

Canadian Trade Diversification

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Issue

Canada is aiming to diversify its trade and investment partnerships beyond North America and Europe in a manner that supports the rules-based international order. New engagement strategies are needed given the political and economic barriers to trade diversification.

Background

Need for Trade Diversification

Canadian trade is currently heavily biased towards a select few countries (see Appendix, Figure 1). Canada's most prominent trade partner is the United States. In 2018, 75 percent of Canadian exports were to the United States (Global Affairs Canada [GAC] 2019c). Canada's heavy reliance on the US market is in line with the predictions of the gravity model of trade (see Appendix 1); however, the dependence on the US market can subject the Canadian economy to volatility. The recent economic and political changes in the United States have created uncertainty for Canadian exporters, highlighting the need for trade diversification to alleviate dependency on the United States. Steps have already been taken towards trade diversification, such as the appointment of a Minister of International Trade Diversification and the signing of trade agreements such as the Comprehensive Economic and Trade Agreement. However, alternative trading relationships and engagement strategies need to be explored further. GAC has tasked us with identifying a region in which Canada can benefit from increased trade.

Why ASEAN?

An examination of Canada's trade bias towards the country's top 55 trade partners reveals regions through which Canada can obtain small gains from trade diversification in relative terms, but significant in absolute terms (see Appendix, Figure 1). One prominent region of under-focus is the Association of Southeast Asian Nations (ASEAN) region, consisting of 650 million people, with a rapidly growing economy of US\$2.9 trillion in GDP (Statista 2019a; 2019b). The ASEAN market includes 10 countries: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam – all of which differ in their economic development, level of regulation, and political and business environment.

Benefits

Political Benefits

There are three political benefits for diversifying Canadian trade with ASEAN. First, Canada will better establish itself in the Asia-Pacific region, which is growing in political and economic importance (Baldwin 2013). Currently, Canada is not present in the East Asia Summit, a forum through which Canada could establish a stronger influence and presence in the region. Second, there are political benefits beyond trade diversification, such as security externalities, that are becoming more important given the rise of China. For Canada to be an effective partner in the Asia-Pacific, the Canadian government must commit to growth, peace and stability in the region (Dewitt et al. 2018). Third, Canada has had long-standing

diplomatic relationships with a number of ASEAN countries, many of which were formed after the countries' colonial independence. Canada enjoys a stronger people-to-people relationship with Malaysia, the Philippines and Vietnam due to immigration, and Brunei and Singapore due to trade and investment in the past two decades (Asia Pacific Foundation of Canada 2017).

Over the past 40 years, Canada has been gradually developing closer political and trade relationships with ASEAN. Canada has been one of 10 ASEAN dialogue partners since 1977; in 2011, Canada and ASEAN adopted a Joint Declaration on Trade and Investment; and Canada currently has diplomatic relationships in all 10 ASEAN states (GAC 2019b).

Canada could benefit from further developing its relationships in the region. As the fast-growing and dynamic region gains economic prominence in the near future, Canada needs to close the gap with other countries such as Australia, China, New Zealand and the United States in re-establishing its profile in the ASEAN region. "Liberalized trade and investment would help Canada build its credibility in the region and expand its involvement in other Asia-Pacific initiatives" (Asia Pacific Foundation of Canada 2017, 10).

Economic Benefits

The economic benefits of increased trade and investment with the countries of ASEAN are plentiful. A rising middle class and non-matured markets in ASEAN show promise for Canadian businesses (ibid. 2017). The Asia Pacific Foundation of Canada estimates that a free trade agreement between Canada and ASEAN could increase bilateral trade by up to CDN\$10.9-billion and generate economic welfare gains of about CDN\$1.1 billion for Canada. These gains are expected to benefit both Canadian companies and employees, stimulating economic growth and job creation (ibid. 2017).

Specific sectors in Canada stand to gain from opening trade with the region. ASEAN's large, growing population is creating increased demand for imports. The Canadian sectors that could best leverage this growth include aerospace, agricultural products, automotive, clean tech, and oil and gas (Baldwin 2013). In addition, the Asia Pacific Foundation of Canada (2017) also contends that the infrastructure and service sectors offer great potential for Canadian businesses.

Challenges

Economic

The first challenge for diversifying trade with ASEAN is economic in nature and lies in the diversity of ASEAN member states particularly with respect to their level of socio-economic development (Baldwin 2013). Consequently, Canadian companies can be confronted with different economic conditions when involved with multiple ASEAN member states (ibid.). ASEAN members differ in their infrastructural advancement and in their labour endowments (ibid.). With respect to the latter, the Asia Pacific Foundation of Canada (2017, 31) states that Canadian businesses face difficulties at times in their ASEAN operations to find "reliable and cost-effective skilled labour." In addition, local companies oftentimes benefit from preferential treatment (ibid.), which may make it more difficult for Canadian companies to compete in ASEAN markets. Small and medium-sized enterprises are particularly prone to facing this issue (ibid.).

