



# NAFTA

**Renewal or Rejection?**  
What Canada is up against





# NAFTA: Renewal or Rejection?

## What Canada is up against

NAFTA renegotiations kicked off last week, and while U.S. Trade Representative (USTR) Robert Lighthizer didn't mince words, it's unlikely to be a one-sided boxing match. There will be jabs on offensive priorities, parrying on mutual sensitivities—and handshakes on areas of shared interest.

A best-case outcome for Canada would play up those shared interests: for the U.S. and Canada, preserving reciprocal market access for goods across heavily integrated industries; reducing “red tape” at the border; expanding services and government procurement access; and bringing digital trade, labour and the environment into the core of the agreement.

A worst-case, however unlikely, would see a U.S. withdrawal from NAFTA, which would have a long-run negative impact on the Canadian economy and chip a percentage point off GDP as tariffs rise. And a bad new deal would raise rules of origin thresholds for “local” content to a level that diminishes Canadian producers' global competitiveness; impose IP rules that stymie rather than support innovation; and possibly remove the impartial trade arbitration afforded by NAFTA's Chapter 19.

## Trade in goods—America's beef isn't really with Canada

- The U.S.'s overarching aim is to **“improve the U.S. trade balance and reduce the trade deficit with the NAFTA countries.”**
  - For Canada, the outlook appears positive—the **Canada-U.S. goods trade is close to balance**. The U.S. registered a small deficit of US\$16 billion for goods in 2016.
  - The U.S. goods deficit with Canada largely reflects Canada's US\$35 billion (2016) **oil and gas** surplus. While this could place Canada in the line of fire, the current U.S. emphasis is on supporting North American energy security and independence—a position consistent with President Donald Trump's support for Keystone XL.
  - The **U.S. is likely to press harder on Mexico**, with which it registered a sizeable goods trade deficit of US\$70 billion in 2016.

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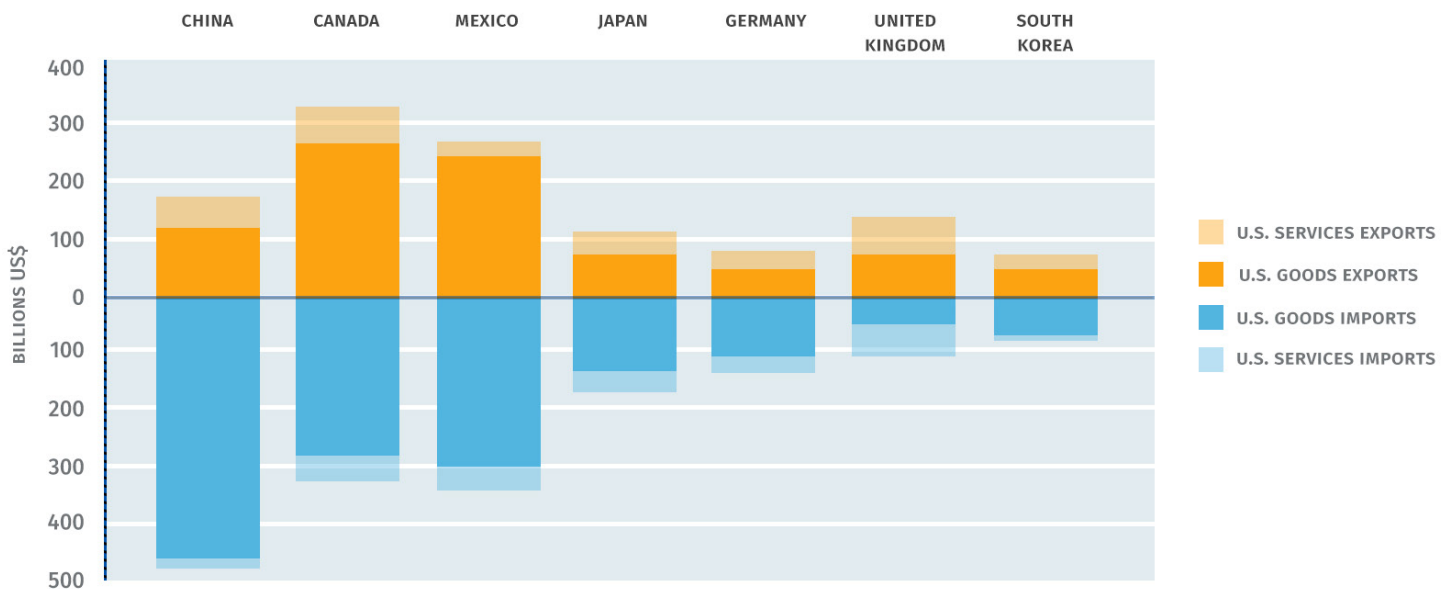
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# CANADA - U.S. TRADE - A BALANCED RELATION

