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THE TRANS-PACIFIC PARTNERSHIP: A NEW GENERATION TRADE DEAL

Highlights

- An agreement on the Trans-Pacific Partnership (TPP) was finally reached in early October. It must be ratified by national parliaments of each of the 12 member countries before it can be implemented – a process that could take years.
- The TPP is much more in-depth than any other free trade deal. In addition to tariffs, it addresses a number of non-tariff barriers as well as the technological advancement that has taken place in recent decades.
- While there will be winners and losers, the benefits are expected to outweigh the costs. For Canada, the cost of not being included in the TPP could be quite significant.
- The potential benefits of the TPP for Canada and the U.S. stem largely from non-tariff barriers and growth in service exports. In fact, the service sector stands to emerge as a key winner in both countries, as this is an area where they have a competitive advantage.

An agreement on the Trans-Pacific Partnership (TPP) was finally reached in early October. It will be the largest regional trade deal to date, with the 12 countries involved – Canada, U.S., Mexico, Japan, Australia, New Zealand, Peru, Chile, Vietnam, Singapore, Malaysia and Brunei – accounting for 40% of the global economy. This, combined with the trade deal recently agreed to with Europe (still to be ratified) will give Canada preferred access to roughly two thirds of the global economy.

Countries outside the TPP, including China, have shown interest in joining the deal, and could enter the partnership at some point in the future as this is a living agreement. Any new entrants would have to accept the provisions already agreed to by the current members.

The TPP deal must still be ratified by national parliaments in each member country before it can be implemented. This process is likely to be lengthy and riddled with uncertainty. In Canada, the Liberal government is generally in favour of free trade but has said they need to review the details before making a decision, and will hold a full and open public debate in Parliament. In the U.S., there is opposition to the TPP from several political front runners, including Hilary Clinton. Obama narrowly obtained fast track permission from Congress – which means that Congress cannot amend the final deal, they can only vote in favour or against. The TPP will need support from both the Democrats and the Republicans. Congress has 90 days from when it receives the full text to review the deal, making it unlikely that a vote will occur before early 2016. The country, however, will be in the midst of a presidential campaign, so a decision may be delayed until after the election. There are 10 other countries that must ratify as well, so the TPP could take years before it is fully ratified and implemented.

Free trade agreements are typically beneficial to the countries involved, by providing increased market access and a comparative advantage relative to those not included in the deal. While the old generation trade deals typically accomplished this by lowering or eliminating tariffs, new generation trade agreements – such as the TPP – have a much broader scope, as they also address the technological advancement

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that has taken place in recent decades as well as a number of non-tariff barriers. In fact, this is where Canada and the U.S. stand to benefit most from the TPP, as tariffs within TPP member countries are already relatively low.

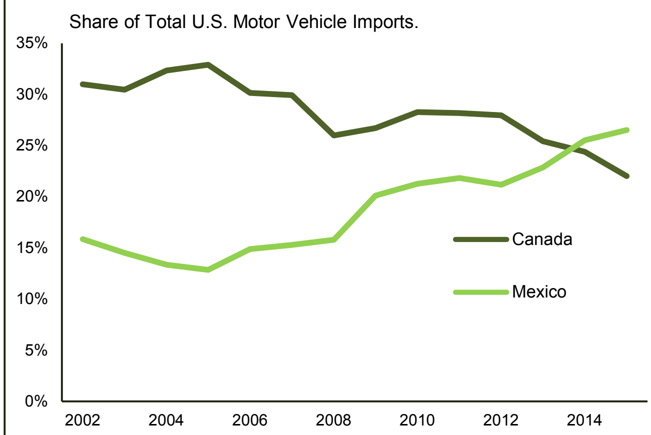
The importance of being a part of the TPP

It is hard to assess the full impact of the TPP on the economies involved – particularly when trying to measure the impact of lower non-tariff barriers. While Canada could definitely take advantage of increased access to the rapidly growing emerging markets, the economic benefits are likely to be quite small. Canada already has free trade agreements with some of the TPP member countries – U.S., Mexico, Peru and Chile – and tariffs on goods between Canada and most other countries are already generally low. Moreover, it isn't just Canada that is gaining access to these markets. Canada will be competing with its TPP peers for a bigger share of each market. For example, while the agricultural sector stands to be a key beneficiary of the TPP, Canadian farmers will be competing with those in the U.S., Australia, and New Zealand who will also have preferential access to the same markets.