Business Environment

The second challenge is that the diversity of ASEAN member states affects Canadian companies' operations on site. According to the Asia Pacific Foundation of Canada (2017), companies face different levels of regulations and a diversity of business cultures. Therefore, it is essential for Canadian companies expanding into ASEAN to familiarize and adapt to the country-specific business culture and market behaviour. Moreover, member states vary quite significantly in their ranking with respect to ease of doing business. A visualization by the Asia Pacific Foundation of Canada shows that according to the 2016 Ease of Doing Business Rankings — regularly published by the World Bank (Baldwin 2013) — Malaysia, Singapore and Thailand score relatively low (high ease of doing business), while Cambodia, Lao PDR and particularly Myanmar are ranked quite high (low ease of doing business). Next to "infrastructure deficiencies" and "inept bureaucracy," corruption is considered a major impediment for doing business (ibid, 9).

Development

The third challenge is that policies in multiple ASEAN countries are inconsistent with the Canadian government's Progressive Trade Agenda. The Canadian government has committed to pursuing "progressive approaches with

trading partners in important areas such as transparency, labour rights, the environment, small and medium-sized enterprises, gender, and Indigenous peoples” (GAC 2019d, para. 9). Labour standards in multiple ASEAN countries do not align with the values that Canada wishes to pursue in trade diversification. Furthermore, ASEAN has not negotiated environmental, gender or transparency-related measures in its previous free trade agreements (GAC 2019a). Based on progressive values not being included in ASEAN’s previous trade agreements, it is unlikely that these values would be included in a free trade agreement with Canada.

These examples allude to three problems with signing a free trade agreement with the entire ASEAN region. First, Canada would be pursuing trade diversification with a region that includes small economies that commit human rights abuses with marginal economic benefits. Pursuing a free trade agreement that includes Myanmar, for example, is a departure from Canada’s role as an international leader in pursuing progressive trade. Second, given the different levels of development throughout ASEAN countries, there is a risk of settling for a lowest common denominator agreement. Developing countries often face obstacles, such as weak bureaucratic capacity, that preclude them from signing complex trade agreements (Pangestu 2000). Therefore, accommodating small ASEAN countries might prevent Canada from signing an agreement that achieves meaningful benefits for the Canadian economy. Third, there could be domestic political consequences for the Canadian government by signing trade agreements with countries that commit human rights abuses.

There are also limitations to pursuing bilateral trade agreements with individual ASEAN countries, such as the significant time and resource investment necessary to develop and finalize an agreement. Taken together, these examples show that pursuing a free trade agreement with the entire ASEAN region, or bilateral agreements with individual ASEAN countries, are inadequate strategies for trade diversification.

Political

The fourth challenge is political — particularly Canada’s absence in the Asia-Pacific region. Canada is not well-established in the Asia-Pacific region and is not included in regional fora such as the East Asia Summit (Asia Pacific Foundation of Canada 2017). Furthermore, as noted, Canada does not have a trade agreement with ASEAN,

while other similar economies such as Australia and New Zealand signed a free trade agreement with ASEAN in 2010.

ASEAN is a politically difficult region for Canada to access, primarily because of differences in social policies such as the attention to human rights. The European Union experienced difficulties when attempting to negotiate a free trade agreement with ASEAN because certain ASEAN countries were deterred by the European Union’s high trade standards (Valero 2018). Therefore, engaging with ASEAN requires the Canadian government to maintain Canada’s progressive trade agenda. Given Canada’s absence in the region, promoting the benefits of Canada-ASEAN trade to all stakeholders is a challenge. The Canadian government should develop methods for promoting increased trade with ASEAN along with establishing a stronger presence in the region.

Overall, the challenges Canada faces in trade diversification with ASEAN makes the pursuit of a region-wide trade agreement an ineffective engagement strategy. In light of the four challenges discussed above, there are three key policy recommendations Canada should pursue to diversify trade in the ASEAN region.

Recommendations

1. **Extend the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) to include Thailand and Indonesia.** Thailand and Indonesia are the next logical extensions to the CPTPP, as the two countries have relatively high Ease of Doing Business indices and high GDPs per capita, signifying the ability to bring about the greatest marginal gains. A CPTPP extension provides the most political and economic flexibility for Canada in maintaining a high-quality agreement with expected minimal domestic opposition. Other ASEAN countries may be added at a later date when and if they become able to fulfill the CPTPP standards and other CPTPP members agree to the addition.

