SPECIAL REPORT
TD Economics

January 24, 2017

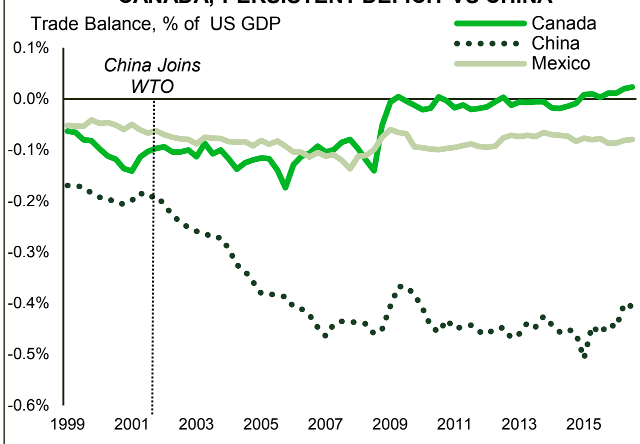
WILL U.S. POLICY TRUMP CANADIAN TRADE? SOME QUESTIONS AND ANSWERS

Highlights

- President Trump made protectionism a major part of his election campaign. With a significant trading relationship, any thickening of the Canada-U.S. border is likely to have a negative impact on the Canadian economy.
- This report examines three key areas: the size and characteristics of the Canada/U.S. trade relationship, the potential implications of the proposals under consideration in the U.S., and what Canada can do in response.
- Canada and the U.S. are the world's largest trading partners, with almost C$900 billion in goods and services exports changing hands annually. The significant linkages between the two economies is reflected in sizeable two-way foreign direct investment and employment.
- A re-opening of NAFTA appears likely. Indications are that negotiations will likely be focused on local content rules.
- Less likely are across-the-board tariffs of 5% or 10%, which would have a significant negative impact on Canadian output and employment, with more modest U.S. impacts. Similarly, border adjustment measures have been proposed which could have far-reaching impacts on Canada. That said, exchange rate movements may help to cushion some of the impacts.
- Regardless of the ultimate outcomes for trade and tax policy, the elevated uncertainty around U.S. trade policy will likely weigh on Canadian investment until some clarity is provided.
- The similarities between the two economies and depth of the relationship may provide a starting point for trade negotiations. Moreover, revisiting NAFTA may be an opportunity to address outstanding issues and improve the trading relationship.

The heated trade rhetoric of the 2016 U.S. presidential election and the outcome of the vote are generating considerable uncertainty for Canadian exporters, investors, and governments. Canada relies heavily on the U.S. as an export market: roughly one fifth of Canadian output is destined for the other side of the border. Campaign rhetoric may translate into policy changes as a number of trade skeptics have joined the President's team, with their focus appearing to shift towards NAFTA. This report focuses on the Canada-U.S. relationship via a series of questions and answers in three key areas: the state of the trading relationship today, the main U.S. trade policy proposals and their likely impacts, and what Canada can do to address these challenges and ensure continued economic growth.

CHART 1: US HAS BALANCED TRADE WITH CANADA, PERSISTENT DEFICIT VS CHINA



Source: Bureau of the Census

Brian DePratto, Senior Economist, 416-944-5069

Q: What is Canada's trade relationship with the U.S., and how does it compare to others?

Until the financial crisis, Canada tended to run a small trade surplus vis-à-vis the United States. Since 2009, this surplus has swung into a slight deficit position (Chart 1). In contrast, Mexico has had a modest but persistent trade surplus. The largest U.S. trade deficit is with China – the deficit more than doubled following China's joining the WTO in 2002, and has shown little sign of shrinking.

