

---

production are the main potential sources of gain from free trade for a small country such as Canada which, unlike other industrialized countries, does not have secure access to a large consumer market.

*Increased Flexibility and Dynamism:*

Free trade implies greater exposure of Canadian business to international opportunities and competition, both at home and in foreign markets. This exposure can be expected to create incentives for greater price flexibility and faster responses to changes in market conditions.

More secure access to the foreign markets, combined with the pressure of a more competitive environment, will increase both the rewards for innovation and the costs of being technologically obsolete. This will stimulate R&D investment in new products and new technologies, and will encourage Canadian firms to participate in newly emerging industries.

*Reduced Uncertainty:* Although tariff rates throughout the world have declined over time, there has unfortunately been an increase in non-tariff barriers (NTBs). In addition to restricting the flow of trade, these measures have created uncertainty for producers with respect to investment in new facilities. Firms must have reasonably secure access to a market before they will undertake large investment projects dedicated to that market. The Canada-U.S. Free Trade Agreement, with its new rules and procedures for the application of trade remedy laws and the resolution of trade disputes, will reduce uncertainty with respect to market access and will thereby encourage investment and risk taking.

*Real Income Effects:* For an open economy like Canada's, the impacts of freer trade on real income depend mainly on two effects: the increase in production made possible by the better and more efficient utilization of resources, and changes in the relative price at which imports can be purchased and exports can be sold abroad – that is, the economy's "terms of trade".

Clearly, Canada-U.S. free trade will lead to an expansion of production in Canada, through the channels discussed above – comparative advantage specialization, economies of scale, increased flexibility and dynamism. Improvement in Canada's terms of trade, however, will depend on the pricing behaviour of Canadian exporters. For example, U.S. demand for Canadian goods can be expected to increase with the removal of U.S. trade barriers. To the extent that Canadian exporters are able to raise their prices, Canada's terms of trade will improve. But lower costs of production in Canada may lead some Canadian producers to reduce their prices in order to sell more goods in the U.S. market, and this could mean a deterioration in our terms of trade. To the extent that average export prices change relative to import prices, the real income gains will diverge from the real output gains.