Canada's Indo-Pacific Trade Strategy and Trade Diversification

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Executive Summary

The Canadian government recently announced funding for its Indo-Pacific Trade Strategy (IPS). This initiative is aimed at, among other things, diversifying Canada's exports away from the United States and towards emerging markets such as India and Indonesia. While some of the goals of the IPS extend beyond geographically diversifying Canada's exports to encompass cooperation with Indo-Pacific countries in matters such as climate change and international security, trade diversification is a key objective of the IPS program. The IPS is certainly not the only current government program to diversify Canada's export markets. Other initiatives include ongoing work to conclude bilateral trade agreements with the UK and Japan, as well as a regional trade agreement with European Union members. However, the IPS is the most recent and potentially the most substantive effort to expand markets for Canadian products outside of the United States.

Reducing trade dependence on the US has been a long-standing objective of the Canadian government. As early as the 1970s, the government of Prime Minister Pierre Trudeau put forward a "third option" strategy which involved diversifying Canada's trade abroad (Bonder, 2018). More recently, the government's 2007 Global Commerce Strategy had as its essential objective that Canada expand trade beyond North America (Beaulieu and Song, 2015). In 2018, Prime Minister Justin Trudeau stressed that the diversification of trade away from the US was a substantial responsibility of his government (Ljunggren, 2018), and a related federal government report posited that geographical diversification of Canada's exports would reduce the risk of trade protectionist measures by individual trading partners and give Canada a better bargaining position in trade disputes and negotiations (Scarffe, 2019). In this respect, the IPS can be seen as an effort to meet this perceived government responsibility.

Notwithstanding the government's expressed imperative to diversify Canada's geographical and industrial trade patterns, and despite Canada's signing trade liberalization agreements with trade partners besides the US, Canada's trade patterns have remained remarkably consistent for decades. In particular, the US has remained Canada's major market for exports, while the industrial mix of exports has remained concentrated in a

small number of industries. This pattern of regionally concentrated trade is characteristic of small open economies besides Canada, including Australia and the Nordic countries. Among other things, it reflects the influence of physical distance as a deterrent to trade flows. The negative influence of distance has received strong empirical support in the literature, and supply chain disruptions related to COVID have, if anything, strengthened the incentives of companies to shorten the geographical distances of their supply chains.

Against the background of both international trade theory and actual trade experience, Canadian government financial subsidies and related policies to promote exports to the Indo-Pacific region are unlikely to be very effective. Moreover, to the extent that government financial subsidies do promote increased Canadian exports to Indo-Pacific countries, a portion of those increased exports may come at the expense of reduced exports to the US. If so, the gains from trade to Canada's economy are likely to decline as more efficient cross-border trade is displaced by less efficient cross-oceanic trade when the latter is directly or indirectly subsidized by the Canadian taxpayer.

Another relevant consideration is that any successful effort to increase Canadian exports to the Indo-Pacific region would need to address two important realities. One is that the main export opportunity in the Indo-Pacific region available to Canada, at least for the foreseeable future, is liquefied natural gas (LNG). However, Canada lags well behind export rivals such as the US, Australia, and Mexico in developing LNG exporting infrastructure. Furthermore, the IPS explicitly focuses on "green energy" exports which presumably do not include natural gas.

A second reality is that China currently dominates supply chains in the Asia-Pacific region and is likely to do so for the foreseeable future. The IPS is deliberately vague about the future course of Canada-China economic relations. However, it acknowledges political and other sources of tension between the two countries, as well as the need for Canada to support the desire of its Western allies to condition trade relations with China so that those relations do not compromise the national security interests of the allies, particularly those of the US. Given the existing geopolitical environment, it seems unrealistic to expect significantly closer economic integration between Canada and China, even though closer economic integration might be a prerequisite to the success of Canadian companies in increasing exports to the Indo-Pacific, especially exports related to Electronic Vehicles (EVs), EV components, and other green energy products.

A prominent argument for diversifying exports away from the US and toward Indo-Pacific countries is that the latter economies are expected to grow at a faster rate than the US economy in the future. While this expectation might prove to be correct, it

ignores an emerging and potentially significant opportunity for increased bilateral trade in services. While the delivery of a growing range of services over the Internet has been ongoing for a while, the COVID epidemic arguably accelerated this development, particularly as commercial and personal travel across borders was curtailed. The US market for services dominates those of Indo-Pacific countries in terms of size and sophistication. Furthermore, cultural similarities between Canada and the US make Canadian service exports to the US both more feasible and more economically beneficial than service exports to the Indo-Pacific region.

To be sure, major obstacles currently exist to expanding bilateral trade in services including regulations limiting the legal right of non-residents to supply specific services to potential buyers in state and provincial jurisdictions, local and state government preferences for purchasing engineering, consulting, and related services from local suppliers, privacy-related legal restrictions on transferring data across political jurisdictional boundaries, and so forth. Therefore, any significant increase in the trade in bilateral services will require a major extension of the existing Canada-US-Mexico trade agreement (CUSMA) to encompass digital services. The forthcoming review of the CUSMA (also known as the USMCA) by the parties to the agreement will also likely oblige Canadian negotiators to address US concerns about Canadian tariffs on dairy products, while providing an opportunity for Canadian negotiators to press objections to US tariffs on Canadian exports of lumber, steel, and other manufactured products. Agreement on irritants surrounding bilateral trade in goods might help smooth the path for major breakthroughs in the area of digital services.

In summary, while major potential gains to expanding bilateral trade exist, they will require hard bargaining and political concessions on both sides. However, it seems more fruitful for Canadian policymakers to focus on expanding and deepening regional trade and investment linkages among the parties to CUSMA than to subsidize (directly or indirectly) costly initiatives to promote Canadian exports to the Indo-Pacific region.

Introduction

As a small, open economy, Canada relies on international trade for its critical contribution to the country's economic performance. In particular, exporting enables Canadian plants and firms to operate closer to their efficient scale than would be the case were export markets less accessible. At the same time, importing allows Canadian firms to specialize in the domestic production of a narrower range of goods and services, while consumers are still able to access the range of goods and services that are available to consumers in much larger economies. Specialization enables Canadian producers to realize economies of scale and specialization, while increased import competition helps ensure that Canadian businesses and consumers can purchase intermediate and final goods and services at competitive world prices.[1]

Canadian policymakers arguably recognize the importance of ensuring that Canadian producers of goods and services have access to international markets as manifested by the numerous trade agreements to which Canada is a signatory including the CUSMA, CPTPP, and CETA.[2] To be sure, the various trade agreements stop well short of eliminating all barriers to trade and foreign direct investment among the signatories. Hence, any assessment of Canada's new trade policy initiatives should assess whether they are likely to promote domestic gains from trade in a substantial way. Gains from trade can be thought of as increases in the surpluses realized by Canadian consumers and producers. Consumer surplus is the amount consumers are willing to pay for the basket of goods that they buy net of the amount they actually pay. Producer surplus is simply the profits

1 Economies of scale refers to increases in efficiency that result from the production of larger volumes of output. Economies of specialization refers to increases in efficiency that result from producers realizing longer production lengths of run by producing narrower ranges of goods and services.