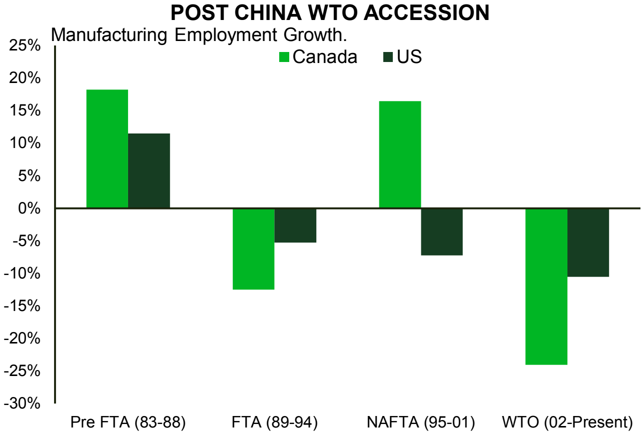
In broad terms, Canada runs a bilateral trade surplus with the U.S. in goods, but a trade deficit in services, notably travel and tourism services. For goods, the largest categories are transportation products (largely motor vehicles and parts), and energy products. In the motor vehicle segment, the surplus masks significant deep linkages, as car parts may cross the border up to six times during the manufacturing and assembly process.[1]

Regionally, the largest Canadian trade surpluses are with Michigan, California, and Illinois, with Washington and New York also important. These states are also the most important from an aggregate trade perspective (exports plus imports), reinforcing the strong industry-specific linkages. Canada runs modest goods trade deficits with 23 states; the most significant deficits are vis-à-vis Ohio, Kentucky, and Wisconsin.

Canada's recent deterioration has reflected two major factors. The value of resource exports has fallen sharply since 2014, reflecting soft commodity prices. Furthermore, weakening Canadian competitiveness in the U.S. market has also taken a toll. The Canadian share of the U.S. market has been declining: Canadian products represented 20% of U.S. goods imports in 2002, but now account for just 12% of the total. This decline was largely the result of China's ascension, as China's share of U.S. goods imports rose 11 percentage points over this time.

Mexico's overall market share in the U.S. was roughly flat over this time, but significant gains were made in some categories, notably transportation equipment, reflecting growing penetration in the light vehicle market. American manufacturing firms also appear to have lost market share, as the growth in domestic industrial production failed to keep pace with import growth.

CHART 2: BOTH CANADA AND U.S. MANUFACTURING EMPLOYMENT SUFFERED POST CHINA WTO ACCESSION



Source: Statistics Canada, BLS. Employment is LFS/Household concept.

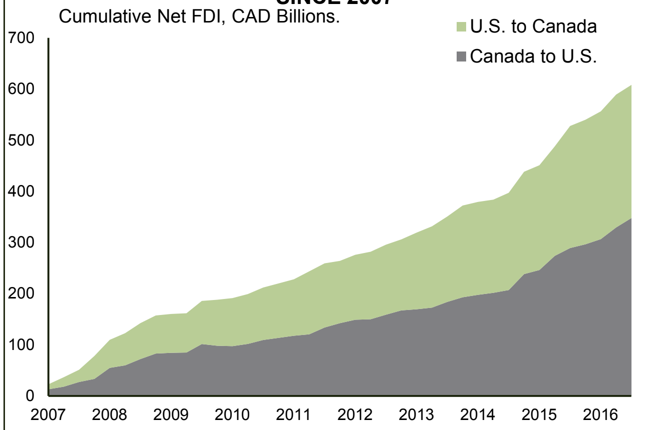
Q: Trump has made much of 'bringing jobs back' in manufacturing – what has happened to manufacturing employment in the U.S. and Canada?

Falling manufacturing employment is not unique to the U.S. – Canada benefitted in the immediate post-NAFTA period, but since China's WTO accession in 2002, both Canada and the U.S. have experienced significant declines in manufacturing employment (Chart 2); Mexican manufacturing employment appears to have had a more mixed performance over this time.[2] The declines in manufacturing employment since 2002 have had a similar pattern in both countries. Significant falls have taken place in durable goods producing industries, notably computer and electronic products, transportation equipment, and metal products. Employment among plastic and rubber product manufacturers has also fallen markedly.

Q: What about cross-border investment?

The U.S./Canada relationship extends beyond trade. Cumulative bilateral direct investment since 2007 has totalled more than C$600 billion, with Canadians investing roughly C$90 billion more in the U.S. than Americans in Canada (Chart 3). Foreign direct investment in Canada has largely been concentrated in the mining and energy sector, although manufacturing is the second largest destination (cumulative flows since 2007: mining/energy: C$174 billion; manufacturing: C$120 billion). The role of foreign affiliates has become much more important as well, with significant sales, employment, and assets extending in both directions across the border. Combined employment among Canadian and U.S. foreign affiliates totals more than 1.7 million jobs, with U.S. affiliates in Canada comprising the bulk of the total.

