Skolnik, Amy

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Amy Skolnik
Bank of Finland Economics Department
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THE U.S. - CANADA FREE TRADE AGREEMENT: A MODEL FOR FINLAND?

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ABSTRACT

As there are many similarities between Finland and Canada, an analysis of the recently ratified U.S.- Canada Free Trade Agreement may be informative for EC - Finnish relations. While Finland has avoided any commitments on further integration plans, we conclude that this policy can not continue much longer. Almost every industrialized country is striving to forge trade alliances on either a bi- or a multilateral basis. These countries are fearful of exclusion from significant markets or of falling pray to protectionist policies. By modeling her approach on elements of the U.S.- Canada treaty; Finland should be able to create a beneficial relationship with the EC, without sacrificing her national identity or neutral foreign policy.

TIIVISTELMÄ

Koska Suomen ja Kanadan välillä on monta yhtäläisyyttä, voi hiljattain ratifioidun Yhdysvaltain ja Kanadan välisen vapaakauppasopimuksen tarkastelu valottaa Euroopan Yhteisön ja Suomen välisiä suhteita. Vaikka Suomi on välttänyt sitoutumista laajempiin integraatiohankkeisiin päättelemme, että tämänkaltainen asenne on mahdotonta ylläpitää kovinkaan kauan. Melkeimpä kaikki teollistuneet maat pyrkivät solmimaan kauppaliittoja joko kaksin- tai monivälisellä pohjalla, jolloin vaihtoehdoiksi jää ainoastaan joutuminen varteenotettavien markkinoiden ulkopuolelle tai protektionististen toimenpiteiden kohteeksi. Hyödyntämällä lähestymistavassaan Yhdysvaltain ja Kanadan välisessä vapaakauppasopimuksessa olevia piirteitä, Suomen pitäisi pystyä rakentamaan antoisat suhteet Euroopan Yhteisöön ilman, että kansallinen identiteetti tai puolueeton ulkopolitiikka joudutaan uhraamaan.

CONTENTS

I. The Creation of a North American Market - Free Trade and International Implications[1]

Over the past four decades, trade has played an increasingly important role in the international environment. As global systems have become further interdependent, most nations have suffered an erosion of independence in their economic policy-making power. Despite the political disdain, this fact will continue to promote international integration on many levels. In the 1980's, almost every major country has reevaluated its global role, particularly from an economic standpoint. Reliable trading partners have been closely scrutinized and numerous countries have begun contemplating the benefits of forming trade blocs or bilateral agreements.

The biggest undertaking has been the European Communities' (EC) Internal Market Plan, launched in 1985.[2] This plan also gave the European Free Trade Association (EFTA) the impetus to take a more active role so as not to be excluded from the European market. Economic integration however, has not been limited to Europe. Japan has been discussing a variety of potential trade blocs both in Asia and elsewhere. More concretely, the U.S. and Canada after years of mistrust concluded a bilateral treaty, and the U.S.-Canada Free Trade Agreement (FTA) went into effect on January 1, 1989.

This paper will provide an overview of the U.S.-Canada Free Trade Agreement including the gains and losses it is estimated to bring both countries. It will also examine the role of the agreement in a global context. The U.S.- Canada FTA will do as much, if not more, sym-

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[1]I am indebted to Seppo Kostiainen for his encouragemenet in undertaking this project as well as his helpful discussions and comments on various drafts.

[2]See Skolnik, A. (1988) The EC Internal Market: An "Economic United States" of Europe?, Bank of Finland Discussion Papers 19/88.

bolically as it will practically; for trade between the two countries has previously been liberalized in many areas. (For example the Auto Pact of 1965 and Defence Production Sharing Arrangements of 1941.) The treaty is also meant as a message to the rest of the world that both countries are serious about pursuing international free trade; particularly as the GATT mid-term review was recently held in Toronto.

