SPECIAL REPORT

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U.S. TRADE PROTECTIONIST TALK: BARK WORSE THAN BITE FOR CANADA

Highlights

- In the current U.S. presidential campaign, both leading candidates have taken somewhat protectionist positions on trade and have lobbied criticisms at NAFTA, generating uncertainty for Canadians.
- New import tariffs on key trading partners would likely do more harm than good. They raise prices for American consumers and have knock-on effects for U.S. businesses through globalized supply chains, with little evidence that they save American jobs.
- Protectionist rhetoric is a common occurrence on the campaign trail. Once in office, leaders don't typically implement the full extent of their campaign rhetoric.
- Non-tariff barriers have been enacted in recent years, but are often contested by counterparties.

As our largest trading partner and neighbour, U.S. presidential elections get a lot of attention on this side of the border. Uncertainty is always heightened in an election campaign, but this time around, change is a certainty. A new U.S. Commander in Chief in 2017 will undoubtedly influence policy and the economy north of the border.

Protectionist rhetoric from both Republican and Democratic candidates is catching the ear of Canadian businesses. Both candidates have been highly critical of NAFTA and said they would renegotiate it. Presumptive Republican nominee Donald Trump has suggested enacting punitive tariffs on Mexican imports, which would run afoul of NAFTA. Criticism has not been directly lobbied at Canada, but we could get caught in the crossfire of initiatives targeted at Mexico through our NAFTA linkages. This is coming at a time when Canada's growth prospects are increasingly dependent on a push from exports. Over $1.5 billion worth of goods crosses the Canada-U.S. border every day.

A long history of trade agreements from the auto-pact, to the Canada-U.S. Free Trade agreement (CUSFTA), to NAFTA and more recently the Beyond the Border Action Plan, have facilitated extensive cross-border linkages in various industry supply chains – perhaps most notably in the energy and automotive sectors. Therefore, it's important that Canada protects the U.S. market access gained under previous trade agreements, and build on them with the next President.

Canadians can be reassured that it would be unlikely for the next President to repeal NAFTA. There are three primary reasons for this. First, new trade policies like tariffs need to be enacted in Congress. It is not at all clear that Congress would go along with a protectionist agenda. Second, the business of America is business. U.S. companies have built up intricate cross-border supply chains over the years, which would be significantly and adversely impacted by an increase in tariffs or the scrapping of NAFTA. That is in addition to the higher costs that tariffs would impose on U.S. consumers and, by extension, the hit to businesses bottom lines. Finally, there are precedents for candidates talking tough on trade and putting "America first" during election campaigns. But, once in office, they typically govern from a more moderate standpoint. That said, even under NAFTA, Canada and the U.S. have had trade disputes

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and irritants, including disputes on softwood lumber, "Buy American" provisions in government procurement and country of origin labelling on meat (COOL). These types of actions can still be costly to Canadian businesses, and show that the existence of NAFTA is no guarantee against a rise in protectionism south of the border damaging Canada's access to the U.S. market.

The art of the possible

It is often said that politics is the art of the possible. And perhaps nowhere is this more true than in the U.S. system of checks and balances, where the division of powers between the executive (the President) and legislative (Congress) branches make it difficult for a President to act unilaterally.

The U.S. can withdraw from NAFTA with six-months' notice. However, it is unclear whether abrogating NAFTA requires congressional approval. Previous trade agreements (CUSFTA, NAFTA and WTO agreements) have been treated as congressional-executive agreements and have been approved by a majority vote of both the Senate and the House of Representatives, and implemented into public law. This would suggest that Congress would be needed to repeal this agreement. However, the law on withdrawal from congressional-executive agreements seems unsettled[1]. In part, this is because there is no precedent for abrogating a trade agreement like this; they are typically superseded by a new trade agreement (like NAFTA and the CUSFTA). Since Republican members of Congress voted in favor of NAFTA (to a greater degree than Democrats), it would be out-of-step for a Republican dominated Congress to support extreme protectionist policies.