2 CUSMA refers to the Canada-US-Mexico Agreement, also known as USMCA. CPTPP is the Comprehensive and Progressive Agreement for Trans-Pacific Partnership which is a free trade agreement between Canada and 10 other countries in the Asia-Pacific region. CETA is the Canada-European Union Comprehensive Economic and Trade Agreement. CETA will come into full effect when all EU member states have completed the ratification process. Until then, the agreement is being applied provisionally. Another agreement that could be mentioned is the Canada-UK Trade Continuity Agreement, which came into force in 2021.

earned by domestic businesses. A government trade initiative can promote increased gains from trade by facilitating access to better and cheaper intermediate and final goods made outside of Canada and by promoting increased exports that allow domestic producers to increase net revenues.[3]

The main issue this essay considers is whether Canadian policymakers are likely to create increased gains from trade by actively promoting trade diversification away from the United States, Canada's largest trading partner, in favour of promoting increased exports to countries in the Asia-Pacific region, as the Canadian government plans to do in implementing its Indo-Pacific Strategy.[4] Canada's Indo-Pacific Strategy (IPS) is a policy blueprint for diversifying Canada's export trade across various industrial sectors with ASEAN centrality a key component.[5] Closer economic engagement with North Pacific trade partners such as Japan and Korea, as well as with South Asian countries, in particular India, is also a core element of the IPS. While China is not excluded from consideration under the IPS, it is not the focus of most of the relevant initiatives, which reflects the politically contentious nature of China's current relationship with Canada.

In announcing the IPS, the federal government highlighted the growing economic importance of countries in the Indo Pacific region. It assessed that by 2040, the region will account for more than half of all global economic activity, which will be more than twice the projected share of economic activity in the US (Canada, 2023).[6] The anticipated future growth rate of the region, as well as concerns about mounting US trade protectionism underlie a growing number of calls by trade analysts for Canada to strengthen its trade and investment linkages with less traditional partners. Among others, Tiff Macklem (2018), the current governor of the Bank of Canada, advocated for the Canadian government to promote trade diversification when he was Dean of the Rotman School

3 For a discussion of the various sources of gains from international trade, see Feenstra (2018). To be sure, the Canadian government's trade objectives are broader than ensuring gains from trade as defined above. In particular, there has been an increasing emphasis on a progressive trade agenda that includes considerations of promoting economic opportunities for women and Indigenous peoples and clean energy use, among others. A consideration of progressive trade objectives is beyond the scope of this study. The interested reader should see Beaulieu, Leblond, Daryanani, et. al. (2019).

4 For a discussion of Canada's Indo-Pacific Strategy, see Canada (2023). Since the focus of the IPS is on geographically diversifying Canada's exports, the relevant potential gain from trade associated with the IPS initiative is increases in the net revenues of Canadian-based exporters.

5 ASEAN stands for the Association of Southeast Asian Nations, which consists of 10 member countries in the region. The IPS will be discussed in more detail in a later section of this essay. For a brief overview of the IPS, see Stephens (2023).

6 The Indo-Pacific region comprises 40 countries and economies including 14 Pacific Island countries; however, the IPS strategy highlights the particular significance of India, Japan, the Republic of Korea, and the Association of Southeast Asian Nations (see Canada, 2023).

of Management at the University of Toronto.[7] Hence, an assessment of the IPS initiative is important when considering Canada's current trade policy environment.

This essay proceeds as follows. By way of background, Section 2 presents and interprets data on Canada's trade pattern from 2012-2022 including the main export and import sectors, as well as the distribution of Canada's exports and imports across its trading partners. Also by way of background, Section 3 discusses the main features of IPS. Section 4 provides a critical perspective of the IPS in light of data presented in Section 2, as well as emerging economic and political developments that will arguably condition Canada's major trade opportunities going forward. Concluding comments are provided in Section 5.

7 Similar arguments for trade diversification are found in Allam (2022) and Bergman (2023). A growing concern about US trade protectionism has also underscored calls for Canada to develop new export markets.

Canada's Historical Trade Performance

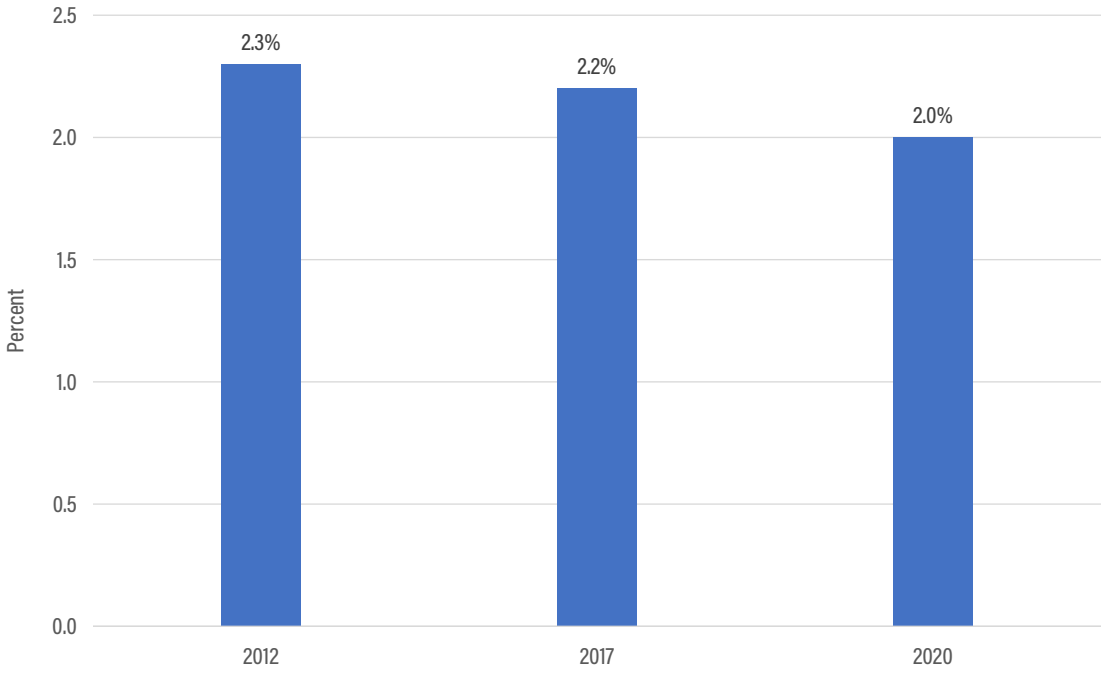
This section presents data summarizing Canada's trade performance over the decade from 2012 to 2022 and highlights the overwhelming and durable importance of the United States in Canada's trade flows. Since the COVID-19 epidemic affected the industrial composition and geographical distribution of world trade, we present the relevant data separately for the sub-periods 2012-2017 and 2017-2022. In fact, a comparison of the two sub-periods shows that while there were changes in Canada's trade pattern, the changes are modest, and the recent pattern is generally consistent with the industrial composition of Canada's exports and imports, as well as Canada's major trading partners over longer-run periods.

Canada's total trade flows (good plus services) increased over the two subperiods. Specifically, exports in nominal Canadian dollars increased by 18.9 percent from 2012-2017 and by 40.7 percent from 2017-2022. Similarly, imports increased by 23.8 percent from 2012-2017 and by 32.5 percent from 2017-2022. Notwithstanding these increases, Canada's share of global exports and imports declined as shown in Figures 1 and 2, respectively.[8] Macklem (2018) cites Canada's declining share of world trade as reflecting the concentration of Canada's trade with the United States and argues that Canada needs to implement policies to promote trade with big, faster-growing Asian economies, namely India and China.[9] Bergman (2023) highlights the decline in exports' share of GDP for Canada over the past two decades from 38 to 30 percent. Like Macklem, he argues that part of the explanation for Canada's relative decline in trade intensity is the fact that Canada's exports go to a handful of traditional trading partners whose economies are growing relatively slowly. He recommends a policy focus on deepening trade with faster growing developing markets. These and similar policy recommendations for government initiatives to diversify trade flows generally do not discuss the challenges associated with geographical trade diversification.

