be found in the electrical and telephone industries. At the turn of the 20th century, Massey-Harris farm implements sold into the American Midwest because they were competitively priced, advanced products. But Canadian industry was very small compared to the United States and served mostly a domestic market, for example in railway cars and engines. Canadian consumers purchased goods that were primarily built in the United Kingdom because British goods were well-made and cheap in Canada even though they were also subject to Canadian tariffs.

The Canadian effort to strengthen east-west trade north of the Canada-U.S. border was evident in other areas, such as the insistence that the Canadian Pacific Railway, completed in 1885, run to the Pacific north of the Canada-U.S. border. In essence, one of the main factors shaping Canada from the mid-19th century to now has been Canada's effort to strengthen east-west ties of culture, trade and commerce against the natural north-south pull of continental geography. Ties of migration and trade continued between the West Coast of the United States and British Columbia, not only on the coastal strip, but even in the B.C. interior where the hard rock mining industry was directly linked to the hard rock mines that could be found in the American West from Idaho to Arizona and even into Mexico. The movement of immigrants, people, ideas and goods also continued between the Plains states and the Prairies, between Ontario and the Midwest, between Quebec and the New England states and between the Atlantic Provinces with New York and New England. Tens of thousands of French Quebecers migrated to northern New York and New England in search of jobs, and names such as Benoit are ubiquitous in that part of the United States. Many thousands also fought for the north in the American Civil War.

In Canada, reciprocity, or at least lower tariffs if not downright free trade, remained popular in the Liberal Party right up to the mid-1890s. In the 1891 federal election the Liberals, led by Wilfrid Laurier, ran on a platform of a customs union with the United States. Very popular in parts of the Atlantic, western Ontario and the West, the Liberals were soundly defeated in the industrial sections of the country in Quebec and Ontario. When Laurier next led the Liberal Party into the election of 1896, there was no talk of reciprocity but instead, assurances given to Canadian manufacturers and industrial workers that the Liberals would adopt the national policy Macdonald had introduced. When Laurier was elected prime minister in 1896, some tariff concessions were made, but Laurier was enough of a realistic politician to know that it was political suicide to try to dismantle the Canadian tariff regime.

The triumph of the progressive movement in the United States at around the turn of the 20th century impacted American government thinking on tariffs. In Canada, the national government remained open to greater trade with the U.S. in natural products, while trying to shield nascent Canadian industries in fields such as textile manufacturing, rubber products and other areas. Suddenly, reciprocity was in reach. A reciprocity treaty passed the U.S. Senate at the behest of then-president William Howard Taft in 1910 and was offered to Canada. Laurier was delighted that a Canadian aspiration since 1866 appeared to be at hand. But opponents from the Canadian business community, who had built their infrastructure on east-west trade, culminating in trans-Atlantic shipment to Britain, opposed the treaty and soon convinced Conservative leader Robert Borden to defend their cause. All the nascent anti-Americanism that lay just below the surface in many sectors of the Canadian economy, even in farmers in Ontario and Quebec, swung behind the Tories who defeated the Liberals, dooming the treaty.

Ironically, just after the First World War broke out, Borden and his finance minister, Thomas White, had to travel to New York to borrow money to sustain the Canadian war effort because British funds were not available. The effort was successful but demonstrated that Canada would have to rely much more on the United States in the future than it had in the past.

The war greatly increased the flow of trade across the Canada-U.S. border, mainly with Canada shipping raw materials to sustain American munitions manufacturing. By the time the war ended in 1918, Canada-U.S. trade had grown considerably since 1914 and the

United States became Canada's largest customer, again in raw materials.

The war also opened Tory eyes to the importance of the American connection when Ottawa strongly opposed the renewal of an Anglo-Japanese naval treaty that Australia and New Zealand greatly desired. Borden and his successor, Arthur Meighen, feared that renewal of that treaty would alienate the United States, which would greatly complicate the Canada-U.S. relationship. Britain dropped the treaty.

No efforts were made in the 1920s to formally enhance Canada-U.S. trade but trade between the two countries grew anyway. Again, U.S. manufactured goods came north while Canadian raw materials flowed south. U.S. investment in Canada also grew in the mining and forest sectors. The Great Depression stimulated a major growth in American protectionism, culminating in the Smoot-Hawley tariff of 1930, which placed prohibitive rates on imports into the United States in the mistaken assumption that the Depression's causes lay primarily outside the United States. Canada, under Conservative prime minister R.B. Bennett, responded with high tariffs also and sought a freer trade agreement with Britain and the Dominions of the British Empire Commonwealth, which was only partially successful.

When Franklin Roosevelt took office in 1933, the tone of the U.S. administration changed substantially. Talks began between the Roosevelt administration and the Bennett government aimed at a partial reciprocity agreement. The discussions proved fruitful, but the Americans balked at signing the agreement during Bennett's term in office. FDR did not want to boost Bennett's electoral chances and held off on signing the treaty until Mackenzie King was re-elected in 1935. King had received his graduate education in the United States and had worked as a labour relations expert for American mining interests during the First World War. He knew the United States and was far friendlier towards the great republic than Bennett had been. The 1936 Reciprocity Treaty began a trend that is still evident today in legislative efforts on both sides of the border to stimulate, rather than retard, cross-border trade. It was followed two years later by yet another reciprocity treaty that further extended the list of products in the original agreement.

During the Second World War, cross-border trade received a significant boost with Canada beginning to send large numbers of manufactured products to the United States including trucks, warships and aircraft. The Hyde Park Agreement of 1941 essentially created one Canada-U.S. manufacturing regime for munitions and weapons. By 1945 the two countries were each other's best customers despite the continuation of tariffs on a whole range of goods.

At the end of the war, Canadians had lots of money to spend after nine years of Depression and six years of war and virtually forced savings. Soldiers came home from the war to start families, raise children, and buy houses, cars, washing machines and radios from the United States. There was a run on the Canadian dollar with so much of it disappearing to the U.S. Canada proposed a free trade agreement with the U.S. which the Americans were ready to accept. But at the last minute, King vetoed the treaty for fear that it would loosen Canadian ties to the Commonwealth and bring Canada closer to the United States. His fears were misplaced (as Canada discovered after the Canada-United States Free Trade Agreement was signed in 1989), but the drive for growing Canada-U.S. trade went on anyway.

The growing together of the two economies was perhaps best symbolized by completion of the St. Lawrence Seaway in 1959 and the creation of the bi-national Seaway Authority to administer it. In the 1960s, the conclusion of a sectoral agreement in auto parts manufacturing and cars swelled Canada-U.S. trade even further as rail links, pipelines and electrical transmission lines expanded and Canadians began to invest heavily in the

United States. This was followed by the Canada-U.S. FTA in 1989 and NAFTA three years later.

Today, the trade ties between the two countries have become institutionalized in hundreds of ways and have grown so strong that nothing will tear them asunder. There is a Canada-U.S. market in agricultural products, automobiles, forest products, oil, gas and hydroelectric power, and in dozens of service industries. Canadians are heavily invested in the United States, especially in the banking and securities sector while U.S. investment in Canada remains strong. The ties are deeply rooted and well established, create millions of jobs on both sides of the border, and will continue whether or not there is a NAFTA or a Canada-U.S. free trade agreement. Trying to sunder Canada-U.S. trade would be like taking a chain saw to separate Siamese twins.

So what will happen if current NAFTA talks fail? Current levels of trade will continue in almost all major sectors although the political and litigious barriers to the free flow of trade will rise. It is also probable that consumer and producer groups in the United States will quickly grow tired of politicians and bureaucrats interfering in questions of economic convenience. Canadian exporters will work with U.S. consumer groups to fight disruptions of cross-border trade and U.S. producers who work harmoniously with their Canadian counterparts in, for example, the food and cattle industries, will raise hell with efforts to hive off the U.S. market from both Canadian and Mexican farmers. American home buyers will balk at paying protected prices for the lumber to build their homes and the auto industry will strongly resist any effort to interfere with well-established, tri-national, value chains. Governors of the more than 30 states whose main customer is Canada will complain, as will U.S. trade associations. Of the top 10 states in the Canada-U.S. trade, eight gave their electoral votes in the 2016 presidential election to Donald Trump. Mayors of cities whose major source of trade and investment is Canada will complain also. It is not that Canada has “friends” in the United States; it is that Americans have national interests in continuing trade and investment between Canada and the U.S. as freely as possible.

NAFTA works well but needs updating and improvement. However, from the Canadian point of view, the search for access to U.S. markets, which goes back at least to the 1840s, is as Canadian as hockey and will continue no matter which brand of politicians may temporarily rule in Washington. Water will always flow downhill from the simple fact of gravity; trade in goods and services between Canada and the United States has become too well established over the past 170 years to be dammed up now. Americans themselves will be Canada’s partners in re-establishing NAFTA, or the Canada-U.S. free trade agreement, no matter what that new agreement is eventually called.

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Canada-United States Trade Relations: Not Just NAFTA

by **STEPHEN BLANK AND MONICA GATTINGER**

Donald Trump rammed NAFTA renegotiation to the top of the North American agenda, and his unpredictability and volatility have made this a taxing and often discouraging exercise. But NAFTA does not embrace the totality of North American – or Canada-U.S. – trade relations. It is one element in an increasingly complex environment being shaped by demographic and social change, fundamental transformations in the energy and climate systems, and the fourth industrial revolution.

In this piece, we argue that it is vital to dig out of the narrow NAFTA trenches and examine the broader context that will shape trade patterns and relationships over the next years. We propose three key strategies to manage the Canada-U.S. trade relationship now and into the future: the importance of long-term foresight and scenarios analysis, the need to challenge conventional wisdom and assumptions about the drivers and underpinnings of bilateral trade relations, and the necessity to develop deep collaboration that moves well beyond the capitals of both countries.

Powerful changes are afoot.

First, demographics. Demographics aren't everything, but projections in the UN's 2015 *World Population Prospects* suggest dramatic changes in the world Canada will inhabit over the coming decades that could reshape its vision of trade policy and Canada-U.S. trade relations.

Canada will have to adapt to a world of new players that will insist on greater roles in global governance. Euro-North American-centric institutions such as the UN, WTO and World Bank created in the years after the Second World War will be pressed to respond to rising Asian-African demands for greater shares of the world's trade and investment. Canada will have to ask itself some tough questions. How will it recast its historic Atlantic-Euro-focused identity and commitments in this new world? What role is it prepared to play (and capable of playing)?

What trade, aid and development policies will Canada adopt in what is likely to be a more protectionist and nationalist global economic environment? Can Canadians assume that Canada will (should?) continue to flourish as a middle power that punches far above its weight, as an exemplar of freer trade and of a progressive agenda for future trade agreements? Is Canada immune from populist and economic nationalist pressures? Perhaps, perhaps not.

The direction the U.S. takes will be a critical element in determining Canada's range of alternatives. Can (should) Canada rely on U.S. leadership in a tumultuous world? Under a Trump administration, this would be ill-advised (to put it mildly), but going forward, will (should, can?) the U.S. and Canada collaborate on approaches and policies for this new world?

The U.S. and Canada will look less alike in the future. Trump's Mexico policy notwithstanding, an increasingly large and influential Hispanic U.S. community might look ever more to the south. Ronald Reagan said of Canada, "We're more than friends and neighbours and allies; we are kin, who together have built the most productive relationship between any two countries in the world today." We won't be such close kin in the emerging decades.

But we will still be closely linked.

We will both be aging nations (although Canadians will be aging more rapidly) and we will share interests in coping with demands for more portable retirement and health-care resources. Both countries face rising economic inequality (although the U.S. situation is worse). Both countries are also likely to continue to see population shifts toward urban-regional areas. Emerging cross-border mega-regions in Greater Vancouver-Greater Portland-Seattle or southern Ontario-U.S. rust belt could be on the horizon.

Economic success and competitiveness in the new technological-industrial world for communities in these mega-regions may hinge on deepening north-south ties. Financial markets will almost certainly become more integrated, and although Canadian concerns for cultural protection will carry forward, the growing digitalization of arts forms and the deeper integration of arts markets make closer collaboration very likely. Each of these developments will influence patterns of trade – who, what and how.

Second, both countries face similar energy and climate problems and questions. They will need to determine how to reconcile the need to lower GHG emissions with their status as major oil and gas producers. The world's list of top energy producers and reserve holders includes a very small number of western industrialized democracies – Canada and the U.S. are among them. Each country has the resource potential to be a major player in global energy markets.

Will the two countries work together to develop their oil and gas resources responsibly for domestic and global consumption while driving down their GHG emissions and transitioning to lower carbon energy systems in the long term? Will they collaborate on developing the energy technologies, policy frameworks and game-changing innovations needed to do so – or will they drift into pointless competition?

Climate change – warming and more erratic weather conditions – will affect both countries and shape new trade issues. Take agriculture. In the U.S., forecasts predict mega-droughts in the California and Midwest breadbaskets that will make farming and ranching all but impossible. Climate scientists generally agree that most of Canada will experience warming over the next decades. Agriculture in the Prairies should benefit with a longer growing season, although with rising demands for more careful water use. This could mean more Canadian water sold south of the border in the form of Canadian grain, vegetables and fruits, replacing the bounty of dried-up farmland in the U.S.

Third, the rise of Industry 4.0 will transform our trade relationships. In the past decades, the U.S. and Canadian economies have been linked less by selling stuff to each other than by making it together. During the 1970s, many North American industries followed the auto example by creating deeply integrated cross-border production and marketing systems. Today, in the emerging Industry 4.0 era, the future of 20th century cross-border production and marketing networks is not guaranteed.

Moreover, services comprise a rapidly growing share of trade, and digital trade is increasing rapidly. Although North America's auto industry continued to improve in a highly competitive global environment – *sans* the new bridge and in the wake of 9/11 thickened borders – success in the 21st century industry of autonomous vehicles, smart infrastructure and complex hardware and software producer networks will demand far more collaboration across more industrial sectors and among governments at all levels in our complex federal systems.

The bottom line is that to maintain vigorous cross-border links, Canada must be at the cutting edge of Industry 4.0, but the pace, scale and scope of change make this a challenging proposition, and trade relationships must anticipate emerging 21st century developments. Tough stuff.

Managing the physical stuff of cross-border integration is an equally challenging file. Infrastructure poses enormous issues in both countries. Much of our trade moves through what are single integrated systems – highways and railroads, pipelines and electric wires, the St. Lawrence Seaway and the great Mississippi River system. Both governments will have to decide whether to pump huge sums of money into defending existing infrastructure or to abandon threatened structures and build anew – or some combination of the two. No easy task: the interminable machinations getting to the second Windsor-Detroit bridge symbolize the challenge. Again, patterns of trade will depend fundamentally on how the U.S. and Canada resolve the looming infrastructure crisis, a crisis made all the more challenging in the context of extreme weather and other climate change impacts.

And there is another, darker side to technological transformations. While new and exciting avenues for jobs and careers are emerging, many people are and will be left behind – particularly those who are older, less educated, lower skilled and less mobile. For them, "innovation" and "Industry 4.0" may become four-letter words, if they aren't already. The most serious threat is that entire geographic or socioeconomic communities are left derelict, raising the spectre of populist and economic nationalist movements growing and gaining strength. In the United Kingdom (Brexit) and the U.S. (Trump), studies reveal how these changes widen economic, social and political cleavages – and how they affect attitudes toward trade. These developments are already affecting Canada-U.S. relations, *viz* anti-NAFTA sentiment and rhetoric in the U.S. (the fact that automation drove down jobs and not trade is beside the point). Is Canada immune from these tendencies inside its borders? We think not. But are leaders seriously considering the prospects of populism and economic nationalism and how to proactively address them? Unfortunately, we also think not.

To effectively respond to both the challenges and opportunities of the transformations ahead, we propose governments pursue three key strategies:

- Foresight not near sight. The unpredictability and volatility of the Trump White House militate towards focusing on short-term trade issues, but those engaged in and managing bilateral trade should position their short-term tactics within a much longer-term view. Given the scale and pace of change in the offing, both countries will need to develop their domestic and bilateral capacities for horizon scanning, foresight and scenarios work, along with policy and program flexibility, adaptability and resilience to adjust to rapid and widescale change in the profile and patterns of trade.

- Challenge usual assumptions. The relatively stable postwar environment of trade liberalization, economic growth and predictable geopolitical fault lines is being replaced by an increasingly complex, fast-moving and unpredictable environment. The futures of trade liberalization, multilateralism and elite-driven politics are very much open questions. In this context, trade decision-makers must consistently challenge their usual assumptions about how the world works – not only for Canada-U.S. trade, but globally – now and into the future.

- All hands on (a co-ordinated) deck. Those managing Canada-U.S. trade relations will need to expand their toolkit and approach substantially. The challenges of an increasingly complex world will require deep collaboration: much more decentralized and extensive relations moving well out of Ottawa and Washington into the provinces, states and municipalities, and building, leveraging and mobilizing multiple ongoing constituencies of political, industry and civil society leaders at the national, regional and local levels. The Trudeau government "gets" this approach – future governments will need to follow suit.

This will not be easy, but it is essential if Canada and the U.S. are to effectively navigate their domestic and cross-border trade environments.

While there is much uncertainty about the future of trade, Canada-U.S. trade relations will be shaped by powerful and disruptive trends. The countries may move in quite different directions over the next decades – as both undergo significant structural transformations to their economies, energy and environment systems and populations. They will confront important and complex issues that require deep collaboration, challenging usual assumptions and looking far into the future to inform actions in the here and now. This will require new approaches, strong relationships and thought leadership on both sides of the border. A tall order to be sure, but an essential one to fill if Canada-U.S. trade relations are to thrive in the coming decades.

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Lead image: **Hill+Knowlton Strategies**

The Great Divergence: North America's Trade Policies

by **SARAH GOLDFEDER**

The United States and Canada are operating from diametrically opposed playbooks on global involvement and trade. While one is seeking to minimize its global responsibilities and maximize trade potential via the use of bilateral tools, the other is reaching out to bring the world more engagement, philosophically positioned to reflect the government's progressive values. This opposition played out not just on the stage at Davos, but it's also present at the negotiating tables for the North American Free Trade Agreement (NAFTA).[1]

Global Positioning

President Donald Trump outlined his vision in a series of speeches, both at home and abroad, but nowhere was it more apparent than in his speech on national security.[2] In the decades since the end of the Second World War, the United States had understood that its security was connected to global security. The Marshall Plan took that a step further and embraced the idea that a prosperous, stable world was a safer world, and the United States had an obligation to contribute to that stability.[3] The world wars were taken as proof points that an isolationist United States was just as vulnerable to the disastrous effects of dictatorship, extremism and instability as any of the countries involved directly with those conflicts. This global sense of responsibility grew to an understanding of itself as a global leader – with obligations to the nascent democracies and the oppressed, as well as to preserving the routes of global trade.

That the United States has turned its back on this globalist philosophy should not be a surprise – frankly, not only has it been decades in the making, many would argue the world would be better off without one nation playing puppeteer via global military might and access to its consumer-driven market. But others would argue that now, with displacement throughout the world due to conflict and natural disasters, and other major powers moving into position for global leadership, the world needs the United States.

Meanwhile, Canada has demonstrated a desire to be part of the global conversation – presenting the idea of middle powers as leaders, using trade agreements and international aid to frame the conversation.[4] The Progressive Trade Agenda is one attempt to move other middle powers toward economies that provide for prosperity for all their citizens.[5] Using economic measures as diplomatic carrots is not new; in fact, the State Department under former president Barack Obama codified a program of economic diplomacy with great success. Additionally, Canada is using a set of defined objectives to determine deployment of its international aid, further entrenching feminism, economic empowerment, environmentalism and inclusion into its foreign policy.

The Economy of the Future vs. the Economy of the Past

The leaders of the two neighbouring countries are focusing on entirely different economic drivers. One is looking toward clean technologies, making urban areas hives of economic activity, while the other considers the resurgence of traditional sectors its primary concern.

Canada's current government has made a point of preparing the Canadian economy for jobs of the future.[6] By focusing on services, highly skilled opportunities in high-tech fields and investment in next-generation technologies, Canada has built up a narrative designed to tantalize the millennials and Generation Z. In gauging what success looks like for trade agreements, Canada is focused on creating modern agreements that provide ample space for navigating the unknown unknowns of future technologies.

In contrast, the United States is looking back to its future.[7] The Trump administration's industrial strategy is built on a foundation of traditional economic engines such as construction, manufacturing and extractive industries. The push to undo regulations that are designed to limit development – including regulatory processes regarding the exploration and extraction of fossil fuels and minerals, building of infrastructure and the protection of federal lands – is key to this strategy. Trade deals that are understood to be a challenge to the U.S. manufacturing environment or that give up procurement space to foreign entities are seen as a threat.

Big Economies Don't Like Multilateral Deals

This U.S. administration is operating in a zero-sum environment where trade deals yield one set of losers and one set of winners. Multilateral deals complicate this math, creating compromise in search of a common, level playing field where all the signatories give up something to get something else. No wonder this administration prefers the bilateral agreement. The problem is, a bilateral agreement with unequal partners leads to an uneven deal.

Market monoliths such as the United States, China and even India, are far more interested in bilateral deals, where they can more easily gain access to new markets while giving up less. Meanwhile, middle-sized, small and developing economies are better served by multilateral trade deals where their combined weight can help to balance out the equation. NAFTA was the first of these, but the TPP and the dormant (for now) Transatlantic Trade and Investment Partnership (TTIP) were intended to be the next generation, creating a modern agreement focused on non-tariff trade barriers and market fairness rather than on one that is tariff-based and goods-driven.

In addition, Canadian and European leaders have accepted the tactic of isolating economies that are not interested in playing by the widely held rules of the global markets. The creation of TPP and TTIP were both driven by this philosophy, now abandoned by the Trump administration. Ironically, these agreements would have served to counteract the World Trade Organization's lessening influence, and establish enforcement mechanisms that would be timely and thus create a fair-trade environment for the signatories.

Selling a 21st Century Agreement to a 20th Century Leader

As NAFTA negotiations continue, Canada and Mexico are facing an increasingly frustrated Trump administration. The American trade deficit has grown in the past year, mostly due to policies the Trump administration has enacted, yet the blame continues to fall on the shoulders of the trading partners. The president, rather than seeing the deficit as proof of a robust consumer economy, sees it as a loss for America. This disconnect, along with the push for the return of 20th century jobs, has set up an impossible task for the U.S. trade negotiators.

No matter what the Canadians bring to the negotiating table, if the disconnect between one party seeking a trade agreement for the future and one party looking to reinvigorate the past is not addressed, the parties will continue to talk past each other. We saw that evidenced in Montreal. Robert Lighthizer has one goal in the renegotiation of NAFTA and that is to reclaim jobs lost, in the same industries (more or less). Making the argument that high-tech or service jobs are a suitable substitute does not meet the mandate under which the United States is operating.