CHART 3: CANADA AND U.S. HAVE INVESTED MORE THAN HALF A TRILLION IN EACHOTHER SINCE 2007



Source: Statistics Canada

Q: What has been discussed regarding potential tariffs?

President Trump has made a number of comments indicating that he is in favour of renegotiating existing trade agreements, and potentially introducing import tariffs. Tariffs as high as 35% to 45% have been threatened, but these may be reserved for specific U.S. firms that move production out of the United States, and it is unclear whether these tariffs could be applied for more than a short period of time without congressional approval.

Earlier this month there was speculation that the Administration was contemplating across the board tariffs of 5% to 10%.[3] Neither the President nor Commerce Secretary have referred to such a move publicly, although should such tariffs be imposed, even at this lower level there would be a significant negative impact on Canadian output and employment.

Additionally, members of Congress have been considering 'border adjustment' tariffs (BTAs), which would be included as part of a comprehensive package to lower the general corporate income tax rate and overhaul the broader tax system.[4] The exact function will depend on what is ultimately legislated; the BTAs under discussion are likely to be a tax on the difference between a business's revenues and its costs, with exports not counting towards revenues (reducing the tax burden), and imports not counting as valid costs (increasing the tax burden).

The imposition of an import tariff or BTA is likely to face significant opposition from U.S. retailers, oil refiners, and other import-intensive industries. Moreover, President Trump has recently made comments indicating that he may not be in favour of border adjustment measures.[5] A BTA system would also likely fall afoul of WTO rules, although the WTO dispute resolution process can be slow.[6] Regardless, given the likely asymmetric impact of trade restrictions, the U.S. may choose to accept any retaliatory measures that may occur.

Q: What else has been proposed?

A 're-opening' of NAFTA appears probable, with rules of origin (how much of a product's content must be produced locally to avoid tariffs) likely to be a focus. Higher local content requirements may have similar impacts to tariffs (depending on industry and product specifics) at least initially, as it will take time for supply chains to be re-oriented, exposing previously exempt products to pre-NAFTA tariff rates.

Such a change would function similar to a tariff, but only apply to specific products. For example, currently, light vehicles must have at least 62.5% NAFTA content to cross the border tariff-free. Should this rise to 75% (for example), a Canadian vehicle that includes 30% non-NAFTA parts would fall out of NAFTA 'protection' and be subject to a tariff on entering the United States, while a vehicle that includes 20% non-NAFTA content would continue to enjoy the same level of market access. Thus, the impact of such a change will likely vary significantly. For some industries, such as oil producers, where there is little-to-no non-domestic content, there would likely be only a minimal impact. However, for integrated manufacturers/assemblers, the impact could be larger, depending on supply chain structure.

Q: Would such measures be effective?

Success of potential measures would likely be measured by the trade balance and/or employment. Preliminary analysis of the proposals suggest that they would likely have little impact on the U.S. trade balance, and would likely reduce America's net foreign asset position.[7] This is because in theory an improvement in export prices relative to import prices is likely to drive up the value of the U.S. dollar, thus muting at least part of the benefits to U.S. net trade. At the same time, the associated revaluation of foreign assets would likely be significant.