8 The most recent data for global exports and imports reported by the World Bank is for 2020.

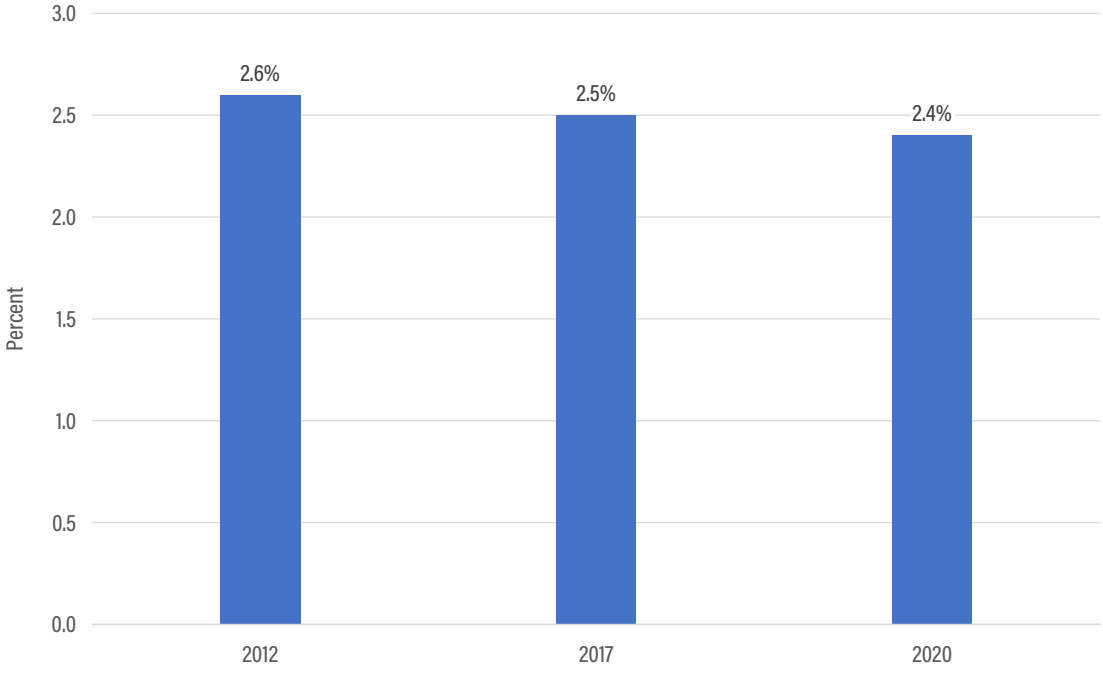
9 An earlier initiative to promote closer trade ties with Asia-Pacific countries involved Canada's joining the Trans-Pacific Partnership (TPP), which came into effect on December 30, 2018.

Figure 1: Canada's Exports as a Percentage of World Exports



Sources: World Bank (Undated); and Statistics Canada (2023a), Table 12-10-0134-01.

Figure 2: Canada's Imports as a Percentage of World Imports



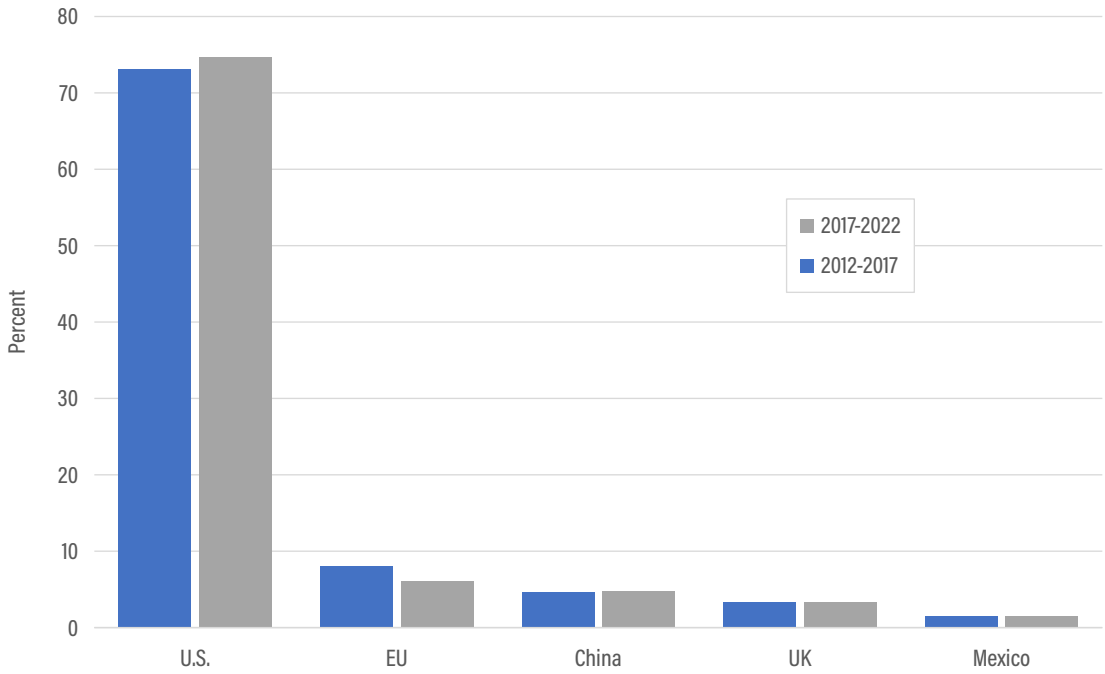
Sources: World Bank (Undated); and Statistics Canada (2023a), Table 12-10-0134-01.

A notable feature of Canada's trade performance is the relative constancy in the shares of Canada's exports and imports accounted for by its trade partners, as well as the product mix of exports and imports. In this regard, figure 3 shows the shares of Canada's merchandise exports going to its 5 largest trade partners for the sub-periods 2012-2017 and 2017-2022, while figure 4 shows the geographical distribution of Canada's merchandise imports.[10] Canada's concentrated trade with the US is clearly identified. Between 2017 and 2022, approximately 75 percent of Canada's merchandise exports went to the US, a small increase over the 2012-2017 period. Almost two-thirds of Canada's merchandise imports came from the US in the 2012-2017 period followed by a small decrease from 2017 to 2022. It is interesting to note that in 1990 approximately 75 percent of Canada's exports went to the US, while almost 65 percent of Canada's total imports came from the US.[11] The US-Canada Free Trade Agreement (FTA) came into effect on January 1, 1989, which could have been expected to increase the share of Canada's total trade with the US in the years after it came into force. The fact that the US's relative position as Canada's trade partner remained relatively unchanged over more than three decades after the FTA was implemented attests to the strength of geographical, economic, and cultural proximity as determinants of trade patterns.

10 Canada's international trade predominantly involves trade in goods. Trade in services accounted for approximately 17 percent of total trade from 2012-2017 and around 19.3 percent of total trade between 2017 and 2022 (author's calculations from data in Statistics Canada (2022), Table 1: Trade in Services by Category).

