EXECUTIVE SUMMARY

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Canada's Indo-Pacific Trade Strategy and Trade Diversification

By Steven Globerman

The Canadian government recently announced funding for its Indo-Pacific Trade Strategy (IPS). This initiative is aimed at, among other things, diversifying Canada's exports away from the United States and towards emerging markets such as India and Indonesia. While some of the goals of the IPS extend beyond geographically diversifying Canada's exports to encompass cooperation with Indo-Pacific countries in matters such as climate change and international security, trade diversification is a key objective of the IPS program. The IPS is certainly not the only current government program to diversify Canada's export markets. Other initiatives include ongoing work to conclude bilateral trade agreements with the UK and Japan, as well as a regional trade agreement with European Union members. However, the IPS is the most recent and potentially the most substantive effort to expand markets for Canadian products outside of the United States.

Reducing trade dependence on the US has been a long-standing objective of the Canadian government. As early as the 1970s, the government of Prime Minister Pierre Trudeau put forward a "third option" strategy which involved diversifying Canada's trade abroad (Bonder, 2018). More recently, the government's 2007 Global Commerce Strategy had as its essential objective that Canada expand trade beyond North America (Beaulieu and Song, 2015). In 2018, Prime Minister Justin Trudeau stressed that the diversification of trade away from the US was a substantial responsibility of his government (Ljunggren, 2018), and a related federal government report posited that geographical diversification of Canada's exports would reduce the risk of trade protectionist measures by individual trading partners and give Canada a better bargaining position in trade disputes and negotiations (Scarffe, 2019). In this respect, the IPS can be seen as an effort to meet this perceived government responsibility.

Notwithstanding the government's expressed imperative to diversify Canada's geographical and industrial trade patterns, and despite Canada's signing trade liberalization agreements with trade partners besides the US, Canada's trade patterns have remained remarkably consistent for decades. In particular, the US has remained Canada's major market for exports, while the industrial mix of exports has remained concentrated in a small number of industries. This pattern of regionally concentrated trade is characteristic of small open economies besides Canada, including Australia and the Nordic countries. Among other things, it reflects the influence of physical distance as a deterrent to trade flows. The negative influence of distance has received strong empirical support in the literature, and supply chain disruptions related to COVID have, if anything, strengthened the incentives of companies to shorten the geographical distances of their supply chains.

Against the background of both international trade theory and actual trade experience, Canadian government financial subsidies and related policies to promote exports to the Indo-Pacific region are unlikely to be very effective. Moreover, to the extent that government financial subsidies do promote increased Canadian exports to Indo-Pacific countries, a portion

of those increased exports may come at the expense of reduced exports to the US. If so, the gains from trade to Canada's economy are likely to decline as more efficient cross-border trade is displaced by less efficient cross-oceanic trade when the latter is directly or indirectly subsidized by the Canadian taxpayer.

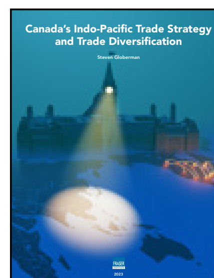
Another relevant consideration is that any successful effort to increase Canadian exports to the Indo-Pacific region would need to address two important realities. One is that the main export opportunity in the Indo-Pacific region available to Canada, at least for the foreseeable future, is liquefied natural gas (LNG). However, Canada lags well behind export rivals such as the US, Australia, and Mexico in developing LNG exporting infrastructure. Furthermore, the IPS explicitly focuses on "green energy" exports which presumably do not include natural gas.

A second reality is that China currently dominates supply chains in the Asia-Pacific region and is likely to do so for the foreseeable future. The IPS is deliberately vague about the future course of Canada-China economic relations. However, it acknowledges political and other sources of tension between the two countries, as well as the need for Canada to support the desire of its Western allies to condition trade relations with China so that those relations do not compromise the national security interests of the allies, particularly those of the US. Given the existing geopolitical environment, it seems unrealistic to expect significantly closer economic integration between Canada and China, even though closer economic integration might be a prerequisite to the success of Canadian companies in increasing exports to the Indo-Pacific, especially exports related to Electronic Vehicles (EVs), EV components, and other green energy products.

A prominent argument for diversifying exports away from the US and toward Indo-Pacific countries is that the latter economies are expected to grow at a faster rate than the US economy in the future. While this expectation might prove to be correct, it ignores an emerging and potentially significant opportunity for increased bilateral trade in services. While the delivery of a growing range of services over the Internet has been ongoing for a while, the COVID epidemic arguably accelerated this development, particularly as commercial and personal travel across borders was curtailed. The US market for services dominates those of Indo-Pacific countries in terms of size and sophistication. Furthermore, cultural similarities between Canada and the US make Canadian service exports to the US both more feasible and more economically beneficial than service exports to the Indo-Pacific region.

To be sure, major obstacles currently exist to expanding bilateral trade in services including regulations limiting the legal right of non-residents to supply specific services to potential buyers in state and provincial jurisdictions, local and state government preferences for purchasing engineering, consulting, and related services from local suppliers, privacy-related legal restrictions on transferring data across political jurisdictional boundaries, and so forth. Therefore, any significant increase in the trade in bilateral services will require a major extension of the existing Canada-US-Mexico trade agreement (CUSMA) to encompass digital services. The forthcoming review of the CUSMA (also known as the USMCA) by the parties to the agreement will also likely oblige Canadian negotiators to address US concerns about Canadian tariffs on dairy products, while providing an opportunity for Canadian negotiators to press objections to US tariffs on Canadian exports of lumber, steel, and other manufactured products. Agreement on irritants surrounding bilateral trade in goods might help smooth the path for major breakthroughs in the area of digital services.

In summary, while major potential gains to expanding bilateral trade exist, they will require hard bargaining and political concessions on both sides. However, it seems more fruitful for Canadian policymakers to focus on expanding and deepening regional trade and investment linkages among the parties to CUSMA than to subsidize (directly or indirectly) costly initiatives to promote Canadian exports to the Indo-Pacific region.



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