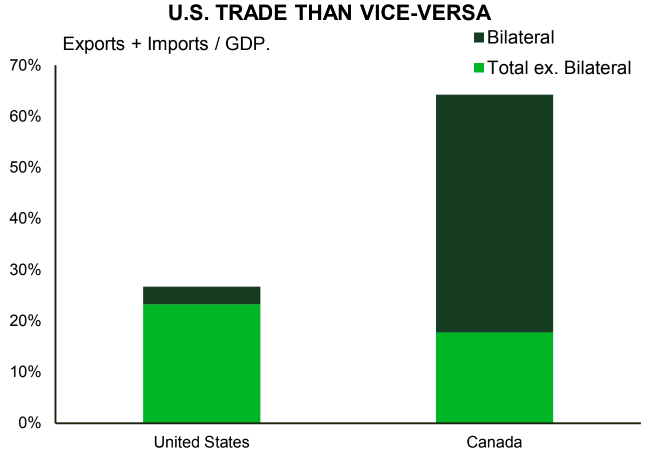
On the employment front, neither proposal is likely to generate meaningful growth. With high labour costs in the United States expected to remain intact, much of the increase in output that does occur is likely to be driven by automation, with modest implications for manufacturing employment. Indeed, despite the falling level of employment highlighted in Chart 2, U.S. manufacturing output continued to rise, highlighting the impacts of automated production processes.

Q: What would the impacts be on Canada?

The impact of these proposals on Canada will depend on the policy specifics, such as how broad-based any tariffs or taxes might be, or any possible exemptions. That said, Canada's high reliance on the U.S. as an export destination leaves the economy highly exposed to potential impacts. The total trade relationship with the U.S. (exports plus imports) is equivalent in size to half of annual Canadian economic output (GDP). By contrast, total U.S. trade with *all* trading partners is roughly a quarter the size of the overall economy (Chart 4). Clearly, any impediment to trade would have an asymmetric impact, being felt much more in Canada than in the U.S.. Impacts would come through some combination of reduced profits (as firms potentially absorb some of the tariff costs), and/or reduced sales volumes.

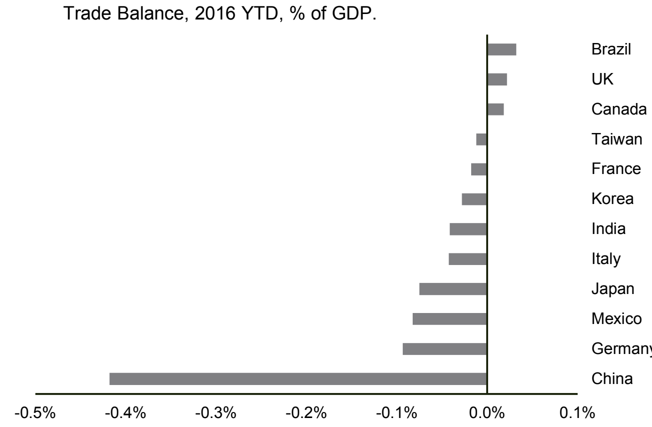
That said, there will be factors that provide some offset. Just as a potentially stronger U.S. dollar will blunt the effectiveness of trade measures, a weaker loonie would have a similar effect for Canada, improving export competitiveness. Moreover, in the case of broad U.S. tariffs, within certain industries, substitutes for Canadian inputs may not be immediately available, delaying/offsetting the impact of protectionist measures. This would be in contrast to the previously discussed prospective NAFTA rules-of-origin changes, where a possibly slow re-orientation of non-NAFTA supply chain linkages could lead to an immediate impact. Indeed, given that rules-of-origin changes will have differing impacts across industries and products, although it would ultimately function somewhat like a tariff, assessing the potential scope is difficult.

CHART 4. CANADA MUCH MORE RELIANT ON U.S. TRADE THAN VICE-VERSA



Source: Statistics Canada, Bureau of Economic Analysis, TD Economics.

CHART 5: WHEN IT COMES TO THE U.S. TRADE DEFICIT, CANADA IS NOT THE CULPRIT



Source: Bureau of the Census

Regardless of what ultimately transpires, a cloud of uncertainty will hang over manufacturing investment in Canada given the sizeable lists of unknowns. Until there is more clarity, Canadian business investment is likely to suffer.

Q: What is likely?

Reading the political tea leaves is always a challenging task, as priorities and alliances can shift quickly. Bearing that caveat in mind, a few outcomes seem probable. First, a renegotiation of NAFTA is likely to be an immediate priority, given both Presidential leeway in the area, and recent statements by Wilbur Ross, nominee for commerce secretary.[8] There have also been indications that President Trump would like to see changes around the investor dispute resolution mechanism.