Consider the Americans' automotive rules-of-origin proposal. Canada, believing that the U.S. position on regional content could be satisfied once the entire life cycle of the car manufacturing process was included, offered up a matrix that would include things like engineering and marketing, as well as research and development in the component list. Lighthizer roundly rejected that, pointing out that once you've included all those aspects, more of the manufacturing could be off-shored. The disconnect between the intended outcome (displaying how the status quo on regional content is optimal for the North American auto sector), and the actual outcome (convincing the USTR that manufacturing continues to be at risk because of NAFTA) is representative of the ongoing dialogue. Until one or the other partners brings a proposal to the negotiating table that addresses the manufacturing issue, the chances of finding a pathway out of this impasse are slim.

It is hard to overstate the gulf between the U.S. and Canada's foreign policy goals and philosophies at this moment. Likewise, it should be expected that those differences will affect how NAFTA will be renegotiated and if it will be concluded. The North American supply chain of the next NAFTA will have to address the manufacturing question in order for this U.S. administration to sign on. Canada will have to accept that the United States does not share its vision of the economy of the future in order to move past the current impasse.

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Lead image: **Shutterstock/Tomas Stehlik**

Crunch Time: NAFTA a Litmus Test for the United States' Place in the World

by **COLIN ROBERTSON**

The NAFTA negotiations will give us a good sense of the Trump administration's trade orientation. Will the reality match its unusual (for a U.S. administration) bombastic, protectionist rhetoric?

The test will come on three issues:

– Can we preserve dispute settlement as a check against unfair protectionism?

– Can we find an equitable formula around trilateral content rules for cars, our most traded commodity?

– Will government procurement stay open to all three nations?

If we cannot resolve these issues, then we have to look to Plan B, life without the North American free-trade agreement.

Foreign Minister Chrystia Freeland's "hope for the best, prepare for the worst"[1] is a fair characterization of NAFTA's prospects. The Trump administration continues to ramp up protectionist actions against foreign competition.[2] In recent months, the United States has hit Canada with punitive tariffs on lumber, jets and now newsprint.[3]

U.S. President Donald Trump's repeated threats to rescind NAFTA is galvanizing hitherto-silent U.S. support into action. The farm community and business, two vital groups in the Trump coalition, want NAFTA improved, not rescinded. Surveys show a majority of Americans like NAFTA.[4] Senators and members of the House of Representatives, especially those in the Midwest and from Texas, are now pressing the President to do no harm to NAFTA.

Canada and Mexico have launched unprecedented outreach campaigns. Canadian envoys have met with more than 65 governors and lieutenant-governors and more than 265 congressmen. We are finding allies. We will need them if Mr. Trump rescinds the agreement or if any new deal reaches Congress.

Canada and Mexico must stay engaged in what should become a permanent campaign to cultivate the biggest market in the world.

But the future of NAFTA now depends on the outcome of the American internal debate.

Canadians faced their moment of truth on trade in 1988. We fought an election over closer economic relations with the United States. It brought prosperity, not, as the critics warned, a loss of sovereignty. Mexicans faced a similar moment in 1994 when they embraced the NAFTA.

For both Canada and Mexico, freer trade proved that we could compete, not just with the U.S., but internationally.

Freer trade also became a catalyst for domestic economic reform.

For Canada, the restructuring included the introduction of a national value-added tax, the GST. Federal and provincial governments cut their deficits. For Mexico, NAFTA restructuring supported democratic change in 2000 after 71 years of one-party rule. More recently, it helped spur the "Pacto por Mexico" reforms to education, finance, labour and energy.[5]

For Americans, NAFTA is a litmus test of its place in the world. Will they replace the rules-based order, created and sustained by the United States for 70 years, with Mr. Trump's vision of America First? Will Americans set aside their traditional generosity towards other countries with one based on mercantilism and beggar-thy-neighbour?

For the first time, the most important global economy wants to renegotiate a trade agreement by increasing trade barriers so as to balance its trade. It's a world of big rolling over small. Middle powers like Canada and Mexico need to push back.

Previous U.S. administrations, both Republican and Democrat, saw U.S. internationalism not as an act of charity, but as reflecting U.S. values and principles. As practised by Roosevelt through Reagan and Obama, the United States used its weight to better the global condition, willing to give more than it received. This is the "indispensable nation"[6] that Ms. Freeland described when she laid out the Trudeau foreign policy last June. She described a United States that sustains the global order, for the greater global good, through a network of alliances, trade agreements and international institutions.

Mr. Trump's "America First" breaks with this American tradition. Will Congress and the courts go along with Trumpism? While Canada and Mexico prepare for the worst, we must stay engaged with the many Americans who see the world, and America's place in it, differently than Mr. Trump.

Ultimately, Trumpism is a test of how Americans see themselves and their place in the world.

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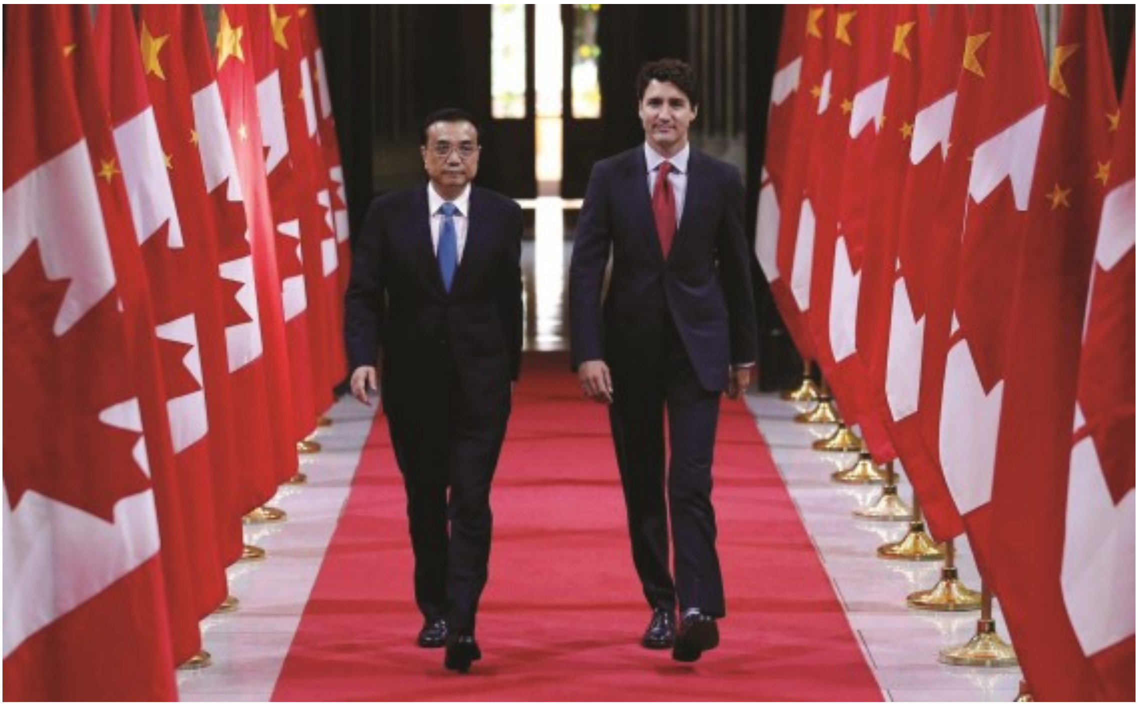
Lead image: **The Canadian Press**



Canada’s “Progressive” Trade Agenda: Let’s be Careful How Far We Push It

by **HUGH STEPHENS**

Back in October of 2016 when the Canada-EU Comprehensive Economic and Trade Agreement, (CETA) was on the cusp of closure, the negotiations hit a roadblock when the Belgian region of Wallonia blocked the necessary consensus for the EU to conclude with Canada. Chrystia Freeland, who was then the minister of international trade, walked out of the negotiations in Brussels and packed her bags to return to Canada. She lamented that “… it is now evident to me, evident to Canada, that the European Union is incapable of reaching an agreement – even with a country with European values such as Canada, even with a country as nice and as patient as Canada.”[1] A core element of her argument was that Canada and Europe shared common values, and therefore the path to an agreement should have been open. As we know, a compromise satisfied Wallonia’s concerns, mainly regarding the so-called investor-state dispute settlement process which allows foreign invested companies to sue governments for alleged discriminatory practices that negatively impact their investments.[2] Canada and the EU went on to sign the agreement, most of whose provisions came into effect on Sept. 21, 2017.[3] The government of Canada has cranked up its communications machine and is touting CETA as “a progressive trade agreement for a strong middle class”.[4]

So, what is a “progressive trade agreement”? If you read or watch the informational material that Global Affairs provides on CETA, you won’t really find a definition but you will learn that the agreement “puts the interests of our middle class at the centre of the discussions”, and that it will “boost trade with our second largest trading partner while protecting labour rights and the environment".[5] How will it do this? Let me quote from the agreement overview provided by Global Affairs:

"Under CETA, Canada and the EU commit to effectively enforce domestic environmental law and not to waive or derogate from those laws in order to encourage trade or investment. EU producers that wish to export and sell their products in Canada must fully respect the relevant Canadian regulations and vice versa. Both Canada and the EU retain the right to regulate in the public interest."

"Canada and the EU have also committed to seeking high levels of labour protection and enforcing labour laws. Specifically, the Agreement includes a commitment to ensure that national laws and policies provide protection for the fundamental principles and rights at work, including the right to freedom of association and collective bargaining, the abolition of child labour, the elimination of forced or compulsory labour, and the elimination of discrimination."[6]

Thus, according to the CETA text, the Europeans (and Canada) will enforce domestic environmental laws and respect labour standards. Since most of the EU is comprised of developed economies with strong concepts of social justice, one can assume that these commitments will ensure a level playing field on environmental and labour issues between the EU and Canada. And just to be sure, if there are disputes over whether environmental laws are being applied appropriately, there is a provision for consultation and even the convening of a bilateral panel of experts to prepare recommendations. These measures are designed to avoid weak environmental and labour practices that might lead to the production of unreasonably low-cost, unethically produced goods that could then be dumped into the Canadian (or European) markets. The interests of the all-important middle class will be protected.

With regard to NAFTA, now under renegotiation, the prime minister has taken the Canadian message to New York, proclaiming that progressive trade is not a "frill" but a necessity, although a more pressing concern is simply to prevent Donald Trump from blowing the whole thing up.[7] A recent study by CIGI, "Modernizing NAFTA: A New Deal for the North American Economy in the Twenty-first Century", outlined a number of areas where NAFTA could be updated, such as adding progressive elements like strengthened labour provisions and the inclusion of language on gender issues.[8]

While having language in a trade agreement to address environmental and labour issues, among others, might satisfy Canadian concerns when it comes to a partner like the EU, or the U.S. and Mexico, the same cannot be said for China or some of the countries (Vietnam, for example, or possibly Malaysia) in what is now known as the Comprehensive and Progressive Trans-Pacific Partnership (the former TPP minus the United States). Regardless, "progressive trade" has become the new Canadian mantra, whether our potential trading partner is an industrial power and advanced democracy like Germany or France or a centrally planned developing economy in Asia.[9] If an agreement is not progressive enough, then Canada may not be able to sign on, or so it seems. When we add other elements of the progressive agenda, such as gender, Indigenous rights and governance to labour and environmental standards, we have a set of aspirations for a trade agreement that not only can be difficult to negotiate with some of our potential partners, but which cut across deep-seated cultural values and traditions as well. As important as these aspirations are, one wonders whether they are achievable through the framework of trade negotiations.

Why is a progressive agenda so important to the Trudeau government? A lot has to do with domestic political considerations. The term "progressive" has a long history in Canada, going back to the Progressive Party of the 1920s, one of the prairie populist protest groups, generally seen as left of centre.[10] Ironically, the name became associated with right-of-centre politics when the Conservatives merged with the remnants of the Progressive Party in the 1940s to form the Progressive Conservative Party of Canada. Since the Tories ditched the "Progressive" appellation after the PCs and the Reform Party merged in the early 2000s, the term has been once again used to describe so-called left-of-centre policies usually associated with the NDP. The end run the Liberals performed on Tom Mulcair's NDP in the 2015 election allowed the Grits to appropriate the progressive label and run with it. Since many so-called progressive voters are assumed to be anti-free trade and anti-globalization, what better way to differentiate Liberal trade policies from those of the Harper government than to declare that the Trudeau trade agenda is progressive? If you are a unionized worker, an environmentalist, a social or human rights activist, a feminist, or even just a self-identified member of the middle class or an aspirant to join it, how could you possibly object to a progressive trade agenda? From a domestic political perspective, it's brilliant.

What is less brilliant is insisting on pursuing progressive trade objectives in trade negotiations with economies that may have quite different cultural values, political traditions and economic levels of development from Canada. That is what apparently happened during Prime Minister Justin Trudeau's recent visit to Beijing, where many assumed the capstone of the trip would be an announcement that Canada and China would be launching bilateral trade negotiations. It didn't happen that way, as we all know, due at least in part to Chinese discomfort with elements of Canada's progressive trade agenda.

China's environmental and labour practices have undergone significant improvement in recent years, driven in part by the growing Chinese middle class's expectations of higher standards. China no longer competes solely on the basis of cheap labour; in fact, Chinese labour costs are rising fast, with the result that many labour-intensive industries have shifted to other jurisdictions such as South and Southeast Asia. Chinese environmental standards are also changing rapidly and, among other things, China is establishing a role as a leader in the area of electric-powered vehicles. But while China's record is improving, it is still spotty given the country's size, and China is apparently not (yet?) willing to sign on to commitments in a trade agreement that would subject these standards to external review and discipline. Other elements of the progressive agenda, such as gender, Indigenous rights and governance (a code word for human rights), are even more problematic for a country like China.

There is nothing intrinsically wrong with any of these progressive objectives, but loading them into a trade agreement may not be the best way to achieve them, especially where there is a wide cultural and economic gap. If Canada is not able to start negotiations with China because of these progressive stumbling blocks, will Canada – and China – be better off? It is hard to argue that this will be the case. Would it not be better to set aside some of the lofty objectives in order to make progress on opening markets and increasing trade, investment and interchange? More open markets, greater trade interdependence, two-way investment flows and expanded movement of people do not necessarily guarantee that values will be transmitted or that economic growth will lead to political evolution. However, not to promote such exchanges will surely not lead to better outcomes. In promoting its values agenda, Canada needs to be realistic. We need to protect our values and stand by them, but also realize that our view of the world is not unique. And while we are a G7 country – a status we like to remind others of – we are a market of only 36 million people. To natter on about our progressive trade agenda when dealing with countries like China, Vietnam, Malaysia or even Japan, may not be the best way to advance our interests.

There is also the matter of tone and messaging. Even a country like Australia, with whom we share a common heritage and who is one of our TPP negotiating partners, seems to have been put off by our selfproclaimed progressiveness. Our last-minute unexpected case of cold feet about whether to commit to an agreement-in-principle for the TPP did not win us any goodwill. Are not the Aussies as progressive (and virtuous) as we are? Canadian exceptionalism is not selling particularly well these days.

A progressive trade agenda is a useful tool to counter populist anti-globalization sentiments in Canada and abroad, and if it enables the Trudeau government to do what is needed for the Canadian economy in terms of trade diversification, its role will have been positive. However, we should be careful not to oversell it, especially if it costs us market opportunities overseas. As Voltaire is reported to have advised, “Don’t let the perfect become the enemy of the good.” That is the risk we run if we push our version of progressive trade too far too quickly.

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Lead image: **Chris Watt/Reuters**

Global Rules of Digital Trade: Can We Adapt Bordered Regulation for a Borderless World?

by **LAURA DAWSON**

How big is the gap between where we are and where we need to be?

The rules of global trade originated for farm products and manufactured goods – things that can drop on your foot. The addition of rules governing non-physical tradables in the 1990s, such as services and intellectual property (IP), challenged the goods regime. We are increasingly trying to stretch the rules meant to govern the sale of a bushel of corn to govern the transmission of electronic signals representing billions of bytes of data. Trade rules for goods are built on the premise that we are able to identify the geographic origin of the product and attach a tariff or other condition on its international sale, usually at the point where the product crosses the border. Digital products by contrast are not bound by geography, nationality or even physical properties. Thus, rule making for this new kind of trade will be very difficult indeed.

Intellectual property rules are mostly about protecting ownership of ideas, processes and technologies, and thwarting attempts by non-owners to use IP without paying for it or in ways that would diminish its value. In the case of handbags and cellphones, IP enforcement can take place at the border if customs officials are able to distinguish fakes from the genuine article, but digital products present enormous challenges to those who try to police the trade in ill-gotten movies, software and digital designs, since transactions move directly between buyer and seller – directly, invisibly and in enormous volumes.

Cross-border services are also difficult to monitor, and thus harder to regulate, but conventional services trade most often involves the movement of a person – either the provider or a consumer – across a physical border. This meant that most services transactions were subject to some form of border monitoring. Widespread, systemic abuse was unlikely because a single person could not deliver or consume thousands of extra-legal services transactions in a single day. Fast-forward to the world of digital trade and it is entirely possible for a digital service provider to conduct tens of thousands of transactions in a single minute.

Perhaps we don't need trade rules for the digital economy. How much of the original rationale for trade rules is applicable to the digital economy? The general purpose of goods trade rules is to protect consumer safety and protect producers from having their products or IP stolen, together with ancillary public policy motivations such as creating cost barriers to protect domestic manufacturers from lower cost imports. Trade rules also provide a means of tracking goods crossing the border so that governments can collect taxes on the product's sale.

When applied to digital trade, these original objectives – with a few modifications – remain relevant. They include:

1. Protection of consumers from fraud and misuse of personal information;

2. Protection of legitimate public policy goals, such as a government's right to access information in other locales (or in the cloud) for law enforcement or national security purposes;

3. Protection of intellectual property rights; and

4. Promotion of the development of digital enterprises.

The last objective is perhaps the most challenging because it involves a range of incentives, such as R&D tax credits, that may or may not be effective. Also, some of the other objectives designed to protect consumers may tie the hands of digital enterprises to such an extent that investment and employment move elsewhere. In an era where policy lags behind rapidly changing technology, governments walk a fine line between providing the constraints necessary to protect individual and corporate rights while also providing the freedoms and incentives to develop robust and competitive digital enterprises.

The stakes are high. McKinsey Global Institute reports that cross-border data flows in 2015 were 45 times larger than they were a decade earlier.[1] By 2020, they are forecast to grow another nine times. Within this same period, cross-border movement of goods and investment has flattened or declined. This has a direct impact at home. Meanwhile, digital trade is robust and growing. U.S. government sources estimate that digitally enabled services account for 52 per cent of all U.S. services to Canada and 46 per cent of all services imports from Canada.[2]

The regulatory challenges are enormous. Technology is moving faster than regulation. Today's problems might be moot by the time we have an effective regulatory regime to deal with them and the challenges of tomorrow have not even occurred to today's regulators. The gap between applied technology and regulation, known as regulatory arbitrage, is being successfully exploited by developers of new service delivery platforms such as Uber and AirBnB.[3] These enterprises disrupt traditional, regulated services by providing new mechanisms of direct service delivery. In doing so, disruptors make a bet that they can operate for a period of time while government policy lags, before being subject to updated rules that might put them out of business.

A second problem stems from the fact that if you can't measure it, you can't regulate it. Rapid technological changes mean that we don't have an accurate understanding of the true dimensions of digital services trade. Trade transactions are quantified and taxed when a product crosses the border. Without a customs declaration, no trade has taken place except what sellers self-report for tax purposes. As organizations such as the OECD note, government enforcement authorities remain in the dark when neither the buyer nor the seller reports a digital service transaction to a government.[4]

Add to this the volume of trade that is possible when geography, shipping and other constraints of the physical world are no longer an issue and it is clear that there is a huge and growing part of the global economy that we know very little about.

Finally, there is a problem of fragmentation. There is no one global digital services organization charged with regulating cross-border digital trade. Trade agreements are picking up the slack, but the regulatory regimes that are emerging from these different institutional venues are fragmented and their effectiveness and enforceability are very much an open question.

None of this bodes well for the near future of digital trade rule-making and a weak understanding of the scope, nature and economic importance of digital trade makes it difficult to decide how to direct and shape trade, investment, and business and workforce development policies.

Technology turns trade on its head

New technologies give rise to new ways to create and deliver goods and services and these technologies are upending the way we think about trade rules. A few examples below help to illustrate the emerging challenges.

3D Printing
With additive or 3D printing, a designer in Country A provides a template for a 3D-printable item to a customer in Country B. [5] The file is downloaded from the cloud while the financial transaction is completed somewhere in the world, not necessarily related to where either the designer or the customer resides. The customer completes the transaction by creating the product on his or her 3D printer, but no physical product has crossed the border so no collection of customs tariffs or other border taxes is possible. Similarly, there is no use of conventional trade instruments such as rules of origin, quotas, export controls or duty drawbacks. So what was traded? A good? A service? What is taxable? What if the product breaks, causing harm to someone? Who is liable?

Digitally Enabled Goods
Digitally enabled goods refer to products where a growing share of a product's function and value is provided by smart technologies. Today, the two-century old John Deere company is fast becoming a technology company that delivers agricultural automation tools via tractor.[6] When customers buy a tractor from Deere, they also get access to the platform MyJohnDeere,[7] a big data analytics tool that helps producers optimize the management of production data, equipment information and farm operations.[8]

Digitally enabled goods pose a particular challenge for trade regulators. Once a conventional goods transaction is completed, it falls off the regulatory radar screen, but digitally enabled goods bring with them continuing questions of IP ownership, movement of data and the value of continuing services trade.

Blockchain
Blockchain is a distributed network that functions as a giant global spreadsheet shared across millions of computers worldwide.[9] The network is a continuously growing database with safeguards against tampering and fraud. Blockchain can be used by manufacturers to maintain accurate inventory and shipping records with their input suppliers, or it can be used to facilitate cross-border payments. In the pre-digital age, verification of payments in cross-border trade was a time-consuming and risky enterprise. Blockchain technology cuts risk precipitously and makes payments practically instantaneous. The shipping

giant Maersk now uses blockchain technology instead of paper-based bills of lading.[10]

While the reliability of blockchain technology is still evolving, its use is growing by leaps and bounds.[11] But, having ledgers in the cloud that are simultaneously everywhere and nowhere is a huge challenge for makers of trade rules who have for centuries relied on the geographic location of transactions and the national origin of products as a basis for decision-making.

Where does public interest intersect with digital trade?