Tariffs on imports for some countries in ASEAN are currently very high. The CPTPP gives Canada a tariff-reducing trade agreement with Brunei, Malaysia, Singapore and Vietnam, but does not cover Indonesia or Thailand, which still have high tariffs for Canadian exports. For example, the tariffs faced by Canadian goods being exported to Thailand can be as high

as 50 percent for processed food or 80 percent for automobiles (International Trade Administration 2018). Countries competing with Canada such as Australia, Japan, Korea and New Zealand already have agreements that reduce these tariffs. Thus, Canadian businesses are currently disadvantaged when exporting to ASEAN countries not included in the CPTPP. Extending the CPTPP would reduce tariffs in these countries, leading to large monetary gains from trade.

- 2. Enhance business relationships with ASEAN.** As a fundamental step to diversifying trade, Canada needs to gain a more prominent presence in the region. In this regard, emphasizing the development of long-term business relationships with local partners is critical (Asia Pacific Foundation of Canada 2017). While the Asia Pacific Foundation of Canada notes that extensive research is involved in building relationships with local partners, it also states, based on its referenced case studies, that thorough research is important for reputational reasons. Moreover, the diverse nature of ASEAN member states would require a differentiated approach, in which its members must receive individual consideration (*ibid.*). Building business relationships could, for example, take the form of hosting joint Canada-ASEAN business consultations to discuss trade and investment challenges, proposed solutions and a devised path forward. This would be relatively low in cost yet valuable to arrange.
- 3. Better inclusion of “after-care provisions” in trade negotiations.** Post-trade negotiations, Canada should develop more effective after-care provisions to ensure that Canadian businesses are provided access to protection mechanisms in foreign markets. For example, Canadian firms can have improved access to Canada’s Trade Commissioner to discuss best practices for overcoming barriers and entering a particular market. After-care will allow more Canadian firms to access foreign markets with a greater understanding of the respective culture and business environment.

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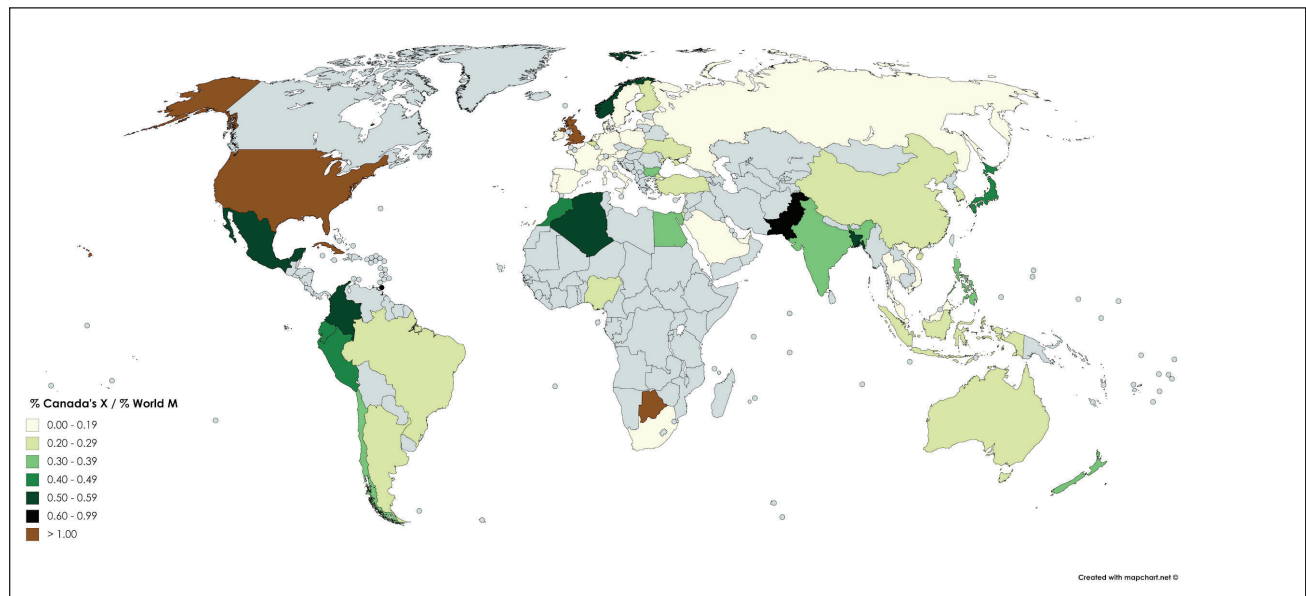
Appendix 1

The gravity model of trade is a regression model estimating the amount of trade between two countries; it is based on the relative size of two economies and the proximity between them:

$$\text{Trade Flow}_{ij} = C \frac{GDP_i + GDP_j}{\text{Distance}_{ij}}$$

Appendix 2

Figure 1: Trade Bias Towards Canada's Top 55 Trading Partners



Source: Authors.

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