The U.S.-Canada Free Trade Agreement is one more outcome of the flourishing role of international trade discussed here. For Finland, increased world-wide integration brings new challenges to its global trade policy. Many trading blocs include some form of political and/or social integration, as well as economic alliances. This precludes a neutral country, such as Finland, from joining these unions. Therefore, it is imperative that Finland explore all potential avenues and policy alternatives. By analyzing other trade pacts, particularly by similarly structured economies such as Canada, perhaps Finland can gain some insight into its future options.

II. The Free Trade Agreement - Why All The Commotion?

The Free Trade Agreement between the U.S. and Canada has been called everything from the protector of free trade to a sell out of national sovereignty. Both of these statements are extremes, but given the extent they were used during the Canadian election campaigns last November; it is obvious that for the Canadians, the FTA is a strong emotional and political issue. Almost no one seems to doubt that in purely economic terms, the agreement benefits both countries. So why all the Canadian uneasiness?

A. Background: Initiated by Fear

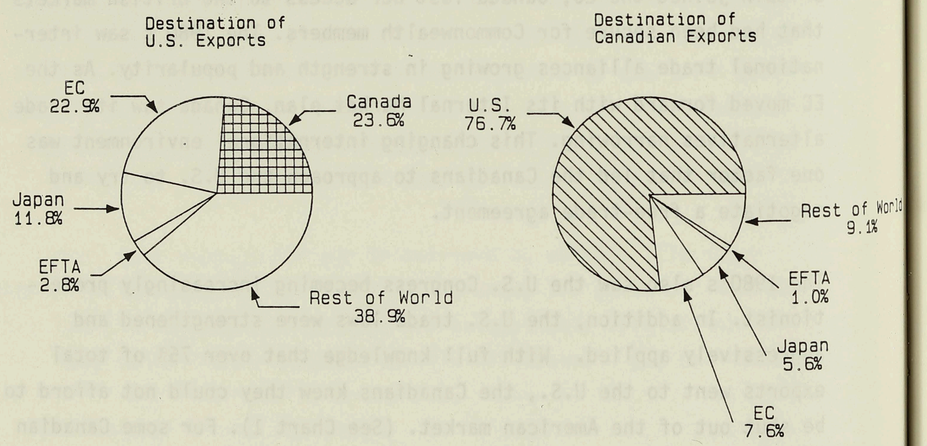
Though the U.S. and Canada have a similar history and a longstanding friendship, (e.g. a 5,525 mile undefended border), there has also always been an air of caution. In the past 100 years, twice in the name of nationalism have Canadians rejected trade agreements with the U.S. (In the process rejecting the governments that even dared to suggest such treaties.) Then in 1973, when Great Britain joined the EC, Canada lost her access to the British markets that had been secure for Commonwealth members. The 1980's saw international trade alliances growing in strength and popularity. As the EC moved forward with its Internal Market plan, Canada saw its trade alternatives narrowing. This changing international environment was one factor that led the Canadians to approach the U.S. to try and negotiate a free-trade agreement.

The 1980's also saw the U.S. Congress becoming increasingly protectionist. In addition, the U.S. trade laws were strengthened and aggressively applied. With full knowledge that over 75% of total exports went to the U.S., the Canadians knew they could not afford to be shut out of the American market. (See Chart 1). For some Canadian industries the dependency is even higher: 98% of motor vehicles and parts exported and 99% of all energy products exported, except coal, are destined for the U.S. Still, fear of antidumping and countervailing duties were an even greater threat than the actual remaining

tariffs. Lastly, Canada was acutely aware that they were one of a very few industrialized countries to lack guaranteed access to a market of at least 100 million people. (Canada's domestic market comprises only 26 million consumers.) This deterred foreign investment and prevented Canadian producers from obtaining the full advantage of economies of scale.