Digital trade rules are developing along three key tracks:

- protect people's privacy
- protect intellectual property
- create an enabling environment for innovation

Protect Privacy
The collection and management of personal information is one of the most contentious areas of digital trade. While the intention is to ensure that people's personal data are not misused or mishandled, many national regulators have defaulted to requiring that their citizens' data be contained within national borders. This practice, called data localization, focuses more on geography as a guarantee of safety rather than on establishing enforceable, generalized standards for data management.

The Canadian provinces of British Columbia and Nova Scotia join China, Russia and Vietnam in demanding that companies store data on servers physically located within their borders.[12] Other jurisdictions allow some information to flow freely but block the movement of accounting, tax, financial and personnel information from moving across electronic borders.

By insisting that data be stored on domestic servers and tended by domestic managers, governments create extra costs for firms whose profitability depends on the scale benefits provided by cloud computing and globally aggregated services. A 2015 study by Leviathan Security Group estimates that data localization drives up computing costs by 40 to 60 per cent.[13]

One of the ironies of data localization is that it actually might make consumers less secure. On Nov. 18, 2017, the U.S. Chamber of Commerce opposed the Brazilian Central Bank's proposed cyber-security regulations that would bar financial institutions such as Citibank and JPMorgan Chase from using data processing and cloud computing services based abroad.[14] The Chamber claimed that not only would such a prohibition raise costs, it would make fraud detection more difficult.

Protect Intellectual Property
The new digital IP issues resemble the concerns of pre-digital IP rights but the nature of the technology provides a new spin on old problems. One of these new concerns is the issue of intermediary liability where online service providers and intermediaries such as Google and YouTube are asking that they not be held liable for copyright violations on material they host or that is uploaded by their users. The intermediaries' position is that they should not be held responsible for third-party content. Moreover, relegating them to the role of enforcer makes the internet "less free, innovative, and collaborative." A June 2017 press release from the Internet Association claims that nearly 80 per cent of venture capital investors are less likely to invest in services where protections from intermediary liability do not exist.[15] Another problem is the demand by governments for foreign entities to reveal source code and other IP in order to protect national security or encourage domestic economic development. The Software Alliance responds that demands for source code "pose significant inherent risk to intellectual property" while providing little security value.[16]

Similarly, there have been a number of recent high-profile cases where companies have been asked to unlock the IT devices of individuals involved in criminal investigations, such as the Apple iPhone owned by the 2017 Texas church shooter.[17]

Enable Innovation and Support Digital Business

As discussed above, too much emphasis on privacy protection through localization or zealous enforcement of intellectual property rights may hamper the ability to create new products and processes or to fully maximize the benefits of the digital economy.

A contentious issue for Canada is the de minimis threshold that exempts low-value shipments from border taxes and duties. In Canada, that level is $20. E-commerce enterprises in the United States – where the de minimis level is $800 – argue that the low Canadian levels hinder the growth of cross-border e-commerce. Moreover, the costs of administering low-value shipments outweigh the benefits in taxes. A C.D. Howe study suggests that the federal government would save $161 million per year by raising the de minimis rate.[18] The Retail Council of Canada counters that Canadian retailers could not compete against the tax-free advantage that e-commerce purchases from the U.S. would enjoy since there is not currently any mechanism for federal or provincial sales tax collection on cross-border purchases.[19]

Where is the new generation of digital trade rules coming from?

TPP and NAFTA

The 1994 North American Free Trade Agreement (NAFTA) contains few provisions that are directly relevant to digital trade. (Most people did not have internet in their homes when the agreement was negotiated.) But, the basic principles of transparency, non-discrimination, protection of intellectual property and avoiding rules that can be used as disguised barriers to trade, provide a good framework upon which to build a new digital regime.

The Trans-Pacific Partnership (TPP) represents a concerted effort, led by the United States, to establish a number of key digital trade principles in legal text. The Digital 2 Dozen,[20] published on the website of the office of the United States Trade Representative, provides a list of U.S. priorities for a new digital trade regime, led by principles of freedom, openness and non-discrimination.

Since the U.S. withdrew from the TPP, leaving the other 11 negotiating parties to sign a similar, but not identical, replacement agreement, the U.S. is facing a gap in its attempts to lead the charge on digital trade rules. An opportunity exists to continue this leadership in a more limited form by installing the TPP rules in NAFTA, currently under renegotiation. This should not be too difficult since the three NAFTA parties were all original TPP signatories and had previously agreed to the TPP digital provisions. However, as politics, interests and technologies change, there is no guarantee that this will be a smooth transition.

Intermediate Liability

The NAFTA negotiations are still in an early stage, but officials report that talks on the digital chapter are going well with the exception of intermediate liability. The U.S., perhaps influenced by its powerful domestic entertainment lobby, is pushing for strengthened liability provisions. Canada is pushing back[21] against expanded liability and this position is shared by many powerful U.S. entities such as the Internet Association, which argues that its members are already supporting the protection of intellectual property and public decency through other regulatory measures.[22]

Government Procurement

In the NAFTA government procurement negotiations, U.S. firms are calling for greater openness in Canadian federal and provincial government services that require Canadian user data to be housed on servers located in Canada. At the same time, the U.S. is proposing severely curtailing the access that Mexico and Canada currently enjoy in many U.S. government sectors – a predictable position for an administration elected on a Buy American, Hire American platform. Given the rancour in this sector overall, it is unlikely that Canada will yield much new access in digital government services, even if the U.S. can guarantee safe handling of Canadian data.

The Special Case of Financial Services

Another element of uncertainty in the interplay between TPP and NAFTA is the issue of data localization for financial services companies. In the original TPP, signatories agreed to prohibit data localization (i.e., to insist on free flow of digital data across borders) for all sectors *except* financial services. This exclusion was meant to reflect the special status of financial services.

Regulating the international movement of financial services hinges on the balance between business demands to eliminate trade barriers and regulators' requirements to have access to the information they need.[23]

The 2008-2009 financial crisis emphasized to U.S. financial regulators the need to have secure and timely access to financial data. The U.S. Treasury Department and key U.S. financial institutions formed an influential bloc seeking to keep financial services out of the broader data liberalization measures in the TPP, staking out a distinct position against their own country's trade negotiators.

Once the negotiations were completed, however, it became clear that the U.S. Congress was unlikely to authorize the TPP with a data exemption for financial services. Thus, in early 2016, then-Treasury secretary Jack Lew proposed a set of compromise positions, chief among them that the financial services sector would not use data localization as long as regulators were able to access information stored abroad.

Since the U.S. withdrew from the TPP in January 2017, the Lew proposal was never tested but the Lew principles provide a guide to U.S. preferences in future negotiations such as NAFTA, the Trade in Services Agreement (TiSA) and the U.S.-EU Transatlantic Trade and Investment Partnership (TTIP).

Data Protection and the EU

The European Union has been at the forefront of the development of data protection rules. Unlike the TPP, which prohibits interruptions to cross-border data flow except in limited circumstances, the EU only permits cross-border data flow when the other territory cannot prove that it is capable of providing an adequate level of protection. Such proof relies on the implementation of EU-sanctioned privacy frameworks regulating the collection, use and disclosure of personal information.

As a partner in this recognition and verification process, Canada implemented the *Personal Information Protection and Electronic Documents Act* (PIPEDA) in 2001.[24] EU member states operate within a similar framework, the General Data Protection Rule (GPDR). Third-party countries are prevented from transfers of personal information from the EU unless they implement similar safeguard measures. The U.S. and EU implemented a more up-to-date privacy shield framework in 2016, but despite temporary peace between these two economic giants, the global rules are far from set. At present, the EU is the global standard bearer for consumers' rights to privacy, setting itself as an obstacle to companies who want to access users' personal data to better market their services or others with more nefarious intent.[25]

WTO

The World Trade Organization rules provide the template upon which other trade agreement texts are created, so it makes sense that the WTO should be a focal point for the emerging area of digital trade governance. Also helpful are principles to ensure that trade rules not be used as a disguised barrier to trade and approaches to trade facilitation at the border which can be adapted from traditional trade to e-commerce.

Many companies, including China's Huawei, argue in favour of using the multilateral WTO system as the arbiter of digital trade rules and dispute settlement, rather than allowing the emerging rules regime to devolve into fragmented arrangements through regional agreements such as the TPP.[26]

Negotiations are ongoing within the WTO for a new TiSA. However, participation in the agreement is voluntary and includes only a small percentage of the WTO's 164 members. Within the TiSA, the U.S. is attempting to extend its global ban on data localization.[27]

China

The differences between the United States and the European Union regarding cross-border information flows are more a matter of degree than of principle, compared to the closed, national system that exists within China's "great firewall".[28] China's 2017 cyber-security law requires that data must be stored inside the People's Republic and subject to various national data retention regulations and that digital equipment be subject to mandatory security inspections.

China's closed cyber-regime has led to the lopsided dynamic of foreign firms selling their stake in Chinese firms while Chinese firms leverage their market power and technology to expand into the West. In November 2017, Amazon Web Services sold its cloud computing servers in China to Beijing Sinnet Technology to comply with China's data localization requirements.[29]

At the same time, while the Chinese market is a huge national market, Chinese service providers and AI companies may find that localization rules prevent them from developing the kind of new technologies and new efficiencies that can be generated from a fully global scale. For example, one of the new regulations requires all health and medical data on Chinese citizens to be stored on servers located inside the People's Republic. IBM has an application designed to compare health records of Chinese citizens against a global disease database but because a Chinese hospital is prohibited from sending patient data outside the country, its records can only be compared against the smaller Chinese sample.[30] Without access to big data, Chinese analysis will be based on medium-sized data with potentially less robust outcomes.

Where do we go from here?

From a regulatory perspective, China's restrictive digital policies put it at the 'mostly closed' end of the spectrum while the United States and even the European Union can be described as 'mostly open'. As global rules develop, we can expect that these three large markets and their regulatory preferences will fundamentally shape the digital trade rules regimes affecting smaller countries like Canada. But even for those countries whose regulatory impulses lean toward an open internet and support for digital business, their liberalizing intent will be tempered by demands to provide stricter protections for intellectual property rights and for consumer privacy.

The WTO, meanwhile, provides a strong framework for progress, albeit very slowly. The glacial pace of trade negotiations compared to the rapid pace of technological change ensures that regulatory gaps will continue. While some enterprises can profit from temporary rules gaps, the absence of transparent, enforceable digital rules of the road will prevent other firms from achieving global reach and scale.

Closer to home, the digital modernization chapter of a prospective NAFTA 2.0 agreement is not likely to yield much beyond what was agreed to in the TPP because the political frictions affecting the current negotiations will get in the way of fulfilling a more ambitious digital modernization agenda, despite strong consensus among all three countries for building North America's digital competitiveness in the world.

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End Notes

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Reassessing Canadian Trade in Asia

by **RANDOLPH MANK**

With the political and media frenzy fading, China probably did us a favour when it rejected Prime Minister Justin Trudeau's efforts to launch negotiations on a free trade deal in December. Now, at least, we know what they don't want – an ambitious and progressive set of trade and economic commitments and disciplines, along the lines of our Comprehensive Economic and Trade Agreement (CETA) with the EU. They have also given us time to pause and think carefully about the emerging new world order into which we may be inadvertently stumbling. It's worth taking the opportunity to look at the broader geopolitical context, examine the current state of Canada-China trade, consider our respective objectives, and from that basis, recalibrate our trade priorities in Asia and elsewhere.

The geopolitical context

Having led the creation of the new world order, post-Second World War, including a liberal rules-based global trade regime, the U.S. appears now to be in retreat from this role. Whether it will be a temporary phenomenon tied exclusively to the Trump administration's idiosyncrasies, or an enduring trend, is anyone's guess. But it does seem as though the high overhead costs of the role – a domestic market relatively open to the world, resultant structural trade deficits, a massive debt load, large payments to support the UN and NATO, not to mention a massive foreign aid commitment and occasional trillion-dollar wars abroad – would be difficult for any future administration to sustain.

Meanwhile, challengers to the unipolar world – in particular Russia and China, not to mention Iran and North Korea – have a deep interest in imposing limits on U.S. dominance. Russia has enormous influence profoundly disproportionate to its economic size by virtue of its nuclear-armed military, as well as its vast landmass and natural and human resources. While maintaining his own domestic power base, President Vladimir Putin appears intent on reasserting the expansionist global role that the former Soviet Union played following the Second World War.

Of course, the bigger geopolitical story is China. Ruled since 1949 by the Chinese Communist Party, it has far exceeded the economic command-and-control prowess of its failed Soviet Union counterparts. It has succeeded, ironically, by borrowing key lessons from the wealth-creating tenets of capitalism.

Starting in the 1970s, and steadily gathering pace with each successive decade, the Chinese government has orchestrated a remarkable flourishing of enterprise – public and private – resulting in an impressive accumulation of capital through world-beating industrial development. Urbanization, a growing middle class, individual prosperity and some circumscribed freedoms have followed, as part of a modified modern social contract that holds China's disparate peoples together.

The result today is a fast growing, $15-trillion centrally planned economy that has been moving methodically from one successful five-year plan to the next, destined to become the biggest economy in the world. China's latest proclaimed ambition is to transition from an export-led, manufacturing economy to one based more on domestic demand, offering higher value-added products and services. In reality, China will be a powerhouse in both.

China's current leader, Xi Jinping, is a 64-year-old, highly experienced party apparatchik, who has been carefully groomed through a combination of education and experience in both policy and administration, steeped always in the ideological orthodoxy of an authoritarian communist system. Neither the American nor the Canadian political system produces leaders or cabinet members with anything near this depth of technocratic experience and training for their roles.

On attaining the top job, Xi set about consolidating power by offering a combination of Mao-like image building and his own inspirational vision. As Xi's recent 3½-hour speech to the 19th Party Congress revealed, these moves constitute the ultimate geopolitical strategy to achieve the "Chinese dream"[1].

The vision includes the highly ambitious goal of developing so-called Belt and Road trade links via fresh overland infrastructure development connecting China to the rest of Asia, and all the way to Europe.[2] At sea, China has asserted aggressive sovereignty claims to the South China Sea by building and then establishing military installations on strategically placed artificial reefs in previously open waterways. It has rejected international legal constraints in doing so.[3]

All the better to circumvent where possible, and challenge when and if necessary, the U.S. Pacific Fleet stationed in Japan as the guarantor of open trading routes in Asia. In the process, they aim to dominate the region and eventually reshape the world order.

The Canada-China baseline

This is what we are up against in our quest for a progressive free trade agreement with China. It's a mismatch of epic proportions and we should not delude ourselves into thinking that it's only about trade.

In addition to glaringly obvious differences in geopolitical ambition, ideology, governance, culture, language and so on, we face in China a population nearly 30 times larger than Canada's, an economy more than seven times larger and a trade imbalance more than three to one in their favour. Though it's our second largest trade relationship, its scale is far behind the nearly $2 billion-a-day business we do with the U.S.

To China's nearly 1.4 billion people we sell only $21 billion a year in merchandise, mostly raw materials – wood and paper products, oilseeds, mineral ores, animal and vegetable products and automotive parts.[4] That's about $15 of Canadian goods for every Chinese citizen, and only about four per cent of our total merchandise exports to the world.

In return, they sell $65 billion in largely manufactured goods – phones, data processors, toys, textiles, electrical equipment and televisions – to our 35 million people, or about $1,857 per Canadian.[5] On the investment side, China has $21 billion in Canada, while we hold $13 billion there.

And the trend line is clear, too. Our exports to them have grown by only about $1.6 billion since 2012; theirs to us by almost $14 billion. Logically, in view of the imbalance, our primary objective in pursuing a trade deal would be to increase our exports above all else.

However, unlike the Canadian economic system, largely based on free enterprise and open markets, modified by a distributive tax and social welfare system, and dependent on trade and economic integration with our neighbour next door, China's economy is centrally planned and led by a phalanx of state-owned enterprises, along with favourably treated private businesses. China has a whopping 150,000 SOEs, owned by both the central and local governments.[6]

Given their disproportionate size and ability to access cheap capital, Chinese businesses are capable of swallowing Canadian ones effortlessly. The Chinese National Offshore Oil Company's purchase of Nexen's oilsands business is a case in point. The original promises, made in order to satisfy Canada's net benefit rules, have mostly been broken, according to some observers, offering a further cautionary tale.[7]

From this basis of understanding, the China free trade project has to be assessed realistically. Those of us who favour free trade in principle everywhere, do so because it has been empirically proven that clear rules and open markets increase trade. We certainly want this with China. Yet, most realists have long recognized the limits of the theory of comparative advantage. When one partner has a gross preponderance of the advantage, and a system tilted to ensure that this will always be so, theory yields to practical considerations.

Combined with the geopolitical context, it's clear that we need to manage the trade relationship with China carefully.[8]

We can learn lessons from others, as well. Countries that are geographically closer to and have much greater experience dealing with China – such as South Korea, Japan, Singapore and Australia – have already felt the sting from becoming even more dependent.[9] China has shown a heavy-handed tendency to punish or control the smaller partner. Examples include restrictions on tourism to South Korea following the decision to station THAAD missile defence systems there, restrictions on Australian coal imports in favour of local suppliers and even the cooling of relations with Singapore after that country's expression of support for the U.S.'s continuing role in regional security.

Finally, China's human rights and rule-of-law record shows little sign of reform, as detained human rights workers and even Canadian business people would attest.[10]

China's goals

So what does China want from Canada through a free trade deal? Though they are less transparent about their goals than we are, China's strategic interests in Canada are clear. They want a first free trade deal with a G7 country, and concluding one with the U.S.'s closest trade and security partner would be a significant strategic bonus. They want to sell even more manufactured goods, while gaining greater access to our supply chains with the U.S. market – our energy and natural resources, our agrifood and our advanced technology in everything from green tech to artificial intelligence to quantum computing. They will use aggressive means to attain these with or without a trade deal.

Specific Chinese negotiating goals would likely include:

- Canadian recognition of China as a market economy;
- Promoting Chinese services and high-value Chinese industries;
- Liberalizing export licences on high-tech exports to China;
- Liberalizing investment thresholds under our net benefit and national security foreign investment review regime;
- Increasing labour mobility of Chinese workers into Canada.[11]

Few of these are shared interests, which underlines the core problem. For, as well as being a trading partner, China is also a strategic competitor in the changing geopolitical order.

The Chinese are capable of deploying people and businesses to pursue their interests, as well as paying local opinion-formers to help shape favourable public opinion in target countries. The Canadian government needs to be wary of this, just as Australia has recently learned.[12] It should also be especially careful about giving government research or advisory contracts to individuals who are also under contract with or receiving favours from the Chinese government, including paid travel to China.

Canada's goals

We should be clear-eyed about what we want and don't want from a trade deal with China. We have both consonant and dissonant interests. First, as much as minor trade imbalances are never a matter for panic, it is certainly not in our interests to have the current systemic and growing structural trade imbalance.

Second, it's clearly in our interest to sell more agrifood products, such as grains, oils, pulses, pork, beef, fish and so on. China shares an interest in having a diverse, high-quality food supply. It's not in our interests, however, to have the Canadian companies who export these products bought outright by Chinese enterprises, nor to have China buy up vast tracts of farmland and use Chinese labour to compete with our own exporters.

Third, it's in our interests to develop China as a market for our oil and gas exports and an investment partner in building our LNG production and transportation capacity, again without selling control of these outright. The energy sector is political dynamite, however, both domestically and internationally and China's participation compounds the controversy. The Nexen deal, as mentioned, is a case in point.

Fourth, it's in our interests to make business transactions in all other sectors as efficient and transparent as possible, unfettered by capricious barriers and interference. This includes service sector trade in such areas as banking, finance, engineering, education and tourism. On the first two, the Chinese financial system is under strain because of too much easy money given to inefficient SOEs. On the latter two, we have to be realistic about our inability to absorb, using existing infrastructure, the enormous numbers of students and tourists that China could easily generate.

Provided Canadian companies have the capacity, engineering opportunities stand out, especially with the possibility of participating in the Belt and Road infrastructure initiative in projects financed by the Asia Infrastructure Investment Bank (AIIB), which we finally joined last year. Participation should be carefully reviewed against strategic interests, however. We don't want Canadian engineering companies building artificial islands in the South China Sea.

Fifth, it's in our interests to make sure that any proprietary intellectual property content we sell in China should be protected from theft or infringement. It is unlikely, however, that we will succeed in this where so many others have failed. China is already a highly advanced technological power that can absorb and commercialize technological innovations rapidly. So, we have to play defence.

Last, a dispute settlement mechanism is another normal ambition in trade deals. But this cuts both ways, as well. China will view such a mechanism as a way of preventing Canadian regulators from blocking takeovers of strategic companies. As a rule-of-law society, we would be hard-pressed to resist. On their side, rule of law would be a less compelling factor than local favouritism in resolving appeals from the Canadian side. And non-tariff barriers are often the real blockage.

This quick assessment suggests that, rather than a classical free trade deal, what we really need is a much more aggressive trade promotion program in China to boost exports. On the trade policy side, if we need anything at all, it would be a highly nuanced and focused sectoral strategy aimed at boosting our exports to China. And since this would never come for free, we need to find ways to hedge.

China's reluctance to incorporate labour, gender, environmental and human rights disciplines into a broad free trade deal reinforces this conclusion. It has become a cliché to tell ourselves in Canada that we have to give up something in our economic system (often supply management) in order to get something in return from a free trade deal. But we are less inclined to think about what the other side is willing to give up or change, if anything at all.

Recalibrating our priorities

Generations of Canadians have understood that our first priority by far is to retain the economic advantages that accrue from our proximity to the generally friendly and open U.S. market. The U.S. also remains our preeminent security partner, with a vast web of closely aligned interests and values.

However, current worries about NAFTA are well founded and extremely serious. So too are sector-specific disputes with the U.S., such as softwood lumber and aviation. Accounting for just under 80 per cent of our exports, North American trade has to remain our principal focus.

Beyond that, everything else is small by comparison. Our priorities shouldn't just be about pursuing new trade agreements. It is equally important, if not more so, to prioritize trade promotion efforts in markets where we already have free trade deals. The Canadian Senate recommended boosting trade promotion globally in 2015 and the government has followed through to some extent by boosting and reallocating trade commissioner support in key markets. More is needed, however, including from the provinces.[13]

The Canada-South Korea free trade agreement, for example, has generated criticism from some and has not yielded the hoped-for increase in Canadian exports,[14] leaving us with a considerable trade deficit and the need for a trade promotion push.

CETA, a huge win in terms of both trade and geopolitics, similarly requires a huge effort at trade promotion if we are to realize the opportunities of freer trade with the EU.