There is less leeway around corporate taxes, and given President's Trump dislike for border adjustment taxes, changes here are likely to take longer, and, if a sizeable stimulus is to be paid for, may involve 'tax shifts' rather than a 'tax cut'. Given the fluid nature of these sorts of negotiations, it is difficult to say what the U.S. corporate tax system might look like in a few years' time.

Q: What can Canada do?

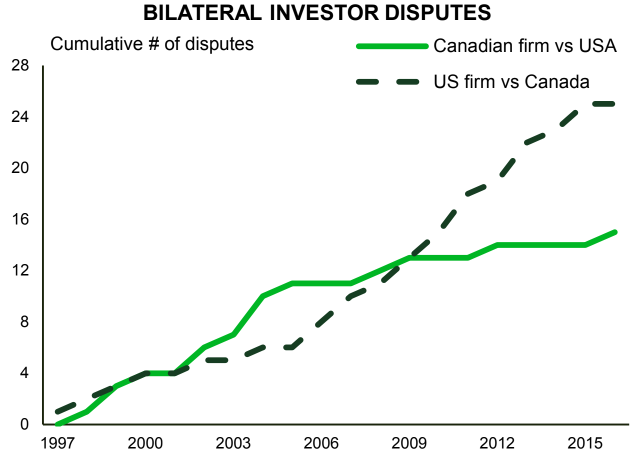
Given the likely asymmetric impact on economic growth of any U.S. border thickening, and proposals both from the President and Congress aimed at reducing trade, ensuring continued Canadian access to U.S. markets is of the utmost importance. A worthwhile starting point for Canadian policymakers may be to focus the attention of U.S. officials on the differences between Canada and the countries that have been the main target of President Trump's ire (China and Mexico). Canada and the U.S. have roughly balanced trade and are highly integrated. To the extent that a U.S. trade deficit is considered a problem, Canada is not the culprit, but rather stands on common ground with the U.S. (Chart 5). The President appears to be focused on manufacturing employment, where Canada has seen more significant losses than the United Sates. Moreover, the strong trade linkage with the traditionally manufacturing-focused Northern U.S. states reinforces how trade with Canada supports American jobs, both directly and through supply chain employment.

Beyond these immediate concerns, 're-opening NAFTA' should be considered an opportunity for Canada.[9] There are many elements of the agreement (and the overall trading relationship) that could be strengthened, and which could result in economic benefits for both nations. Canada needs to nail down a list of areas where Canadian and U.S. interests are likely to be aligned, including security, infrastructure, dispute resolution and energy. This could form the basis of negotiation.

Q: What can be easily addressed?

Nothing is easy in international trade negotiations. That said, security and border times are both areas where achieving consensus may be less challenging. Increased pre-clearance of goods for export may reduce bottlenecks at the border. Allowing more U.S. inspectors to operate in Canada should help allay potential American concerns about security while making things easier for exporters and trans-shippers. President Trump has indicated his displeasure with the investor dispute mechanism of NAFTA, and similar concerns continue to plague the Canada-European Union free trade agreement (CETA). Many more disputes have originated from the U.S. than from Canada (Chart 6). Moreover, among the cases that have been resolved, American firms have generally had a mixed performance utilizing the investor dispute mechanism, whereas Canadian firms have generally been unsuccessful. Given this asymmetry, this may be another area where alignment can be achieved with little cost to Canada.

CHART 6: U.S. FIRMS HAVE LAUNCHED MORE BILATERAL INVESTOR DISPUTES



Source: United Nations Conference on Trade and Development, TD Economics.

Q: What are the more challenging areas?

More challenging will be some of the perennial sore points: softwood lumber (which represents roughly 1.7% of 2015 Canadian exports by value), drywall dumping (0.4% of imports by value), 'Buy America' provisions, and Canadian protection of some agricultural industries (roughly 1.5% of nominal GDP). While these have proven difficult areas to find agreement on in the past, there is scope across these areas for potential give and take, as there have been a number of irritants to both countries. Addressing these irritants is likely to benefit consumers in both jurisdictions.