Maintaining stable trade relations with Canada was also important to the Americans. Though the U.S. is much less focused on Canadian trade than vice versa; Canada is nevertheless, their largest trading partner absorbing over 20% of American exports. (See Chart 1). The U.S. also benefits as Canadian tariffs are on an average higher than those levied by the U.S. Lastly, the U.S. was eager to negotiate a FTA to support its commitment to trade liberalization and to serve as a model for the multilateral Uruguay round GATT talks and for other future bilateral agreements.

CHART 1
Chares of U.S. and Canadian Exports, 1987
(percent values in million of U.S. dollars)



Source: OECD, Monthly Statistics of Foreign Trade, December 1988.

B. The Actual Agreement

The U.S.-Canada Pact will, over a period of ten years, eliminate all tariffs on goods and services and liberalize cross-border investment policies. Though already approximately 80% of the $150 bilion bilateral trade in goods is duty-free, gains do stand to be realized with the elimination of the rest. Some tariffs will be removed immediately and others in installments over five or ten year periods. As each side will retain an independent third country trade policy, rules of origin will be closely monitored. Goods will qualify for the bilateral tariff treatment if they have been sufficiently changed in either Canada or the U.S. For manufacturing, the general guideline will require that a minimum of 50% of the costs be added domestically.

The agreement also abolishes almost all quotas and other import/export restrictions. Exceptions include some aspects of the energy sector: for shortages, conservation, or national security reasons; limited U.S. forest product exports; and some seasonal quantitative restrictions in agriculture. Due to the complexity of agricultural issues, many issues were left for global negotiations; though the two sides have agreed to work on the elimination of all trade distorting subsidies.

1. History is Made in Investment and Services Sectors

More significantly, the FTA removes many invisible, non-tariff barriers. For the first time, an agreement governing the entire financial sector has been made. Capital expansion, market share, and growth restrictions currently imposed on U.S. banks will be removed. Investment will be subject to national, nondiscriminatory treatment. Current bilateral investment between the two countries totals over $68 billion and is expected to increase. Capital movements will still occasionally be restricted as Canadian will continue the screening of some direct acquisitions but this practice will be abolished for all indirect acquisitions.

Besides investment, it is also the first time that trade in services has been addressed in an international trade treaty. Numerous areas are covered including: computer services, tourism, professional services, insurance, and retail and wholesale trade. The principles of national treatment, access to domestic distribution systems, and transparency of rules and procedures will all be applied to service industries.

Labor movements and taxation policies were not addressed in the FTA. A previous U.S.-Canadian treaty has established reciprocal tax treatment and harmonized policies. Passports are not required to enter either country, only proof of residency, and there are no limits on length or frequency of visits. Labor movement is fairly free, though technically a prior job offer is required upon entering the neighboring country.

Standards and government procurement practices have also been liberalized by the agreement. Neither country will use technical standards as a barrier, for instance as requirements for testing accreditation. The agreement extends the GATT Government Procurement Code, currently at a threshold of $171,000; down to cover all government purchases over $25,000. This is expected to open substantial market opportunities for both countries, estimated by the Canadian Economic Council at C$3 billion for Canadian suppliers and C$400 million for U.S. companies.

2. Binding Dispute Settlement Mechanism is Created

Lastly, the FTA establishes a bilateral trade tribunal to settle disputes. This was a very important issue for the Canadians, as in recent years, actions taken under U.S. trade remedy laws seems to have had a serious detrimental impact on investment and employment in Canada. There was much difficulty in establishing a settlement mechanism suitable to both countries but the outcome blends bilateralism with national laws; and the Canadians feel they have obtained a more secure access. The U.S.-Canada Trade Commission will be led by

Cabinet-level representatives and meet at least once a year. However, either country may request a meeting whenever they have a grievance. The Commission's recommendations are final and binding. Safeguard provisions, including antidumping and countervailing duty law, will be dealt with separately, in their own panel. Each country will apply its own laws, but if requested a special binational dispute panel will review the case, applying the domestic law of the importing country.