The Brexit process means that we will also need to focus on devising a trade arrangement that draws on our long historical relationship with the U.K., as well. After all, not only is it our fourth largest trading partner, but our head of state also resides there, making it clearly a special case. The CETA model, already cited by our respective PMs as the basis for a bilateral deal, gives us a headstart.[15] Yet, inevitably, the devil will be in the details. While we have to wait until Brexit is complete, a Canada-U.K. trade agreement should be on the priority list of our trade negotiators and ready to go.

As a side note, if NAFTA collapses, it would also be prudent to consider the option of a trilateral deal between Canada, the U.S. and the U.K. in its place. In that scenario, our trade relations with Mexico could be maintained under the now renamed Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) deal.

Turning to Asia, rather than bilateral deals, our priority should be to complete the CPTPP agreement. It meets most of our progressive goals and is well within grasp.

But this deal is only partly about access to the growing Asian markets. Several of the parties – Chile, Mexico, Peru – are not Asian at all. Each of these already have a free trade agreement with Canada. The only Asian participants are Brunei, Japan, Malaysia, Singapore and Vietnam. Among these, Japan, the world's third largest economy and our fifth largest trading partner, is the main opportunity, though Vietnam has seen remarkable growth as well.

CPTPP participants from Oceania – Australia and New Zealand – are as much competitors for Asian markets, as they are market opportunities for Canada.

This means that, once we accede to the CPTPP, we should of course pursue broader access to Asia, including the giant markets of China, India and Indonesia.

We have choices for how to do this. We can pursue bilateral deals, in keeping with our current approach. Or we can attempt to join in on the ongoing Regional Comprehensive Economic Partnership (RCEP) process already well advanced among the giants of Asia and ASEAN.[16] Or we could advocate for other Asian countries to join CPTPP once concluded.

In the meantime, and to shore up our qualifications to join RCEP, the government is right to pursue a Canada-ASEAN free trade deal. We are the only ASEAN dialogue partner never to have done so.

This doesn't completely eliminate the possibility of a bilateral trade deal with China. If they can be turned around on the merits of a progressive deal, fine. Otherwise, Canada should try to negotiate a sector-specific agreement aimed at bringing trade into much closer balance. Obviously, this is asking a lot from our trade negotiators.

In the end, while nice to have, a Canada-China free trade agreement is no more make-or-break for them than it is for us.

Conclusions

Canada has played a significant role in shaping the postwar, rules-based global trading system. With the exception of our close relationship with the U.S., our trade policy experts have always been cautious about a strategy of pursuing willy-nilly bilateral trade deals around the world. With WTO progress halted, caution about bilateralism appears to have been thrown to the wind in recent years.

So, too, have geopolitical considerations fallen out of fashion. Some cling to a naïve belief that the existing international order will endure. Evidence points, however, to a changing global order, with China the ascendant power. While we clearly need beneficial relations with rising China, we need to ask ourselves to what extent we are willing to abet it by granting even less fettered access to our resources and technology.

Canada has a tradition of multilateralism, which relies on credible international institutions to maintain global order and advance human progress. We have always striven for fundamental human rights, rule of law and respect for democracy. Rather than casting these aside at the very time when the global order is shifting, it is as important as ever to align with those who share those enduring interests.

In that light, though some criticize it, our pursuit of progressive free trade deals is absolutely correct and in our interests.

There is another problem underlying all of our efforts to conclude trade deals around the world. Trade accounts for more than 60 per cent of GDP, and one in five Canadian jobs.[17] Yet the pool of Canadian companies that take advantage of new markets is relatively small; 40 per cent don't export at all.[18] The ease of doing business with our immediate neighbour to the south makes companies risk-averse about looking farther afield. While this is especially true of SMEs, even our large corporations have been slow to exploit opportunities in new markets. Where they have, they have naturally pursued low-effort, lucrative partnerships that are understandably in corporate interests rather than national ones. That our legendary Candu nuclear reactors are mostly being built in China for domestic use and re-export to third countries is a good illustration.[19]

Without a change in business culture, negotiating new trade agreements is largely moot for all but the producers of bulk raw materials and those who can take advantage of cheap labour via global supply chains and profitable partnerships.

Can we ever hope to fully realize the opportunities of freer trade around the world without our own industrial strategy? Probably not. Alas, we should admit that China's five-year planning strategies offer an impressive model for that.

As a trading nation, there is no doubt that we need access to other markets. But, in a rapidly changing world, we must also be careful what we wish for.

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Lead image: **HQ Vancouver**

Japan in the New, Unpredictable World of Trade: What's in it for Canada

by **FERRY DE KERCHKHOVE**

From what happened in Vietnam on Nov. 10 at the Trans-Pacific Partnership (TPP) negotiations – maybe because of our own NAFTA issues with the U.S. – Canada may not have fully appreciated how much Japan is a pivotal player in international trade. Few countries have as high a stake as Japan had/has in the TPP, as trade accounts on average for 35 per cent of Japan's GDP.[1] To the extent that numbers matter, although difficult to predict accurately, Japan's recent agreements with 10 Pacific Rim countries and the EU would represent a minimum $100 billion increase in GDP and a revised, Trump-less TPP would add the equivalent of 2.5 per cent of real 2016 GDP.[2] To achieve such a result through the new Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), Japan is prepared to sustain more than a $1 billion output loss in agricultural, fisheries and forestry products.[3]

Japan's relentless pursuit of the CPTPP, if need be to the detriment of bilateral agreements with former TPP associates such as Canada, is based on a clear-eyed view of the agreement's benefits for its economy and a belief that, inevitably, further down the road, the U.S. will rejoin.[4] All this takes place in a region swirling with a multiplicity of trade arrangements, agreements or pacts in the making through negotiations, such as the 16-member Regional Comprehensive Economic Partnership (RCEP) viewed by some as an alternative to the TPP, and which includes China and India.

TPP for Japan

It is no wonder that Prime Minister Shinzo Abe was the first leader to go to Washington to meet Donald Trump even before his inauguration.[5] It was all about TPP and the defence of Japan's exports to the U.S. To Abe, TPP was as much a strategic bulwark against China as it was the ultimate framework to relaunch the Japanese economy. At 40 per cent of the world economy, the 2015 agreement was a huge rule-setting instrument, capable of offsetting both the dramatic 2008 collapse of the western economic model and Chinese initiatives such as the Asian Infrastructure Investment Bank or the Belt and Road initiative. Japan, somewhat oblivious to its own closed markets, saw TPP as opening opportunities overseas for its firms, notably in the automotive sector, thanks in part to changes in rules-of-origin provisions. Even in the agricultural sector, TPP was seen as incentivizing Japanese producers to become more competitive in more open markets.[6]

TPP was an integral part of Abenomics,[7] aimed at sustaining external demand while stimulating domestic demand, as the latter was known to be inextricably weak, leading to continued deflation.[8] Abenomics was predicated on a stimulus package focused on recovery for the earthquake-affected areas, fostering globally competitive SMEs through financial support, innovation and promoting workforce diversity. High technology infrastructure investment underpinned these efforts. Some positive results were obtained in terms of growth although the trade balance eventually returned to negative territory. Having secured his reelection, Abe can push for further agricultural restructuring, energize the health-care industry, liberalize the energy sector and broaden labour market reform. Fiscal consolidation progressed but the ultimate results of structural reforms will definitely depend on a predictable trade and commerce playing field which the new CPTPP is designed to provide. Growth will continue to depend on foreign trade until the reforms stimulate domestic demand.

A tough environment

There is some complacency on the part of non-Asian TPP partners about the security environment facing Japan within its immediate region, U.S. alliance notwithstanding. While there seems to be a lull in tensions between North and South Korea, there remain huge concerns about President Donald Trump's unpredictability between "fire and fury" and "I try so hard to be his friend". Managing its alliance with the U.S. is of critical importance for Japan. It is the only country to have had two North Korean missiles fly over its territory – with Kim Jong-Un threatening to "sink Japan". As much as South Korea and the U.S., Japan needs China's assistance in reining in Kim.[9] China is also Japan's No. 1 trading partner – as all Asian nations are – which creates a fundamental ambiguity in terms of fostering a CPTPP which excludes China while "playing nice" to that country to avoid a backlash on Japanese exports. The Regional Comprehensive Economic Partnership (RCEP), if concluded, might partly offset these concerns. But all Asian countries have had to face some of these choices when it came to the Belt and Road initiative.[10] Yet, despite what Harsh V. Pant calls "Trump's shambolic approach to international affairs"[11], he sees some hopeful signs in the form of a "re-emergence of the idea of a democratic 'quad' focused on the United States, Japan, India, and Australia … The reason is simple: there is growing nervousness in the regional power centers in the Indo-Pacific about China's emergence as a major global power … So the Quad is back.[12] It may still not work the way many would like it to. But the signals from the Indo-Pacific are that regional states are willing to work together to manage the externalities of China's rise and America's incompetence."

Two elephants in the room and a bull in the U.S. shop

The U.S.:
As today's U.S. tends to look at Japan from a strictly trade perspective, it fails to appreciate the significance of the changes Abe has made. As Sheila Smith argues, "Japan's choices in a changing Asia will define the region's future and will have tremendous impact on U.S. policy in Asia."[13] This fact underpins the complexity of their trading relationship.[14] As Tobias Harris puts it, "the United States and Japan want fundamentally different things from their trade relationship." With the U.S. leaving the TPP, the Trump administration initially

appeared to want to pursue a bilateral free trade agreement with Japan. However, Commerce Secretary Wilbur Ross indicated it was premature after having called it a high priority.[16] The Pence/Aso meeting in April 2017 led to a more modest statement, referring to the pursuit of discussing "a bilateral framework for setting high trade and investment standards; perspectives on trade and investment initiatives of the United States and Japan in the regional and global trading environment."[17] The bottom line for the U.S. is reducing the trade imbalance; an FTA with Japan on U.S. terms would entail harder rules-of-origin provisions than the TPP framework. Indeed, as Tobias adds, a U.S. FTA in the present circumstances "is a backward step for an Abe government determined to play a leadership role in Asia and the global economy – especially if the Trump administration were to demand concessions that went beyond the already historic concessions Japan offered to the United States in TPP negotiations." This uncertainty and the concerns associated with an unpredictable U.S. administration strengthen Japan's commitment to CPTPP as opposed to engaging in bilateral trade arrangements.

China:
Beyond Japan's delicate dancing around on the Belt and Road initiative, there is the interconnection between its highly sensitive political relationship with China and a powerful trade relationship. Japan is China's fourth largest trading partner after the EU, the U.S. and ASEAN.[18] China is taking advantage of the U.S. policy vacuum to exercise pressure on Japan (and South Korea) to join its initiatives. As Chinese Premier Li Keqiang argued: "China and Japan should work together to safeguard economic globalization, speed up the negotiations on the Regional Comprehensive Economic Partnership (RCEP) and free trade area talks between China, Japan, and the Republic of Korea, so as to contribute to the stability and prosperity of the region and the world."[19] It is clear that both parties understand that the prosperity of the whole Asia-Pacific region depends on the peaceful management of their differences. But China gains more of the upper hand whenever the U.S. – through ineptitude or deliberate policy – withdraws further from its leadership role. In a way, the North Korean missile crisis forces the U.S. back into the fray, only to realize that the best cards are in China's hand, spurring more defensive nationalism in the Japanese psyche.

The bull:
Trump is playing a dangerous anti-multilateral game as other trade blocs strengthen or expand their links. Naturally breast-fed on a European unity ideal, French President Emmanuel Macron's pro-Europe campaign rests in large part on the defence of the multilateral order and international rules-based trade. The rekindling of the faith in U.S.-less plurilateral trade agreements stems from the need to find alternatives to earlier objectives when the EU and Japan "for years had their eyes on separate trade agreements involving the United States — for Japan, the 12-nation Trans-Pacific Partnership (TPP), and for the EU, the Transatlantic Trade and Investment Partnership (TTIP). The prospect of deepened trade integration with the United States served both economic and geostrategic rationales."[20] While negotiations between Japan and the EU (its second largest trade partner) have been ongoing since 2013, a broad agreement was pointedly announced a day before the Hamburg July 2017 G20 summit, lowering barriers on virtually all the goods traded between them.[21] Brattberg and Schoff conclude: "In so doing, they are also sending a clear message to Washington: get on board or risk getting left behind … The EU has also recently struck other trade deals in Asia with South Korea, Singapore, and Vietnam and is currently considering launching negotiations with Canberra on a bilateral EU-Australian FTA. This flurry of activity puts Brussels, not Washington, in the driver seat of global trade."[22] Importantly, in this day of Brexit and obtuse nationalism, as Anthony Fensom puts it, "The Japan-European Union (EU) trade pact has sent a powerful message to the rest of the world, amid concerns over growing protectionism."[23]

The Canadian dimension

In light of what is at stake in these multi-country, multi-billion dollar, multiple trade agreements, arrangements or concluding processes, as many commentators have underscored, Canada should be under no illusion that the prime minister's opting out of a son-of-TPP signing ceremony on the creation of the CPTPP provoked a very negative reaction on the part of key players.[24] It is seldom that Japanese at the highest levels openly express their displeasure. The Australians had no qualm about stating how they felt. It is important to remember that Canada is the second largest economy in the U.S.-less TPP after Japan, the next country in line being South Korea. Some expressed an exaggerated concern that in response to Canada's withdrawal, "countries currently working with Japan on the TPP will seek out other trade partnerships in the region and look to China for leadership."[25] But there is no question that the Canadian walk-out sent shock waves through the system and that Canada has a long way to go to re-establish fully its relationship with its Asian and other partners. This was followed by the prime minister coming out pretty empty-handed from China, after hopes for the launching of a trade agreement negotiation collapsed on the altar of Canada's legitimate push for the protection of labour and gender rights. But that should have been cleared before the trip for, as John Manley put it, "Prime ministers usually don't go on trips like that without something to announce."[26] The withdrawal from the TPP meeting is all the stranger because all this takes place in the context of ongoing work towards the finalization of the Japan-EU Economic Partnership Agreement (JEEPA), which is very much along the lines of the Canada-EU CETA model. For Japan it was a very serious rebuff "as the country seeks to solidify a trade and investment regime for the region that would serve as a touchstone for other future deals".[27]

While the TPP, renamed the Comprehensive and Progressive Agreement for Trans-Pacific Partnership – allegedly to please Prime Minister Justin Trudeau – was salvaged after long negotiations, questions remain as to Trudeau's motivations, which are critical in terms of Canada's next steps. The Business Council of Canada had clearly indicated its view to the government, quoting the deputy chief economist of Global Affairs Canada to the effect that "the TPP 11 could be more beneficial to Canada than the original agreement."[28] The rationale was based on the preferential access to Japan, the world's third largest economy, and other TPP markets, while the United States remained frozen out.[29]

The reason Trudeau put forward was: "I wasn't going to be rushed into a deal that was not yet in the best interest of Canadians. That is what I've been saying at least for a week, and I've been saying it around TPP12 for years now and that position continues to hold."[30]

Various reasons were attributed to Trudeau's sudden change of heart, such as concerns over automotive imports and cultural issues, and Canada's desire to appear a tough negotiator amid new talks with the United States over NAFTA.[31] But none of the specific trade issues were deal killers, a point made by Japanese interlocutors. Indeed, the Japanese negotiators were all the more upset because the Canadian trade minister had told them the day before that Canada was in, but also that the issues worrying Canada on labour, culture and gender were easily manageable (culture was one of the limited set of provisions which will be suspended). Some referred to a possible hidden agenda, such as wishing to avoid annoying the American president or even a snub because of Japan's continuing refusal to renew bilateral trade negotiations with Canada, a $25 billion merchandise trade relationship.[32]

Looking to the future

Obviously, Canada should make all necessary efforts to ensure that the bad feelings are rapidly erased and that it fully engages in the finalization and subsequent implementation of the CPTPP agreement which "maintains the high standards, overall balance, and integrity of the TPP while ensuring the commercial and other interests of all participants". While Canada is totally consumed with the NAFTA renegotiations, it will be able to benefit early on from the CPTPP which includes "all of the tariff reductions and goods market access outcomes originally offered by this group."[33] While not as impressive as the TPP including the U.S., the CPTPP offers real advantages to Canadian exporters and as the second largest economy, Canada should be in the co-driver seat with Japan the sooner they kiss and make up.

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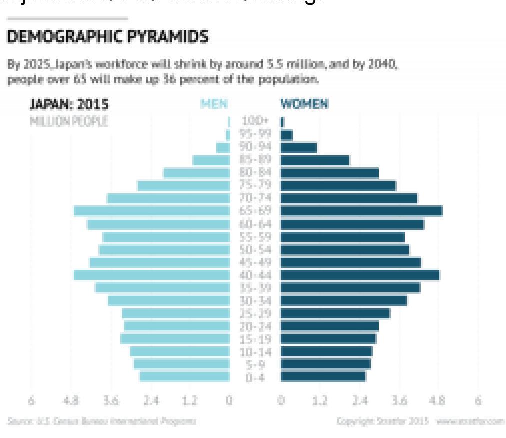

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Lead image: **CTV News**

Trudeau Must Make Haste on Trade with India

by **COLIN ROBERTSON**

Prime Minister Justin Trudeau's visit to India this week will reinforce and underline our growing people-to-people ties. The economic relationship is less buoyant, but if Indian Prime Minister Narenda Modi can deliver on his promised domestic reforms, there is the potential for more two-way trade and investment.

With stops in Agra, Amritsar, Ahmedabad, Mumbai, as well as New Delhi, it will be a rare session that does not include some reference to family living or studying in Canada.

The Indian diaspora includes several members in the Canadian Parliament, with four members in the Trudeau cabinet. Nearly 4 per cent of Canadians claim Indian decent, with 40,000 Indians migrating to Canada last year. The 124,000 Indians studying in Canada are our second-largest group of foreign students. No surprise that tourism is also on the rise, with more than 210,000 Indians visiting Canada last year. There are daily and non-stop flights.[1]

India definitely deserves Canadian attention.

India will soon surpass China in population, with one-sixth of humanity. It is also the world's largest democracy, which is a cacophony of caste and creeds. The two Prime Ministers will empathize over the challenges of managing federations with strong sectional and regional pressures. Some of these, such as the Sikh separatist movement, play into Canadian affairs.[2]

At the World Economic Forum in Davos last month, Mr. Modi was forceful in his embrace of globalization.[3] He described his "New India"[4] reform agenda and its pillars of structural reform: technological governance; physical infrastructure; business facilitation; and inclusive development. Designed to give "good administration and better amenities," Canada needs to identify the niche opportunities within each pillar.[5]

Trade and investment will figure in every discussion. Investment from Canadian pension funds in real estate and other sectors has picked up in the past couple of years.[6]

With its steady GDP growth, India is expected to become the third-largest consumer market by 2025.

But Canada and India are still some distance from long-promised deals on foreign investment and closer economic relations.

The foreign-investment protection agreement negotiated by the Paul Martin and Stephen Harper governments that was concluded in 2007 has yet to be implemented.[7] Free-trade negotiations began in 2010.[8] The six-month "road map" to its achievement, that Mr. Harper and Mr. Modi enthused about during the Indian Prime Minister's Canadian visit in April, 2015, has yet to materialize.[9]

Much of the problem lies, as the World Bank consistently reports, with India's trade restrictiveness.[10] Mr. Modi talks a good show on reform and, while he is making some progress, the structural impediments are deep and entrenched.

There is also, notwithstanding Mr. Modi's declaration in Davos, Indian protectionism.

The imposition late last year of a 50-per-cent import tariff on peas and a 30-per-cent tariff on chickpeas and lentils should be high on Mr. Trudeau's discussions with Mr. Modi. Agricultural sales to India are a major market, especially for Prairie farmers.

Mr. Trudeau will likely get a receptive hearing on climate and the progressive trade agenda that can be parleyed into useful initiatives.

Mr. Modi will raise Indo-Pacific security and likely ask about Canadian capacity and capabilities. Indian policy under Mr. Modi has shifted from "Look East" to "Act East." His "Neighbourhood First" policy is roughly analogous to the Trudeau government's new "Strong, Secure, Engaged" defence policy. At last month's Association of Southeast Asian Nations forum, there were discussions about the "congagement" – containment and engagement – of China.[11] Mr. Trudeau should listen to Mr. Modi's perspective.

With the Trans-Pacific Partnership now a reality and likely to be implemented later this year, our trade in the Pacific will only increase. It will oblige more attention and commitment to Indo-Pacific security.

The tempo of Indo-Pacific activity by our Esquimalt-based warships has picked up. HMCS Chicoutimi, one of our Victoria-class submarines, is completing a nearly six month successful Pacific exercise that also took it to Japan.[12] If we want to be seen as a serious Indo-Pacific partner, the current tempo will be seen as the bare minimum.

Mr. Trudeau's India visit is his longest yet to a single country. The Indian backdrop will provide a spectacular picturesque travelogue against a celebration of family ties. But real success will also require serious and continuing conversations on trade and security.

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Lead image: **The Associated Press**

The Pacific Alliance is a Trade Deal that Canada Must Not Ignore

by **COLIN ROBERTSON**

Among the spaghetti bowl of trade deals currently on the Canadian menu, associate membership in the Pacific Alliance should be an easy choice.

The government and House of Commons International Trade Committee are currently holding consultations. Here is what they should consider:

The Alliance members – Chile, Colombia, Mexico and Peru – are business-minded. They embrace the rules-based, democratic order. Their economic well-being affects the economic health of Canadian companies, especially in resources, infrastructure and finance.

The "Pacific pumas" have more than 221 million consumers. Their combined GDP is equivalent to the world's sixth-largest economy. Canadian investment in the alliance is estimated at $50-billion.[1]

The alliance's goal is to achieve free movement of goods, services, capital and people. The members are integrating their stock markets, and are even sharing embassies in certain countries.

Canada already has free-trade agreements with individual alliance members, so some ask why we should become an associate member.

The first answer is that we must take our opportunities when they come.

We would have first-mover advantage within the best trade agreement in the Americas, just as we will have with trans-Pacific countries through the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), and trans-Atlantic through the Comprehensive Economic and Trade Agreement (CETA). That means a bigger payoff as we establish a customer base ahead of the opposition. The cumulative rules of origin would weave the individual free-trade agreements (FTAs) with alliance nations into a seamless web. That would mean improved competitiveness of Canadian products.

Second, the Pacific Alliance is consolidating itself as a platform for economic integration within the Americas.

Canada would become a leader within the Pacific Alliance by virtue of being the biggest economy in the most liberalized caucus of trade nations in the world.

While the alliance is mostly about trade, it is also about building deeper co-operation through regulatory integration and addressing emerging issues such as the digital economy. What better place to advance the progressive trade-agenda goals in gender, labour, environment and small and medium-sized enterprises, than in this group of progressive democracies. And we have already begun. Last year, the Canada-Chile FTA was revised to include gender rights.

