

# Chicago Fed Letter

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## The Great Lakes border and economy

by Thomas Klier, senior economist, and William Testa, vice president and director of regional programs

The events of September 11, 2001, focused attention on the importance of border security. What are the implications for the economy of the Great Lakes, an economy that depends heavily on the movement of people and goods across the border between the U.S. and Canada? A recent Chicago Fed conference discussed the importance of the two countries' close business relationship and the need for policies that enhance security without hampering trade.

On April 4 and 5, 2002, the Federal Reserve Bank of Chicago held a conference on the nature and extent of economic linkages within the Great Lakes economy, an area that encompasses parts of the U.S. and Canada, and related policy issues, such as border crossings, trade barriers, and immigration. The event took place at the Chicago Fed's Detroit Branch, minutes away from the Detroit Tunnel and the Ambassador Bridge, the two busiest border crossings between the two countries. This *Chicago Fed Letter* summarizes the conference discussions.

William Testa, vice president and director of regional programs at the Chicago Fed laid out a roadmap for the conference. He stated that the core idea was to take a fresh look at the economic relationship between two parts of the Midwest, a single region that overlies two countries: Canada and the U.S. He encouraged participants not only to assess the importance of this relationship but also to create a vision of how the relationship could progress. But first, Testa noted that, given the events of September 11, 2001, and the resulting security concerns, we need to examine current travel and trade policies and prospects for the free flow of goods and people across the border.

### Border security

Chris Sands, fellow and director of the Canada Program at the Center for Strategic and International Studies in Washington, DC, opened the conference by putting the current debate on border security in perspective. He provided a detailed timeline to illustrate that the 30-point "Smart Border Declaration" issued by the U.S. and Canada on December 12, 2001, resulted from thinking that started in February 1993 in response to that year's 1993 World Trade Center bombing. Both governments saw the need to more effectively track the movement of individuals across the border, in light of evidence pointing to the existence of a terrorist network. A number of agreements were formalized along the way, such as the U.S.–Canada Shared Border Accord, the Cross-Border Crime Forum, the CUSP (Canada–U.S. Partnership Forum) meetings, as well as the first test of NEXUS. NEXUS is a security system that ensures identification of low-risk individuals and facilitates the land border crossings of those who have previously registered, to allow a greater focus on those not identified as low risk.

Looking ahead, Sands argued that government to government communication is crucial to address joint security

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needs. From the U.S. perspective, there are several points to keep in mind: Security concerns will not trump economic concerns; underfunded mandates rarely succeed; the border to Mexico and the border to Canada are characterized by very different issues; and, finally, unilateral decisions on border issues ultimately make things harder. His lessons for Canada were as follows: Economic concerns don't trump security concerns; there is a need to close the credibility gap with the U.S. on security issues; there is a need to recognize and deal with a trilateral border policy relationship in North America; and, finally, there are political consequences to deepening economic integration. Since September 11, Sands said, a reasonable balance between economics and security has been struck. In particular, he pointed to the improved funding situation on security issues and suggested that the U.S. and Canada have found room for bilateral policy on border issues.

Sands' speech was followed by a panel discussion on border security issues. Phil Ventura, assistant deputy minister in Canada's Privy Council Office, referred to the region of southwestern Ontario and southern Michigan as one large manufacturing assembly system. The role of the border in this very highly integrated region changed dramatically on September 11 from a mere nuisance to a potential stranglehold, owing to significantly heightened activity between the U.S. and Canadian governments to address national security issues. The ongoing challenge in this effort, he argued, is to come up with security solutions and procedures that do not make this region vulnerable and dysfunctional on the economic side. Ventura went on to outline the strategy of the Canadian government for dealing with border security issues. Canada established a cabinet-level committee that is being chaired by Deputy Prime Minister John Manley. The principal approach of this effort is reflected in the Smart Border Declaration. The operational concept is to apply risk management to border security, i.e., to implement policies and procedures that

help separate high-risk people and goods from low-risk people and goods. Such an approach will allow a more efficient use of resources at the border. Since September 11, Ventura added, Canada has significantly stepped up its funding of border security, committing an additional \$7.7 billion (Canadian dollars) over the next five years. It issued new permanent resident cards at the end of January 2002. The visa policies between the U.S. and Canada are now being coordinated. Furthermore, there is the possibility of establishing pre-clearance centers to improve efficiency at the actual border crossings. The NEXUS program, currently suspended after its initial test, will be rolled out on the West Coast in June, with a tight timetable to extend it for the entire border. Ventura concluded by arguing that a successful approach to border security issues needs to include monitoring of the actual implementation of new security measures, as well as keeping a long-term perspective on their efficacy.