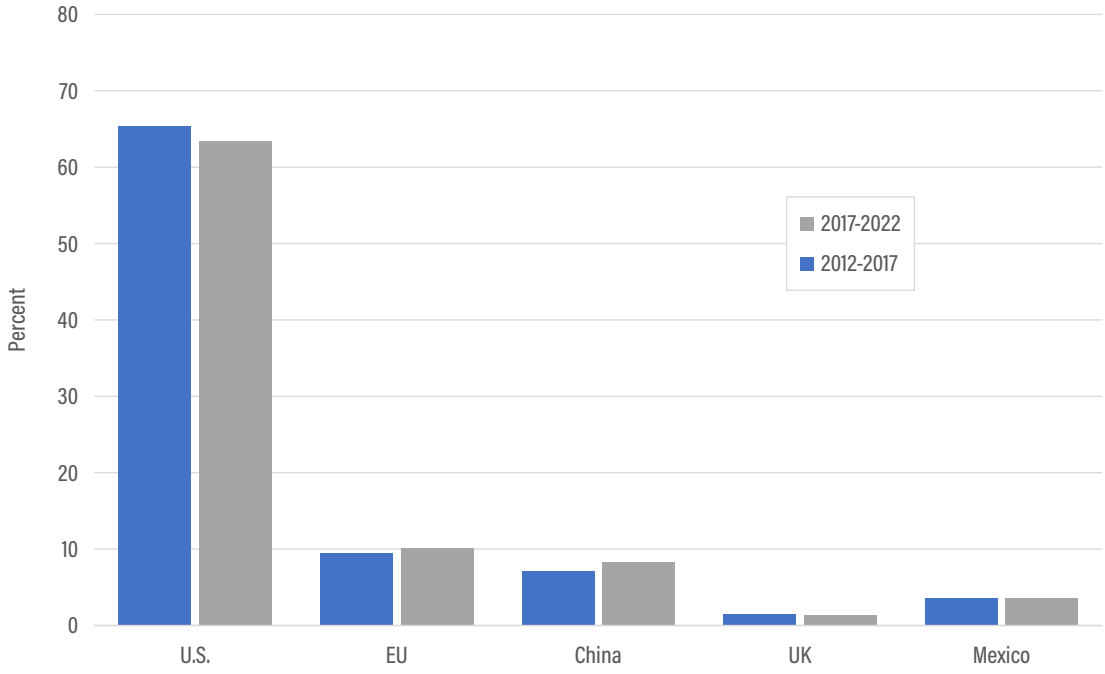
11 This data is from World Bank (Undated), WITS World Integrated Trade Solution.

Figures 3: Canada's Exports by Leading Trade Partners (Percent)



Source: Statistics Canada (2023b), Table 12-10-0011-01.

Figures 4: Canada's Imports by Leading Trade Partners (Percent)



Source: Statistics Canada (2023b), Table 12-10-0011-01.

The US is also Canada's dominant trade partner for services. Specifically, the US's share of Canada's service sector exports averaged 53.7 percent from 2012 to 2017. It averaged a slightly lower 52.6 percent between 2017 and 2021.[12] The EU minus the UK was Canada's second largest service trade partner accounting for 10.6 percent of Canada's services exports over the period 2012-2017 and 11.2 percent over the period 2017-2021. The UK was Canada's third largest service trade partner over the 2012-2021 period. Canada's service exports to the UK averaged 5.2 percent of total services exports from 2012-2017 and 5.7 percent between 2017 and 2021. Hence, the main service sector trading partners have not changed and their relative sizes as export markets were relatively unchanged over the period.

Certainly China has become one of Canada's larger trade partners since 1990. In 1990 China accounted for slightly over 1 percent of Canada's merchandise exports and imports.[13] The data show that China's share of total Canadian merchandise exports was almost 5 times larger from 2017 to 2022 as it was in 1990, while China's share of total Canadian merchandise imports over the same period was over 8 times its share in 1990. Exports to China from Canada's service sector increased at a slower pace—from around 4.3 percent of total Canadian service sector exports in 2012 to around 5 percent in 2022. Hence, while the relative growth of total trade with China is significant, trade integration with the United States is much more important for Canada's economy than is its trade integration with China, notwithstanding the substantial growth of China's economy over the past three decades and its inclusion in the World Trade Organization.

Over time, the pattern of Canada's exports and imports by industry has also been relatively slow to change. Table 1 reports the share of Canadian exports accounted for by the seven leading merchandise export industries for the two periods: 2012-2017 and 2017-2022.[14] There is some variation in the relative share of exports accounted for by individual industries when comparing the two sub-periods, particularly in the cases of energy products and metallic and non-metallic mineral products. However, energy products and motor vehicles and parts were clearly the main export sectors over the decade

12 Country-specific services trade data is available only through 2021. See Statistics Canada (Undated—Archived), Table 36-10-0024-01.

13 See data from World Bank (Undated), WITS Integrated Trade Solution.

14 The data are for the fourth quarter of each year in the sub-period, averaged over the sub-period. The consistent use of fourth-quarter data eliminates concerns about seasonal influences on the time series. However, unequal disruptions to supply chains and changing consumer patterns related to the COVID-19 crisis could well influence comparisons between the two sub-periods. The seven industries account for around 70 percent of total Canadian exports in the two sub-periods.

from 2012-2022; they accounted for 37 percent of total exports in the first sub-period and 39 percent of total exports in the second sub-period.

Table 1: Exports by Industry as a Share of Total Exports (Percentage)

Industry	2012-2017	2017-2022
Energy Products	23.4	26.7
Motor Vehicles and Parts	13.9	12.6
Metallic and Non-Metallic Mineral Products	11.2	8.7
Forestry Products	7.2	6.8
Industrial Machinery and Equipment	6.3	6.5
Electronic and Electrical Equipment	4.7	4.7
Food and Beverages	4.5	4.3

Source: Statistics Canada (2023a), Table 12-10-0134-01.

Table 2 reports the share of Canadian merchandise imports accounted for by the seven leading import industries for the two sub-periods. Canada's industrial imports are less concentrated by industry than its exports, as the leading seven import industries account for 55 percent of total imports in the first sub-period and 58 percent of total imports in the second sub-period. This compares to a 71 percent share of total exports for the seven leading export industries in the first period and a 70 percent share in the second period. As in the case of exports, there is some variation over time in the relative importance of individual industries. However, three industries (motor vehicles and parts, electronics and electrical equipment, and industrial machinery and equipment) account for the largest share of imports in both sub-periods. Specifically, they account for almost 40 percent of total imports in the 2012-2017 period and slightly over 41 percent in the 2017-2022 period.

Table 2: Imports by Industry as a Share of Total Imports (Percent)

Industry	2012-2017	2017-2022
Motor Vehicles and Parts	17.5	18.7
Electronics and Electrical Equipment	11.8	13.1
Industrial Machinery and Equipment	10.2	9.5
Cleaning Products	4.6	4.9
Food and Beverages	4.5	4.4
Clothing and Footwear	3.5	3.6
Pharmaceuticals and Medicine	3	4.2

Source: Statistics Canada (2023a), Table 12-10-0134-01.