The Canadian government has yet to produce figures on the estimated impact. Before details of the TPP were released, independent studies estimated that it would increase real GDP by 0.1% by 2035. However, the difficulty in measuring the benefits precisely are in part due to the fact that the TPP focuses on areas that were not previously included in old generation trade deals. In other words, there is no precedent to evaluate possible gains. In addition, the TPP adds greater focus on non-tariff barriers, which should enhance trade in services where developed economies tend to have a competitive advantage. Given its depth, the TPP could also potentially serve as a base for additional trade agreements and speed up negotiations. If Canada were to agree to freer trade with other countries, the benefits to its economy could rise substantially.

Adversaries of the TPP have speculated that the costs of entering into the agreement are quite high given the concessions Canada will have to make relative to the benefits. However, putting aside the negotiated details within the TPP, there is a bigger picture to consider: the cost of being excluded from the partnership. Roughly three quarters of Canada's exports are destined for the U.S., and the preferential relationship with its largest trading partner that was established by the North American Free Trade Agreement (NAFTA) could be lost. Ditto for Mexico, although Canada's share of exports sent to that country are much smaller (1%). Indeed, this deal is larger and deeper than NAFTA both in terms of the number of countries involved, as well as the range of tariff and non-tariff barriers addressed. NAFTA was largely a trade deal for goods. The TPP covers issues that go well beyond what was in NAFTA, more deeply addressing issues such as services, intellectual property, labour and the environment that weren't as relevant 20 years ago when NAFTA was negotiated. For example, provisions relating to electronic commerce, digital media and third party logistics are not included in NAFTA, but would greatly enhance the agreement. Indeed, technological advancement over the last two decades and widespread use of the internet has changed the way in which business is conducted. Transactions and services are increasingly taking place in the digital world and standards are needed to help facilitate this trade. The TPP includes an entire chapter dedicated to e-commerce.

CHART 1: U.S. AUTO IMPORT MARKET



Source: Census Bureau. Data ends 2015 Q2.

On top of the preferential access that Canada enjoys with these countries relative to non-NAFTA members, NAFTA supply chains could be disrupted with a TPP agreement that excludes Canada. For example, the rules of origin requirement for automobiles under NAFTA is 62.5%. Under the TPP, it will be 45%. If Canada is not a part of the TPP, auto manufacturers in the U.S. and Mexico could source more parts from TPP countries, automatically putting Canada at a disadvantage. Already, Canada is losing its share of the U.S. transportation import market, falling from 30% ten years ago to 20% last year. Meanwhile Mexico's share of U.S. imports has risen from 15% to 25% over that same time period. (See Chart 1) This downward trend would be exacerbated if Canada was not part of the agreement. Being included in the TPP negotiations allowed Canadian officials to ensure the preservation of Canada's existing relationship with the U.S. and Mexico.

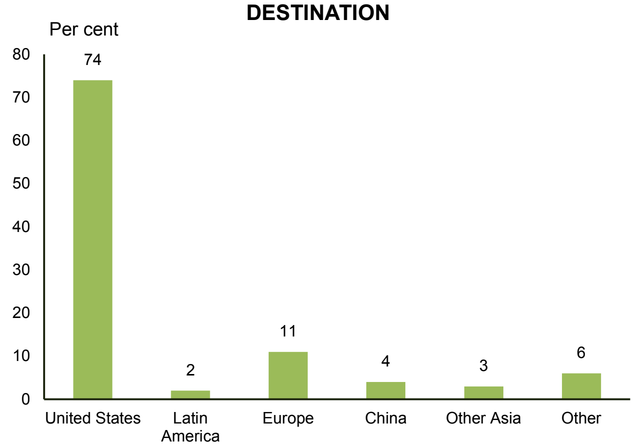
Aside from preserving NAFTA relationships, the TPP will also help protect Canada's relationship with Japan. Prior to the TPP, these two countries did not have a bilateral trade agreement. But, Japan is Canada's fourth largest trading partner. If excluded from the TPP, Canada's share of Japanese imports would likely deteriorate as other TPP members would have preferential access to its market.

Potential benefits stem from non-tariff barriers

The benefits of the TPP for Canada are going to stem largely from the non-tariff barriers, as well as the modernization of the TPP, as it addresses generational changes. Indeed, one key difference between the TPP and NAFTA is that the TPP includes an entire chapter on E-commerce. This will work to reduce the barriers to electronic trade by ensuring no duties are imposed on digital products, preventing requirements for local data servers, protecting personal information and facilitating the free flow of information across borders. Moreover, other chapters of the TPP include provisions that reflect technological advancement as well. For example, the telecommunications chapter in the TPP includes a section on international mobile roaming – something that wasn't an issue when NAFTA was negotiated .

