

Trade hysteresis refers to a permanent change in the pattern or volume of trade following a temporary -- though sometimes prolonged -- change in the exchange rate. Although it has been argued that between 1989 and 1991 the overvalued Canadian dollar led to a permanent decline in the manufacturing sector by reducing exports, extensive research has failed to confirm the hysteresis hypothesis. A pressing concern to the Department of Foreign Affairs and International Trade is the possibility that prolonged exchange rate misalignments could result in calls for protection in some of our trading partners. If, for example, foreign firms are unable to compete with Canadian exporters due to a temporary decline in the Canadian dollar, they might put pressure on other governments to restrict imports from Canada.

In order to avoid the uncertainty of exchange rate variability and eliminate the resulting impediment to trade, some would argue that the exchange rate between close trading partners, especially in free trade areas, should be fixed. Periodically, it has been proposed that the Canadian dollar be fixed to the U.S. dollar, or that the two countries should share a common currency. However, the surrender of political and economic sovereignty associated with a common currency is such a sensitive issue, that it is not likely to be the subject of any negotiated trade agreement involving Canada until well into the foreseeable future. The best way to assist in creating an environment in which exchange rate variability is less of a concern to Canada's trading firms is to support the Bank of Canada's policy of price stability. This is particularly important given the global move towards lower inflation.

The financial services industry is uniquely affected by the internationalization of financial markets. Trade in financial services has quickly made its way into international trading agreements, as is evidenced by the FTA, the NAFTA and the GATS. To take full advantage of the opportunities associated with integrated financial markets, financial institutions require access to foreign markets to set up local establishments. Of special interest to Canadian banks is the large U.S. market. Although the NAFTA provides little immediate progress in liberalizing trade in financial services between Canada and the U.S., Canadian firms can benefit from any future liberalization within the U.S. (such as the lifting of restrictions on interstate banking) and now have access to a formal government-to-government dispute settlement procedure.

As for the Japanese market, the establishment of direct branches of foreign banks is not prohibited, but a simplification of the licencing procedure administered by the Ministry of Finance would be a welcome improvement. The European Union's single passport for financial services could make it more difficult for Canadian institutions to compete there. If the German universal banking model becomes more widespread, foreign financial institutions might not be able to vie for market share with large, efficient European banking networks.