Third, stronger links with the alliance would give us better place and standing in the Americas. History and migration have given us strong links across the Atlantic and the Pacific. Our ties south of the Rio Grande, by comparison, are less so.

The Pacific Alliance commitment to transparency and anti-corruption within Latin America is the better model than its protectionist counterpart, Mercosur – Argentina, Brazil, Paraguay, Uruguay – and a contrast to the periodic illiberal governance in places like Venezuela. Canadian participation in the alliance would reinforce its attraction to the rest of the Americas.

But there are potential challenges to membership. For example, the alliance's mobility provisions – free movement among the member states – might not work for Canada.

One option could be to negotiate trusted-traveller programs for business. Our guest-worker program with Mexico could serve as a model. Operating for more than 40 years, it now brings more than 22,000 seasonal workers to Canada annually.[2]

The provinces must be active partners in considering the Pacific Alliance, just as they have been in the negotiations of the CETA, CPTPP and the talks to renegotiate the North American free-trade agreement (NAFTA). Trade is increasingly less about tariffs at the border and more about standards and regulations in areas of provincial or shared responsibilities.

Trade liberalization acts as a catalyst to domestic economic restructuring. Most are winners, but there are also losers. We have developed institutions between the levels of government to find and implement solutions, including adjustment assistance and retraining. We must continue and refine this.

Against a backdrop of "America First" protectionism and no foreseeable conclusion to the zombified Doha round of talks at the World Trade Organization, we need alternative markets. Middle power groupings, such as the Pacific Alliance, pick up the slack and help sustain the rules-based trading order.

Other key Pacific partners – Australia, New Zealand, Singapore and South Korea – are actively considering associate membership. It is always better to be a driver setting the course in the front seat, rather than a late passenger along for the ride. Canada should move now on associate membership in the Pacific Alliance.

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Lead image: **Reuters**

Africa: Shaping the "Canadian Way" on the Continent

by **ANDREW CADDELL**

At a roundtable in the fall of 2013 the deputy minister responsible for development at Global Affairs Canada facetiously expressed his sympathies when I described my responsibilities for trade in 25 countries in West and Central Africa. When asked why, he replied, "Well, promoting Canadian trade in Africa must be a pretty tough job. There can't be much going on."

Given that the deputy minister had a reputation as a strong player in government, his remarks were surprising. His perceptions were ill-conceived. In reality there were $800 million of pending contracts between Canada and West and Central Africa at the time – involving mining, pipeline projects and the sale of aircraft. He was astonished to learn that Global Affairs Canada's officers in the region were working at full capacity.

At another meeting a few months later on Africa's economic challenges, development officials were discussing their work in sustainable farming, advocating for tools to be sent to Africans farming small rural plots of land. Only a few weeks before, a major African multinational agrifood business had approached Global Affairs Canada seeking Canadian advice on how to deal with spoilage of fruit and vegetables in transportation and storage – a major factor in food supply in Africa.

Canada, with its vast distances and efficient food supply system, was seen as an excellent source of expertise to deal with the issue of spoilage, a challenge in the African climate. While the development advocates around the table sat in silence, the representatives of major banks and investment groups joined in enthusiastically to talk about their own experiences with investment and trade in the "new" Africa.

Both these anecdotes illustrate the dichotomy of the Canadian view of Africa –

there are those in positions of authority who presume the continent is the same as it was decades ago, and that policy prescriptions should not change. This is not reflective of 21st century Africa. Canada must combine trade strategies with development programs or we will be left behind.

For Canada, the conundrum lies in deciding which Africa our government wants to cultivate – the emerging Africa of free enterprise or the dependent Africa, relying on development funds to sustain its economy. Of the $5.4 billion offered in Canadian official development assistance in 2017, about half went to Africa – $400 million to a range of southern Sahara countries; $190 million to Ethiopia; about $130 million each to Mali, Tanzania and Ghana; Nigeria received $105 million.

Could we be investing that money more effectively? While there remain substantial challenges to development in Africa, including governance, infrastructure, training, education and conflict, there are several positive indicators that should lead Canada to join in the growing international interest in the continent's economy.

According to a 2016 report from McKinsey Consulting, the three key advantages Africa offers are substantial – a young population, compared with the trend to aging in much of Asia and Europe; the move towards greater urbanization, where the levels of productivity are far higher than in the countryside; and the rapid adaptation of technology, from the workplace to the proliferation of smartphones.

Population: In 2034, Africa is expected to have the world's largest working-age population – 1.1 billion – with the growth in employment pegged at over 3.5 per cent per year.

Urbanization: Growth in the cities will contribute to growth in consumption by households and businesses. According to McKinsey, household consumption grew at a 4.2 per cent compound annual rate between 2010 and 2015 – faster than the continent's GDP growth rate – to reach $1.3 trillion in 2015. They project Africa's consumers will spend $2 trillion by 2025.

Technological change: East Africa is already a global leader in mobile payments. Smartphone penetration is expected to hit at least the 50 per cent mark in 2020 from only two per cent in 2010.

As Africa grows, there will be a demand for more effective infrastructure. Spending on bridges, roads, ports, pipelines and airports is already growing at a rate of 3.5 per cent per year. Canada is well-placed to take advantage of these changes; our expertise in building bridges, roads and ports is recognized globally. In aerospace, Bombardier has established maintenance hubs in Morocco and South Africa; its Q400 has proved popular, as there are many trips between cities in Africa of 600 nautical miles (1,100 km) or less. The market for turboprops in Africa is expected to be 550 aircraft between 2017 and 2036.

Pipeline companies have fought for a foothold in the region as well, as demand for energy within the continent increases. Canadian engineering, construction and mining companies have a long history in Africa, and should see growth as demand increases.

Not surprisingly, notably in extractive industries, the government of Alberta has been a model in its trade relations with Africa. This year, there will be four Alberta trade missions to Africa – the Egypt petroleum show in February, an agricultural mission in May, a June delegation to the African Energy Forum and a September oil and gas mission to targeted countries.

Shane Jaffer, senior director for Africa at the Alberta International Development Office in Calgary, listed the areas he emphasizes: engineering, financial services, training, technology, renewable energy and infrastructure. He says his office likes to work closely with African partners on the ground: "I was surprised so many people sitting across at the table have been trained in

Canada or by Canadians. Last year, in Angola, there were over 400 alumni from SAIT (Southern Alberta Institute of Technology in Calgary) at an event to discuss Canadian oil and gas expertise."

Across Africa, SAIT and its Edmonton equivalent, NAIT, have thousands of graduates, many of whom have trained at "gateway programs" based in Mozambique and Equatorial Guinea before coming to Alberta. Jaffer notes that those links provide credibility for Canada: "When I have an educational institution in the room there is a level of trust and they help to break down the barriers with the people there."

This is one of the interesting byproducts of being a country small in population but rich in expertise. Canadian companies who go to Africa have had to rely on training local talent, rather than shipping in expatriates, as China has done recently. What is known as the "Canadian way" in Africa – of training and promoting Africans – grew completely out of necessity, but has engendered a great deal of goodwill for the Maple Leaf.

The Trudeau government has promoted alternative energy companies as the answer to the dependence on petroleum-based energy sources. This strategy may prove timely in an Africa leaping from one stage of technological development to another. When I was in rural Africa in 1997 with the UN, I noted the lack of telephone or electrical wires. Today, the move to a wireless society has huge advantages – rather than spending on large infrastructure projects for overhead wiring, communities can go directly to cellphones, solar and wind electricity.

Canada has dozens of trade and development officers in Africa. Working together, they could focus on combining development objectives with trade tools in Africa to emphasize our inherent skills – trade expertise, good governance, investment and education.

Trade expertise: Africa is hamstrung by protectionist policies among its 54 countries. At a 2016 World Economic Forum meeting in Rwanda, it was revealed that trade among African nations accounted for just 11 per cent of total transactions, compared with Asia where regional trade accounted for 40 per cent and Europe, where it was 70 per cent. As a world leader in open trade, Canada could be showing the way for the freer flow of goods and services within the African Union. Working with the leadership in those countries, our trade experts could point to the huge economic advantages and growth we have experienced from free trade in NAFTA, Europe and soon with Asia.

Good governance: Canada should be able to call on experts from both our government and our own African diaspora, which has increased significantly with immigration. This new "Team Canada" could encourage reforms in governance, discourage corruption and promote women's involvement in politics and government.

Investment: We need to open up more sources of investment in Africa in the resource and extractive industries. Currently, billions of Canadian dollars are invested in mining in Africa. The TSX is the world's largest source of financing for mining; it could partner more effectively with Canadian resource companies and pension funds to free up more investment.

Given Canada's experience in alternative energy, the government should be encouraging Canadian investment in solar, wind and geothermal power in African communities, as well as using our skills in communications technology to expand wireless networks across the continent. There are clearly opportunities for Canada's banks and financial services in these sectors.

Education: Following the Alberta example, more Canadian technical schools could open gateway campuses to assist in training technical students, as well as encouraging a greater presence of African students in Canadian universities. There should be an increase in African immigration, and better contacts with the African diaspora in Canada to encourage trade.

All of these initiatives lead to the strengths for which Africa recognizes Canada, and they rely on the expertise and knowledge of both the private and public sectors.

Global Affairs Canada is currently in the process of developing a new trade and development strategy for Africa. While it has not yet been made public, there are some indications as to what it may contain.

On the Global Affairs Canada Development website, there is a focus on the feminist international assistance policy, which offers to encourage the status of women and girls in governance, education and the economy. It adds, “In line with the international assistance policy, Canada will build innovation into its international assistance, (offering) new solutions to development challenges.”

Encouragingly, a November 2017 working paper for GAC says: “There are opportunities to better link trade and development strategies, both in areas of current strength (e.g., agriculture and agri-food) and especially from a forward-looking perspective with regards to high-tech, high-value added and ‘sunrise sectors’ (e.g., clean technologies), in a …‘win-win-win’ for development impact, Canada’s international priorities and future trade and investment diversification.”

If Canadians want to be truly innovative, we have to put aside the separation of development and trade in Africa. If the new direction and thirst for innovation is any indication, Global Affairs Canada is at last recognizing the two are not mutually exclusive.

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Lead image: **Force Ten Design**

A NAFTA-EU Economic Agreement: A Crazy but Ultimately Smart Idea

by **ROBERT HAGE**

In 1948, in the midst of negotiating the North Atlantic Treaty, then-External Affairs minister Lester Pearson and his deputy minister, Escott Reid, had a crazy idea. While NATO was to be a military and defence alliance in response to "an aggressive, subversive Communist juggernaut on the move", the two diplomats had an additional thought. What if NATO could be more than collective security? What if the organization could go beyond defence and work to strengthen its members' "free institutions", bring about a better understanding of the principles underlying them and encourage "economic collaboration" by any or all of NATO's members?

Even Canada's negotiator, ambassador Hume Wrong, was lukewarm to the idea. However, Pearson and Reid prevailed and these objectives became Article 2 of the treaty, known as "the Canadian Article".

Despite the best efforts of Canada, Britain and the United States, a lack of consensus within NATO on Article 2's application kept it from reaching the intended goal. In fact, Europe embarked on its own economic path three years later by initiating the European Coal and Steel Community, the genesis of today's European Union.

The idea of North Atlantic political and economic co-operation remains, however. In fact, the North Atlantic community might well need Article 2's thesis more than ever as it faces yet another communist regime, one that is arguably more invidious and ambitious than the USSR – China.

British professor and author Niall Ferguson has noted the paradox: since the 1990s, he says, the principal beneficiary of the West's liberal international order has been "a communist, one-party state". China now has the world's second largest economy and will likely take over first place from the United States before 2030.

An old expression holds that the only two organizations in the world with a long-term vision are the Catholic Church and the Communist Party. China certainly has a world vision for the future which it has made abundantly clear. President Xi Jinping, whom the Chinese media call "the Supreme Leader", told last October's Communist Party's National Congress that the Chinese model has opened "a new trail for other developing countries to achieve modernization".

"It offers a new option," he went on, "for other countries and nations who want to speed up their development while preserving their independence; and it offers Chinese wisdom and a Chinese approach to solving the problems facing mankind … Socialism with Chinese characteristics is flying high and proud for all to see."

The *Globe and Mail*'s China correspondent, Nathan Vanderklippe, described the "Chinese model" as "authoritarian capitalism as an alternative to the Western democracy it is seeking to undermine".[1] China is putting its words into action with the creation of its Belt and Road Initiative, sometimes called China's New Silk Road, which will provide billions of dollars of infrastructure to more than 60 countries. The objective, according to *The Economist*,[2] is to create a China-centred Eurasian trade as a rival to transatlantic trade focused on the United States. China has even announced plans for a Polar Silk Road using Canada's Northwest Passage.

In his first speech to the United Nations General Assembly in 2015, Xi underlined that China was the first country to put its signature on the UN Charter in 1945. "We will continue to uphold the international order and system," he said, "underpinned by the purposes and principles of the UN Charter."

He failed to refer to the important role China played in the drafting of the UN's Universal Declaration of Human Rights which began the following year. The UN's human rights director and Canadian legal scholar John Humphrey provided its blueprint. In December 1948 the General Assembly adopted the Declaration's 30 articles which include: recognition of liberty and security of the person and the right to be recognized before the law, freedom from torture, freedom from arbitrary arrest or detention, public trials, and the right to freedom of thought, occupation and religion. Of the Declaration's 30 articles, China is in violation of 25 of them.

The Economist[3] put it well in saying China is in a new global battle to guide, buy or coerce political influence. In contrast to the Soviet Union during the Cold War, China is a sought-after trading partner investing huge sums around the world in trade, investment and infrastructure. It is using this acquired influence to "muzzle criticism, of its political system, human rights abuses and expansive territorial claims". All of these are examples of China's "sharp" as opposed to "soft power".

Xi proclaimed that China has a vision of "guiding international society towards a more just and rational world order". Perhaps it is time for Western democracies, which established the post-world war international order, to set out their own vision for the future. It's time for the North Atlantic community to harness the idea of political and economic co-operation envisaged by Article 2 of the North Atlantic Treaty, but in a modern, not Cold War, context.

Perhaps this is another "crazy idea". Trump times do not augur well for economic agreements. NAFTA itself is in jeopardy and the Transatlantic Trade and Investment Partnership (TIIP), launched by former president Barack Obama with the EU, is likely as dead as U.S. participation in the

Trans-Pacific Partnership. But visions have to start somewhere, sometime. Ferguson noted that Donald Trump was the only presidential candidate who saw that anti-democratic China was able to benefit more from the West-created international order than the United States.

A NAFTA and EU economic agreement makes economic as well as political sense. Together, these two groups make up the largest economic area in the world with half of its GDP. North Atlantic trade, including that within NAFTA and the EU, makes up 37 per cent of global merchandise flows and a higher per cent in services trade.

Writing in the January 2014 issue of *Foreign Affairs* on NAFTA's 20th anniversary, former United States trade representative Carla Hills concluded her analysis of NAFTA's success with a section entitled "Beyond NAFTA" in which she made the case for a transatlantic trade agreement.[4] She noted that Canada was just concluding its broad-based economic agreement with the EU (CETA) and Mexico's FTA was being updated.

If the U.S. were to agree to NAFTA-EU economic negotiations she said, it would mean entrepreneurs on both sides of the Atlantic would avoid having to deal with three sets of agreements with different rules of origin and different customs measures with increased regulatory costs. Hills makes the vital point that a single agreement between NAFTA and the EU "would bring badly needed regulatory coherence to more than half of the world's trading volume".

University of Ottawa business and public policy professor Patrick Leblond sees such an agreement as increasing the efficiency of transatlantic economic exchanges and boosting the global competitiveness of European and North American firms. He maintains that it could help set the trade and investment rules for the world, particularly China.[5]

In the same *Foreign Affairs* issue, former Canadian trade minister and Washington ambassador Michael Wilson said that, after two decades of NAFTA, "North American economic integration" has stalled.[6] He cited "the deep-seated skepticism of free trade among average Americans, which US policymakers have never been able to overcome" as the reason.

There is no question leadership on both sides of the Atlantic is required to make a NAFTA-EU economic agreement possible. It will take leaders, particularly in Washington, who are prepared to build on the years of shared values, interests and security that Europe and North America have together enjoyed. They will see they cannot leave China alone with its own worldwide agenda and that, by engaging democratic states on both sides of the Atlantic to create the world's largest trading block, they will enhance the future wellbeing of all their citizens.

Armand de Mestral, McGill University Chair in the Law of International Economic Integration, identifies the country that could well be the greatest advocate for what he calls "the Atlantic Free Trade Area (AFTA) – Great Britain".[7] By advocating and achieving transatlantic free trade, the British could have their Brexit cake and eat it, too. Now, that's a smart idea!

ROBERT HAGE *is a Fellow at the Canadian Global Affairs Institute, was a Canadian diplomat with the Department of Global Affairs for 38 years and served as Canada's Ambassador to Hungary and Slovenia, as Director General for Europe and Director General for Legal Affairs. He also served in Canada's embassies in Washington, Lagos and Paris, as Deputy Head of the Canadian Mission to the European Union in Brussels and, in early 2012, acting Head of Mission at the Canadian Embassy in Riyadh, Saudi Arabia.*

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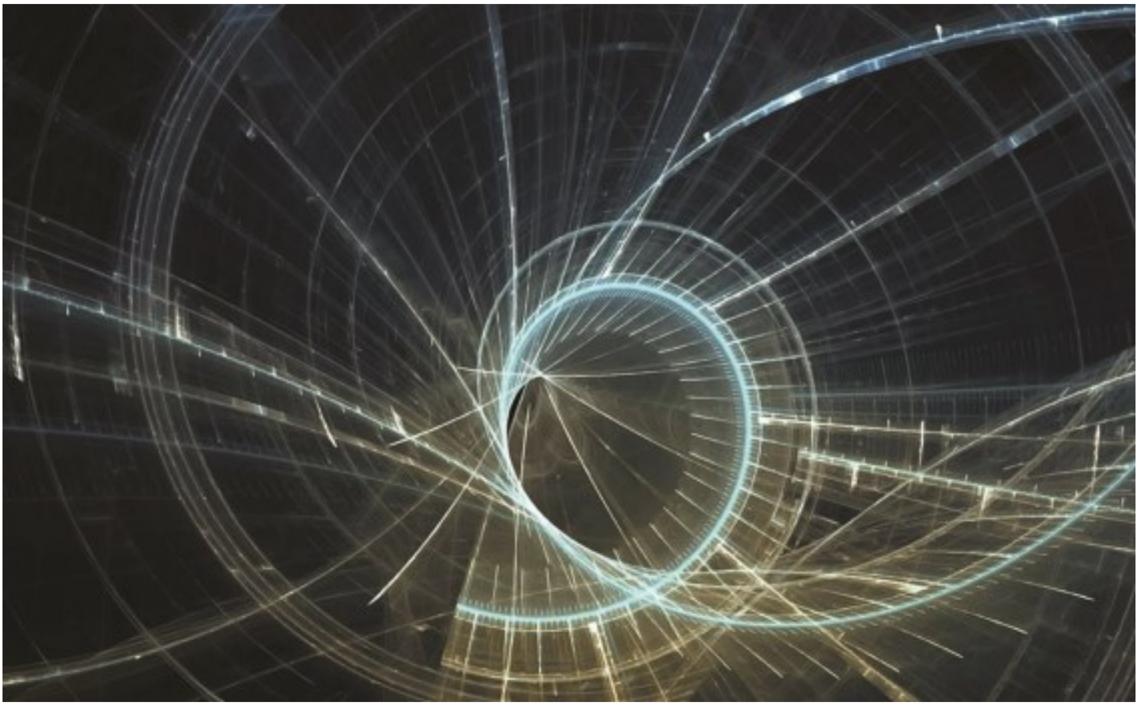
Lead image: **CBC**



Quantum Diplomacy for a New Technological Age

by **RANDOLPH MANK**

What do alleged Russian meddling in the U.S. presidential election, the recent spate of global cyber-attacks, increased use of cruise missiles and drones, advances in nano-technology, the commercialization of quantum computers, and rapid developments in robotics and artificial intelligence (A.I.) all have in common? They point to a rapidly changing technological landscape with broad and disruptive policy implications, not least in the spheres of security and diplomacy.

The scientific discoveries around the strange realities of quantum mechanics date back a full century.[1] Those discoveries, about the counter-intuitive behaviour of atoms and their sub-particles, have already yielded enormous technological advances, leading to today's computers, smartphones, the internet, medical imaging, and an array of other remarkable and welcome inventions.

Yet the same scientific discoveries have had profound consequences for war and peace, as well. The early promise of an atomic solution to the age-old search for clean energy, yielded quickly to the horrifying realities of nuclear weaponry during the Second World War. This in turn led to a postwar flurry of international diplomacy to control its proliferation, with the Comprehensive Nuclear Test Ban Treaty, the Nuclear Non-Proliferation Treaty, the International Atomic Energy Agency and a host of other Cold War agreements and mechanisms. Today, in the ongoing threat from North Korea, it is clear that the need to control the proliferation of this technology remains as current as ever.

If that was the first phase of the Quantum Age, and if the by now familiar Information Technology revolution -- including computers and the internet -- were its second act, we are now undoubtedly on the threshold of a new and equally portentous phase. With the pace of change exponential, not linear, the demands to control its more lethal aspects will be upon us sooner than we think.[2]

Though much has been made of the disruptive social and economic consequences of this new phase, relatively little discussion has been devoted to the challenges for global security and diplomacy.

Standing at this tipping point, it is timely to ask: what will be required of a new quantum diplomacy,[3] and what should we be looking at now in preparation?

The Unfolding Quantum Age

With technological changes underway in almost every sector, it is clear that today's world will look substantially different a decade from now and beyond. As they should, governments mostly support this change and actively encourage it, eager for the economic benefits that will accrue from innovation.

The mapping of the human genome, at first expected to take decades, unfolded much faster than initially predicted and now points the way to significant future improvements in medicine. Similarly, refinements and cost efficiencies in solar and other renewables are also advancing more rapidly than expected and offer hope for a very different energy future with important environmental benefits.

Lest we forget how fast technology can change the world, it was less than twenty years ago that Canadian company, Research in Motion, now BlackBerry, played a pioneering role in smartphone development. In the short period of time since then, the impacts of mobile computing have been as profound as the commercial changes in the industry itself.

Technological change is about to speed up even more dramatically. Quantum science is on the verge of delivering qubit-powered computing, exponentially faster than anything we have ever seen. It is claimed that an already existing quantum computer is 100 million times faster than a conventional one.[4]

Far from being science fiction, the first quantum computers have already been developed and sold by the Canadian company D-Wave. It promotes its latest model as a 2000 qubit model, (though there remains technical debate over whether it is truly quantum).[5] NASA, Google and defense giant Lockheed Martin have been among the early customers.