Trade in services is dominated by the commercial services category which encompasses some 15 sub-industries that include all service transactions other than those involving travel, transportation,[15] and government services. Some of the sub-industries include communications, insurance and other finance, computer and information, management, research and development, advertising, architectural, engineering, and other technical, audio-visual and personal, cultural and recreational. Commercial services trade as a share of Canada's total goods and services trade averaged 10.4 percent over the period 2012-2017 and 10.8 percent between 2017 and 2022.[16]

In short, the data reported above strongly suggests that Canada's overall trade pattern as disaggregated by the importance of specific trading partners and of specific industrial sectors is quite stable over time. To be sure, different rates of technological change across trading partners as well as different rates of investment by countries in physical and human capital can alter the comparative advantages of those countries, thereby altering geographical and industrial patterns of trade.[17] However, geographical proximity is a major determinant of trade intensity between countries. The primary importance of physical distance is captured in the most widely used model of international trade flows, i.e., the so-called gravity model. Chaney (2013) identifies the gravity equation in international trade as one of the most robust empirical findings in economics. The gravity equation specifies bilateral trade between two countries as being proportional

15 Statistics Canada (2003) provides a full list of commercial service sectors.

16 Author's calculations from Statistics Canada (2022), Table 1: Trade in Services by Category.

17 See Salinas (2021) for a recent empirical analysis of factors influencing trade diversification at the country level.

to the product of the sizes of the two countries as measured by Gross Domestic Product (GDP) and inversely proportional to the geographic distance between them.[18]

Chaney notes that while there have been profound changes in the international trade environment over the decades, the empirical distance coefficient in the gravity equation has remained essentially constant. He ascribes this stability of the distance coefficient to the emergence over time of a stable network of importers and exporters. He identifies the size distribution of firms as influencing the stability of trade networks. Specifically, as firms get larger, they trade more and also trade with more geographically distant partners. Hence, whether a country exports more or less to distant places depends on whether there are relatively many or few large firms.

To summarize, notwithstanding the rapid economic growth of potential trading partners in Asia over the past few decades, particularly China, as well as Canada's implementation of various regional trade agreements beyond the US-Canada Free Trade Agreement and the North American Free Trade Agreement (subsequently the USMCA), the US remains Canada's dominant trade partner.[19] Moreover, Canada's industrial pattern of trade has also shown remarkable stability in spite of technological changes that have altered supply and demand conditions in numerous industries. To the extent that economies outside of North America grow faster than the US economy in the future, the gravity equation of international trade suggests that some diversification of Canada's trade away from the US will occur through market forces, but it will be slow. If Canadian policymakers, for whatever reason, think it is desirable to accelerate Canada's trade diversification away from the US as well as away from Canada's main traditional export sources, i.e., oil and gas, and automobiles and parts, they will need to identify and implement policies that reduce the costs and related disadvantages to Canadian companies associated with trading over longer physical (or cultural) distances and establishing new and stable networks of trading partners. The next section identifies and assesses emerging Canadian government policies to increase Canada's trade with Indo-Pacific countries and to diversify trade away from primary industries, particularly oil and gas.

18 It should be noted that the gravity equation has primarily been applied to trade in goods, which has been the dominant focus of international trade to date. As will be discussed in a later section, cultural similarity, including similar language, plays a significant role in patterns of trade in services. Therefore, cultural distance is a stand-in for geographic distance in the context of service sector gravity models, although cultural distance is typically correlated with geographic distance.

19 US officials use the USMCA acronym; Canadian officials use the acronym CUSMA.

Canada's Indo-Pacific Strategy

Canada's Indo-Pacific Strategy sets out an ambitious plan for enhancing trade, investment, and supply chain engagement with countries in the Indo-Pacific region. However, the goals of the IPS are much broader than diversifying away from Canada's reliance on the US as its dominant trade partner. Indeed, table 3 summarizes five strategic objectives of the IPS and it shows that only one is directly and singularly focused on expanding Canada's trade and investment ties to the Indo-Pacific region, although the objective to expand trade, investment, and supply chain diversity is indirectly linked to the imperative to diversify Canada's international economic linkages with the Indo-Pacific region being a prominent target. Promoting so-called green energy and sustainable development is another key goal. It is identified explicitly as a fourth objective and the IPS mentions advancing collective efforts towards meeting sustainable development targets as part of its third goal: investing in and connecting people. Promoting women's rights and providing feminist international assistance are sub-goals in promoting peace, resilience, and security, and investing in and connecting people.

Table 3: Strategic Objectives of the IPS

1. Promote peace, resilience and security
2. Expand trade, investment and supply chain resilience
3. Invest in and connect people
4. Build a sustainable and green future
5. Be an active and engaged partner to the Indo-Pacific

Source: Canada (2023).

The IPS sets out an extensive list of actions needed for it to achieve its stated objectives. Table 4 summarizes them. In broad terms, the IPS will encompass an expansion of Canada's trade network in the region by establishing a trade gateway and an agri-food office in Southeast Asia, appointing a new Indo-Pacific trade representative, and launching Team Canada trade missions. These initiatives will be accompanied by government financial support for small and medium-sized Canadian enterprises pursuing new trade and investment opportunities in the Indo-Pacific region, particularly those in the clean energy sector, as well as by strengthening and expanding existing trade agreements such as the CPTPP, seeking to join the newly established Indo-Pacific Economic Framework

for Development, and negotiating new free trade agreements with India, Indonesia, and the ASEAN countries. To ensure the resilience of supply chains, the federal government will make significant investments in domestic transportation infrastructure through the National Trade Corridor Fund, including investments in the ports of Vancouver and Prince Rupert and for major upgrades to road, rail, and port infrastructure.

Table 4: Initiatives to Expand Canada's Trade Network

1.	Launch a Trade Gateway in Southeast Asia
2.	Appoint a new Indo-Pacific trade representative
3.	Launch a series of large-scale Team Canada trade missions
4.	Provide financial support for domestic SMEs
5.	Provide enhanced economic support for Indigeneous people and women entrepreneurs
6.	Open an Agri-Food office in the region
7.	Strengthen and expand existing trade and related agreeements with partners in the region
8.	Join the newly established indo-Pacific Economic Framework for Development
9.	Negotiate new free trade agreements with ASEAN, India, and Indonesia
10.	Make significant investments in domestic infrastructure

Source: Author's summary from Canada (2023).

It is relevant to note that investments to expand and improve domestic port, rail, and road infrastructure would arguably enhance Canada's capacity to export to other regions in addition to the Indo-Pacific although the degree to which this is the case obviously depends upon the specific nature of the relevant investments. As such, infrastructure investments might well be trade-creating rather than trade-diverting.[20] On the other hand, direct or indirect government subsidies linked to doing business in the Indo-Pacific region might be trade-diverting as such subsidies make it relatively more profitable for Canadian companies to try to expand their business activities in the subsidized region relative to regions that do not receive the same financial preferences.

A central focus of the IPS is increasing exports to the ASEAN countries, which are: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam. The IPS also aims for closer engagement with North Pacific trade partners such as Japan and Korea, as well as with South Asia, particularly India. The position of China in the IPS is somewhat ambiguous. On the one hand, the IPS

20 Trade-creating initiatives increase a country's overall volume of trade, whereas trade-diverting initiatives shift a country's trade flows across trading partners while leaving overall trade flows relatively unchanged.

recognizes the economic importance of China as a global trading partner. On the other hand, it diminishes that importance relative to earlier years when there were ongoing discussions between Canada and China regarding a free trade arrangement.[21]

Increasing political tensions between Canada and China as well as the collateral trade and investment complications stemming from escalating trade frictions between China and the US have dampened the enthusiasm in both Canada and China for deepening their bilateral trade and investment relationship. Most recently concerns about interference by the Chinese government in Canadian elections have become a flashpoint in the trade and investment regimes between the two countries. However, an arguably more problematic issue for Canada-China trade and investment linkages is the explicit and implicit restrictions imposed by Canada's trade and investment relations with the US. In this regard, a provision of the USMCA, the successor to the North American Free Trade Agreement, allows a party to the USMCA to withdraw from the agreement if another party enters into a free trade agreement with a country it deems to be a non-market economy. This provision was clearly implemented with China foremost in mind and for all practical purposes means that any significant Canadian effort to liberalize trade with China would threaten the US-Canada economic relationship as it is governed by the USMCA.

