



***Challenges and Opportunities
For North America in a Changing World
Ottawa, Canada
October 11-13, 2012***

SUMMARY OF PROCEEDINGS

The *North American Forum* met in its eighth annual session in Ottawa October 11-13, 2012 under the leadership of its three co-chairs: Mr. Thomas P. d'Aquino (Canada), the Honorable William J. Perry (United States), and Dr. Pedro Aspe Armella (Mexico). At its opening dinner, the three chairs and founding US co-chair, the Honorable George Shultz (United States) took the opportunity to pay tribute to Canadian founding co-chair, the Honourable Peter Lougheed. Mr. Lougheed was remembered not only for his inspiring leadership on North American issues but also for his sterling service to Alberta and Canada during his long political career as premier of Alberta and as a senior Canadian statesman.

The *Forum*, attended by some 100 participants, considered a series of pressing economic and security concerns that all three countries need to address, organized around the conference theme: "Challenges and Opportunities for North America in a Changing World." This theme was explored in four plenary sessions focused on the North American and global economy, North American trade and investment prospects, North America's energy future, and North American defense and security cooperation.

The discussion clearly demonstrated that, while there has been substantial progress over the past decade in forging a more cohesive and effective North America, there remains considerable scope for further cooperation and joint effort among the three partners. Attendees agreed that there is significant potential for working together on a number of issues, including:

- trade and investment policy, particularly through the TransPacific Partnership (TPP) and ongoing border and regulatory initiatives;
- energy development, including exploiting established and emerging hydrocarbon resources, renewable resources, and energy distribution; and
- North American security, including shielding North America not only from traditional external threats but also from internal threats such as organized crime and drug trafficking and emerging concerns such as cyber attacks.

Participants agreed that leadership at the top is critical if the three countries are to realize the benefits of their respective assets and experiences in meeting the challenges of the 21st century, including competition from emerging economies, demographic changes, fiscal restraints, and non-traditional security threats such as terrorism, trans-border organized crime, and cyber attacks.

Perspectives on the North American Economy and Global Economy

In discussing global and North American economic developments, participants focused on the implications of the slow economic recovery from the 2008-09 global recession, particularly in the traditional engines of economic growth: the United States, Europe, and Japan, all of which are facing mounting, interconnected fiscal and demographic challenges. By contrast, prospects in the emerging economies – China, India, Brazil, Indonesia, Mexico, and others – are much better, pointing to significant re-alignments



in future currency values and capital flows and perhaps increased migration to offset declining labour forces in the major economies of the past. The world's three principal economic regions – Europe, North America, and Asia – are on different growth paths. Europe is clearly declining and Asia rising, with prospects for North America less clear. Productivity improvements will be key to offsetting the effect of aging populations in the United States and Canada. The US fiscal debt is now over 100 percent gross and 85 percent net, but unfunded public liabilities and continued political reluctance to address the fiscal gap point to potentially much larger problems in the future.

In the immediate future, prospects for recovery in North America are better than in Europe and Japan, based on such fundamentals as stock prices, business investment plans, innovation performance, and hydrocarbon reserves. In the longer term, however, persistent failure to address the looming fiscal cliff in the United States will create a major drag on economic growth in all three countries. Canada is generally in good shape but faces unsustainably high household debt and will need to continue on its path of export market diversification. Mexico's recent growth, as well as demographic factors, have created a solid foundation for continued growth, but drugs, crime and an underperforming energy sector need to be addressed in order to secure its economic future. For all three countries, better integration into growing Pacific trade, investment, and production patterns will be an important determinant of future growth. Progress in reducing barriers to intra-North American trade and investment will be equally important, requiring better institutional mechanisms than are currently in place.

North American capacity to weather short-term problems and retain global economic competitiveness will require strong political and business leadership and a willingness to tackle some deep fissures in the political landscape, for example, the gap between the US public's support for a strong social safety and its unwillingness to accept the necessary tax burden. Increasing business taxes would be a huge mistake; rather, US political leaders need to come together on a pragmatic combination of reduced spending and increased revenue, such as was recommended by the 2010 Simpson-Bowles Commission. Similarly, sustaining the current energy boom will require adjustments in tax and other incentives, giving markets a greater role in the development and distribution of various sources of energy.