The changing nature of work has made the current TN visa system outdated. A simplification of the application process and expanded scope will make it easier for professionals to work in both jurisdictions, benefitting both economies. Additionally, services have for some time been the largest component of the Canadian and U.S. economies, but NAFTA does not reflect the reality that 'e-commerce' is no longer just about shipping goods, but has come to encompass nearly all major service categories. Liberalizing trade in services and strengthening intellectual property protections may be another area of action. It is important to note that the alignment of interests in these areas means that both countries are likely to benefit from reduced transaction costs, greater product and service selection, and higher employment.

Q: Are there implications for Canadian trade with other countries?

With protectionist sentiment on the rise south of the border, Canada should also be looking beyond North America to seize trade opportunities in the void left by the U.S.; CETA provides a great template for future agreements. Asia is likely to remain a fast growing economic bloc, and the now likely failure of the Trans-Pacific Partnership (TPP) means Canada will have just one trade agreement in place in Asia for the near future (with South Korea).

China is an obvious starting point in the region given its global importance.[10] As well, the TPP experience should not go to waste, but rather the discussions that have already taken place may provide a starting point that can be leveraged into bilateral discussions with potential signatories such as Singapore, Vietnam, and Malaysia. The Antipodean economies (Australia and New Zealand) are structurally similar to Canada, which creates challenges from a trade perspective, but also opportunities for agreements that are deeper in scope, focusing on services and investment.

Q: What else can Canada do to address these risks?

The potential negative impacts of 'Trumpism' for Canada should serve as motivation to address domestic impediments to growth. Interprovincial barriers remain a significant inhibiting factor for efficient growth, and are estimated to cost Canada billions of dollars per year.[11] Harmonization in areas such as professional certifications and securities regulation will make it easier for Canadians to apply their skills in the areas of the country where they are most needed, and reduce red-tape for firms seeking funds to expand their operations.

The macroeconomic backdrop cannot be ignored. TA reduced U.S. corporate tax rate will erode one of Canada's advantages on that front, while reducing and simplifying the personal tax code will have a similar impact on individuals. Although taxes form only part of the overall innovation and growth equation, this (alongside the potential for thickening borders) is likely to be an important area of action in the coming years. As discussed in the TD Economics report Canada-Wide Carbon Pricing Offers Opportunities But Is Not Without Risks, new revenues raised through carbon pricing may help address Canadian competitiveness.[12]

Brian DePratto, Senior Economist
416-944-5069

ENDNOTES

1 Source: Canadian Manufacturers and Exporters (See http://www.cme-mec.ca/?lid=41J5D-HTHQN-F9V37) ↑

2 This remains true even if the sample is shortened to exclude the financial crisis period. ↑

3 For reference, a return to WTO 'most favored nation' status would result in a 3.5% tariff. ↑

4 A good summary of the proposal can be found at http://www.wsj.com/articles/export-friendly-u-s-tax-revamp-risks-cool-reception-at-wto-1482356641 ↑

5 See http://www.wsj.com/articles/trump-warns-on-house-republican-tax-plan-1484613766 ↑

6 For instance, a U.S. tax break for exporters introduced in 1971 was finally ruled illegal in 2002 (although it was revamped several times in the interim). ↑

7 See https://www.project-syndicate.org/commentary/trump-tax-plan-hurts-competitiveness-by-emmanuel-farhi-et-al-2017-01. Paul Krugman has offered a similar analysis. ↑

8 See for instance https://www.bloomberg.com/news/articles/2017-01-18/trump-s-commerce-pick-signals-plan-to-launch-nafta-talks-early ↑

9 It is also possible that in the extreme, Trump may abolish NAFTA. The Canada-US Free Trade Agreement (CUSFTA) would likely then be in force. ↑

10 There have been indications that preliminary talks may begin soon (See http://www.theglobeandmail.com/news/politics/ottawa-weeks-away-from-starting-free-trade-talks-with-china/article33646385/). Based on past negotiations, potential negotiations with China will likely take many years to conclude. ↑

11 See http://www.parl.gc.ca/content/sen/committee/421/BANC/Reports/2016-06-13_BANC_FifthReport_SS-2_tradebarriers(FINAL)_E.pdf ↑

12 Unlike international trade policy however, the use of carbon pricing revenues is controlled at the provincial level. ↑