In the case of tariffs on China, under existing laws, the U.S. could (and has) impose tariffs or countervailing duties on specific categories of goods by demonstrating violations of trade rules, such as export subsidies, dumping or to temporarily "safeguard a domestic industry". The President does have the authority to apply "safeguard" measures and to withdraw them, after the International Trade Commission (a bipartisan six member independent agency) recommends that safeguards be imposed. Implementing broader tariffs requires congressional approval and unilateral tariffs on Chinese imports would be in violation of World Trade Organization (WTO) rules. So while the next President does have some authority to implement more protectionist measures, the more extreme policies suggested by the presumptive Republican nominee would be far more difficult, and likely require the cooperation of Congress.

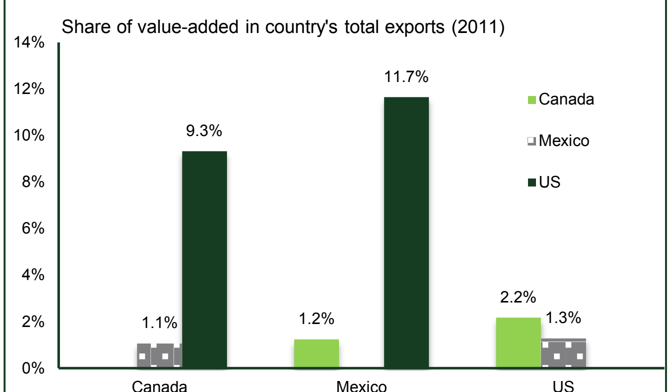
The business of America is business

In an increasingly globalized world, the supply chains of U.S. companies stretch across borders. Therefore, it is not so simple to impose punitive tariffs on products that are "Made in Mexico" or "Made in Canada". Chances are those products contain a high degree of content that was "Made in the USA". For example, nearly 10 cents of every dollar Canada exports is value added by the United States, and the number is even higher for Mexico (see Chart 1). Therefore, American businesses suffer as well when U.S. trade barriers reduce demand for Mexican imports, they also hurt demand for U.S. goods and services incorporated into these products.

Donald Trump has threatened to impose 35% tariffs on Mexican imports into the U.S. These would run afoul of NAFTA, which has been enacted into law by Congress. Even if the next President were able to circumvent Congress and enact targeted tariffs on Mexico, this would exact a cost on American businesses who supply intermediate inputs to Mexican factories.

In fact, one study[2] estimates that due to highly shared production processes between the U.S. and Mexico, Mexican imports into the U.S. actually have 40% U.S. content. That is ten times greater than the linkages to China. That shows that tariffs on Mexican imports would heavily impact U.S. suppliers, in addition to raising prices for consumers. The biggest imports from Mexico are transportation equipment (which includes motor vehicles and pars), computers and electronic products and electrical equipment, appliances and components. Therefore prices for many big-ticket items would increase for American consumers. Furthermore, research from the National Bureau of Economic Research

CHART 1: U.S. BIGGEST CONTRIBUTOR TO ITS NAFTA PARTNERS' EXPORTS



Source: OECD Dataset - Trade in Value Added (TiVA), Origin of Value Added in Gross Exports; TD Economics.

(Calienda and Parro, 2012) shows that when estimating the welfare benefits of tariff reductions that occur in trade agreements like NAFTA, including estimates of supply chain linkages (or trade in intermediate goods across borders) amplifies the affects[3].

At the same time, the implementation of a tariff wall to keep out Mexican imports is unlikely to result in a substantial boon for U.S. manufacturing employment. Aside for the significant amount of U.S. value-added in these products, which would in and of itself hurt U.S. industry and jobs, the repatriation of the work currently done in Mexico would result in only a limited number of jobs returning to the U.S. Given the higher productivity of U.S. workers, it would take comparatively fewer additional U.S. jobs to compensate for the reduced Mexican imports, as firms substituted capital for labor – with the latter being more expensive in the U.S. In fact, a back-of-the-envelope calculation suggests that U.S. auto workers are about 3.5 times as productive as their Mexican counterparts, implying that reshoring of 10,000 Mexican auto sector jobs would result in a more subdued increase in U.S manufacturing payrolls – to the tune of 3,000. Moreover, any gains would have to be netted out by job losses resulting from reduced exports to Mexico, partly related to the significant U.S. value-added content in these products. Lastly, reshoring of some lower value-added production processes, currently performed in Mexico, would likely lower U.S. labor productivity and could put downward pressure on U.S. manufacturing wages in the longer run.

