Discussion of

"Economic Integration in Europe: Its Effects on Canada"

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The process of European integration is in many ways a unique experiment. One issue that has been widely studied is whether this integration process, in addition to several benefits it provides, has negative repercussions for other economies by inducing trade creation within Europe at the expense of trade diversion with other economies. The paper by R. Cameron, D. Côté & C. Graham tackles this issue for the case of Canada by asking whether Canada's exports to the European Union (EU) have declined due to EU integration. It does so by presenting a broad array of stylised facts relating to Canada's trade patterns and market shares, and by estimating a simple export market share model of Canada vis-à-vis 14 of the old EU countries.

The key stylised fact the paper focuses on is the decline of Canada's export market share in the EU since 1960. The paper puts forward two hypotheses to explain this decrease. First, EU integration may have raised intra-EU trade at the expense of trade diversion with non-EU members. The second hypothesis is that the removal of the preferential treatment by the UK of Canadian exports in the 1960s and 1970s may have played a role in understanding the steady decline of market share of Canadian exporters. A first point to stress is that the two hypotheses are two separate and fundamentally distinct ones. In fact, I will argue in this comment that the evidence presented in the paper support the second hypothesis, while there is compelling evidence *against* the first hypothesis. Moreover, other explanations, foremost the rapid integration process of Canada with the United States, may play a central role in understanding the evolution of Canada's exports over the past five decades.

To investigate the validity of the two hypotheses, the paper presents a number of stylised facts, which offer an interesting and compelling picture of Canada-EU trade since the 1960s. First, the key factor that accounts for the drop of Canada's export share in the EU is the decline of its exports of non-energy commodities to the UK (Figures 6 and 16). By contrast, the export share to other EU countries has remained relatively stable since the 1960s. This in itself already suggests that if there had been trade diversion from EU integration, one would have expected that Canada's export shares in other, non-UK EU countries should have dropped as well. However, we do not observe this. An even stronger piece of evidence against the trade-diversion hypothesis is the fact that intra-EU trade has been rather stable at around 60% since the mid-1960s (Figure 7). Again, if trade diversion from EU integration had been such a central feature, one would expect intra-EU trade to rise relative to extra-EU trade. Both pieces of evidence thus rule against the trade-diversion hypothesis, at least for the EU excluding the UK.[1]

This leads to the question of why the UK was and to some extent still is such an important partner for Canada, and how to explain the sharp drop in Canada's export shares in the UK. The paper discusses nicely the special relationship between Canada and the UK in the 1960s and 1970s and how this has resulted in very close trade and investment ties between the two economies. A remarkable feature is that in the 1960s, Canada had an export market share in

[1] Note at this point that the common definition of trade diversion in the literature relates to the *level* of trade, i.e. implying that a reduction in trade barriers e.g. in the EU should reduce trade of the EU with non-EU countries. In this context here, the trade-diversion hypothesis is meant to extend to trade *shares*, which means that trade diversion may imply lower growth in trade due to EU integration.

the UK of around 8%, compared to only 12% for the United States and to only 4% each for Germany and France (Figure 11). It is in many ways impressive that a smaller and quite distant economy as that of Canada had about twice the market share of UK neighbouring countries such as France and Germany. From this 8% share in the 1960s, Canada's export market share in the UK has fallen to around 2% in recent years. The key question is whether this decline reflects effects of EU integration, or other factors.

One way of understanding the decline of Canada's exports to the UK is to investigate the counterfactual: in a world free of trade barriers, preferential treatments and trade agreements, what would Canada's trade with the EU, and in particular with the UK, be? Clearly, like any counterfactual this question is inherently difficult to answer. But it seems obvious that Canada export market share in the UK of around 8% in the 1960s, compared to only 4% each for Germany and France, was most likely not a natural outcome that reflected "normal" levels of trade between the two countries, but the result of the above mentioned preferential treatment of Canada's exports by the UK. The literature frequently employs gravity models of trade to not only find the determinants of trade, but also to derive such "normal" or equilibrium trade shares that are explained by factors such as distance, common borders, transport and communication costs, and *not* due to trade barriers or trade agreements. The authors note that relatively little work has been done on Canada-EU trade, but it seems obvious that an 8% export market share for Canada, compared to 4% for countries such as France or Germany, was not such an equilibrium level, but rather an artificially high level. By contrast, the 2% export market share Canada now has in the UK seems much closer to what one would expect to find in a gravity model of trade. Therefore, this finding that Canada's current trade share with the EU is largely in line with what one would expect based on factors independent of EU integration, provides an additional argument against the trade-diversion hypothesis of EU integration.