To be sure, US concerns about exports to China are currently and primarily focused on products that raise national security concerns such as AI semiconductor chips, and the US government's enlistment of support among its allies is focused on their implementing their own export restrictions on goods that are strategic to China's military. As such, US national security concerns would not seem to be relevant to Canada's traditional exports to China such as grain commodities. However, as China's boycott of Canadian exports of canola demonstrated, any significant export from Canada to China can be an indirect "hostage" to disputes between the US and China, as was the case several years ago when a leading executive of the Chinese company Huawei was detained in Canada upon request by the US, which was seeking her extradition; that action triggered both China's arresting and detaining two Canadians and China's ban on Canadian canola.[22]

The government announcement of the IPS cites and discusses many of Canada's conflicts with China, while acknowledging that China's sheer size and economic influence makes cooperation necessary, [23] particularly to address problems such as climate change. The IPS also recognizes that China's economy offers significant opportunities for

21 See Stephens (2023) for an overview of the IPS.

22 China suspended imports of canola seeds from Canada's two largest exporters on grounds that pests had been detected in shipments. It removed the three-year old ban in May 2022 after the Huawei executive returned to China (see Reuters, 2022).

23 See Canada (2023).

Canadian exporters. With respect to China, Canada is improving the Trade Commission service for Canadian exporters to provide services that ensure commercial opportunities are consistent with national security. Notwithstanding, it seems likely that increasing exports to China in the years ahead will be much more challenging than in previous decades absent major changes in China's political and economic governance.

The IPS is the centerpiece of the government of Canada's current trade diversification push, which the government has identified as a national imperative. The Trudeau government announced that it will spend $2.3 billion over the next five years to fund the IPS. The biggest chunk of that money will fund defence and security initiatives including $493 million for the Canadian navy to provide it with adequate resources to participate in regional military exercises. An additional $180 million is set aside for Team Canada trade missions, while $32 million will go towards creating an Indo-Pacific Agriculture and Agri-Food office that will have as its mandate to get Canadian food into more markets.[24]

The next section evaluates the likelihood that the IPS will significantly increase exports to the Indo-Pacific region and thereby diversify Canada's trade away from its major US partner against the background of an increasingly fraught trade and investment relationship with China.

24 See Karim (2022) for an overview of planned spending. Canada (2023) provides more details.

Assessing the Indo-Pacific Strategy

Several empirical observations provide useful context for evaluating the likely impact of the IPS on Canada's trade patterns. One observation is that the combined total imports by all of the ASEAN countries from Canada in 2020, plus Japan, Korea, and India's imports from Canada that year (US$2,296 million) were less than total US imports from Canada (US$2,405 million) and only slightly greater than China's total imports (US$2,070).[25] An implication of this observation is that if Canada is going to diversify its exports to the Indo-Pacific region in a meaningful way, and if national security considerations and related concerns constrain the growth of Canada's exports to China, Canadian exporters will need to increase their business linkages with a substantial number of trade partners with which they have done only limited business to date, some of whose economies are relatively small. This will make the trade diversification process more costly and difficult.[26]

A second and related observation is that the trade linkages of Asia-Pacific countries are largely regional, as is also the case for North America and the Euro zone.[27] Unsurprisingly, China is the leading source of imports for Japan, Korea, and India, as well as for the largest ASEAN countries including Indonesia, Vietnam, Thailand, Malaysia, and Singapore. In almost all cases, the US is the only country outside the Asia-Pacific region to rank among the top 5 exporters to the countries listed above. Its market share ranges from a high of 12 percent in the case of Korea to a low of 5 percent in the case of Vietnam. By comparison, China's market share ranges from a high of 33 percent for Vietnam to a low of 14 percent for Singapore. An implication of the regional trade integration in the region and the trade dominance of China is that Canadian exporters will face tough and

25 Author's calculations from data reported in World Bank (Undated), WITS World Integrated Trade Solutions.

26 The discussion in this section is focused on Canada's export diversification as that seems to be the focus of the IPS.

27 For a discussion of how post-pandemic supply chains are increasingly being built with a focus on regionalization, see Page (2023).

established competition from Asia-based exporters, particularly China-based companies, that have established supply chain linkages to suppliers and customers in the region.

To the extent that Canada's trade advantages are concordant with demand patterns for intermediate and final goods from potential buyers in the Indo-Pacific region, Canadian exporters would face a less daunting task of exporting to that region. Therefore, it is informative to identify the leading imports of the intended Indo-Pacific trade partners and compare them to Canada's revealed comparative trade advantages.[28]

In this regard, the prominence of imports of petroleum products and liquefied natural gas by countries in the region complements Canada's clear revealed advantage as an exporter of petroleum and natural gas, although not as yet of liquefied natural gas. For example, petroleum and liquefied natural gas accounted for almost 12 percent of Japan's total imports in 2020.[29] And petroleum oils and natural gas accounted for almost 16 percent of Korea's total imports that year. For India, almost 20 percent of its total imports in 2020 consisted of petroleum products and liquefied natural gas, and petroleum products were among the top five imports of Indonesia, the Philippines, Malaysia, Thailand, and Singapore.

Clearly, over the foreseeable future there is a significant market opportunity for increased Canadian exports of carbon fuels to the Indo-Pacific region. However, the emphasis of the IPS is on exporting clean energy products. Even if natural gas qualifies as clean energy from the perspective of Canadian policymakers, Canada lacks the infrastructure to liquefy and export natural gas to the Indo-Pacific region. At the same time, other countries are positioning themselves to be significant suppliers of liquefied natural gas (LNG) going forward, including Mexico. Canada recently ranked as the world's sixth largest producer of natural gas, but it doesn't yet have any operating LNG terminals.[30] Analysts forecast that the US will be the top LNG exporter in 2023 followed by either Australia or Qatar (see Jang, 2023). If most of Mexico's LNG projects and proposals get built, Mexico could eventually become the world's fourth largest exporter of the fuel. Mexico imports the vast majority of its natural gas through pipelines originating in the US.

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28 Industries showing a revealed comparative advantage are those whose exports account for a disproportionate share of a country's total exports. Other measures of export competitiveness are sometimes used as discussed in Deslauriers, Gagne, Gouba and Pare (2018).

29 World Bank (Undated), WITS World Integrated Trade Solutions reports import data for Japan and other countries.

30 An LNG facility near Kitimat, BC, is scheduled to be completed in 2025.

While Canada enjoys a revealed comparative advantage in motor vehicles and parts, the latter category is not among the leading import categories for countries in the Indo-Pacific region. Recently announced government financial assistance packages to Volkswagen and Stellantis for construction of EV battery plants in Ontario underscore the commitment of the federal government to move Canada's motor vehicle industry away from producing carbon fuel-based vehicles and parts towards electronic vehicles. There was initial concern on the part of Canadian government officials that the Biden Administration's Inflation Reduction Act would exclude Canadian-assembled EVs from the generous tax credits the US government will provide under the Act for purchases of EVs. However, in a speech before Canada's Parliament in March 2023, President Biden announced that Canadian-assembled EVs are eligible for US tax credits (Vacchiano, 2023).