The TPP also seems to put more focus on transparency, which will help to lower the cost and risk for exporters. Increased transparency and ease of doing business in partnering markets could prove to be especially beneficial for small and medium sized businesses (SMBs). SMBs account for the majority of businesses in Canada, and only 10% exported in 2011, with export receipts accounting for roughly 4% of total revenues. What's more, SMB exports to Latin America and Asia are negligible[1]. Hence, the TPP could facilitate greater market access by SMBs in the region.

CHART 2: SMB EXPORT INTENSITY BY DESTINATION

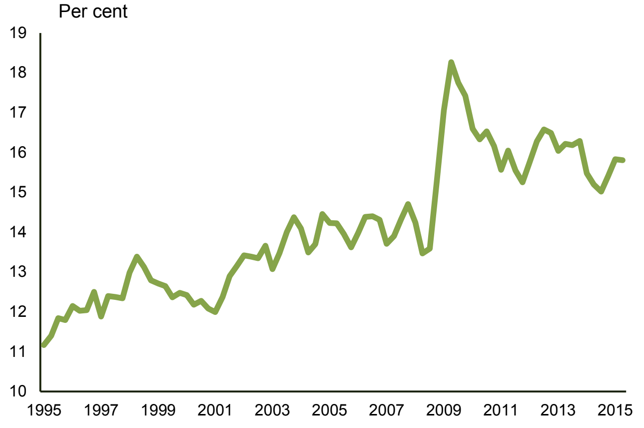


Source: Industry Canada

The Intellectual Property (IP) chapter – which has been quite controversial – is extremely complex, and much more involved than that in NAFTA. It too includes provisions to incorporate generational shifts such as subsections on domain names and internet service providers. But, it also promotes cooperation between member countries to protect and enforce intellectual property rights. However, it's not realistic or feasible to produce an ironclad trade pact that is singularly beneficial to all parties. There's give-and-take in negotiated deals, and one area of "give" that has received some criticism includes the copyright extension from 50 years following an author's death to 70 years. This timeframe is in line with current U.S. law and the delay in introducing works to the Canadian public domain could be costly for consumers. Moreover, there has been some concern that costs and limited access to protected technologies from the U.S. would make it difficult for Canadian firms to build their own technologies. On the flipside, others have signaled that in terms of broad strokes, the IP chapter appears to be largely in line with current Canadian IP rules suggesting that not much will change here. As well, as IP protection becomes harmonized, it will help to put Canada on a level playing field within the TPP region, perhaps attracting business to Canada. Overall, the IP chapter is intended to help stimulate innovation in Canada, which has the advantage of the knowledge, skillset and means to innovate.

While not making as many headlines, the services sector stands to emerge as a big winner. The chapter on cross-border trade in services is quite comprehensive, as it includes all services except those specified by each country. The TPP will help knock down barriers within the services sector such as those relating to qualification requirements, technical standards and licensing requirements and provide a framework for voluntary mutual recognition agreements between partnering countries. It also addresses unfair competition from state-owned or government subsidized enterprises, which should help to increase access for Canadian firms. Moreover, companies will not be required to establish a local presence in foreign countries in order to access the markets. Removing barriers to tradable services will present significant growth opportunities for Canada for a number of reasons. Services represent a growing share

CHART 3: SERVICES AS A SHARE OF TOTAL CANADIAN EXPORTS



Source: Haver Analytics

of total trade (15% in 2014) due in no small part to the rise of the internet and the ability to transfer knowledge instantaneously. What's more, most tradable service industries hold a larger amount of intellectual property and require a higher level of education. As a result, wages are typically higher than in other export-oriented sectors such as manufacturing. Moreover, its highly skilled workforce gives Canada's service sector a comparative advantage in emerging markets. Hence, under the TPP there is great potential for service providers to expand their operations. Indeed, the engineering, construction, environmental and transportation services that Canada has to offer could be quite valuable for emerging markets as these economies build up infrastructure. Financial and other business service providers, such as lawyers, insurance, consulting and marketing firms, are also well positioned to take advantage such an agreement, as it provides not only access, but a more predictable environment in which to conduct business.

In the case of financial institutions, the government website suggests that the highest growth potential for financial services is in Malaysia, Vietnam, and Singapore. In addition to providing services in foreign countries, benefits could also stem from increased business from their clients who are expanding trade in these countries. Meanwhile, the TPP will provide financial institutions with more clarity on risks involved in lending to businesses who export within the region.

