

2. Recent Canada-EU Trade Trends

2.1 Canada-EU Merchandise Trade

Since the advent of the North American Free Trade Agreement (NAFTA), trade with Europe has declined in importance, both strategically and economically. While the underlying economic logic of the 1980s and 1990s has been to form regional trading blocs, in Canada's case this has undoubtedly resulted in trade creation with the US, but has increased Canada's dependency on this trade. The Government of Canada has been attempting to develop trade with Asian countries (with, for example, Team Canada visits), and coupled with the rapid growth in these countries trade with this region has now surpassed that of Europe. Nevertheless, after the US and Asia, Europe is still of strategic importance for Canada, and particularly for Central and Eastern Canada. Also, it should be noted that although the EU is the third most important Canadian trading partner after the US and Asia, in the US, the ordering for Asia and Europe is reversed, with the EU the second most important trading partner after Asia. The trends in the trade statistics for Canada-EU trade flows are clearly important, so an analysis of the statistics is now presented.

Table 2.1 shows summary statistics for the evolution of Canadian-EU trade in goods over the period 1980-96. The table includes countries that were members of the EU in each year, so the trade statistics represent the trade for a growing number of countries over time. The most immediately obvious trend has been the deterioration in the trade balance over the period as a whole, but with two definite phases. In the period 1980-88, the trade balance deteriorated almost consistently year-on-year. From 1989-92, the trade balance then showed an improving trend, followed by a rapid deterioration from 1993-96.

Inspection of the export and import statistics with the EU reveals several interesting phenomenon. First, the trade balance for goods and services for Canada with the world has increased from \$6.9 billion in 1980 to \$42.0 billion in 1996, whereas Canada's trade balance with the EU has moved from nearly a \$5 billion surplus to over a \$7 billion deficit. So the EU component has actually been going against the trend. This could suggest that the formation of the NAFTA has caused trade diversion to occur with EU. On what grounds might such a view be justified? The reasons why the creation of a trade bloc stimulates trade with bloc partners are complex, and include such factors as exchange rate policy with trade bloc partners as well as associated hysteresis effects, geographical distance and changes in common external tariffs. In addition, the development of NAFTA roughly coincided with the measures taken by the EU to complete the single market, so trade diversion effects might have taken place on both sides of the Atlantic. In terms of NAFTA, Waschik (1996) uses a computable general equilibrium model to show that there was a small amount of trade diversion in the NAFTA as a whole, and a significant amount of trade diversion for Canada individually, given constant external tariffs during the NAFTA implementation¹. Sapir (1992) argues that regional integration in the EU did not create any net trade diversion effects, as the process of EU integration boosted intra-EU trade, but also was a catalyst for reduction in Europe's external trade barriers through the General Agreement on Trade and Tariffs (GATT) Kennedy and Uruguay rounds of negotiations. Winters (1993) partially dissents from this view, asserting that the EU fostered a minor amount of trade creation on balance, but in certain sectors, such as agriculture, the Common Agricultural Policy (CAP) and other measures have acted as a distortionary and protectionist trade barrier. In terms of whether trade diversion exists, it is extremely difficult to isolate this particular economic effect, as in theory it assumes *ceteris paribus* conditions are met for variables such as exchange rates, growth rate differentials, inflation differentials, as well as micro considerations such as the extent of variety and the scale of production. In more recent work, Winters (1997) has suggested that neighbouring countries linked tightly to the EU economy could lose significantly from the latter's integration, but that for other countries the

¹ Other useful references on the welfare effects of NAFTA are Brown, Deardorff and Stern (1992) and Cox (1994).