The issue of national culture and identity is an extremely sensitive Canadian matter. Therefore, all cultural industries, including any form of media or communications, are completely exempt from the agreement. Transportation, basic telecommunications, education, and all health and social services are also not covered. In addition, the two countries have no plans for formally unifying, or even coordinating their currencies. These exceptions sharply contrast with the European Communities integration plans which includes not only economic integration, but proposals for a monetary union and unifying social programs and benefits.

III. Canadian Resistance

A. Culture Craze Causes Strong Opposition

The strong resistance to the Free Trade Agreement in Canada was not based primarily on economic logic, but on an apprehension of a loss of social and cultural identity. Fear of being absorbed into the U.S. was so extreme at times, the opposition began predicting that Prime Minister Mulroney would soon be running for Governor of the 51st State. Anti-Americanism has frequently run strong in Canada were intellectuals are prone to argue that they have a superior society. Yet according to one Canadian writer, "American-bashing is simply a national sport." This is the cause of much of the antifree trade rhetoric.

Aware of the increased social and culture exchange that often occurs when one language (primarily) is shared; Canadian are anxious to differentiate themselves from their powerful neighbor. From the numerous articles written on this subject, it appears that this has little to do with Canadian opinion of American values, (many which are closely shared), but a need to demonstrate their individualism or "non-American-ness". Anti-Americanism in Canada is not ideological, observes one Canadian journalist, rather it justifies Canadians very raison d'etre.

Many Canadians have an obsession with their dependency on the U.S., fearing that they have become too reliant on their big neighbor. So, when times are good, (as the 1980's have been), they feel they should reduce the support and influence of the U.S. Defendants of the agreement however, aware of the current global role of international trade, are wary of rebuffing one of the world's richest country. They are worried over the economic consequences of failing to secure a larger market and reliable trading partner.

B. Concern for Social Systems

Another argument against the FTA is that Canada's welfare system, including national free health care and extensive unemployment benefits would be endangered for the U.S. could claim such programs as unfair subsidies to Canadian businesses. Canada's evolution towards a European-style mixed economy, balancing social democracy and capitalism, may also then be undermined. As competition pressures increase Canadian firms may be forced to harmonize costs and employee benefits with U.S. companies. However, since all social aspects are explicitly excluded from the FTA, Canadian advocates feel this fear is unfounded. (Unfortunate-ly there is no way to know, a priori, whether the Americans will pursue this issue under a disguised form or stick to the true spirit of the Agreement.) A study for the Economic Council of Canada though, also concludes that the FTA will have little impact on Canada's health care system.

Adversaries should also be reminded of the basic economic principle of free trade: it benefits everybody. Much of the rest of the world, is probably surprised about Canada's apprehensions. Most likely, they see an incredible, even envious opportunity for Canada to be securely tapped into the dynamic American market of 250 million consumers.

IV. Winners and Losers in the Game of Free Trade

The numerous studies on the Canada-U.S. agreement have drawn a variety of conclusions, but most agree that the economic gains from the Free Trade Agreement outweigh the losses for both countries. After all, this is the very fundamental reason for trade. Some Canadians feel however, that Canada sacrificed too much for too little. Canada's real GDP has risen an average of 4.2% per year since 1982, faster than any other OECD country. High growth is predicted to stabilize, but continue at about 3% over the next year. These opponents see free trade as a solution to a non-existent problem. They are however, neglecting some of the other benefits besides economic growth, such as lower prices, higher employment, and dynamic competition, that the FTA will bring; particularly in the long-run.

A. U.S.-Canadian Similarities

Before elaborating on these benefits, it is important to examine the structure and the relationship between the Canadian and U.S. economy and policies. As previously mentioned, the pact is more symbolic than practical as the two economies are already closely intertwined. Both follow similar policies as to inflation and monetary targets. The demographic and industrial composition of the two countries is remarkably alike. Minimum wage laws and other labor regulations are also compatible.