If predictions of author and inventor Ray Kurzweil are correct – and he has been remarkably prescient so far – in the next 10-25 years, we will be approaching what he calls a technological 'singularity', no less than the merging of human and machine-based intelligence.[6]

Though hotly debated, we are already headed down this path, with A.I. finding its way into more and more everyday products. While warning against the existential dangers of fusing artificial intelligence and biology – as Stephen Hawking has also done – Elon Musk has founded Neuralink, a new startup aimed at achieving just this. The firm will strive to develop a 'neural lace' connecting the human brain and A.I.[7] Musk's reasoning is that humans need to find a way to keep up with and control A.I.-capable machines.

In Canada, the University of Toronto recently announced its new Vector Institute to advance research and development in A.I.[8] Already well established are the Perimeter Institute and the Institute for Quantum Computing at the University of Waterloo. The list of others around the world involved in the race to develop this technology is growing fast. Large corporations like Amazon, Google, Microsoft and IBM are already rapidly amassing most of recorded human knowledge in massive cloud data storage centers and moving ahead on A.I. as well.

These repositories of what's known as Big Data, using the vehicle of the internet, will become the neural centres of the interconnected national and global systems, whose secure functioning will become vital to our future. They could also become our Achilles' heel.

The Risks

On the one hand, we should avoid Cassandra-like fears and welcome these new technologies. After all, technological solutions to environmental degradation, climate change, poverty, and health care will be crucial to our future.

Yet, we should also admit to the risks. Those actors who both understand and know how to capitalize on new technologies are relatively few. More than governments, a comparatively small number of entrepreneurs are shaping our future, and doing so without any prescribed direction or accountability for the socio-economic and political ramifications. The move to develop autonomous vehicles, for example, has been instigated by the private not the public sector, despite profound socio-economic consequences.

The future of employment is already a subject of widespread concern, as increased automation is affecting traditional occupations. In the past decade alone, we have witnessed disruptions in whole industries, with both winners and losers in such areas as communications, finance, travel, transportation, and entertainment, to name a few. While debate continues about whether or not sufficient new replacement jobs will be created, guaranteed basic income is a policy response already under discussion and even trial.[9]

Cyber security threats are also already causing regular disruptions and eliciting policy responses. Beyond current technological capabilities, however, quantum computers combined with A.I. will be much more potent. Together with advanced algorithms, massive quantum computing power will be able to crack even the most advanced security codes in use today.

The so-called 'Internet of Things' – where sensors embedded in everyday items will all be connected and controlled through the internet – is being built in earnest. It is already connecting infrastructure, banking, security systems, and much else to the internet. Relying on even the best security encryption available today, it is dangerously exposed to risk. Those risks could be potentially catastrophic in the future.[10]

So, too, the internet itself, and its vast network of servers around the world, could be vulnerable. Having emerged from the oversight of the U.S. Department of Commerce just this year, the internet is now governed under an opaque and amorphous international multi-stakeholder conclave, convened several times a year by the International Corporation for Assigned Names and Numbers (ICANN) based in Los Angeles. It fiercely defends the freedom and openness of the internet, while lacking both direct accountability to any higher entity, or any national or international protector.[11]

Meanwhile, the development of advanced robotics and miniaturization through nano-technology, which has already revolutionized everything from assembly lines to heavy industries, is proceeding toward its own rapid merger with advanced A.I. Japan, with its declining birthrates and shrinking workforce, has been working on humanoid robots for decades, and consumer versions are now becoming available.[12] IBM's famous "Watson" has shown that computers equipped with A.I. and using 'deep learning' can rival and even defeat the most skilled humans at our own complex games, including most famously chess and Jeopardy. Google's 'Deep Mind' has done the same in the game of Go.

It would be naive to hope that these benign consumer and industrial applications of robotics, combined with still early A.I., will not find their way into more sophisticated and lethal military applications. Autonomous drones are already a frequently used weapon of aerial surveillance and warfare. Through its Defense Advanced Research Projects Agency, DARPA, the U.S. Defense Department also has other weapons systems under development that draw on advanced technologies. One company, Boston Dynamics, has recently unveiled surprisingly agile robots capable of backflips and other highly athletic movements.[13] It's reasonable to assume that America's strategic competitors are on the same path.

And this is where we reach a tipping point that merits well-considered policy responses to questions we should be posing and debating today. The marriage of these technologies will be an exponential force multiplier that will lead to a whole new level of risk in relatively short order.

The Foreign Policy Vacuum

While technological progress has been breathtaking, the intellectual energy devoted to debating its policy implications, outside of science labs and technology gatherings, has been anything but.

In the international relations field, noble attempts to generate discussion on quantum diplomacy have been few and far between.[14] Discourse among a few dozen academics is a start, but the issues need to be mainstreamed in national policy debates. Government officials, caught up in the controversies and crises of the day, are normally reluctant to look too far ahead. In the United Nations, the G7/G20, NATO, and elsewhere, well established but largely undervalued cyber-security working groups continue to play policy catch up to technological change.

Fortunately, history shows at least one case in which scientists have so far been able to regulate themselves. In 1975, microbiologists established the so-called 'Asilomar guidelines', named after the site of a biotechnology conference that year in Monterey, California. They agreed that, for reasons of global safety, deliberate containment measures should be built into any experiments on, and development of, recombinant DNA for genetic manipulation.[15]

Ironically, it's also the computer science community itself that sounded the alarm on A.I. in 2015, writing an open letter calling for international controls.[16] The United Nations responded under the Convention on Certain Conventional Weapons (CCW) and convened a so-called experts group on Lethal Autonomous Weapons Systems (LAWS) the same year.[17]

More recently, G7 finance ministers flagged the importance of cyber security in their May 2017 statement issued in Italy. G7 leaders also included references to the problem in their communiqué a few weeks later. Such declarations are important, but they are narrow in focus and ring hollow without follow up actions.

As for international law, the Budapest Convention on Cybercrime came into force in 2004 and is the main, though quite limited, vehicle for global co-operation in this field. The focus among the 52 parties to the agreement is on preventing crimes such as the dissemination of hate material and copyright infringement, as well as on co-ordinating laws and their enforcement.[18]

Given the Budapest Convention's limited aims, the international community clearly needs a more ambitious legal regime aimed at preventing the hostile use of advanced cyber, robotic, and A.I. technologies. Reviving the so far unsuccessful attempts to generate a new cyber security treaty would be a natural place to start.[19] Though necessary, it will be far from sufficient. Cyber security is indeed a real threat but other threats will flow from the proliferation of the full array of new technologies. Given that the technological trend line is irreversible and that, unchecked, its use in future warfare is as utterly predictable as it would be devastating, there is merit in championing an international campaign that extends beyond the discussions thus far.[20]

Should Canada succeed in its bid to obtain a two-year rotating seat on the United Nations' Security Council in 2021, pursuing such an agreement could be a worthy though challenging initiative during its tenure.[21]

After all, Canada's 2017 defence policy review acknowledged the importance of cyber and new technology threats.[22] It would take a great deal of time and effort, but Canada's prominence in quantum computing and A.I., along with lessons learned from the mixed success of the 1999 Anti-Personnel Mine Ban Convention, might further bolster the credibility of such an initiative.

Parameters of Quantum Diplomacy

How can we meaningfully define the parameters of foreign policy debate on such new and unpredictable technology? We should begin by addressing a list of very practical questions that arise already, which suggest areas for follow up. A good starting point would be to consider the following:

First, on security, looking at two, five and 10 year timelines:

What are the main foreseeable threats from new technologies?

- National threat assessments should be reviewed to consider threats from remote controlled, highly intelligent and lethal weapons, including to critical infrastructure systems.

What systems will be required to defend against these threats?

- Post-quantum cryptography assessment projects should be initiated.
- National preparedness and business resumption plans should be reviewed.

What weapons systems will be outmoded/ required?

- Major, multi-year weapons procurement plans with 10-20 year time frames should be reviewed (fighter jets, naval vessels etc) and challenged for their effectiveness against new technologies.

How can we defend against quantum attacks by non-state actors?

- Assessments, plans, and controls should be developed and co-ordinated with NATO allies and globally.

How can quantum technology be turned to security advantage?

- The role of quantum technology should be assessed in both encryption and intelligence gathering.

Second, on diplomacy:

Can A.I. become a tool for modernizing the practice of diplomacy?

- New diplomacy tools should be developed for the age of Big Data, the Internet of Things, and A.I.

- New technology should be applied to the movement of people, especially travel and migration documents and tracking.

What changes to the international legal regime and institutions are needed to safeguard global security?

- An A.I., nano-technology, robotics, and quantum computing treaty should be proposed to counter both weaponization and proliferation.

- An international oversight body for monitoring and control should be considered.

- Quantum computing and A.I. export controls should be incorporated into trade agreements.

What positive opportunities do quantum technology and A.I. present?

- Explore the use of new technologies for preventive diplomacy, peacekeeping, and international development.

Such questions show how complex and entangled the challenges and opportunities will be. The point is to tackle the issues now and develop policy as the technology unfolds, rather than *ex post facto* when it may be too late.

Conclusions

Though technological advance should be embraced for its many potential benefits, the coming marriage of robotics, nano-tech, A.I. and quantum computing also presents a set of foreign policy challenges that we will need to face in the coming decades. The challenges are likely to be at least as fundamentally disruptive as those that emerged from the early decades of the Quantum Age, if not more so.

Arms races drawing on the new technologies may well affect international relations. And, as always, malevolent non-state actors will attempt – and unfortunately on occasion succeed – in using new technology to threaten national and international security. We should heed the warnings of several prominent thought leaders about the existential threats to humanity that unregulated A.I. itself poses.

Though no one can predict the future, we know enough already to begin to engage in practical assessments and debates about appropriate policy responses. Future foreign and defence policy reviews, as well as international deliberations, will need to address these coming challenges with ever increasing urgency.

While reaping the benefits of technological advancement, not to look squarely as well at its pitfalls is to put at potential risk nothing less than the security of our nations and the international system upon whose stability we depend.

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End Notes

1 A good overview of the evolution of quantum science: Frank Close, *The Infinity Puzzle*, Alfred & Knopf, 2011.
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3 For the history of the term Quantum Diplomacy see: https://www.diplomacy.edu/blog/quantum-diplomacy-ideas-other-side-looking-glass
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Lead image: **Advexon**

Following the Funding in Strong, Secure, Engaged

by **DAVID PERRY**

On June 7, 2017, Minister of National Defence Harjit Sajjan unveiled Canada's new defence policy, *Strong, Secure, Engaged*. On the day of the policy's release, and since, the Trudeau government has espoused the policy's unprecedented degree of underlying financial rigour and the 20-year funding model that underpins it. The claim of a long-term, well-costed defence policy, though, is not original. Canada's last defence policy prior to this Liberal government, the 2008 *Canada First Defence Strategy,* had stated that "with this funding framework, National Defence will be able for the first time to plan for the future on the basis of stable and predictable funding."[1] As it happened, that policy's funding proved neither predictable nor stable. *Strong, Secure, Engaged* uses both of those descriptors for its budget plan, while adding that the funding is furthermore "realistic",[2] as it is "transparent, rigorously costed and fully funded."[3] As with any defence policy, the budget supporting this one is fundamental to determining whether the Department of National Defence (DND)/ Canadian Armed Forces (CAF) will actually be able to do what the policy says it should, or not. With *Strong, Secure, Engaged*, the Trudeau government has gone a step further by explicitly staking the policy's credibility on the assertion that this policy, unlike many that have preceded it, has gotten the funding right.

It remains to be seen if this is so and if the funding endures over time. As Parliament resumes after the 2017 Christmas break, it is already evident that spending the money made available will be the real short-term financial problem associated with the policy. While *Strong, Secure, Engaged* was predicated on relatively small annual increases in overall spending in its first few years, it called for a dramatic and immediate increase in capital spending. In the first fiscal year of the policy, DND is on track to deliver barely better than half of the intended spending on new equipment and infrastructure.

The Budget Rule Changes

In addition to a funding increase, detailed below, Canada's new defence policy is predicated on a number of changes to the structure of the defence budget and rules around its use. These changes are important in their own right and if history is any guide, the new rules may last longer than the funding increase itself.

Strong, Secure, Engaged is underpinned by a 20-year funding commitment with a fully accrual-based capital budget for new capital purchases and separate source of funding for in-service support costs. The shift to a full accrual budget is a beneficial improvement over the more complicated funding system it replaces that featured two separate capital budgets governed by different rules (one accrual, the other, modified-cash). The older system also had two different possible sources of funds for in-service support costs. The old budget construct required that a funding source had to be identified and agreed upon for each new project's acquisition costs and then in-service support. Further, having part of the capital budget operate under cash-based rules that precluded spreading capital project costs over a long period of time limited DND's ability to fund costly projects. The new budget construct is simplified and provides one source of funds for all capital projects and a different, single source of funding for in-service support for new projects. The new policy relies on the accrual space as the sole funding source for capital projects which permits the costs of every new capital project to be spread out over time.

Similarly, the policy provides another significant benefit by locking in DND's yearly budget escalator at an annual rate of increase of three per cent, and dedicating a third of that increase to fund the in-service support of new projects. Previously, that annual defence budget boost had been set to expire a decade from now; now, it has been made permanent. Dedicating one per cent of the three per cent escalator to fund in-service support costs is important because in the past, these aspects of owning and operating new equipment had sometimes gone un- or underfunded. Finally, the policy is unique in being underpinned by a top-to-bottom full life cycle re-costing of all defence projects, supported by outside auditing agencies. This has improved both the costing of the policy's new initiatives and also resulted in a re-baselining of existing project costs. This puts the policy on a more secure financial footing than previous policies which generally were less rigorously costed and paid less attention to the costs of older projects rather than new initiatives. In combination with the commitment to full life cycle costing, this should place the CAF on a more stable budgetary footing.

The Funding Increase

On top of these rule changes, *Strong, Secure, Engaged* provides a modest annual budget increase, which over the life of the 20-year policy injects an additional $48.9 billion in funding on an accrual basis and facilitates an additional $62.3 billion in cash terms. Crucially, the bulk of this funding increase is allocated towards new capital purchases. Prior to the defence policy review, addressing a significant capital funding gap was arguably the most critical imperative of the Trudeau government's review of defence policy. On an accrual basis, the new policy provides $33.8 billion in new capital money over the policy's 20-year lifespan to fund 52 projects which previously had no funding at all. This includes the "Key 18", a batch of the most important projects DND has identified as critical to Canada's defence, which were unfunded prior to the review, as well as a number of others. In addition, over that same 20-year period, the policy has reallocated within the pre-existing funding envelope an additional $5.9 billion (on an accrual basis) to bolster the budgets of a number of projects which did not have enough money assigned previously. The two biggest changes saw the budget for the Canadian Surface Combatant increase from $26.2 billion to between $56 billion and $60 billion, with the Future Fighter Capability Project's budget rising from $9 billion to between $15 billion to $19 billion.

If *Strong, Secure, Engaged* is implemented as outlined, it will see a complete paradigm shift in the amount of annual spending on capital. In inflation-adjusted dollars, the policy would see annual spending on capital (both infrastructure and equipment) quadruple over the next seven years on a cash basis. In the last decade, capital spending peaked at $4.3 billion (in 2017/2018 dollars) annually in 2010/2011, and since then the annual rate of spending has progressively declined. In 2016/2017, the last year for which final year-end spending data are available, DND spent just $3.1 billion on capital. The plan outlined in the new policy would see that spending jump dramatically to more than $6 billion in 2017/2018, increase to $12 billion annually by 2023. *(See Figure 1)*

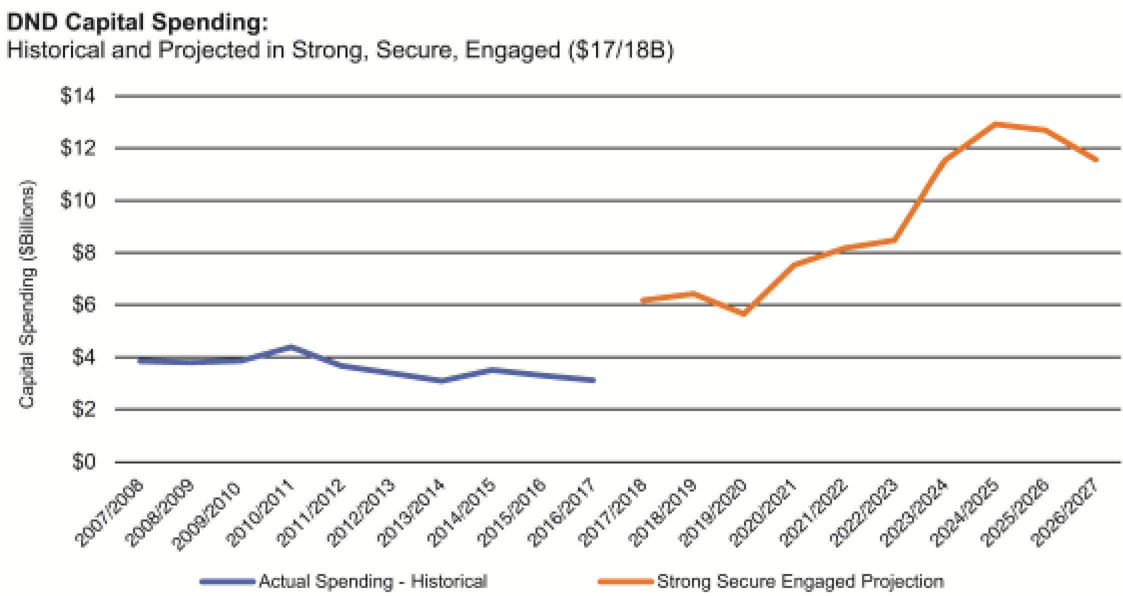

Figure 1.

As a percentage of annual expenditures, the new policy would see the share of defence spending allocated to capital rise massively, from 12 per cent to 15 per cent over the last several years, to 30 per cent immediately, and a whopping 43 per cent of all defence spending in just seven years. In historical comparison, the last time as large a share of Canadian defence expenditures were devoted towards kit and infrastructure as *Strong, Secure, Engaged* envisions will happen, was during the Korean War.[9] *(See Figure 2)* Canada has historically set targets for how much of its defence spending show be allocated to capital, most of which set targets of between 30 and 20 percent, with the latter being the target set out in the Canada First Defence Strategy. This massive increase to these expenditures would see spending on major equipment specifically well surpass the lesser known of NATO's spending targets. The lion's share of discussion about NATO burden sharing focuses on the alliance's commitment to see defence spending reach two per cent of GDP, but a second, arguably more important, commitment is for allies to spend 20 per cent of their defence budgets on new equipment and research and development. Canada's new defence policy would see spending on equipment rise to 32 per cent of defence spending by 2024/2025.[10] In contrast, over the last five years, actual Canadian spending by the NATO measure (which is what the alliance measures, not planned or projected spending) has ranged between eight and 13 per cent.[11] If implemented as written, the Trudeau defence policy and associated spending profiles will lead to a hugely significant, positive shift in Canadian defence spending that will see a paradigm shift in the share of defence expenditures devoted to capital. It would facilitate what defence economist John Treddenick termed a "high recapitalization"[12] of the Canadian military. Notably, however, this same plan would see spending fall below the 20 per cent target again after 2031, when the major surge in capital spending is slated to stop.

Spending by Component:
Historical and *Strong, Secure, Engaged*

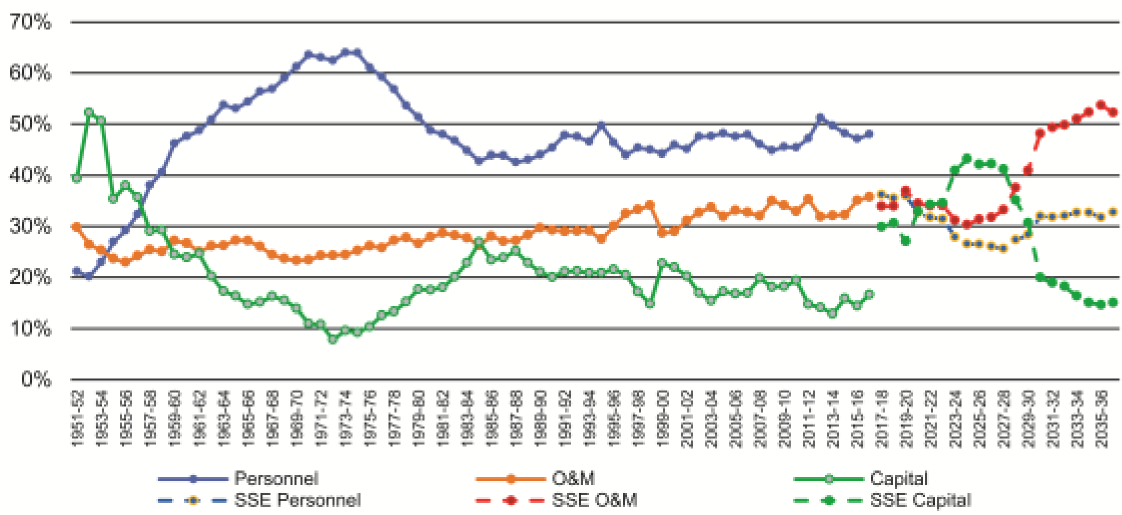

Figure 2.

Burden Sharing

As the new policy also outlines, the net impact of these budget changes would push defence spending (measured on a basis consistent with Canada's historical method of reporting) to 1.2 per cent of GDP by 2024/2025. Under the new method of calculating Canada's share of GDP spent on defence (as reported to NATO) a number of items are now associated with defence spending which previously were not. As a result of this change to Canada's reporting structure, the share of spending will rise to 1.4 per cent of GDP by 2024/2025 – assuming that DND actually spends as much money annually as *Strong, Secure, Engaged* envisions (a matter discussed below) and the economic projections underlying the policy hold true.[13] Spending on other defence-related departments for such items as payments to veterans, employee pensions and benefits, the budget for the Communication Security Establishment, information technology support provided to DND by Shared Services Canada, and Coast Guard ice breaking in support of naval operations will now be included in Canada's calculations for NATO.