The Biden Administration's commitment to extend US tax credits to EVs that undergo final assembly in the US, Canada, or Mexico maintains the legal trade environment that underlies the regional integration of the North American motor vehicle industry. While this integration does not necessarily preclude Canadian participation in EV-related supply chains in the Indo-Pacific region, the emerging dominance of China makes any such participation on a significant scale unlikely. The International Energy Agency (2022) explains that China has been better able to reduce the price gap with traditional cars by producing smaller vehicles and enjoying lower manufacturing costs. On average, the price of an EV in China is only 10 percent more than that of traditional cars, which is significantly lower than the 45 to 50 percent average gap in other EV markets (IEA, 2022). In addition, more than half of all lithium, cobalt, and graphite processing and refining capacity used for manufacturing EV batteries is located in China. The latter also has 70 percent of the production capacity for cathodes and 85 percent for anodes, both of which are essential components of EV batteries.

China's competitive advantage in manufacturing EV batteries and assembling EV vehicles enabled it to displace Japan in the first quarter of 2023 as the world's largest auto exporter (Ip, 2023). Against this backdrop, it seems unlikely that North American auto manufacturers will be able to produce EV vehicles cheaply enough to compete against China-based EV companies in order to sell EVs profitably in developing markets in the Indo-Pacific region such as India and Indonesia. At the same time, the emphasis the US government is placing on security of supply of rare earth minerals used in manufacturing

EV batteries makes Canada an attractive source of such minerals to North American EV manufacturers.[31]

In short, unless Canadian-based producers of critical minerals and related inputs are willing and able to integrate into regional supply chains in the Indo-Pacific region, significant Canadian exports of critical inputs to EV manufacturing seem unlikely, and since those supply chains are dominated by Chinese companies, the diversion of Canadian rare earth minerals to the Indo-Pacific region would potentially jeopardize Canada's advantaged position in the North American motor vehicle market owing to the US-Canada-Mexico Free Trade Agreement.[32]

Certainly, there are opportunities for increased Canadian exports to countries in the Indo-Pacific region other than China, particularly in the case of ASEAN countries and for value-added agricultural products, including plant-based proteins (Asian Development Bank, 2021). However, more than half of all trade that takes place in the Asia-Pacific region is intra-regional, which again suggests that Canadian agricultural companies will face significant challenges to increasing their exports to ASEAN countries given already-established supply chains within the region.

Other major industrial sectors that comprise prominent sources of imports by countries in the Indo-Pacific region include semi-conductors, data processing equipment, and electrical apparatus. These are sectors in which the US enjoys a strong comparative advantage. Moreover, a significant share of the production of electrical equipment in Canada is directly or indirectly tied to the motor vehicle sector (Sanders, 2022). The latter observation further suggests the importance of Canada's continued integration into the North American supply chain for transportation equipment to Canada's export sector.

In sum, any successful effort to expand Canadian exports to the Indo-Pacific region arguably requires Canadian exporters to integrate successfully into existing supply chains in that region. Since China plays a major role in those supply chains for a number of prominent sectors including EVs and the materials and components that go into EVs and other "clean energy" products, increasing Canadian exports to the Indo-Pacific region in a substantial manner will oblige Canada to strengthen its trade and investment ties with China. However, the IPS highlights a number of reservations that the Canadian

31 Ford Motor Company recently provided a vote of confidence in Quebec's nascent lithium manufacturing industry by signing an 11-year contract with Nemaska Lithium for future production from two planned facilities in the province (Willis, 2023).

32 The use of Canadian mined and refined minerals by North American EV producers would help qualify Canadian-assembled EVs for subsidies under the Inflation Reduction Act as it would count towards North American content.

government holds against doing so that are related to China's human rights practices, its interference in Canadian domestic politics, and other non-economic concerns. One might also add the reservation that trade relations with the US might be undermined by a resumption of trade liberalization negotiations between Canada and China.

There has been much talk in the media about companies moving production facilities out of China and into other Asian countries, thereby potentially reducing the importance of direct trade and investment linkages with China for North American companies seeking to do more business in the Indo-Pacific region.[33] While there has been some geographical diversification of supply chain operations in Asia by some companies, most experts caution that replicating supply chains outside of China will, for many activities, require massive sums of capital investment spread across many years. This is particularly true for the automotive and electronics industries, which are emphasized as priority sectors in the IPS given their linkages to EVs and clean energy production and to engineering more generally.[34] A recent survey highlights that the extent of supply chain restructuring varies by industrial sector. In this regard, North American automotive companies report that they are shortening their supply chains by sourcing from local suppliers and building battery plants closer to the US and European markets (Knizek, Jenner, Dharmani, and Vail, 2022). Hence, investments by Canadian EV component suppliers to expand or deepen their supply chain linkages to the Indo-Pacific region would be a departure from a more general industry trend toward greater regionalization.

None of the foregoing is to say that Canadian government initiatives to promote freer trade between Canada and Indo-Pacific countries are pointless or that it is misguided for Canadian companies to identify and exploit profitable opportunities to do business in that region. Rather, it is a caution against the federal government making the IPS a priority when larger gains to trade for Canada would arguably be obtained from deeper integration within the North American trade zone, and when substantial advances in liberalizing trade and investment can still be realized within the existing USMCA framework. This caution is even more apropos to the extent that the government directly or indirectly financially subsidizes exporting activities to the Indo-Pacific region by Canadian companies when their exporting activities would otherwise be directed toward North American buyers. The end result would be trade diversion subsidized by Canadian taxpayers with lower gains from trade for Canada as a whole. Alternatively, if significant increases in Canada's exports to the Indo-Pacific region create or exacerbate trade

33 See, for example, Economist Intelligence Unit (2023).

34 See Brown (2020), Rodrik (2022), and Economist Intelligence Unit (2023).

frictions between the US and Canada because of necessarily closer Canadian economic linkages to China, indirect trade diversion might occur if the US imposes penalties on Canadian exports to the US on grounds of national security, violations of North American content provisions of the USMCA, or some other perceived provocation. Alternatively, significantly closer economic ties between Canada and China might compromise defence and other agreements between Canada and its Western allies including the US.[35]

Proponents of trade diversification have raised the objection that Canada should not make itself vulnerable to political subservience to US foreign and domestic policies by "allowing" the US to be such a dominant customer for its exports. Without gainsaying this concern, it seems fair to argue that China would be even more demanding of Canadian support for its international political and economic objectives than the US were Canada to deepen its economic ties with that country, as this essay maintains would be a necessary feature of a successful IPS.

Another argument that can be challenged is that there are limited significant trade opportunities with the US compared to those in the Indo-Pacific region.[36] Specifically, one can argue that the emergence and growth of digitally delivered services content is enhancing the potential for major initiatives in cross-border trade across a wide range of services including telehealth, education, business consulting, engineering, entertainment, and finance among others. Since services account for the bulk of economic activity in Canada and the US, technological changes that are mitigating the penalty of geographic distance in exporting services are creating the potential for new and immense gains from trade.

To be sure, to the extent that the costs of electronic delivery of services are not distance sensitive, opportunities also exist for increased service exports to Indo-Pacific countries. However, the gains from services trade with the US are likely to substantially exceed those from services trade with other countries. For one thing, the size and sophistication of the service sector in the US substantially exceeds that of Indo-Pacific countries. By way of illustration, the size of the service sector in the US was about US$18.2 trillion in 2021, whereas it was around US$1.3 trillion in India (see Barnes, Bauer, and Edelberg, 2022; IBEF, 2023). For another, numerous studies highlight the role that cultural distance plays in conditioning exports of services. Specifically, the more similar countries are in terms of cultural characteristics including language, consumer tastes and preferences, legal and regulatory institutions, business practices and traditions, and so forth,

35 Hirsch (2023) expresses similar concerns.

36 This is equivalent to an argument that there are limited gains from additional trade with the US relative to additional trade with Indo-Pacific countries.

the more trade in services will take place between the countries, other things constant.[37] While there are important differences in the cultural values and practices of the US and Canada, the two countries are arguably more similar culturally than any bilateral pairing between Canada and any of the Indo-Pacific countries.