While small relative to the overall benefits Canada will gain from the TPP, tariff reductions will still be quite valuable for certain sectors – particularly the agricultural and food sector where high duties are still present in some countries. Given that several of the partnering countries are developing economies, with rising populations and incomes, food-related sectors such as meat and processed foods could benefit from the deal. In particular, Canadian beef, pork, fish, barley and canola producers will have increased access to the highly protected Japanese market, as well as the rapidly growing emerging markets of Malaysia and Vietnam who have all agreed to significantly lower tariffs over the next 15-20 years if not upon implementation. Other commodity exporters – from forestry to mining producers – will also benefit from lower tariffs in Japan and the emerging markets.

TPP not without concessions

As mentioned earlier, any trade pact is unlikely to satisfy all parties and two areas of contention were of particular focus within recent media reports: the auto sector and the viability of a supply-managed agricultural system that includes dairy, poultry and egg producers. In regards to the first, under the agreement, tariffs will be phased out across TPP countries, with Canada eliminating its 6.1% tariff over 5 years. It is the rules of origin requirement that has been making headlines though, which requires a certain portion of the vehicle or part to originate in the common region in order to qualify for reduced duties. Under the TPP, that portion will fall from the 62.5% under NAFTA to 45% under the TPP for vehicles and major parts, and as low as 35% for other parts. There are mixed views on whether it will benefit or hurt the sector. Some worry that it will hurt auto parts manufacturers – particularly the small and medium-sized parts makers – as automakers will import more parts from lower cost regions and produce less in Canada. Meanwhile, others suggest that this could be good for the industry as assembly manufacturers can be more profitable if they import parts, producers will gain preferential access to TPP member countries, and it will force Canadian manufacturers to increase productivity and value-add. Larger auto parts manufacturers have generally been supportive of the TPP, but smaller manufacturers have voiced concern. The Harper government had said it planned to provide $1 billion over 10 years for the industry through an extension of the Automotive Innovation Fund once it expires in 2017-18. It is unclear as to whether the Liberals would adopt this commitment. Canada and Japan also bilaterally negotiated a number of auto-related agreements, including tariff snapback protection which allows Canada to reinstate existing tariffs for 100 days if Japan fails to comply with TPP or bilateral commitments.

With respect to the supply-managed agricultural sector, details of the agreement suggest that protection will remain largely intact, with a small share of imports allowed for each commodity. Foreign import allotment will rise to 3.25% of Canadian dairy production over the first five years, and less for eggs and poultry. Thereafter, foreign allotment volumes will rise by 1% per year for the following 13 years. In the case of milk, 85% of imports will be sent to Canadian processing facilities for further food processing, while the remainder can be directed for retail sale. There was mixed reaction from the sector following news of the deal. Some were thrilled with the implication that the supply-managed framework will remain intact for years to come, while others were disappointed with the concessions made. That said, the phase-in period will give those impacted some time to adjust to the changes, while possibly also being compensated for any associated losses. The Harper government had announced compensation of about $4.3 billion over 10 years for those producers who will be impacted; however it is unclear whether the newly elected Liberals would stick with this program or how they would alter it should they ratify the agreement.

Impact of TPP in the US will be similar

For the U.S., the motivation for being included in this deal is different than for Canada. First off, while it encompasses 40% of the global economy, about half of that is the U.S. alone. So the potential for having preferential treatment in 40% of the economy does not mean the same as it does for some other countries involved. The U.S. was attracted to participate in this deal primarily so it could write the rules for trade with the Asian countries in order to level the playing field – particularly in terms of labour and environmental standards – and to increase access for goods and services higher up the value chain.

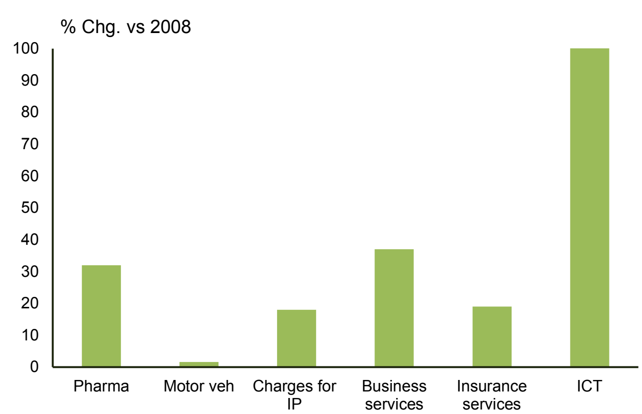
Indeed, the globalization of trade has been long underway and low value-add industries in the U.S. have already taken a hit from low cost producers around the world. Instead, growth in U.S. exports has been driven largely by industries higher up the value-add chain, as well as those tied to intellectual property. For example, ICT exports have doubled over the last seven years, and pharmaceuticals and business services are among the top performing export industries, with growth of about 30% and 40%, respectively. Proceeds from intellectual property generated in foreign countries have also seen robust growth of nearly 20%. This compares to motor vehicle exports which are in line with levels seen in 2008. Creating a trade agreement that provides easier access to Asian and emerging market economies is important to facilitating further growth of these exports.