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Next, Ken Swab, legislative director in Congressman John LaFalce's office, discussed the Northern Border Caucus, established by LaFalce after the passage of the North American Free Trade Agreement (NAFTA) in 1993. Its goal is to pursue policies that facilitate the movement of commerce and people, as well as providing secure borders. Swab praised the ideas in the Smart Border Declaration and discussed the additional resources that have been directed to the U.S.-Canada border since September 11. In 2002, 716 personnel have been added to the northern border, with another 114 planned for 2003. Congress has authorized a tripling of northern border staff, but appropriations appear to be short of that level. However, more than people are needed. Also key to expediting the flow of goods and people is new technology, such as a long overdue new computer system (Automated

Commercial Environment, or ACE), which is to be implemented by fall 2005. The budget for that system, however, remains underfunded.

Jim Phillips, president and CEO of the Canadian American Border Trade Alliance, represented the views of a broad-based binational business organization, whose member businesses are closely tied to a well-functioning U.S.-Canada border. Concurring with earlier presenters, Phillips reiterated that, historically, the northern border had been underfunded. Additional resources that are being made available under the U.S. Patriot Act are encouraging, he said. He strongly recommended the implementation of a joint U.S.-Canada low-risk traveler technology system, such as NEXUS, to allow participating U.S. and Canadian citizens to enter either country via dedicated lanes. Finally, he addressed the existing infrastructure limitations at the actual border crossings by presenting simulation results

commissioned by a group called the Perimeter Clearance Commission. Using the Buffalo Peace Bridge crossing between the U.S. and Canada as an example, this study shows how the efficiency of an existing border crossing can be improved significantly without costly infrastructure changes. By moving three U.S. Customs primary inspection booths from the U.S. to the Canadian side, as well as introducing the NEXUS system, one could realize substantial improvements in waiting and processing time at the border crossing. However, Phillips pointed out that even with improvements like these, the existing border crossing infrastructure will not be able to meet expected growth in trade during the next five to ten years.

#### **The region's economy**

Peter McPherson, president of Michigan State University, opened the second day

of the conference with a keynote address on the region's economic linkages. He stated that the region enjoys a mature trade structure. Since the U.S.–Canada Free Trade Agreement (FTA) 13 years ago, trade between the two countries has grown at 10% per year. This is particularly significant for Michigan, with 58% of its exports going to Canada. Looking ahead, he pointed out two areas of policy interest. First, to deal effectively with border security issues, he suggested working toward formalizing a “zone of confidence.” As part of such a zone, for example, Canada and the U.S. could achieve a level of security that works for both countries without having to adopt uniform immigration and asylum policies. Second, while the FTA and NAFTA have been very successful, there still exist a number of trade barriers that should be removed. McPherson suggested that a commission should be formed to work through very specific and technical issues, such as government procurement rules, trade in services, and rules of origin, and make recommendations on how to reduce barriers to trade.

### **Transportation of goods, the automotive sector**

Thomas Klier, senior economist at the Federal Reserve Bank of Chicago, opened the session on the automotive sector by discussing the concentration of auto sector plants in the Midwest. He illustrated the north–south extension of the auto corridor, as well as its continuation into Canada along Route 401. The Detroit region continues to be the hub of a spatially very concentrated industry. Klier showed that essentially all of Canada's auto industry is located within 400 miles of Detroit. Of the U.S. auto industry, two-thirds of independent supplier plants, 84% of assembler-owned supplier plants, and 58% of assembly plants are clustered within a day's drive of the Motor City.

David Andrea, director of the Forecasting Group at Altarum's Center for Automotive Research, summarized a recent study on the role of the border for the auto industry. The study is based on a number of interviews with representatives from assembly plants, logistics

suppliers, and tier 1 suppliers on both sides of the border. It quantified the cost of border delays by assessing shut-down costs, costs of holding increased inventory to make up for unexpected border delays, and higher transportation costs. The experience of September 11 has focused the industry's attention on the need for a dependable and consistent time frame for passing through customs.

Taking up this point, Kevin Smith, regional director of Customs Administration at General Motors Corporation (GM), noted that the auto industry is extremely cost competitive and cost sensitive. In a business environment where keeping costs down is crucial, border delays are unacceptable. Smith expressed concern that, post September 11, the fundamental issues of border operations have not yet been solved. He argued that customs practices need to be aligned with business practices. Currently, a number of different documents in different systems need to be produced just for customs needs, generating paperwork. The goal is to move to an approach where information is provided electronically to customs at the time the goods are shipped. GM has participated in such a prototype for the automotive sector (NCAP, or the National Customs Automation Program), where data for low-risk traffic are automatically transferred to the border agencies. The goal is to have such a system implemented by 2006. Finally, Smith pointed out that security issues cannot be addressed at the border alone. By that token, a focus on border security should not complicate border transactions.