North American Trade and Investment Prospects

On the trade and investment front, participants considered North America's success in forging a much more integrated economy, the desirability of further progress in reducing disincentives to intra-North American trade and investment, and the prospects for jointly pursuing opportunities beyond North America. The current focus in Canada is on diversifying markets, particularly across the Atlantic (the Comprehensive Economic and Trade Agreement with the EU – CETA) and around the Pacific Rim (the TPP and bilateral initiatives with China, India, Japan, Korea, and others), development spurred on by the slow US economic recovery and by some adverse political decisions such as the Keystone Pipeline delay, resurging Buy America sentiments, and slow progress on border and regulatory initiatives. TransPacific overtures involve mostly complementary economies, which should facilitate negotiations. The results, however, may be mixed due to asymmetrical interests and preparedness.

Investment concerns will be central to these discussions. North Americans have not yet grasped the full significance of the rise in asymmetric savings rates in emerging and industrial economies, which will translate into Canadians, the Americans and, to a lesser extent, Mexicans, looking increasingly across the Pacific for their capital requirements. There is an obvious political disconnect when Canadian federal and provincial governments seek to do more energy business with Asia while at the same time agonizing over



Asian investments in the energy sector. This is an issue that will not go away. State-owned enterprises (SOEs) and sovereign-wealth funds (SWFs) have become major vehicles for channeling Chinese, Indonesian, Malaysian, and other savings into Canada, the United States, Europe, and elsewhere, raising sensitive political issues. Even if current proposals, such as the CNOOC takeover of Nexen, are approved, none of the three governments has charted a clear path as to how they will treat future major investments by SOEs and SWFs. Some participants pointed out that such investments can be a mixed blessing, supplying needed capital, but experience also suggests that many SOEs are not as well positioned as private firms to make the best use of this capital; some are excellent, but others depend on subsidies, are hampered by poor management, deliver poor returns, and can prove a drag on growth.

Participants discussed the need for governments to develop transparent criteria for approving foreign direct investment proposals, such as their impact on competition, on national security, and on transfers of knowledge and technology. Some participants indicated that governments should be prepared to use access to North American resources and technology as leverage to get better, more meaningful access for North American-based firms to markets across the Pacific. Others suggested that SOE participation in established firms should be limited so that they cannot exercise control, similar to the limitations placed on institutional investors, for example, pensions funds. Participants agreed that a full discussion of these issues needs to take place in all three countries.

Turning to NAFTA, participants considered the extent to which the agreement has worked and whether or not it needs to be upgraded to catch up to new circumstances. While intra-North American trade and investment have soared, boosting integration and interdependence, North America remains less integrated than Europe and East Asia (53 percent versus 70 and 55 percent respectively). Two issues need to be addressed to deepen mutually beneficial integration: areas that were not fully covered by NAFTA – e.g., agriculture, energy, and migration – and trade relations beyond NAFTA, using the agreement as a platform to forge joint agreements with such partners as the EU, Latin America, and Asia. The three governments can strengthen NAFTA by, for example, agreeing to move more tariff lines to free on an MFN basis, eliminating the need for costly tariff administration in some sectors. Some participants pointed to the need to liberalize labour flows within NAFTA. Failure to address this dimension will reduce future opportunities. The fear of large flows of Mexican migrants no longer reflects reality; the illegal movement of migrants across the Mexico-US border has slowed to a trickle as economic opportunities in Mexico have increased.

Some participants pointed to the TPP as a potentially important instrument for achieving greater engagement with Asia and Latin America, particularly if the three countries agree to pursue TPP negotiations on a joint basis. Pursuing such an ambitious approach will require efforts to educate the public on the benefits of greater openness, particularly in the United States, where trade agreements continue to attract opposition from a significant portion of the public and from political leaders. Others pointed to the strategic importance of the TPP as the only significant trade initiative on the horizon, the first post-NAFTA negotiation to fully engage the United States, focused on the world's most dynamic economies, sending a critical but positive message to the rest of the world. Potentially, the TPP could be a building block for an even bigger agreement involving, for example, Korea, Japan, Colombia, and others. Well handled, a successful TPP could replace as many as twenty separate bilateral agreements signed by Canada, Mexico, and the United States, and perhaps more. From this perspective, the best chance for success would be to focus in the immediate future on a relatively conservative agreement, one that draws on the best of current bilateral free-trade agreements (FTAs) and combines them into a single, high-quality agreement that extends to as many participants as possible. For the United States, for example, current TPP participation adds four countries