How tariffs rob Peter to pay Paul

A recent example of an import tariff on Chinese tires shows how tariffs can raise prices for consumers, have consequences for American businesses in unrelated industries and produce few benefits for U.S. producers. In 2009, when President Obama imposed tariffs on Chinese-made tires in response to accusations of dumping (tariffs were for 3 years, 35%, 30%, 25%, in consecutive years). Analysis by The Peterson Institute[4] showed that these tariffs came at a high cost to the pocket book of American consumers.

They estimated that the total cost to consumers for higher tire prices was around $1.1 billion in 2011. From September 2009 to September 2011, tire manufacturing employment rose by 1,200 jobs. Under the generous assumption that all of the increase in jobs was due to the tariff – which is highly unlikely given the U.S. economy was in the midst of a cyclical upswing – these jobs came at a cost of at least $900,000 per worker in 2011. This supports the finding generally in the research that the cost of protection generally exceeds by a wide margin a reasonable estimate of what a jobs program for displaced workers might cost.

As a result of the tariff, Chinese tire imports fell, but imports from other countries rose. In other words, overall tire imports did not fall. Substitution towards higher-cost suppliers occurred to exporters in Thailand, Indonesia, and Mexico. This means that the bulk of higher prices accrued to foreign tire manufacturers, rather than U.S. producers. And, higher prices for tires meant American consumers had less money to spend on other goods, at an estimate of a net loss of 2,531 jobs in other sectors. Furthermore, China retaliated with tariffs of 50.3% to 105.4% on American poultry imports, which reduced U.S. exports to China by $1 billion.

Another study attempted to control for the cyclical upswing in the economy over the time the special safeguard on Chinese tires was imposed. It found that total employment in the sector and average wages in the U.S. tire industry showed no different trend from a modelled counterfactual scenario without import tariffs. This is primarily due to the result that the drop in Chinese tire imports was completely offset by imports from other countries – import diversion – leaving scant gains for domestic producers[5].

In another more anecdotal example, in 2012, the U.S. imposed anti-dumping duties of up to 78% on Chinese solar panels after German-owned SolarWorld AG complained that below-cost Chinese imports were hurting its U.S. production. China responded with 57% duties against U.S. producers of polycrystalline silicon, the raw material for photovoltaic cells. This hurt an industry that was expanding fast to meet demand from Chinese solar panel makers. A $1.5 billion investment in a new polysilicon plant was abandoned in 2014 by Dow Corning.

All of these factors, supply chain linkages, potentially higher costs to American consumers with little net benefit to domestic producers, and knock-on impacts to other U.S. sectors from retaliatory tariffs are all reasons why it is not a clear cut case that punitive tariffs against key trading partners would benefit Americans. At the very least, it can be said that any benefits that accrue to one segment of the economy carry costs to another, and this trade-off needs to be understood in advance on any action.

U.S. sights not on Canada…

Canadians can be somewhat becalmed as the worst protectionist comments in the campaign are primarily directed at China and Mexico. While there are trade irritants between

Canada and the U.S., the two countries have enjoyed a generally positive trading relationship, and it seems unlikely Canada would be targeted by protectionist policies. Critics of free trade typically cite the offshoring of jobs to lower cost jurisdictions, or countries with lax labour and environmental standards. Canada does not exactly fit that bill. Still, since we are a part of the NAFTA agreement, punitive action on Mexico or repealing NAFTA would clearly have a damaging impact on Canada.

There is no roadmap for what happens to Canada in the unlikely event that NAFTA is scrapped. What we do know is that the United States would give Canada six months' notice that it intends to withdraw from the agreement. It is possible Canada could negotiate a separate trade agreement with the United States to replace NAFTA, if the primary target for import tariffs was Mexico, but there is no guarantee. Some argue that the Canada-U.S. trade relationship may also revert to operating under the rules of the original CUSFTA. Alternatively, as a member of the WTO, it would seem likely that Canada would trade with the U.S. like any other WTO nation, but would lose its preferential access to the U.S. market, as would Mexico.