Even in lieu of the new policy, Canada will fall well short of NATO's two per cent of GDP target, and the policy indicates that Canada will not produce a plan to commit to meeting that two per cent target over the next 20 years. However, the new policy would see an end to the progressive decline in the share of Canadian wealth devoted to defence spending and the share of GDP devoted to defence will actually increase by over 20 per cent if the policy's spending plan unfolds as intended. By returning spending to 1.2 per cent of GDP (according to the historical accounting method) this will restore it to the same share of the economy it occupied between 1999 and 2006. This was the period immediately after Canada's post-Cold

War budget cuts, but before the Martin and Harper governments increased the defence budget meaningfully.[14] In other words, the policy would see the share of GDP devoted to defence rise from a post-Cold War low point but only return to where it was at the end of the Decade of Budget Darkness.[15] *(See Figure 3)*

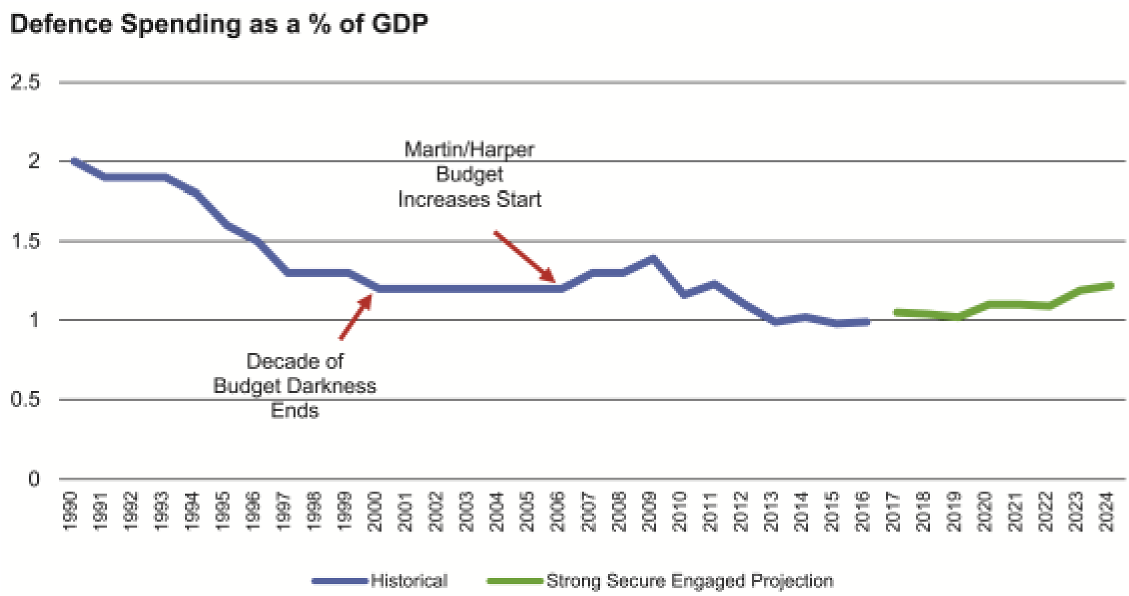

Figure 3.

Interestingly, the Trudeau government – which took great pains to argue in public that the share of GDP devoted to defence was not the metric by which Canada's alliance contributions should be measured[16] – devoted an entire page of its defence policy to outlining precisely how Canada will measure up in that regard as a result of the new policy. Further, the same government had DND's finance officials devote their scarce time and resources to investigating how Canada's allies calculate the share of their GDP that they report to NATO as being spent on defence and then revising Canada's formula for doing so. On both counts, this provides evidence that however imperfect a measure the share of national wealth devoted to defence is as an indicator of alliance burden sharing, the Trudeau government considered it important to communicate how Canada measures up in this respect. The favourable reception the policy received in Brussels and Washington would similarly seem to indicate that Canada's allies are content with the new policy, even though it means that Canada is not meeting its agreed upon 2 percent of GDP spending commitment, and has no plans to do so in the future.

Fiscal Transparency

The full-page discussion on Canada's defence spending as a percentage of GDP is only one among several examples of fiscal transparency throughout *Strong, Secure, Engaged*. The government should be commended for publishing 20-year spending projections on both an accrual and a cash basis. The *Canada First Defence Strategy* did the former, but not the latter, making any attempt at judging the previous government's progress on their policy's spending plans impossible with public documents. A comparison of the two policies on an accrual basis shows that in its first decade, *Strong, Secure, Engaged* is actually based on a less ambitious defence budget than the one that originally underpinned the *Canada First Defence Strategy*. *(See Figure 4)* By publishing a cash spending forecast, the Trudeau government has laid out a crystal-clear spending plan against which their – and any future government's – track record on defence can be compared.[17] This will become even easier to do if the government follows through on the promise in the new policy to publish the defence investment plan in 2018.

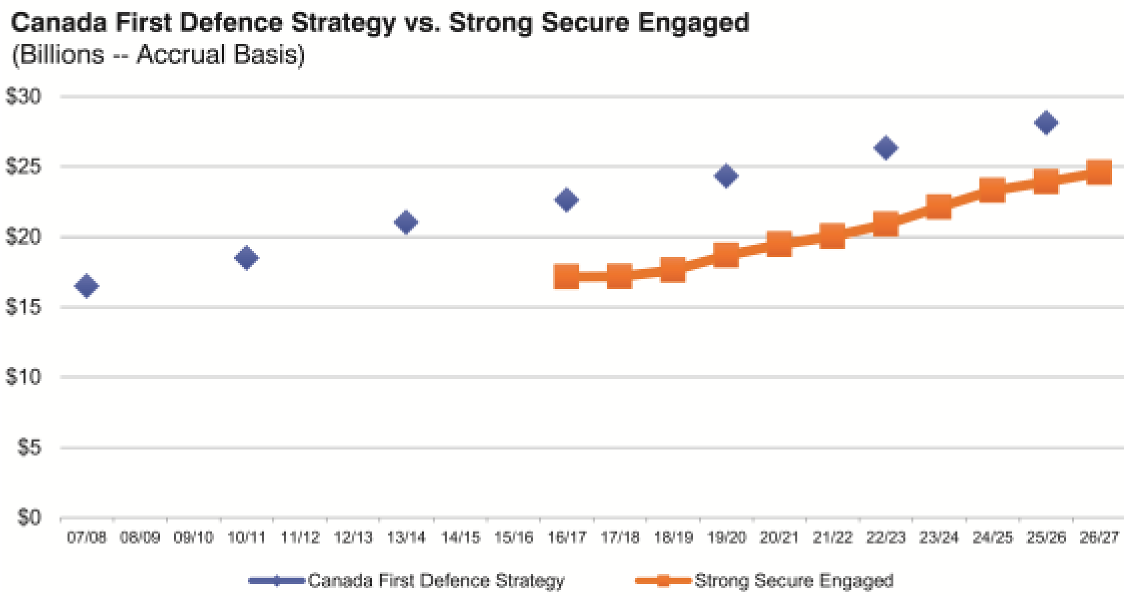

Figure 4.

Another commendable aspect of the document's fiscal transparency is the extensive discussion of the two accounting methods (cash and accrual) DND employs. This discussion helps illustrate the budgeting benefit afforded to DND by accrual accounting and simultaneously helps explain how what is presented as an enormous increase in defence spending was palatable budgetarily to the Department of Finance. Taking the figures presented in the document at face value, cash spending is stated to increase by 70 per cent over the next decade, while the defence budget, in accrual terms, is set to increase by only just over 40 per cent.

Since only the accrual budget affects the government's fiscal position, and not cash spending, the much more gradual increase in DND's accrual budget (roughly in line with projections of nominal Canadian economic growth) helps explain the Department of Finance's comfort with what is otherwise a very dramatic increase in spending (on a cash basis). The other aspect of the plan that would help make it palatable to Finance is that a significant portion of the spending depicted in the policy, and a significant portion of the annual increases, would have happened anyway if the Trudeau government had simply adhered to the defence spending plans it inherited. The policy presents the 70 per cent increase in cash spending that will occur between 2017 and 2027 as an outcome of *Strong, Secure, Engaged* alone. In reality, however, that calculation appears to have been predicated on a hypothetical scenario where defence spending on a cash basis would have, absent *Strong, Secure, Engaged*, somehow remained static over the next decade. Over this period of time, though, under previous plans, DND's three per cent escalator on its own would have added a little over $6 billion in additional annual defence spending by the end of that decade. Any increases to pay and compensation costs for Defence personnel (another prior built-in budget planning assumption) would have also driven nominal spending higher, by hundreds of millions a year more.[19] Although in any given year defence spending fluctuates as a result of initiatives' sunsetting and changes to the capital program, it is difficult to see how the extraordinarily pessimistic projection against which *Strong, Secure, Engaged's* 70 per cent increase was based, could have ever come to pass. This arguably augurs well for the fiscal sustainability of the new policy, because its budgetary impacts are much less significant than the document's presentation would suggest. Again, the policy contains meaningful new spending, but significantly less of it is truly a result of *Strong, Secure, Engaged* than is suggested.

Implementing Strong Secure Engaged

Following the publication of the new policy, significant attention has been focused on whether the funding in the new policy is real, and whether it is fiscally viable, long term. The history of Canadian defence budgeting would indicate that *Strong, Secure, Engaged's* funding will not survive any federal deficit reduction exercise, and is therefore intimately tied into Canada's business cycle, federal revenue projections and the Trudeau government's interest in returning to fiscal balance.[20] The magnitude of the funding increase associated with the new policy alone has been greatly exaggerated, the annual increase in budgetary terms is roughly in line with economic projections, and the share of GDP devoted to defence even at the peak of the policy's spending will be modest. These are reasons for optimism that the funding beneath *Strong, Secure, Engaged* can survive so long as Canada's fiscal fortunes do. The Liberal Party of Canada's 2015 campaign platform committed only to maintain existing defence funding, the policy's release was delayed by months, and the funding for *Strong, Secure, Engaged* was not announced in the 2017 budget. These are all reasons to be skeptical about the Trudeau government's fiscal commitment to its own policy, as this all suggests that the additional funding is not a Liberal priority.

The more immediate point of concern with the new policy's spending plans, however, is whether they can be achieved as outlined. As noted earlier, over the last decade DND has faced significant difficulty in spending its allocation of annual funding, and spending on capital in particular has been declining in recent years. And yet the allocations for capital spending, representing the bulk of the new funding in *Strong, Secure, Engaged*, are projected to double in its first year, and then quadruple, increasing by an order of magnitude in a short time.

The way that this policy was written does not bode well for it being implemented on schedule. A small team of officials, primarily from DND's policy group and the Chief of Force Development, wrote *Strong, Secure, Engaged* under strict provisions of secrecy. The concern for secrecy meant that substantive interaction with other members of the DND, CAF and other government departments that will need to implement the policy, did not occur until after its publication. On its own, separating policy creation from implementation imperils success, and the same is likely to be true with this defence policy.[21] This limited the ability to realistically validate the hundreds of individual project schedules and their spending forecasts that comprise the capital spending plans of *Strong, Secure, Engaged*. This is important, because a project's schedule dictates when DND will actually spend money. If schedules slip, funds are not spent as intended – a dynamic that has occurred repeatedly over the last 10 years. To reiterate, the collective capital spending plans outlined in *Strong, Secure, Engaged* would see a complete paradigm shift in defence capital spending in Canada.

Yet, despite this planned shift in spending, the procurement changes proposed in the policy to realize such a dramatic change are incremental at best and apply to DND alone. The policy lists a number of initiatives to streamline Canada's procurement system:

i) reducing project development and approval timelines by at least 50 percent;

ii) increasing DND's delegated contracting authority to $5 million by 2018;

iii) increasing transparency with defence associations;

iv) providing regular project updates;

v) growing and professionalizing the procurement workforce;

vi) incentivizing Canadian research and development; and

vii) ensuring procurement adheres to environmental standards.[22]

All of these are sound initiatives. However, the sixth and seventh are not likely to improve the speed of procurement delivery in the short term. The others, while helpful, are unlikely to create a paradigm shift. The need to grow and professionalize the procurement workforce is real, and has been underway for some time. The number of Full Time Equivalents in the Material Group at DND has increased from 2473 in March 2016 to 2705 by December 2017. Hiring only another 60 additional procurement staff, 50 of which are earmarked for the Material Group is difficult to reconcile with a plan to quadruple spending.[23] The goals of increasing procurement transparency and providing regular updates are laudable, but the results thus far are not encouraging. In May 2016, Judy Foote, then-minister of Public Services and Procurement Canada, promised both annual and quarterly updates on Canada's shipbuilding efforts, but as of Jan. 16, 2018, only one annual report and zero quarterly updates have been published.[24] The increase in DND's contracted authority to $5 million seems wise intuitively, but there are currently no publicly available data to assess the impact of increasing that delegation, and the wording around this initiative leaves both the timeline and likelihood of increasing the delegation to $5 million unclear. Reducing project approval timelines is an even more commendable goal, but the slow introduction of this initiative thus far is limiting its potential benefit. A subset of the possible projects to which it could apply have been selected (those falling under the Minister of National Defence's approval authority), with the intent of demonstrating the approach and then progressively applying it more broadly. Although a cautious approach is understandable, given the possible reputational risk to DND if this initiative is not handled appropriately, achieving the desired 50 per cent reduction in process time will require fulsome implementation of the streamlining as originally intended. Achieving this in a timeframe that will help DND start spending significantly more money quickly, will require that the initiative would need to be accelerated.[25] And finally, none of the first five initiatives is new. The first was launched in 2012, by Vice Admiral Bruce Donaldson, then-vice chief of defence staff, and the second, third, fourth and fifth were launched four years ago at the time of writing as part of the defence procurement strategy. While the procurement changes outlined in *Strong, Secure, Engaged* are all sensible and likely to have some positive impact on procurement, they are unlikely to support the paradigm change required.

Beyond these specifically itemized procurement changes, there are other changes being made at National Defence to the management of the department as a whole that are likely to positively impact procurement as well. The role of some of the key governance boards at DND, particularly the Defence Executive Committee and the Programme Management Board, are being adapted to give them a more hands on role in the policy's implementation. In addition, the implementation of the policy is being underpinned by the use of data analytics which will provide senior decision makers with more data about this policy's implementation than was available for the implementation of past policies. These changes are recent, precluding any definitive assessment of their impact. In the seven months since the release of the policy, though, the department has moved forward to enact several of the 111 specifically enumerated initiatives, most of them personnel related, indicate the merits of these changes.

But the progress on these initiatives, while important, is not reflective of the timely implementation of the policy overall. The first fiscal year of *Strong, Secure, Engaged* is already providing evidence that the policy's spending plans will not be achieved as outlined unless significant changes are made. Although overall defence spending is on track to meet the target outlined in the policy, the intended distribution of that spending is not. DND's cash allocation through Supplementary Estimates B 2017/2018 suggests that unless DND's final period of supply for 2017/2018 differs radically from all those that preceded it over the last decade, DND will fall well short of spending $6 billion on capital this fiscal year as intended by *Strong, Secure, Engaged*.[26]

As of Supplementary Estimates B, DND has only been allocated $3.8 billion for capital.[27] Going back to 2007, DND has never received more than $55 million in additional capital allocations in Supplementary Estimates C.[28] In fact, in all but two years since 2007 DND has actually had capital funding withdrawn from its allocation in Supplementary Estimates C –an average of $100 million. While past spending patterns do not dictate current spending, unless a decade-long pattern of defence spending is broken, DND will not be allocated more money for capital than the $3.8 billion allocated as of Supplementary Estimates B.

How much of its allocation DND is likely to spend, is another matter. Here, too, unless this fiscal year breaks a decade-long pattern, the department will likely spend well short of its allocation. Over the last decade, DND has never spent more than 86 per cent of the capital funds allocated to the department at Supplementary Estimates B by the end of the fiscal year.[29] Over the last decade, it has spent an average of only 78 per cent of the Vote 5 allocation as of Supplementary Estimates B and as little as 69 per cent. This suggests that unless DND's spending this year breaks the pattern, the department is likely to spend at most $3.3 billion purchasing capital equipment and infrastructure, and likely less than that. Thus, DND is on track to fall at least $2 billion short of the capital spending plans outlined in the policy, and more likely, closer to $3 billion below the policy's plan by the end of this fiscal year. *(See Figure 5)*

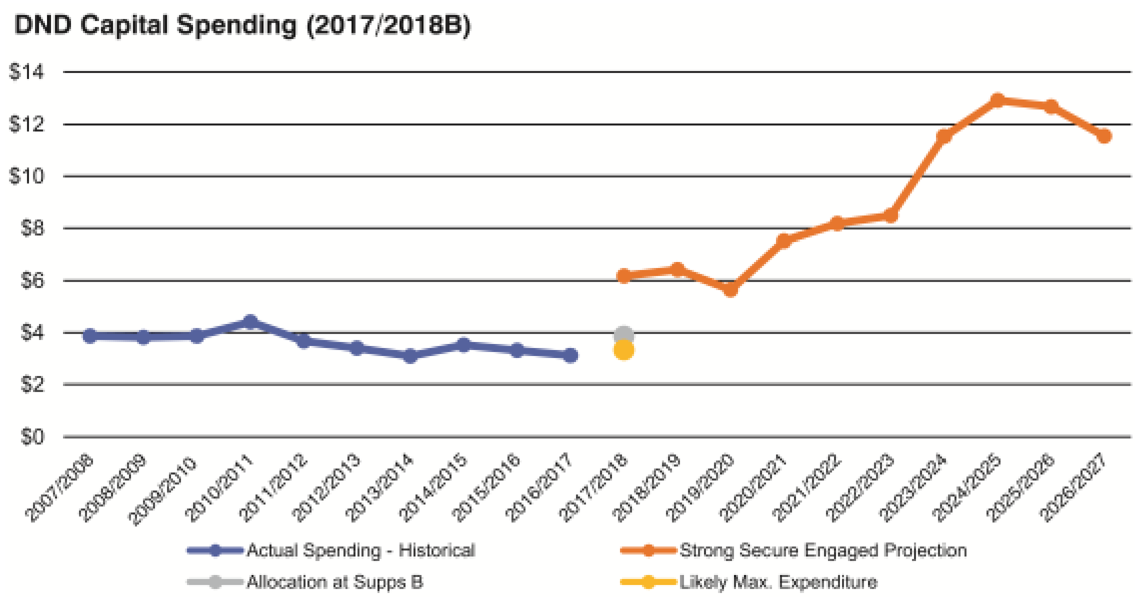

Figure 5.

Although this is only one year's worth of incomplete data and *Strong, Secure, Engaged* was not released until June of 2017, the results are troubling as they call into question the policy's overall realism and its spending plans. This is important for several reasons. First, the spending outlined in the policy is needed to deliver upon the policy commitments that are described. To cite one clear example, the policy states that the Royal Canadian Navy will have "A fleet built around an ability to deploy and sustain two naval task groups, each composed of up to four combatants and a joint support ship." At the time of writing, Canada has no support ships and therefore no ability to deploy or sustain one task group, let alone two, leaving a clear capability gap.[30] Second, while the policy is intended to cover a 20-year timeframe, in reality Canadian defence policies have short shelf lives.[31] The last four all experienced fundamental changes within two years of their launches. There is little reason to think that *Strong, Secure, Engaged* will fare better. Whatever momentum exists behind the policy's implementation can therefore be expected to attenuate when Parliament rises and the federal Treasury Board session ends in the spring of 2019 ahead of the federal election. Support for policy implementation will only atrophy over time, and in 2019 a new government (even if a Liberal one) will be elected with new priorities which may or may not include implementing *Strong, Secure, Engaged*. Third, this defence policy is both a Canadian public policy document and an expression of Canada's contributions to its international defence commitments. This is true of all defence policies, but this one arguably more than most, given its extensive discussion of fiscal burden sharing. The inability thus far to spend capital funding on the intended schedule suggests that Canada is unlikely to devote the share of GDP to defence spending that the policy indicates we will. The bulk of the spending increase depicted in *Strong, Secure, Engaged* is comprised of spending on capital projects. Unless DND quickly starts spending as much money as intended on these projects, Canada will fail to reach the 1.4 per cent of GDP mark outlined in the policy, and may not see the share of GDP devoted to defence (when measured on a consistent basis) increase at all. To the extent that the proposed level of burden sharing the Trudeau government communicated to Canada's allies with *Strong, Secure, Engaged* still matters to the government, this will be problematic.

Conclusion

The intent outlined in *Strong, Secure, Engaged* is sound. The policy would see real investment in much-needed areas, allowing both the retention of capabilities that would have otherwise atrophied for lack of funding and the addition of others needed to deliver the commitments made in the policy. The long-term affordability and viability of the policy's funding is a concern, but less so than the ability to actually spend the money needed to bring the policy vision to fruition. If it can be implemented as outlined, *Strong, Secure, Engaged* would bring about a paradigm shift in capital spending. The early indications are already showing, though, that the incremental improvements outlined to make this happen will at best only incrementally increase Canada's ability to spend defence dollars. For *Strong, Secure, Engaged* to be realized, Canada needs a paradigm shift in our approach to defence procurement which would require some combination of major increases in capacity and competency (both at defence and across government), major changes to the institutional arrangements for procuring capital projects and major changes to procurement processes. Without serious change of this sort, *Strong, Secure, Engaged* will not be implemented as intended.