Yet Canada has always lagged a bit behind the U.S. Since 1980, Canadian per capita income and aggregate productivity levels have remained about 10% below their U.S. equivalents. The manufacturing productivity gap grew from 18% in 1980 to 25% in 1987. Unemployment has also been a persistent 3% higher in Canada since 1982. Many believe these differentials are a result of Canada's small population which is thinly spread out along her long border with the U.S. This has prevented her from attaining a high level of specialization and full economies of scale.

B. Canada's Main Benefits: Scale Economies and Market Access

Canada's most significant advantage from free trade will be scale economies and specialization; as well as vast technological resources which will now be attainable through the enormous American market. Some benefits will arise once Canadian companies, long protected in the domestic market, are forced to fight for their market share with U.S. firms. Vertical integration, will also increase economies of scale as well as increase Canadian access to U.S. research and development. Many consumer products that Canadians now find much more expensive than their Southern counterparts, will be reduced. In general, competitiveness and efficiency will be encouraged.

According to one Canadian Economic Council study, (Discussion Paper No. 357), the deterioration of the Canadian manufacturing productivity gap in the 1980's, was caused by movements in the exchange rate. The U.S. manufacturing industry responded to this change through rationalization - which led to gains in U.S. manufacturing productivity; and to a decline in the real wage-productivity gap for U.S. manufacturers. In addition, over 70% of Canadian manufacturers comprise small and inefficient plants, operating with above average unit costs. Therefore, the FTA would enhance competition and speed up the much needed rationalization in the Canadian manufacturing industry. It is estimated that this would increase productivity gains in the manufacturing sector by about 4.0%, as well as raise real income per capita. Adjustment may be painful for weak firms, but a ten-year transition period should allow for a sufficient adaptation.

The study also concludes that the dynamic effects of free trade, such as acceptance and availability of new technology, quicker reallocation of resources from declining to rising industries, and improved room for market forces; may in the long-run, bring even higher gains than those from scale economies. Canada's success depends on her ability to quickly adjust to the changing economic environment domestically, and abroad.

Another important asset of the agreement for Canada is a guaranteed market. For example, the FTA will protect Canadian access to the U.S.

in such industries as steel and uranium; which Canadians had feared would soon be subject to stricter import quotas. The treaty will also result in a Canadian market that is tenfold its current size, with an equally large buying power. (see Table 1) This also contributes to productivity and efficiency.

TABLE 1
Indicator of Market Size
(1986 GDP at current prices and exchange rates)

Market	GDP (Billions of U.S. Dollars)
Canada	363.93
United States	4,185.49
Japan	1,955.64
EC-12	3,461.25

Source: OECD, National Accounts, 1960 - 86)

Canada is greatly benefiting from the direct foreign investment that is flooding in in anticipation of the expanded market. The "national treatment" provision for the financial sector is also expected to aid Canada more. It assures that if Americans get wary of the large sums of foreign investment they are currently receiving, its doors will not be shut on Canadian investment. This is important to Canada as the U.S. is the recipient of over 50% of Canadian direct foreign investment.

Lastly, The FTA will be beneficial to the economy, particularly in the medium and long-run. One analysis shows Canada's economy expanding 5% faster over the next ten years than it would have otherwise. GDP is also expected to maintain its current level of high growth at 2-3% per year during the next 5 years. Canada's Department of Finance has estimated that the accord will boost manufacturing output by 10.5% and exports by 3.5% over the ten year transition period. Though in the short run some jobs will be lost due to adjustment costs; by 1998, employment is estimated to rise by approximately 2%.

C. It's a Game of Give and Take: Some Concessions Must Be Made

The opposition feels that Canada's current conservative government conceded too much to the Americans out of anxieties and trepidations of increased protectionism. These sacrifices include secure access to Canadian energy supplies as well as other natural resources. In return, Canada was unable to get a guarantee, excluding itself from U.S. trade laws. Canada had hoped to be exempt from action under U.S. unfair trade legislation; but instead had to settle for further discussions and a bilateral tribunal for disputes.