If Canada were to trade with the U.S. under WTO rules, U.S. import tariffs are actually quite low for many of the goods imported from Canada. Tariffs on auto-related imports are 2.5%, and crude oil is 52.5 U.S. cents per barrel, (roughly 1% at current prices). If Canadian exporters had to pay the normal tariff level for the top 10 exports to the U.S. it would amount to about 1.2% of the level of exports in 2015, so the tariffs themselves would not be the biggest cost. The red tape involved in transitioning interconnected supply chains to a new system would be significant. Trade in services, which had more limited provisions under the original CUSFTA, and were expanded under NAFTA, could also be thrown into uncertainty. The U.S. actually exports more services to Canada then it imports, so disruption to the $124 billion of two-way trade in services between the U.S. and Canada would be counter intuitive and uneconomical for the U.S.

… but specter of protectionism still looms

Even though the presumptive Democratic candidate for President, Hillary Clinton, has not supported the more extreme protectionist measure of Donald Trump, she has been critical of NAFTA, and does not support the Trans Pacific Partnership (TPP). Thus, both leading candidates have a protectionist bent, and could still enact anti-trade policies, even if they are not as extreme as 35% or 45% tariffs.

Despite the economic arguments against tariffs, countries frequently enact rules or non-tariff barriers that hurt a country's trading partners. Even in a free-trade zone like NAFTA. Recent examples include "Buy American" legislation in government procurement and country of origin labelling (COOL) in the meat industry. Canada and Mexico ultimately won a challenge against the COOL requirements, but the WTO ruled that the damage to Canada's meat industry amounted to $1 billion annually, while the rules were in place from 2009 to 2015. So there are real economic impacts from protectionist measures, even if they are ultimately repealed. Therefore, Canadian businesses do have reason to be concerned about the protectionist rhetoric in the current campaign, as it suggests a bias towards future challenges to Canada's preferential access to the U.S. market.

Posturing, not policy

Finally, there is precedent for Presidential candidates to talk about "putting America first" during election campaigns, but once elected govern from a more even-handed stance. These kind of protectionist sentiments play well in regions were traditional industries have declined as a result of globalization. A free trade agenda is a tough sell in an election campaign. The main challenge of promoting freer trade is that the costs are highly concentrated (damaging job losses in certain industries in specific regions, which can be devastate a region), while the welfare benefits of lower import prices are diffuse, and tough to explain in a soundbite.

One recent example is President Obama, who also made many anti-NAFTA statements during the 2008 election. Once elected, the President became a supporter of the TPP. This is because U.S. exports of services have been growing at an average of about 8% over the last ten years, and the greater market access enabled by the TPP is to the U.S.'s advantage (see TD's report on the TPP). As American business leaders have pointed out, 95% of potential customers, or 80% of global economic activity lie outside of the United States, and American business have more opportunities to grow in a world where trade deals try to level the playing field and safeguard market access for American firms.

As for the current candidates, we don't have a voting history to fall back on for presumptive Republican nominee Donald Trump. Although presumptive Democratic nominee, Hillary Clinton, has made disparaging remarks about NAFTA and the TPP during the current campaign, her voting record as a Senator was for the most part supportive of past free-trade deals.

The Bottom line

The U.S. may be less exposed to international trade than other countries, but it is still a globalized economy that would experience many undesirable consequences from increases in the types of import tariffs proposed by the presumptive Republican nominee. They would lead to higher prices for many consumer goods, while import substitution to suppliers in other countries often leaves few benefits for U.S. producers. Furthermore, interconnected global supply chains mean that demand for many U.S. suppliers would be directly affected. Last but not least, countries are likely to initiate retaliatory tariffs, which would impact many U.S. exporters. That, combined with the likelihood of needing congressional approval to abrogate NAFTA or imposing new tariffs, makes implementing these extreme policies much more complex than a simple strike of the pen. That said, there are many non-tariff barriers the U.S. can put in place outside of large tariffs or scrapping existing trade agreements that can have damaging consequences for its trading partners. However, here too, anything deemed unlawful by the targeted country would surely elicit a legal or retaliatory response.

Canadians watching the campaign rhetoric south of the border may be understandably concerned about how these policies might affect the close ties between the Canadian and U.S. economies. But, we can take some solace in the fact that it is common for presidential candidates to talk tough on trade, and "putting America first" on the campaign trail. But, when it comes time to govern, they frequently implement much more pragmatic policies that attempt to level the playing field rather than rewrite history. Protectionist policies are like trying to put the toothpaste back in the tube – it's difficult to do, messy, and can be wasteful.

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ENDNOTES

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