to the current list of signatories to US bilateral FTAs, but in a single, high-quality agreement. In future, greater ambition could look to a TPP-EU agreement, adding other Asian economies, particularly China, and, more gradually, building momentum for the high-quality agreement that could not be found during the WTO's Doha Round.

Some participants cautioned against writing off the Doha Round, arguing that the world cannot afford a failed negotiation. To prevent such a disastrous result, the United States, as in all previous multilateral negotiations, will need to exercise leadership. The TPP may prove a catalyst similar to the NAFTA's impact on the Uruguay Round. Others pointed to the increasing popularity of bilateral and regional FTAs, including in East Asia (e.g., ASEAN-Japan-Korea and ASEAN-China), none of which have succeeded in galvanizing the political will needed to overcome the stalemate in the Doha Round.

Other participants suggested that the major challenge that could be addressed through the TPP is how best to accelerate the transition of China and other statist emerging economies into more orthodox governance of their markets. A TPP that does not include major East Asian economies such as China and Indonesia will prove a disappointment, particularly if they are suspicious of the TPP. While WTO membership has clearly improved access to these markets, it has not been enough to ensure that the competitive conditions that are the hallmark of open economies will become the basis of doing business in many emerging markets. Much serious homework, cooperation, and discussion will be required to develop the rules that will create more level playing fields in these markets. Others suggested that efforts to "contain" China would be a serious error. China is prepared to strengthen market forces in its economy, but on its own terms and on its own timetable. Progress in gaining better access to China's trade and investment market may well require a willingness by Western countries to accept continuing differences in political and economic perspectives.

North America's Energy Future

Turning to North American energy challenges and opportunities, participants considered the merits of the three countries pursuing a North American energy strategy. Technological developments have expanded the prospect for North American suppliers to satisfy all of the continent's energy requirements on the basis of largely domestic resources, and even to become net exporters. At the same time, however, the climatic and environmental impacts of energy development and use command increasing public attention.

Participants discussed North America's growing energy needs, not only to satisfy growing domestic demand, but also to meet global competition. In order to compete with a country like China – which can build a 30-story hotel in 15 days – Canadians, Americans, and Mexicans will need to be prepared to upgrade their energy resources. All three countries, for example, need to increase their electrical generating and distribution capacity, relying on a mix of traditional and new generating sources. Generating costs for coal-fired (with carbon capture and sequestration), gas-fired, wind, and voltaic should all converge within the next decade or two, providing governments with more realistic environmental policy choices. All four types of generating facilities, however, will require expansion of efficient distribution capacity.



Participants learned that new technologies are rapidly expanding North America's capacity to exploit its vast hydrocarbon reserves. With the right policy choices, North America can become a competitive net exporter of energy. As is, without overt policy support, both imports and carbon emissions are declining. With supportive policies, North America can experience an energy boom with positive repercussions throughout all three economies. With the right infrastructure, Canada can expand its capacity and sell to either US or Asian refiners. Mexico can also increase its oil exports by reforming Pemex and relying more on domestic gas. Pemex is planning to invest more in developing new capacity and new technologies and working with private partners, but needs further reforms. Properly restructured, Pemex can operate on a profitable basis, realizing 3 million barrels of oil a day from current and future fields further off the coast in deeper water. More generally, increased domestic gas supply has broken the oil-gas price link in North America; increased LNG capacity for export can extend this benefit beyond North America, further undermining OPEC's ability to influence energy prices. Gas can be an important bridge to the energies of the future, providing needed energy with reduced carbon emissions.

Participants agreed that current energy prices and policies remain volatile, complicating investment choices in new energy capacity. Some participants suggested that a revenue-neutral carbon tax would help to stabilize prices, directing investment toward more carbon neutral energy, and moving North America toward a more responsible climate policy. The need for capital to expand energy capacity led to a further discussion of the pros and cons of investment in the energy sector by Asian SOEs and SWFs. Looming labour shortages in the energy sector echoed the earlier discussion of the need for an agreement providing for more open intra-American labour movement.