The second main element of the paper is an empirical model based on Canada's export market shares. In the benchmark model, the size of export market shares has two key determinants: price competitiveness – proxied by relative real exchange rates – and relative demand – proxied by relative income. The paper estimates this model for a panel of 14 country pairs, i.e. of Canada vis-à-vis 14 of the old EU member states. The paper finds that relative demand is a significant factor in explaining the time and cross-sectional variations in export market shares. The model is then extended to include country dummies and time trends. The country dummy for the UK is positive and significant, indicating that Canada traditionally has higher exports to the UK than to other EU countries. Moreover, the time trend for the UK is negative, indicating a decline in Canada's export market share to the UK over time, even after controlling for price competitiveness and relative demand. By contrast, the time trend for the EU excluding the UK is not significant in the benchmark model of Table 2.

These findings are interesting, although of course it is not straightforward to interpret them in a meaningful way. In particular, what do the time trends included in the model capture? It is not clear whether these time trends can really be interpreted as reflecting EU integration. First, the EU integration process has been far from a linear and steady process of the years and decades since the 1950s. In fact, some work in the literature has shown that European integration has gone through phases of very rapid progress, such as the 1960s and late 1980s-early 1990s, while in other decades there was little change in terms of economic integration (see e.g. Dorrucci et al. 2004). Other strands in the literature stress that exchange rate uncertainty, and in particular the creation of currency unions, such as achieved with EMU in Europe in 1999, have a marked impact on trade (Rose and van Wincoop 2001). This suggests that the linear time trend included in the model may indeed not capture EU integration well.

Second, the stylised facts that the paper presents implicitly propose a potentially important, complementary explanation for the decline of Canada's export shares in the EU. This potential explanation is that the rapid integration of Canada with the United States may have induced trade diversion away from trade with the EU. In fact, there are several pieces of strong evidence for this hypothesis. In particular, Canada's exports, as a share of its total exports, to the US rose from around 55% in the 1960s to 85% in recent years. Canada's export shares to the EU correspondingly declined significantly, but so did Canada's exports – again not in absolute terms but as a share of Canada's total exports – vis-à-vis most of is trading partners apart from the US. This 85% export share to the US compares to intra-EU trade of currently only around 60%, and which has been very stable since the mid-1960s.

Overall, these two pieces of evidence together suggest that it was not EU integration but Canada-US integration that caused trade diversion, thus possibly explaining an important part of the drop of Canada's export shares in the EU. It would thus be important to test this hypothesis in the paper's proposed export market share model, and also to control for a potential excluded-variable problem of a model that only looks at Canada's trade with the EU. Another interesting test would be to exclude commodities from the empirical model to see whether the current results are driven by this one sector or hold for all export sectors.

In summary, the paper tackles an interesting issue both from a Canadian perspective and from a Europe perspective. My reading of the evidence in the paper is that EU integration most likely has led to remarkably little, if any trade diversion away from extra-EU trade. In fact, Canada's current export market shares in the EU seem very much in line with what gravity models of trade would tell us they should be, despite existing preferential trade within the EU. The main factor explaining the decline of Canada's export market shares in the EU is its rapid drop of trade with the UK, from (possibly unsustainably) high levels in the 1960s. An interesting hypothesis for future research is to extend this work to understand to what extent Canada's integration with the US economy has induced trade diversion of the trade with the rest of the world and whether it is capable of explaining Canada's evolving trade patterns.

References

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