Next, John Taylor, senior lecturer of marketing at Wayne State University, discussed the various elements that make up the border infrastructure. He pointed out that the greatest capacity constraints tend to be from inadequate staffing—at best half the available inspection booths tend to be staffed, leading to uncertainty and delays.

Then, Harry Caldwell, chief of intermodal freight at the Federal Highway Administration, discussed national freight policy. Caldwell illustrated that logistics expenditures—comprising

transportation costs, the costs of owning and operating warehouses, ordering costs, and carrying costs of inventory—currently represent about 10% of gross domestic product. While that share fell from 1981 to 1993, it has since stalled. One option to reduce this expenditure is to focus on building transportation infrastructure into seamless transportation corridors/gateways. While state governments currently have to fund improvements through their general department of transportation allotments, one could create a specific funding program for international freight gateways. Examples of emerging major freight access and security projects include the Seattle–Tacoma FAST (freight action strategy) corridor and the Detroit–Windsor border crossing. Caldwell argued that gateway policies need to achieve three objectives: increase freight throughput, increase national security, and reduce local congestion and community impacts. He demonstrated a border-crossing simulation that showed the potential benefits of improvements such as dedicated lanes for frequent users and the importance of channeling and sorting traffic into such lanes to avoid congestion and gridlock.

### **Keynote address**

In his mid-morning keynote address, John Engler, Governor of Michigan, likened border crossings to the lifeblood of the Michigan and Ontario economies.

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To continue with the analogy, delays at the border are like blocking the artery. Engler said the border needs more agents to avoid backups. Backups could also be avoided if auto companies and others that make frequent crossings could have their trucks pre-approved at their factories. On trade policy, he argued that it is very important to remove trade barriers on goods and workers. For example, Engler would like to see agreements so that professionals like nurses would not have to get two sets of credentials to work on either side of the border. He also proposed harmonizing regulations to make it easier for companies to bid on business across the border. In addition, he suggested that universities develop similar intellectual property agreements to make it easier to start new businesses. Engler endorsed the idea of a permanent binational commission to explore ways to ease problems such as border delays. He also announced a Michigan–Ontario summit on border issues to take place June 13–14 in Detroit and Windsor.

#### **Movement of people and capital**

Richard Egelton, senior vice president and deputy chief economist at the Bank of Montreal, illustrated the degree of integration of the U.S. and Canadian economies. While the two economies are far from perfectly integrated, the growth in trade and related truck border crossings under the FTA has been

remarkable. For example, from 1996 to 2000 alone, the number of trucks crossing the border annually increased from 5.5 million to just under 7 million. Egelton also documented the increasing integration of both countries' capital markets by referring to the increased flow of direct foreign investment between the two countries, as well as increased cross-border flows of bonds and equities. As for the movement of people, net migration flows are currently small, with movements in both directions near historic lows. He suggested that the long-term decline in the migration rate is related to increasing labor force participation rates, resulting in more dual income households.

Michael Donahue, president and CEO of the Great Lakes Commission, discussed the quality of life, tourism, and the environment in the Great Lakes–St. Lawrence system. He emphasized that the Great Lakes, the physical border separating the U.S. and Canada in the Midwest, represent a jointly shared resource. Regarding earlier suggestions on establishing a commission to explore further liberalization of trade between the U.S. and Canada, Donahue said it might be worthwhile to study the institutional arrangements that govern the Great Lakes.

Next, Daniel Cherrin, director of public policy at the Detroit Regional Chamber, reiterated the sheer magnitude of

the economic linkages between southeastern Michigan and southwestern Ontario. He discussed the importance of the movement of people across the border for the Detroit metro area. Prior to September 11, about 110,000 Canadian workers crossed the border every day. Notably, the health care sector in greater Detroit relies heavily on a reliable flow of people across the border, with around 1,600 nurses, many of them highly skilled and specialized, commuting from the Windsor area to jobs in Detroit.

#### **Conclusion**

This conference highlighted the integration of the economy of the Great Lakes region and a range of issues that need to be addressed, in view of the events of September 11, to prevent the U.S.–Canada border from becoming a stranglehold on regional commerce and trade. A number of speakers endorsed the concept of a zone of confidence; this would imply moving some security procedures away from the border through harmonization, as well as binational cooperation and communication. In addition, it was widely pointed out that a number of practices and regulations currently exist that impede the flow of goods and services across the border. Several participants recommended the establishment of a permanent commission, patterned, for example, after the International Joint Commission, to address these problems.