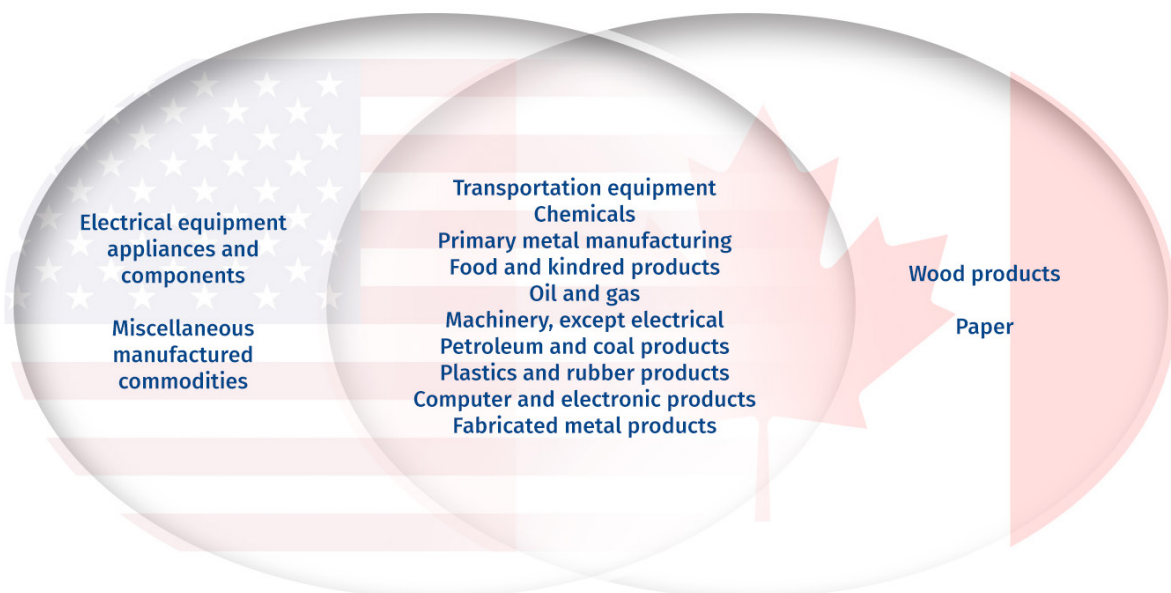
## U.S. GOODS AND SERVICES TRADE WITH TOP TRADE PARTNERS, 2016



- On **industrial and agricultural goods**, the U.S. aims to “maintain existing reciprocal duty-free market access,” while lowering non-tariff barriers (NTBs) that constrain U.S. exports to NAFTA partners.
  - Canada’s largest non-energy goods export sectors to the U.S. include transportation equipment, food products and machinery. Ten out of the 12 top Canadian export sectors to the U.S. are also among the U.S.’s 12 top export sectors to Canada, meaning keeping open access is a **win-win**.

### TOP U.S. GOODS EXPORTS TO CANADA 2016

### TOP CANADIAN GOODS EXPORTS TO U.S. 2016



- **Supply management** is politically sensitive for Canada. Aligning with Trump's support for U.S. dairy, the USTR aims to remove discriminatory barriers, quotas and other measures that it says unfairly limit access for U.S. goods.
  - The U.S. stance is at odds with Canada's pledge to defend supply management.
  - The U.S. may push Canada for a minor concession, such as the 3.25% market share it had conceded to the group of TPP countries in the now-defunct TPP talks.
  - Given U.S. dairy exports to Canada exceed imports from Canada by 2.5 to 1 and that it also subsidizes or otherwise supports domestic agriculture, Canada does not lack a case to push back on U.S. demands.

## Trade in services—wanting what the other side cannot easily concede

- The U.S. aim is to secure “**fair and open conditions for services trade**,” including removing restrictions on the number of services suppliers in the market as well as the requirement that cross-border services suppliers first establish a local presence.
  - **Services offer compelling prospects:** the U.S. already has a services surplus with both Canada and Mexico (US\$24.6 billion and US\$7.6 billion in 2016, respectively), and Canada would welcome the opportunity to boost services exports to the U.S. (which have held around US\$30 billion annually).
- Granting greater access to Canada's services sector could touch upon **sensitive sectors**: i.e. **telecommunications, financial services, and cultural industries**—the latter a longstanding sensitivity with respect to the American giant next door.
  - The U.S. has maintained a sizeable trade advantage with Canada in **telecommunications**, notwithstanding a decrease in the gap since 2013. The U.S. may push on ownership restrictions in the sector.
  - Canadian **financial services** exports to the U.S. have grown steadily since the Great Recession, but with a yawning gap relative to U.S. financial services exports to Canada that has remained just as steady. The USTR's aim is to improve “transparency and predictability in their respective financial services regulatory procedures.” Looser regulations could be a tough sell in Canada given the crisis-tested strength of the Canadian sector, as could the loosening of cross-border data flows in financial services.