Much to some Canadian negotiators' apprehension, the delicate issue of distinguishing between an acceptable and unacceptable subsidy was also left undecided - for talks over next five years. This is unsettling to many who, despite U.S. appeasements, believe U.S. business will claim that Canada's social services programs are an unfair subsidy, thereby threatening the entire Canadian welfare system.

The FTA is also expected to result in a further increase in the Canadian current account deficit, which is presently over $30 billion. This comprises an even larger percentage of GDP than the U.S. deficit. Prime Minister Mulroney has promised to uphold all of Canada's costly social programs and reduce the trade deficit which can only mean higher taxes for Canadian citizens.

D. U.S. Benefits From the Treaty

Though in principle it is the small country that gains relatively more from free trade, the U.S. also gains some advantages. The U.S. benefits from larger Canadian tariff cuts as Canadian duties are currently 3-5 times higher than American ones. (see Table 2) For the U.S. banking industry, there will be substantial breakthroughs. They will now have access to Canada's more permissive financial sector which allows commercial banks to engage in underwriting. This is a large source of revenue which U.S. banks, now restricted by the U.S. Glass-Steagall Act, will be eager to pursue.

TABLE 2

Average Post-Tokyo Rourd Tariffs,[a] United States and Canada

	U.S. Tariffs on Imports from Canada	Canadian Tariffs on Imports from U.S.
Average	.7	3.8
Agriculture	1.6	2.2
Food	3.8	5.4
Textiles	7.2	16.9
Clothing	18.4	23.7
Leather Products	2.5	4.0
Footwear	9.0	21.5
Wood Products	.2	2.5
Furniture and Fixtures	4.6	14.3
Paper Products	0	6.6
Printing and Publishing	.3	1.1
Chemicals	.6	7.9
Petroleum Products	0	.4
Rubber Products	3.2	7.3
Nonmetal Mineral Prod.	.3	4.4
Glass Products	5.7	6.9
Iron and Steel	2.7	5.1
Nonferrous Metals	.5	3.3
Metal Products	4.0	8.6
Nonelectric Machinery	2.2	4.6
Electric Machinery	4.5	7.5
Transportation Equip.	0	0
Misc. Manufactures	.9	5.0

a) Weighted by bilateral trade.

Source: Brown, Drusila K. and Robert M. Stern. 1987. "A Modeling Perspective." In Perspectives on a U.S.-Canadian Free Trade Agreement, Robert M. Stern, Philip H. Trezise and John Whalley, eds. Washington, D.C. The Brookings Institution.

In addition, the U.S. gained a fairly secure energy and natural resource supply. This is critical, in a world where oil embargoes have become a powerful political weapon. Along these lines, the U.S. hopes that a North American trade bloc will help balance current international competition from Asia and Europe.

Of course in terms of market access, the U.S. gained relatively little for opening its vast frontiers. Another drawback for U.S. companies is Canada's official bilingual status which requires all product labeling and instructions to be in both French and English. Lastly, U.S. investment will still be subject to some restriction. Large investment of over C$150 billion will still be reviewed by Canadian authorities; potentially allowing for a national bias in investment projects. In addition, U.S. investment will continue to be restricted in all Canadian cultural industries which include advertising and telecommunications.

V. What Can Finland Learn?

Though thousands of miles apart, there are many similarities between Finland and Canada. To begin with, both are small open economies. Among their closest trading partners, generally neither has a strong influence over trade issues. In addition both their government structures and their trading patterns, such as a dominance of the forest industry are comparable. As global integration intensifies, both countries have begun to change some of their practices. For example Canadian investment in the U.S. has notably increased in the 1980's as Canadian companies feared the U.S. would become more protectionist. Similarly, Finland is increasing its investment in the EC prior to 1992 for fear of being shut out of the Internal Market.