New Avenues in North American Defense and Security Cooperation

In considering new avenues for North American defense and security cooperation, attendees focused on how best to pursue cohesive, unifying strategies to address transnational criminal and terrorist activity and other threats to human security. Canada and the United States have a long record of working together to address common security threats through NATO, NORAD, and other institutional channels. Cooperation with Mexico is a newer development, but is proving to be a natural result of deepening economic integration, and an important bridge to strengthening security relations with Latin America. Enhanced joint activity in the Arctic is a further area of growing security cooperation.

Participants learned that over the next few years the world will need to transition out of the current defense and security posture concentrated on the Middle East and focus on other emerging threats. At the same time, US defense priorities will need to adapt to fiscal reality, by cutting at least half a trillion dollars out of planned spending over the next ten years, more if the US Congress fails to pass a budget by the end of 2012. Such a failure would make US spending subject to "sequestration," characterized by one participant as "arbitrary and stupid," but mandated by Congress as part of the current process. US policy planning is focused on four priorities:

- Meeting all historic commitments;
- Rebalancing the US security posture in the Pacific;
- Strengthening US partnerships and alliances;
- Investing in future capabilities, particularly to enhance cyber security, maintain a counter terrorism posture, and harness science and technology to meet future threats.



Cyber security is emerging as a critical component of North America's security posture. Both state and non-state actors can potentially compromise networks and wreak havoc. China and other states are developing sophisticated capacity to use technology to gain private and public intelligence. In response, the United States, for example, is spending at least \$3 billion this year to protect Defense networks, strengthen measures to protect public assets more generally, and develop capacity to protect private cyber assets. The latter is complicated because it crosses delicate privacy boundaries and because it is difficult to convince private networks that they face serious threats and need to invest in more defensive security measures. Modern threats point to the need for greater public-private cooperation and information sharing, both of which engage legal issues of liability and privacy. This is a concern for all three countries because many cyber networks and their infrastructures are shared resources, for example, electric grids and energy pipelines and their computerized management. As such, modern security threats engage much more than traditional security agencies but extend to agencies that are responsible for regulating energy flows, communications, and other modern conveniences. Responding to cyber threats requires significant forward planning and coordination due to the speed with which an attack can be launched.

Participants agreed that past cooperation has made North America the safest and most prosperous region in the world, but that new threats in today's networked world require new cooperative efforts. Traditional threats are largely stable, but NORAD and other institutions need to continuously adapt to evolving circumstances, including the need to address, for example, emerging cyber, criminal, and terrorist threats, or Arctic security, in which partnerships with many more security agencies have become the new center of gravity. Capacity to deal with networks dedicated to undermining public confidence in government is critical to combating modern security threats.

Borders tend to be a weak point in combating crime, because most policing is constrained by borders, while criminals and terrorists are not so constrained. Vigilance at the border and transnational cooperation are critical to combating modern, networked criminal and terrorist activity. Enhanced cooperation over the past decade among US, Canadian, and Mexican border and security forces, both at the border and further inland, has begun to pay off. Cooperative capacity building is also beginning to prove its value.

One of the many challenges raised by the need for cooperative efforts to combat emerging trans-border threats is to overcome traditional reluctance among security and defense agencies to share information and enlist the cooperation of non-traditional players. Communication intercepts, for example, are a critical new tool to combat crime and terrorism but create concerns about privacy. Drug trafficking, sales of contraband goods, money laundering, and other criminal activities all depend on willing citizens turning a blind eye and thus contributing to the success of organized crime. Experience indicates, however, that the risks of sharing information and cooperating with new partners is more than offset by the benefits.