Canada - U.S. telecommunications services trade (US\$ million)	2010	2011	2012	2013	2014	2015
U.S. exports to Canada	681	757	749	688	719	641
U.S. imports from Canada	451	399	377	304	349	432
Canada - U.S. financial services trade (US\$ million)	2010	2011	2012	2013	2014	2015
U.S. exports to Canada	5,483	5,090	5,354	5,894	6,731	6,155
U.S. imports from Canada	1,025	1,260	1,301	1,541	1,903	1,813



- Canada is pushing for freer **movement of professionals**, which is increasingly critical to companies' ability to innovate across blended supply chains.
  - The movement of professionals, which Canada achieved with the EU in CETA through the mutual recognition of professional credentials, is an important component of cross-border trade in services. It is a push unlikely to be welcomed by the U.S., given the current administration's stance on immigration and jobs.

## Rules of origin—the risk of building a North American trade fortress

- **Rules of origin (ROOs)** are key to Trump's manufacturing agenda. The USTR aims to strengthen the rules to "incentivize the sourcing of goods and materials from the United States and North America" in order to ensure that the benefits of NAFTA go to products "genuinely" made in the region.
  - For the U.S., **ROOs have more to do with imports from outside North America** benefitting from preferential access to the U.S. market. The USTR appears bent on more North American content overall, and may seek a higher U.S. share of content even within those more stringent parameters.
  - North American upstream suppliers to major export sectors such as auto could see higher demand as a result of more stringent ROOs. But manufacturers of final products such as vehicles could face higher production costs, potentially hurting their competitiveness and sales.

## Reducing "red tape"—a way to reverse the thickened border?

- The USTR's desire to reduce "red tape" within NAFTA by streamlining and harmonizing rules where possible could be the best result of a revamped NAFTA for Canada, whose exporters have grappled with the costs and uncertainty of a thickening Canada-U.S. border since 9/11.
  - A Statistics Canada report found that the cost to ship goods across the Canada-U.S. border relative to domestic shipping rose from 16.3% in the years before 2000 to 25.1% in the 2000s.
- Canada will be challenged by the U.S. desire to increase the value of goods that can be shipped into Canada without the collection of taxes or duties. Canada's current de minimis threshold (DMT) is C\$20; the U.S. is asking for one **"comparable to the U.S. de minimis shipment value of US\$ 800."**
  - C.D. Howe estimated that raising the DMT to C\$200 would save the Canadian government \$161 million a year (foregone revenue is more than offset by enforcement cost savings) while consumers would save C\$313 million and businesses would save C\$174 million.
  - **Less than half of Canada's retail sector should be significantly exposed** to foreign competition if the DMT is raised. Auto dealers (23% of retail sales) won't be affected by a modestly higher DMT. Gasoline retailers and grocers should also have relatively limited exposure.



# Digital commerce and intellectual property—the building blocks of long-term innovation and competitiveness

- The U.S. and Canada agree that provisions for **digital trade** are essential to a modernized NAFTA.
  - The question of liberalizing **cross-border data flows** for financial and non-financial digital services alike will be a sensitive one for Canada, given Canada's more stringent privacy laws.
  - There is an important economic competitiveness dimension to data. With the emergence of **big data analytics** and a more **artificial intelligence**-driven economy—one predicted by some measures to add US\$15 trillion to global GDP by 2030—data is digital gold.
  - Freer digital trade could benefit smaller players on either side of the 49th parallel that find opportunities to grow across the North American marketplace, given the low transaction and investment costs often associated with achieving scale in the gig economy. Disbanding localization requirements is also essential to services that rely on cloud computing to unlock the advantages of speed, flexibility and cost savings.
  - However, freer digital trade could also deepen the relative advantage of U.S. tech giants.
- On **IP**, the U.S. aims to “ensure provisions governing intellectual property rights reflect a standard of protection similar to that found in U.S. law”, and to “provide strong protection and enforcement for new and emerging technologies and new methods of transmitting and distributing products.”
  - **IP will be a complex and contentious matter for Canada.** Supporters of tighter IP protection under trade rules suggest this would help domestic innovators grow and export by ensuring they reap the fruits of their discoveries. Detractors say tighter standards favour incumbent IP owners at the expense of new innovators and consumers.
  - In the digital economy, given new innovation often involves the recombination and application of existing ideas and processes, or the creation of new distribution platforms, some are concerned that excessive copyright and patent protections could become an anti-competitive barrier to new entrants.