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End Notes

1 Canada, National Defence, *Canada First Defence Strategy* (Ottawa: 2008), 13.
2 Canada, National Defence, *Strong, Secure, Engaged* (Ottawa: Minister of National Defence, 2017), 43.
3 Ibid.
4 The document also spells out in great detail the way these two accounting systems work for anyone interested in learning about the differences.
5 For capital expenses, cash payments do not count against DND's budget, whereas a capital asset's annual depreciation, does, but only after a capital asset is accepted by the DND/CAF. While the spending forecast presented in *Strong, Secure, Engaged* will see spending on a cash basis increase significantly, because the majority of this intended spending will go

towards capital projects, and not all of those capital assets will be accepted over the next 20 years, the annual increase to the defence budget, in accrual terms, will be relatively modest, and gradual.
6 David Perry, "The New Defence Policy Needs to Focus on Procurement, Not Prose," *Canada Naval Review,* vol. 12:1 (Spring 2016): 16-21; Commodore (ret'd) Eric Lerhe, "Getting the Capital and Personnel Mix Right," in Ann Griffiths and Eric Lerhe (eds.), *Naval Gazing* (Halifax: Centre for Foreign Policy Studies, 2010): 54-95.
7 Government of Canada, National Defence, "Backgrounder: Investments in the Royal Canadian Navy (RCN)," http://dgpaapp.forces.gc.ca/en/canada-defence-policy/news.asp . Accessed Jan. 18, 2018; Daniel Leblanc and Steven Chase, "Ottawa Lays Out $62-billion in New Military Spending over 20 Years," *Globe and Mail*, June 7, 2017. https://www.theglobeandmail.com/news/politics/ottawa-lays-out-62-billion-in-new-military-spending-over-20-years/article35231311/ Due to the expected timelines for the project, the increase to the Canadian Surface Combatant budget is relatively modest in the initial 20-year window, as the start of that build program is still at least five years away, and the acceptance of the first ship would not follow for several years after that.
8 Nominal actual spending data are sourced from Government of Canada, Receiver General of Canada, Public Accounts of Canada (various years) volume II. (Ottawa: Minister of Public Services and Procurement). Spending projections in budget year dollars were provided to the author. Data were deflated using the defence economic model.
9 Historical data are from Government of Canada, Receiver General of Canada, Public Accounts of Canada (various years) volume II. (Ottawa: Minister of Public Services and Procurement) and Craig Stone (ed.) *The Public Management of Defence in Canada*, Appendix 2. (Toronto: Breakout Education Network, 2009). *Strong, Secure, Engaged* Projections were provided to the author.
10 *Strong, Secure, Engaged*, 46.
11 North Atlantic Treaty Organization, "Information on Defence Expenditures (Various Years)," https://www.nato.int/cps/ic/natohq/topics_49198.htm Accessed June 19, 2017.
12 John M. Treddenick, "Distributing the Defence Budget," in Douglas Bland (ed.), *Issues in Defence Management* (Kingston: School of Policy Studies, Queen's University, 1997), 57-82.
13 It is actual spending, not planned or projected spending, that NATO measures over time. Although NATO does report data for years that are not yet completed, denoted with an 'e' to indicate that it is an estimate only.
14 North Atlantic Treaty Organization, "Information on Defence Expenditures (Various Years)," https://www.nato.int/cps/ic/natohq/topics_49198.htm Accessed June 19, 2017.
15 The term Decade of Budget Darkness used here refers to the period of reduced defence spending that started with budget cuts in 1989 and ended a decade later when defence spending started to rise in real terms.
16 Mike Blanchfield, "Trudeau Says Canada One of NATO's 'Strongest Actors' Without Committing More Money," CBC *News*, http://www.cbc.ca/news/politics/justin-trudeau-angela-merkel-germany-1.3987562 , Feb. 17, 2017.
17 It should be noted that the analysis of the Trudeau government's record to date at achieving its spending plans (on a cash basis), discussed below, is only possible because the government was atypically transparent and provided the plan in the first place. A similar analysis could not have been provided on the Canada First Defence Strategy
18 Canada, Department of Finance Canada, *Fall Economic Statement 2017* (Ottawa: Her Majesty the Queen in Right of Canada, 2017).
19 This is especially so given the Trudeau government's support for public sector unions to this point in time. DND employs just under 30,000 public servants and military pay is linked to that of the public service.
20 See comments from Ross Fetterly and Craig Stone at *Un-Packing Strong, Secure Engaged* Oct. 4, and Rob Fonberg, at *Creating a Big Bang*, Oct. 26, Canadian Global Affairs Institute Conferences, Ottawa, ON. http://www.cgai.ca/conferences .
21 Eugene Lang, "The Shelf Life of Defence White Papers," *Policy Options,* June 23, 2017 http://policyoptions.irpp.org/magazines/june-2017/shelf-life-defence-white-papers/ and Jeffrey L. Pressman, Aaron Wildavsky, *Implementation*, 3rd Ed. Berkely, University of California Press, 1984.
22 *Strong, Secure, Engaged*, 75.
23 The more pressing personnel requirements are likely elsewhere in the DND/CAF, given the need to advance newly funded projects from the Identification of Options Analysis phase into Definition, which relies on staff from the CAF project sponsors. Public Services and Procurement Canada is working to double the number of staff working on shipbuilding projects as part of a series of changes announced to the National Shipbuilding Strategy in May 2016.
24 Government of Canada, Public Services and Procurement Canada, "National Shipbuilding Strategy Reports," https://www.tpsgc-pwgsc.gc.ca/app-acq/amd-dp/mer-sea/sncn-nss/rapport-report-eng.html Accessed Jan. 18, 2018.
25 Public Services and Procurement Canada is undertaking a similar initiative which is also proceeding with pilot projects.
26 For an overview of Canada's financial cycle see Parliament of Canada, House of Commons, "Financial Procedures," https://www.ourcommons.ca/About/Compendium/FinancialProcedures/c_d_financialcycle-e.htm , Accessed Jan. 18, 2018.
27 Canada, *Supplementary Estimates (B), 2017–18* (Ottawa: President of the Treasury Board, 2017).
28 Canada, Supplementary Estimates (C), *2007-2008 to 2016-2017* (Ottawa: President of the Treasury Board).
29 Canada, *Supplementary Estimates (B), 2007-2008 to 2016-2017* (Ottawa: President of the Treasury Board) and Government of Canada, Receiver General of Canada, Public Accounts of Canada (*2007-2008 to 2016-2017*), vol. II. (Ottawa: Minister of Public Services and Procurement). Recent changes to facilitate transfers of unused amounts between projects may increase the proportion that is actually spent this year, however.
30 A contract for one interim-auxiliary oiler replenishment vessel is slated to start in the winter of 2018, however.
31 Eugene Lang, "The Shelf Life of Defence White Papers," *Policy Options,* June 23, 2017 http://policyoptions.irpp.org/magazines/june-2017/shelf-life-defence-white-papers/.

Lead image: **Maclean's**

Canada Can't: Our National Infrastructure Challenge

by **KELLY J. OGLE**

Most everyone is familiar with the acronym NIMBY (Not In My Back Yard). However, BANANA is a poignant acronym for "Build Absolutely Nothing Anywhere Near Anyone". It seems that in the recent past this has become the norm rather than the exception.

Today, all jurisdictions face extensive, laborious and clock-robbing consultation processes to build *anything*. For example: it takes five to 10 years to build a new highway in Nova Scotia due to consultations and environmental analysis.[1] A natural gas power plant takes a minimum of three years.[2] Moreover, the process isn't limited to the transportation and hydrocarbon sectors. Take, for example, a wind farm. The applicant must hold municipal consultations, provide wind assessment data and subsequent wind farm design, conduct an environmental study, do land acquisition and permitting and conduct more public consultations – all prior to manufacturing, site preparation and construction. These examples are part of a big and growing problem for Canada: all too often governments (municipal, provincial and federal) obstruct or reject all sorts of development projects. It becomes easier to understand why pipelines are not built anymore.

Importantly, it isn't just pipelines. Canada has an overarching infrastructure problem. In a 2017 report, the Canadian Chamber of Commerce said, "Ten thousand years is how much additional time commuters in Toronto, Montreal and Vancouver spend stuck in traffic every single year as a result of road congestion from key bottlenecks in those cities."[3] This severe congestion affects more than the commuters and residents of those cities. It stifles the entire Canadian economy. According to the Business Council of Canada, our country may need to invest $1 trillion to make the economy run with optimal productivity and efficiency. James McKellar, professor and director of the Brookfield Centre in Real Estate and Infrastructure at York University's Schulich School of Business in Toronto, states that "the inability to get people to the right places at the right times and to move goods and services is a tremendous loss." McKellar adds that the profit that's missed is money that might just as well be burned.

In 2016, the *Financial Post* compiled a list of 35 major resource projects in Canada that were in limbo, representing a staggering $129 billion of investment.[4] Thousands of new Canadian jobs would be created in the trades and spinoff effects, as those workers buy homes, go out for dinner and support businesses in other sectors of the Canadian economy. Also consider the massive tax revenues that governments would receive. TransCanada estimated that over its life the Energy East project would contribute $10 billion in tax revenue.[5] Is infrastructure spending the issue? In the resource sector it may not matter, as the capital required to continue development may not be available. Recent changes to Canadian taxation and regulatory hurdles have stalled the flow of capital, especially in the resource sector. Unfortunately, Canadian resource investment is viewed as fraught with an obstacle course of regulatory uncertainty, political duplicity and public apathy. Investors are afraid that Canada's regulatory and tax environment do not contain enough certainty. Capital is mobile and fungible and obeys the laws of gravity, taking the path of least resistance to where it can make a reasonable return.

Last April the repurposing of TransCanada Corporation's gas mainline seemed a "must do" project that would provide additional North American market diversity and access to tidewater for Canada's enormous oil resource bounty.[6] However, on Oct. 5, 2017 TransCanada announced that it would not be proceeding with its repurposed mainline (the Energy East Pipeline) and Eastern Mainline projects. Some 3,000 kilometres of the 4,600-kilometre proposed Energy East pipeline already exist as a natural gas line stretching from Alberta to the Ontario-Quebec provincial boundary. The remainder would be newly constructed pipeline in Quebec and New Brunswick.

When coupled with weak global oil prices, regulatory and environmental challenges caused TransCanada's board of directors to direct management to allocate future capital expenditures to other projects – such as Keystone XL, existing and future projects in Mexico and other U.S. assets. It is important to note that in its fourth quarter financial statements, TransCanada will take an approximate $1 billion charge against income due to Energy East, the majority being the pursuit of regulatory approval.[7]

From the start the project was plagued by regulatory delay and regional pushback, particularly in Quebec, eventually leading the National Energy Board (NEB) to cancel a scheduled Montreal panel session and hearing to discuss the project's validity. Protesters criticized the NEB's integrity and staged a sit-in at the site of the hearing in August of 2016. After the panel members subsequently resigned,[8] Natural Resources Canada (NRCan) implemented a vigorous modernization of the NEB to "continue to effectively regulate energy in a way that has the confidence of Canadians."[9] The announcement caused then-Saskatchewan premier Brad Wall to call into question his province's role in the federation. He pointed the finger at the federal government, blaming them for regulatory hurdles that frustrated the project's progress. In rebuttal, NRCan's Jim Carr argued that TransCanada made a business decision based on low oil prices.

How did this happen? Was this decision based solely on the project's economic viability? What other factors influenced TransCanada's decision to stop the project? We will never know exactly what was said in the TransCanada board room, but one can surmise that the corporation had had enough. Furthermore, the failure of the Energy East project and the reconstitution of the NEB were the watershed events in a much bigger problem plaguing infrastructure projects in Canada. To be succinct, Canada Can't.

There is no question falling global oil prices undermined TransCanada's business case. However, when the NEB opted to evaluate both the upstream and downstream carbon emissions[10] of the project, one could contend that TransCanada viewed the path to approval as fraught with added delay, risk and cost.

Furthermore, President Donald Trump's revival of the Keystone XL project raised legitimate questions about whether a new east-west pipeline was necessary. A plethora of political, strategic and economic factors were inherent to this debate.[11] First: the ever-fluid and dynamic global oil trade and Canada's place in it, which led to the second: Canada's asymmetric oil relationship with the U.S. and the vagaries and risk of having one client for your product. The safety, economic benefits and relative simplicity of the construction and operation of pipelines and, the export optionality for this largest of Canadian resources are also key factors. In the last year, not a lot has changed regarding any of these issues.

According to the International Energy Agency's (IEA) latest *World Energy Outlook* (released in November 2017), powerful impetus from other sectors will keep oil demand on a rising trajectory to 105 mb/d by 2040. Current global demand is about 95 mb/d. Although much of this increased demand is transportation driven, oil to produce petrochemicals and many other everyday products is the largest source of growth.

Canada supplies four per cent of global liquids to a growing global oil market, and Canadian oil production will continue to grow. This is primarily due to oilsands projects that were sanctioned before the 2014 downturn and are now entering the production phase. For several decades these long-life, low-decline oilsands resources will keep Canada at the forefront of global oil suppliers.[12] Moreover, unconventional liquids production is growing as well. According to the NEB, the Duvernay and Montney formations in Alberta and British Columbia hold marketable resources estimated at 500 trillion cubic feet of natural gas, 20 billion barrels of natural gas liquids and 4.5 billion barrels of oil.[13] For as long as hydrocarbons are in the global energy mix, Canada should be a major player; but will we?

Our asymmetric oil export relationship with the United States has not changed, and it can be argued that it has worsened. A recent leak on the original Keystone pipeline and forecast increases in oilsands production has caused a temporary supply glut in Alberta. Although the world price of crude oil is finding a home in the US$65/barrel (West Texas Intermediate WTI) range, medium and heavy quality crude oil in western Canada (connoted Western Canadian Select or WCS) is nowhere near that. There is a pronounced discount, commonly known as "the differential" between WCS and WTI. The differential is a function of quality; WCS is heavier and sour relative to WTI. After dropping as low as US$10/barrel in mid-2017, the WCS-WTI differential has widened to ~US$28/bbl.[14] Meanwhile, other North American benchmark heavy oil differentials (U.S. imports from Mexico and Venezuela) have tightened, confirming the differential is largely related to current pipeline bottlenecks.

West Texas Intermediate vs. Western Canadian Select Oil Prices
(2009-2017) [$US/bbl]

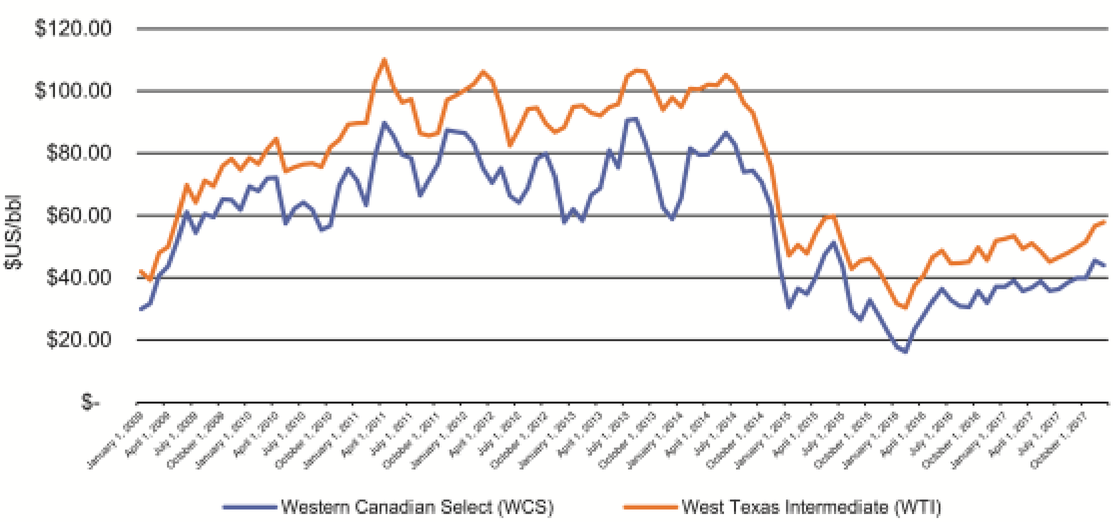

Figure 1: A graph illustrating the price per barrel of West Texas Intermediate oil & Western Canadian Select oil. (Source: Government of Alberta Economic Dashboard)

Keystone XL, Enbridge Line 3,[15] and the Kinder Morgan Trans Mountain line are years from completion. Keystone XL continues to face stiff opposition in Nebraska and the operator, TransCanada, has not committed 100 per cent to the project. Furthermore, an interprovincial political storm and possible constitutional crisis is occurring regarding the Trans Mountain pipeline and the movement and potential dangers of spilt diluted bitumen (dilbit). The NDP government of British Columbia has thrown down the gauntlet indicating a desire that the Trans Mountain pipeline never be built, and stating that it plans to let the courts decide. If the political powers that be allow that to happen, Kinder Morgan is likely to walk, pure and simple.

The Notley NDP government of Alberta has responded in kind, breaking off interprovincial electrical generating discussion regarding the proposed Site C dam and banning the import of BC wine. More importantly, Prime Minister Justin Trudeau has entered the fray, albeit tentatively, citing the importance of getting "our oil resources to markets other than the United States for the Alberta economy, for the Canadian economy to continue to grow." However, he also stated that he was not about to opine on an interprovincial trade dispute. The question one must ask is: who is ultimately in charge here?

In certain circumstances government can provide a catalyst for industry. The construction of the original TransCanada mainline was such a time. In the mid-1950s TransCanada was a fledgling corporation with no assets, simply not big enough to complete a project of that magnitude. In June of 1956 the Liberal government of Louis St. Laurent invoked closure in the House of Commons so that construction of the pipeline could begin. This overt action was led by C.D. Howe, the federal minister of trade and commerce, and caused uproar in the House.[16] For construction to begin by summer 1956, this proposed bill needed to move rapidly through Parliament. The Opposition claimed patronage, secrecy, abuse of power and lack of due process. Nonetheless, the Liberals stifled debate at the committee level, rushed the bill through first and second readings, and used closure to force third reading and approval. Many believe that the imposition of closure contributed to the demise of the St. Laurent government in 1957. For our discussion, one could argue that had the St. Laurent Liberals, led by Howe, not done this, the TransCanada mainline may have never been built, which is an interesting topic for another day.

Mark Twain said history doesn't necessarily repeat itself but sometimes it rhymes. The past few days have forced the polity to question government's role in the development of large infrastructure projects. Kinder Morgan, Enbridge and TransCanada certainly don't need the capital required to build these projects, as TransCanada did in 1956. What they do require is the political will at the national level to ramrod this project through if necessary. In November of 2016 when the prime minister approved the Trans Mountain line, he clearly iterated that the project was "in our national interest" and that it would be built, a statement he repeated at town hall meetings in Edmonton and Nanaimo. We will see in the next few months whether or not politics trumps policy.

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End Notes

1 https://novascotia.ca/tran/highways/hwytwin.pdf
2 http://www.cbc.ca/news/canada/saskatchewan/saskpower-to-run-natural-gas-plant-swift-current-1.3679387
3 https://www.oakvillechamber.com/wp-content/uploads/170719_StuckInTrafficFor10000Years.pdf
4 http://business.financialpost.com/commodities/energy/arrested-development-a-searchable-database-of-billions-worth-of-stalled-blocked-and-cancelled-resource-projects
5 https://ca.reuters.com/article/businessNews/idCABRE9890VZ20130910

6 https://d3n8a8pro7vhmx.cloudfront.net/cdfai/pages/1564/attachments/original/1492446014/Ogle_-_With_the_latest_developments_on_the_North_American_pipeline_landscape__is_Energy_East_necessary.pdf?1492446014

7 As a result of its decision not to proceed with the proposed projects, TransCanada is reviewing its approximate $1.3 billion carrying value, including allowance for funds used during construction (AFUDC) capitalized since inception and expects an estimated $1 billion after-tax non-cash charge will be recorded in the company's fourth quarter results. TransCanada stopped capitalizing AFUDC on the project effective Aug. 23, 2017, as disclosed on Sept. 7, 2017. In light of the project's inability to reach a regulatory decision, no recoveries of costs from third parties are expected.

8 On Aug. 23, 2017, the National Energy Board (NEB) issued its Decision on the List of Issues for the review of TransCanada's proposed Energy East and Eastern Mainline projects. The List of Issues is intended to be an indication of the key items that are relevant to the NEB's review. An important determination in the recent Decision is that the NEB's consideration of the applications will consider all greenhouse gas (GHG) emissions associated with the projects. This includes the direct GHG emissions of the pipelines as well as changes to the amount of oil production resulting from project operations (upstream emissions) and changes to the amount of oil consumption resulting from project operations (downstream emissions). When considering the economic viability of the projects, the NEB will also consider the potential market impacts of GHG reduction targets embedded in laws and policies.

9 https://www.canada.ca/en/services/environment/conservation/assessments/environmental-reviews/national-energy-board-modernization.html#about

10 The NEB opted to evaluate both the upstream and downstream carbon emissions of the project — taking into account not only the emissions footprint of the project itself, but the increase in emissions from harvesting and consuming more oil. And that came *after* the NEB had to start the process over because the members of the first NEB panel were conflicted out after having been lobbied by TransCanada.

11 https://d3n8a8pro7vhmx.cloudfront.net/cdfai/pages/1564/attachments/original/1492446014/Ogle_-_With_the_latest_developments_on_the_North_American_pipeline_landscape__is_Energy_East_necessary.pdf?1492446014

12 The new Suncor Fort Hills and CNRL Horizon Phase 3 oilsands mining projects are ramping up their production into 2018 and should push Canada's total crude oil production near 4.5 MMB/d by the end of 2018 compared with 4.1 MMB/d in 2017. However, future oilsands growth is expected to slow as no new major projects have been sanctioned since the downturn.

13 CAPP/Wood Mackenzie. Canada's shale output stands at about 335,000 bpd, according to Wood Mackenzie, which forecasts output should grow to 420,000 bpd in a decade. The pace of output growth could accelerate and the estimated size of the resources could rise as activity picks up and knowledge of the fields improves, according to the Canadian Association of Petroleum Producers. See: www.capp.com and www.woodmac.com

14 See: www.genscape.com Genscape assessed WCS on Dec. 11 at $22.50/bbl below the calendar month average of West Texas Intermediate (WTI CMA), the lowest level since Genscape began its assessment in August 2014, and $5.15/bbl below the previous week's assessment. The previous low was WTI CMA minus $19.50/bbl on Aug. 11, 2014. The market continued to tank as the week went on, with WCS heard to trade on Dec. 14 as low as WTI CMA minus $28.50/bbl before parsing the losses at the end of the day. With no end in sight for any of the factors leading to the recent weakness, the Canadian crude markets are expected to remain under pressure in the foreseeable future.

15 The commissioning of the Line 3 replacement is expected to occur in 2020.

16 Construction was to begin in the summer of 1956, two years behind schedule. When financial problems threatened construction, the Ontario and federal governments agreed to form a Crown corporation, Northern Ontario Pipeline, to pay for the portion of the line through the worst part of the Canadian Shield. Unfortunately, TransCanada needed help as well, and the corporation turned to the federal government for financial aid. In May of that year, Howe proposed a bill whereby the Crown corporation would loan TransCanada $80 million, repayable a year later or TransCanada would turn the whole project over to the government.

Lead image: **AP/Sue Ogrocki**

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The Canadian Global Affairs Institute focuses on the entire range of Canada's international relations in all its forms including (in partnership with the University of Calgary's School of Public Policy), trade investment and international capacity building. Successor to the Canadian Defence and Foreign Affairs Institute (CDFAI, which was established in 2001), the Institute works to inform Canadians about the importance of having a respected and influential voice in those parts of the globe where Canada has significant interests due to trade and investment, origins of Canada's population, geographic security (and especially security of North America in conjunction with the United States) or the peace and freedom of allied nations. The Institute aims to demonstrate to Canadians the importance of comprehensive foreign, defence and trade policies which both express our values and represent our interests.

The Institute was created to bridge the gap between what Canadians need to know about Canadian international activities and what they do know. Historically Canadians have tended to look abroad out of a search for markets because Canada depends heavily on foreign trade. In the modern post-Cold War world, however, global security and stability have become the bedrocks of global commerce and the free movement of people, goods and ideas across international boundaries. Canada has striven to open the world since the 1930s and was a driving factor behind the adoption of the main structures which underpin globalization such as the International Monetary Fund, the World Bank, the International Trade Organization and emerging free trade networks connecting dozens of international economies. The Canadian Global Affairs Institute recognizes Canada's contribution to a globalized world and aims to educate Canadians about Canada's role in that process and the connection between globalization and security.

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