However, there are also significant differences between the two nations. The majority of Canada's trade is with one country, the U.S. with which it has long been closely integrated on many levels. Finland's U.S. counterpart is EFTA, an entire bloc of countries, and such thorough integration is unlikely for many reasons. Canadian culture and history also have much closer and firmer ties to the U.S. than Finland has with most European countries. In addition, Finland's most pressing current problem is how to deal with the EC, a large, powerful trade bloc with which it has relatively no influence.

As seen through the analysis of the U.S.-Canada Free Trade Agreement; there are many elements in the treaty that could aid Finland in its relations with the EC. Canada and Finland share many of the same misgivings over integration such as loss of culture, decay of welfare systems, and an erosion of independent policy-making ability. Despite these apprehensions, Canada, already heavily influenced by the U.S., has allowed herself to go even one step further, becoming even more integrated into the U.S. by entering into a trade treaty. The key implications that this has for Finland, can be seen by analyzing what was, and was not, included in the U.S.-Canadian agreement.

For Finland, one of its biggest fears of further European integration is a loss of cultural and national identity. Yet this was also one of

Canada's largest concerns. The Canadians overcame part of this problem by carefully negotiating an accord dealing solely with economic issues. Furthermore, trade and investment in all Canadian cultural industries, (which encompasses a wide area including communications, education, and media), is still prohibited. If the Canadians were able to circumvent the issue of culture then surely the Finns can as well. National identity is far more threatened in Canada, which is very similar to the U.S., than it would be for Finland. The EC is currently comprised of twelve countries with varied cultures and different attitudes. So far none of them have claimed to be loosing their identity. For Finland, a limited agreement would bring no sizable threat either.

The FTA also established a unique bilateral dispute settlement mechanism which guarantees impartial application of respective trade remedy laws. Many Canadian fears of American noncompliance were pacified by the creation of this panel, as its decisions are binding to both sides. The domestic law of the importing country are applied in all cases. In addition, a Trade Commission, at the Ministerial level, was established to implement and enforce other aspects of the FTA. If Finland was to enter into a bilateral agreement with the EC, mechanisms such as these could prevent Finland from loosing its independence in trade law. They would also be a useful selling point to the opposition, who fear Finland would be completely subjugated to all EC law.

Other adaptable components of the FTA that would be beneficial for Finland include the right of both sides to maintain an independent third country trade policy and the exclusion of any form of currency union or alignment. This allows Finland to maintain some independent domestic policies, and to protect its unique foreign policy and neutrality status. The advantages for Finland, of forming some type of agreement with the EC are numerous. Some of the most significant could include new technology, research and development findings, and access to an enormous market.

Of course it is not simply Finland's choice whether a bilateral agreement with the EC is formed; and this is where some differences

with the U.S.-Canada Pact are evident. The U.S. was very responsive, even eager to create a free trade treaty with Canada. The EC however, is currently preoccupied with its internal problems and its 1992 project. This, combined with the fact that the EC is a union of many countries often with conflicting goals, may reduce Finland's bargaining power. (Vis a vis Canada's leverage with the U.S.). There is the potential that the EC will want to set the rules providing Finland with the simple choice of all or nothing. In this case, it would be very difficult for Finland to cooperate. Still, some compromises would have to be made as economic isolation is close to suicide for any nation.

The majority of Canadian reservations over the Free Trade Agreement were non-economic as are Finland's avoidance of the EC. (i.e. foreign policy, national pride.) However, the passage of the FTA in Canada shows how economic realities were able to override the anxieties of a loss of national identity and independent culture. Economic soundness and well-being along with the potential repercussions of isolationism defeated patriotic nationalism. Maybe some day Finland will follow the same path. For now, this historic agreement should be an example for Finland: to encourage and facilitate a continued dialogue as well as increase cooperation with the European Community.

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