Violence in Mexico appears to have reached a plateau, with significant declines evident in some regions. Recent experience suggests that there are limits to public tolerance of the violence and lawlessness of organized crime. The cartels are also beginning to experience recruitment problems due to the high mortality of their gunmen. Mexican authorities are now accepting that much of the violence is a result of dysfunctional local policing, and are working with US and Canadian authorities on how best to integrate federal, state, and local policing. Canadian and US experience points to the importance of public trust as key to successful policing; Mexico needs to recover that trust. US and Canadian cooperation is also critical to efforts to interdict the movement of drugs through Mexico, much of which originates elsewhere. The cartels are now moving some of their as-



sets to Central America; they also have major assets in the United States and, to a lesser extent, Canada, indicating that cooperation among US, Canadian, Mexican and other security forces is critical to bringing them down.

Participants considered the central role of illegal drugs in modern trans-border crime and wondered whether perhaps the time had come to reassess current approaches to the use of drugs. Some pointed to the human waste of incarcerating millions of minor users, the thousands killed, and the overall cost of the interdiction strategy. Participants agreed that there needed to be much more emphasis on education and prevention to reduce demand. Some thought that the current strategy had proven a colossal failure and that the time had come to decriminalize drug use and devote the resources now dedicated to criminal interdiction of possession to investments in treatment centers and to launching an education campaign analogous to the successful anti-smoking campaign. Others pointed out that minor possession alone is now rarely prosecuted but that the money needed to support drug use leads to other criminal activity. They believed that decriminalizing production and distribution would have tragic consequences. Participants agreed that they would like to see a more in-depth discussion of this issue at their next meeting.

New Administration in Mexico

A new Mexican administration under the leadership of President-elect Enrique Peña Nieto takes office in December 2012. Attendees took the opportunity to learn about the priorities of the new administration. They learned that the new administration intends to focus on energy and fiscal reform, to increase domestic competition, and to recover peace and liberty for ordinary Mexicans. The Mexican energy sector, dominated by state-owned Pemex, has long failed to live up to its potential. The new administration's reforms will allow more outside players to work with Pemex, bringing in the knowledge and resources needed to increase efficiency and innovation. This should return production levels to 3 million barrels a day, an important goal for Mexico's fiscal health and its balance of payments.

Mexico's long-term fiscal health has long been marred by its inability to generate tax revenues beyond 20 percent of GDP, of which 8 percent comes from Pemex profits and royalties. To implement its reform agenda, Mexico needs a more stable tax base and increased revenues. To reach these goals, the new administration will seek to broaden the tax base and develop a more decentralized collection system. Currently, the federal government collects 90 percent of tax revenues. Reformed competition laws and their more vigorous administration will lead to a more competitive domestic economy, and should also strengthen the tax base.

Success on the first two priorities, leading to significant additional financial resources, will allow Mexico to focus on increasing human security and reducing the violence arising from drug trafficking and trans-border crime. Priority reforms include doubling the size of the federal police and strengthening state-level policing to replace municipal policing, the level at which corruption has been most problematic. The extra federal resources will be used to develop more specialized policing capacity. Reforms to the judicial system will aim for more transparency and predictability and strengthening the rule of law, including penal reform and efforts to strengthen social safety nets. Finally, the administration will expand access to all-day schooling to provide young Mexicans with more positive alternatives to the lure of drugs, crime and the cartels.



Participants agreed that the new administration's agenda was ambitious and would face significant political hurdles but that such ambition was needed to combat the corrosive impact the cartels have had on Mexico's social and economic welfare. Some pointed out that achieving these priorities might require some constitutional amendments and a high level of political cooperation, but that prospects for success appeared higher than in the past due to the common ground on these two issues between the Institutional Revolutionary Party (PRI) and the National Action Party (PAN), Mexico's two leading political parties. During its past decade in power, the PAN favoured many of these reforms and will find it difficult to oppose them now.

Next Meeting

Participants agreed that this meeting had demonstrated the extent to which the *Forum* had matured and had confirmed the benefits of in-depth discussion of emerging policy challenges. They suggested that the next *Forum* – to be hosted by Mexico in Mexico City, October 3-5, 2013 – should focus in more detail on some of the issues first raised at this meeting of the *Forum*, particularly issues related to the treatment of investments by SOEs and SWFs, the challenges of cyber security, and the spread of narcotics-based trans-border crime. Other participants proposed including a session on the changing demographic profile of North America and another session on evolving energy developments. The co-chairs agreed that they will consult and develop a similarly challenging agenda for the next meeting.