

policies. These policy areas are sometimes perceived to create unfair trade advantages or burdens but those perceptions are mistaken. In our view, these policy issues should be kept off the negotiating table in any bilateral trade negotiations.

Monetary and Fiscal Policies

Fiscal policy should be unaffected by an FTA; one country can have a more active stabilization policy than the other, with or without an FTA. As a small open economy, however, Canada has severe restraints on its fiscal policy. For example, the stimulus to domestic demand that results from a higher federal budget deficit in Canada is usually reduced because part of it leaks into imports. The reduction of bilateral trade barriers is not likely to change such restraints significantly.

The conduct of monetary policy also is unlikely to be affected in the long term. While each country could follow different monetary policies, the exchange rate would fluctuate -- assuming both countries continue with flexible rates. Harmonization pressures on Canada then would arise from the high mobility of short-term capital flows between the two countries. If fixed rates were to be adopted, the pressures on Canada would change because of the multilateral coordination of monetary and fiscal policy that would ensue. In neither the fixed nor the flexible rate case, however, would the creation of an FTA be expected to influence those harmonization pressures.

There is one possible exception to this conclusion that is worth some notice. If the FTA were to be such a failure for the Canadian economy that it caused major outflows of capital from Canada to the United States, this would drive down the value of the Canadian dollar below its purchasing power parity rate vis-à-vis the U.S. dollar, and give a temporary advantage to Canadian