Geopolitical reasons – namely a move to get China to adhere to the same rules – likely also played a big role. If the TPP is ratified as is, and China wants to enter, it will have to accept the terms that have already been agreed upon.

Like Canada, the tangible, measurable economic benefits of the TPP for the U.S. are expected to be small. No doubt the U.S. will reap several benefits similar to Canada, including increased market access, and lower tariff and non-tariff barriers. In fact, several of the potential winners in the U.S. will mirror those in Canada. For example, the agricultural sector stands to gain from lower duties in Japan and some of the emerging market economies in the TPP. And, it even gained slightly more access to Canada's highly protected dairy sector. While a small gain, it is better than the provisions in NAFTA, and some are happy to call it a step in the right direction.

The manufacturing and technology sector are also seen as key beneficiaries of the deal. This stems largely from the removal of duties on products including autos and technological devices such as smartphones, which are currently subject to high tariffs in some TPP countries. Moreover, the higher labour standards that each country must adhere to – including a minimum wage, the right to form unions and no child labour – will level the playing field somewhat. That said, given the transition that has already taken place in the U.S. manufacturing sector, it is the high-skilled and higher paid work with more value-add where the U.S. will have a competitive advantage going forward.

CHART 4: GROWTH IN U.S. REAL EXPORTS



Source: Haver Analytics, TD Economics

Similar to Canada, a key winner buried in the headlines will be the service sector. Exports of services from the U.S. have been growing by an average of about 8% over the last 10 years, and the TPP offers further growth opportunities. Indeed, provisions addressing lower non-tariff barriers including quotas, restrictive licensing and discrimination against foreign firms will allow American service providers greater access to TPP markets. The U.S. has a highly educated workforce, and exports of transport, travel, financial, and business services are likely to be among the key beneficiaries of the TPP. The U.S. service market is said to have low barriers already, so in a sense they are giving up less than they are gaining. Looking at the Korea-US free trade agreement as an example, service exports from the U.S. to Korea rose 24% between 2011 and 2014 after the agreement was implemented[2].

The biggest points of contention for the U.S. surrounded sugar protection, intellectual property rights – specifically pharmaceutical patents –and the auto sector. Final wording of the TPP suggests that sugar producers remain largely protected, and many of the IP provisions are consistent with current U.S. law. Indeed, the copyright provisions continue to protect U.S. producers, with some – such as technology companies – poised to benefit through increased patent protection in some foreign countries. However, the U.S. had to make some concessions on pharmaceutical patent protection, which was reduced from the current 12-year period to 5-8 years on biologic drugs. This has disappointed those in the industry, but should still give them protection that is supportive of further innovation. Meanwhile, it will give American consumers access to cheaper drugs more quickly. Hence, it seems to strike a balance between the benefits for both producers and consumers.

On autos, the deal is akin to Canada's with respect to rules of origin; however, the U.S. will gradually eliminate tariffs of 2.5% on cars and 25% on trucks within 30 years. The U.S. has also agreed to a side deal with Japan regarding autos, which includes accelerated dispute resolution procedures and a snap-back mechanism to reinstate tariffs should Japan fail to comply with its obligations.

There have been some concerns raised that the TPP will reduce U.S. wages and jobs. However, as noted by the Peterson Institute, sound econometric estimates suggest that the benefits of TPP will far outweigh the costs to dislocated workers, and there is little evidence to suggest that wages will fall.

Bottom line

Overall, the benefits of the TPP for Canada and the U.S. are quite similar, stemming largely from non-tariff barriers and growth in service exports. But perhaps bigger than that, the TPP is a new generation deal, and will lay the foundations for global trade in things such as e-commerce.

While there will be winners and losers – as is the case with every trade deal – the benefits are expected to outweigh the costs. For Canada, the cost of not being included in the TPP could be quite significant. Indeed, being a part of the deal has ensured the preservation of existing trade relationships and has not risked losing demand from its key trading partners.

All told, the TPP is a revolutionary agreement that is much more in depth than any other free trade deal. While unintended consequences are bound to pop up, it appears as though being a part of this agreement will prove to be beneficial for all involved.

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ENDNOTES

[1] Industry Canada

[2] Peterson Institute for International Economics: http://blogs.piie.com/trade/?p=446