of reliable data on "unobserved" trade costs has led to a reliance on proxies that only poorly reflect the real size of these costs. Secondly, estimation complexities have been encountered in establishing a causal link (covariance issues arising between the estimated border coefficients and measures of border related costs).

Even though empirical research has not yet succeeded in providing a definitive answer on the source of the border effect[41], it is generally accepted that even apparently small trade impediments can potentially have large effects on bilateral trade[42] if traded goods are close substitutes, which recent research evidence seems to confirm to be the case. As the CUSFTA has significantly reduced the border effect in Canada-USA bilateral trade[43], the "border" gravity literature suggests that reduction or elimination of UTCs by means of a common market, monetary union, or even smaller scope agreements such as closer regulatory co-operation would lead to significant increases in bilateral trade. Gravity models, however, cannot predict the impact of policy change on other aspects of the economy such as gross domestic product, industry structure, prices, etc. This is one area where a computable general equilibrium model can provide useful insights on the impact of trade policy on economic factors besides bilateral trade flows.

Design of the experiment
We use our CGE model to simulate the impact of a hypothetical policy change that completely abolishes the unobserved trade costs in Canada-USA trade. Given that unobserved trade costs arise from a broad range of sources, only the most ambitious economic union scenarios, including a common currency, would likely come close to eliminating them.

Our model calibrates the UTCs as ad-valorem tariff equivalents following the methodology described under 'dataset and calibration proceedure'. Given that we are implicitly assuming that the border effect captured by the gravity models is fully due to unobserved trade costs, these calibrated values can only be considered as upper bound approximations. The resulting UTCs are reported in Table 9. We observe that in most sectors, UTCs are larger trade impediments to U.S. exports in Canada than vice versa.

In the wholesale trade sector for instance, UTCs are the equivalent of a 45 percent tariff facing U.S. exports to Canada. As expected, UTCs in the services sectors (communications, finance/business and personal services) are also particularly high, especially so in Canada. The same observation applies to the

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[41] Two alternative explanations: a) Canada and the U.S. are very similar countries, thus unlikely to trade (the comparative advantage hypothesis) and b) the border induces changes in the composition of trade are either not tested directly or their estimations are also prone to the criticism mentioned above.

[42] See Obstfeld and Rogoff (2000).

[43] Helliwell (1998) examines the impact of the CUSFTA on border effects for Canada's trade flows. His estimates cover the period 1988-1993. He finds that the average border effect was constant from 1988-1990 and then fell substantially from 1990-1993. The border effect was the same as in 1973 and about 60 percent of the estimated 1990 value.