In summary, there are reasons to question whether efforts to increase Canadian exports to the Indo-Pacific region will prove successful, and even if successful, there is reason for concern that Canadian government subsidies to promote exports to that region may well come at the expense of reduced Canadian exports to the United States. Direct and indirect trade diversion away from the US is presumably not an objective of the IPS; however, it might well be a consequence. While the risk of trade diversion away from the US is not necessarily a definitive argument against the initiatives proposed in the IPS, prioritizing those initiatives over efforts to preserve and even deepen the bilateral trade relationship is arguably a misguided trade policy, since the gains from increased trade with the US may continue to exceed those from increased trade in the Indo-Pacific region for the foreseeable future, especially given the potential explosive future growth in trade in services.[38]

It is beyond the scope of this essay to discuss in detail initiatives that could promote a deepening of bilateral economic linkages in order to capture additional gains from trade between Canada and the US. Notwithstanding the extension of US EV tax credits to EVs manufactured in Canada, which was a major action to ensure transportation equipment supply chains in North America remain intact, other issues threaten the bilateral trade relationship.[39] An emerging source of conflict is Canada's announced intention to impose a digital-services tax at the start of 2024. The latter is a 3 percent tax on technology companies' revenues from providing digital services to Canadian users or selling Canadian users' data. The tax would be implemented on January 1, 2024, and would be retroactive to revenue dating to 2022. It is widely acknowledged that the bulk of the tax would be paid by US-based companies such as Meta and Alphabet, the parent company of Google.

37 See, for example, Felbmayr and Toubel (2010) and Harms and Shuvalova (2020). Hellmanzik and Schmitz (2015) highlight the importance of "virtual" cultural proximity as being especially influential in trade in audio-visual services. Virtual cultural proximity reflects bilateral hyperlinks and bilateral website visits between countries.

38 A caveat to the concern about trade diversion is that there may be political imperatives for Canada to deepen cooperation with Indo-Pacific countries on environmental, human rights, and related matters that outweigh economic considerations.

39 There are two relevant EV tax credits per EV of US$3,250 each. The first credit applies when the critical minerals in batteries, notably lithium, are extracted or processed in countries with which the US has a free trade agreement. The second credit is available if battery components are manufactured or assembled in North America (see Sanders, 2022).

Canadian business leaders, including Goldy Hyder, president of the Business Council of Canada, have warned that implementing the tax could complicate efforts to persuade the US Congress to renew the US-Mexico-Canada trade treaty when it comes up for legislative review in 2026.[40]

The proposed digital-services tax can be seen as part of a larger and burgeoning source of bilateral trade conflict as an increasing share of services trade and advertising are conducted on the Internet. In this regard, US trade authorities continue to object to Canadian content rules as applied to programming distributed through conventional broadcasting distribution outlets such as cable companies, as well as to streaming services distributed online (see International Trade Administration, 2022). As more programming content is distributed over the Internet, the long-standing concern about Canadian content broadcasting regulations on the part of US-based content producers is bound to increase and threaten other areas of bilateral trade.[41] Hence, a comprehensive bilateral negotiation to resolve conflicts surrounding digital services is arguably a more pressing trade policy issue for Canada than initiatives identified in the IPS.[42]

While a comprehensive bilateral agreement on trade in digital services is an emerging priority for the bilateral trade relationship, other and longer-standing issues remain contentious. One notable issue in this regard is Canada's supply management system which effectively restricts US dairy exports to Canada.

40 See Vieira (2023) for a discussion of the digital services tax and Canada's justification for implementing it.

41 The Canadian government's recent decision to require US-based Internet platform operators such as Meta's Facebook to pay Canadian-based media companies for the latter's content that is made available on those platforms is yet another example of trade disputes arising as the prominence of Web-based information services and associated advertising revenues increases. Canadian foreign ownership restrictions in telecommunications and "cultural industries" are also prominent and related sources of bilateral trade tensions.

42 Any successful negotiation regarding digital services is likely to require Canadian concessions regarding Canada's restrictive polices on imports of dairy products, which have long been a contentious issue for US trade administrations. At the same time, Canada might press for a resolution of the long-standing softwood lumber trade dispute, as well as the removal of US tariffs on Canadian steel and aluminum products.

Concluding Comments

The Canadian government's strategy to increase Canada's exports to the Indo-Pacific region can be seen as an effort to reduce Canada's trade dependence on the US, thereby also reducing the political leverage that the US enjoys as a consequence of being overwhelmingly Canada's most important export market. At the same time, the strategy hedges Canada's commitment to deepening its trade linkages with China. However, it can be argued that any successful reduction of Canada's trade dependence on the US in favour of increased trade with Indo-Pacific countries will require Canadian exporters to integrate into regional supply chains that, in many cases, remain anchored around Chinese companies. A deepening of Canada's trade and investment ties with China will almost certainly raise concerns with any US administration in power and thereby threaten Canada's trade opportunities in North American clean energy sectors such as EVs. The transformation of the Canadian economy away from the production and exporting of carbon fuels and conventional natural resources in favour of clean energy intermediate and final products is a prominent objective of the IPS. It would therefore be ironic if the IPS undermined this transformation by disrupting the bilateral integration of the transportation equipment sector.

One area of opportunity for Canada to increase exports to the Indo-Pacific region that arguably does not require deeper trade and investment integration with China is liquefied natural gas. However, the ambivalence of the Canadian government to Canada's participation in this sector has arguably put Canada well behind other LNG exporters such as the US and Australia as a competitive source of supply to the Indo-Pacific region, even if the government prioritizes the construction of domestic LNG terminals going forward.[43]

Increases in the volume and breadth of services delivered over the Internet represent a major economic transformation that is likely to be accelerated by an increasing number of people who work from home either part-time or full-time, as well as by

43 As noted earlier, the LNG Canada project near Kitimat, British Columbia is the only LNG facility under construction in Canada. It is scheduled to be completed in 2025.

the development and implementation of AI platforms. These developments promise to expand trade opportunities in many service sector industries, perhaps dramatically. Since the delivery of financial, entertainment, legal, and other professional services has hitherto been largely "place bound," trade in services has been dwarfed by trade in goods. By way of illustration, from 2012 to 2022, merchandise trade accounted for approximately 81 percent of total world trade in goods and services.[44]

To the extent that major new opportunities are emerging for efficient international trade in services, a new set of export marketing opportunities will be potentially available to Canadian businesses. While the death of distance implies that markets for exported services will emerge and grow around the world, they are likely to grow faster in high-income countries than in emerging markets such as India and the ASEAN countries. Moreover, cultural differences may well emerge as the main barrier to selling services over the Internet. In this regard, the US market is arguably the most profitable potential market for Canadian online businesses over the foreseeable future, and the potential growth of bilateral trade in services represents a major growth opportunity for Canadian exporters. As such, negotiating and developing an expanded trade agreement with the US that comprehensively addresses issues surrounding trade in digital services should be a high priority for the Canadian government. Diverting business resources and management's time and attention to pursuing export opportunities in faster-growing but still relatively low-income countries in the Indo-Pacific region ignores what might well be a larger opportunity in the form of the potential growth of Canadian services exports to the United States.

44 Author's calculations from data reported in UNCTAD (2022).

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