## Trade disputes and remedies—the challenge with Chapter 19

- The USTR aims to preserve its ability “to enforce rigorously its trade laws, including the antidumping, countervailing duty, and safeguard laws” and to “**eliminate the Chapter 19 dispute settlement mechanism.**”
  - For Canada, preserving a “process to ensure anti-dumping and countervailing duties are only applied fairly when truly warranted” is key. The Canadian business community, stung by the softwood dispute, echoes that view.
  - NAFTA's Chapter 19 ensures U.S. anti-dumping or countervailing duties can be referred to a binational panel of trade experts for resolution on objective grounds. Doing away with



Chapter 19 could expose Canadian exporters to fighting trade disputes in U.S. courts, notwithstanding WTO disciplines that would provide some mitigation.

- It is too early to tell if there is political room to negotiate an impartial trade remedy process that substitutes for Chapter 19, while preserving its necessary features.

## Government procurement—the fine print?

- The USTR wants to increase opportunities for U.S. firms to sell their products and services into the NAFTA countries and to establish fair and non-discriminatory rules to govern government procurement among the NAFTA partners.
  - Given Canadian concerns with U.S. procurement protectionism in the form of “Buy American” clauses, this U.S. goal should be welcome news.
  - The dampener is that the **USTR specifically excludes the meat of the procurement market**—sub-federal coverage (state and local governments) is off, as are “Buy America” requirements on federal assistance to state and local projects, and defense contracting. It is questionable how much of the nearly US\$1.7 trillion U.S. procurement market will be opened. Canada may therefore not need to concede much of its own procurement market in return.

## A progressive agreement—labour, the environment, women and indigenous communities

- The U.S.’s objective to bring **labour** into the core of the new NAFTA agreement is not surprising, given the Trump administration’s emphasis on American job losses due to trade pacts. Its aim to include the **environment** is more surprising, given its intent to withdraw from the Paris Agreement.
  - This matches Canada’s objective of a “**progressive agreement**” that would include labour and the environment. Labour issues are unlikely to be overly contentious between Canada and the U.S., given the comparability of standards prevailing in both countries. The negotiation with Mexico is set to be more complex.
  - While the U.S. wishes to see the renegotiation “establish rules that will ensure that NAFTA countries do not fail to effectively enforce their environment laws,” Canada will need to guard against U.S. exporters gaining unfair trade advantages in the absence of the Paris Agreement being in force south of the border.
- Canada aims to introduce chapters on **gender** and **indigenous** rights, in keeping with the country’s focus on economic inclusiveness. The incorporation of such language would create a precedent in trade agreements by enshrining the broader benefits of inclusiveness.



# Best case vs. worst case outcome

- **Best case:** There is some upside potential for Canada in the NAFTA renegotiation.
  - On **trade in goods**, the easing of non-tariff barriers could be positive for Canadian sectors that have suffered from U.S. NTBs in the past. For example, the Canadian beef and pork industries estimated that U.S. Country of Origin Labeling (COOL) requirements cost them hundreds of millions in annual losses. Ensured access could allow exporters to specialize further, reap advantages from economies of scale and potentially improve their productivity.
  - Given the U.S. intends to make **ROOs** more restrictive, a best case scenario for Canada would be a minor increase. The ROO impact on intra-NAFTA trade flows is notoriously difficult to quantify, however.
  - On **trade facilitation**, a best case scenario would see more streamlined and harmonized procedures at the border—hence lower costs for the movement of goods.
  - On **services**, even if the NAFTA partners cannot come to an agreement on their respective sensitivities (movement of professionals for the U.S., opening up of cultural industries and telecom for Canada), extending market access for services should prove mutually beneficial for the increasingly services-driven economies of North America.
- **Worst case:** A worst case scenario would see the Trump administration withdrawing from NAFTA.
  - On **trade in goods**, it is challenging to identify how much GDP growth is caused by increased trade versus other factors. We noted that average U.S. tariffs outside of free trade agreements are not that high (the U.S. “most favored nation” tariff rate averaged 3.5% in 2016 according to the WTO).
  - An approximate 4% rise in tariffs in Canada and the U.S. under a worst case scenario (NAFTA withdrawal) would have a significant longer-run negative impact on the Canadian economy, reducing Canadian GDP by around 1% over the next 5 to 10 years relative to a “no-change” baseline. The cumulative impact could amount to some C\$20 billion loss of annual economy-wide income in today’s dollars.
  - The broader cost is hard to quantify. Scrapping NAFTA would also hit business and consumer confidence, further weighing on growth and investment and potentially fuelling a cycle of falling interest rates and a declining Canada dollar.

