

THE USMCA: MANAGEABLE CONCESSIONS, LESS UNCERTAINTY

October 1, 2018

Canada late Sunday joined a reworked, trilateral NAFTA replacement deal. While the United States-Mexico-Canada agreement came somewhat sooner than we were expecting, the details we've seen so far point to an outcome with few surprises. The concessions that Canada made, such as on rules of origin in the auto sector and in granting the U.S. more access to the domestic dairy market, had been well telegraphed. And even some of Canada's wins, like getting an exemption from potential U.S. auto tariffs, weren't surprising. While it's possible to conclude that the deal consists largely of tweaks to the old agreement, we believe reduced uncertainty about the U.S.-Canada trade relationship could prompt businesses to put more investment dollars to work and will support exports. Overall, however, the new deal doesn't much change our base-case economic outlook. And we believe the USMCA won't alter the Bank of Canada's thinking on the pace and extent of future interest rate hikes.

What did Canada concede?

- **Rules of origin:** As expected, Canada was okay with new auto rules of origin agreed to bilaterally between Mexico and the U.S. that upped required North American content and included a new 'high-wage' component. Canada likely wouldn't have asked for the changes at the outset of negotiations but the new rules will be more significant for Mexico than for Canada.
- **Sunset clause:** The original U.S. demand for a 5-year termination of the new deal softened into essentially a 16-year agreement with an option to extend after 6 years. Given any party already has the option to terminate NAFTA with 6 months' notice, a 16-year 'sunset clause' with high likelihood of extension probably doesn't change the calculus from a long-run business investment perspective all that much relative to the status quo.
- **Dairy trade:** Also as expected, Canada made some concessions on dairy trade and will allocate the U.S. ~3 ½% of the Canadian dairy market – but leave the existing dairy supply management system largely in place. Canada had already made similar concessions in agreements with Europe (CETA) and partner countries in the CPTPP. As in past agreements, the government is likely to provide some compensation to Canadian farmers for this latest market share concession.
- **Biologic drugs and 'de minimis' thresholds:** Canada also gave into demands to lengthen patent protection for biologic drugs to 10 years from 8 years and will reportedly boost the amount of cross-border online purchases available for duty-free import to \$C 150 from \$C 20. The latter could cause some consternation among Canadian retailers, but probably will be welcomed by consumers.

What did Canada get?

- **Exemption from potential auto tariffs:** Perhaps the most important measure for the near-term economic outlook was the inclusion of measures to protect the Canadian auto sector from potentially significant U.S. auto tariffs – along the lines of the 10%-25% aluminum and steel product tariffs already implemented – pending the conclusion of an ongoing U.S. investigation into trade in the sector. Those tariffs against Canada were always viewed as unlikely because close industrial integration across the border means U.S. producers would also be hurt. Nonetheless, if implemented, they would probably have a larger near-term negative impact on the economy than a NAFTA tear-up itself.
- **Dispute resolution:** In somewhat of a coup for the Canadian side, Canada was successful in keeping NAFTA's so-called Chapter 19 dispute settlement mechanism largely intact – a measure that the Canadian side had argued was indispensable, particularly given the seemingly erratic approach of the current U.S. administration to tariff actions.
- **Tariff cool-down period:** Canada will get a 60-day exemption from any further US tariffs or import restrictions imposed under Section 232 to allow the two parties to work toward a negotiated outcome.
- **Less uncertainty:** Canadian business investment has been on the soft side despite low financing rates and production running close to capacity limits already. This agreement doesn't entirely eliminate uncertainty – new trade frustrations could yet emerge and broader U.S. trade tensions globally remain. Nonetheless, less uncertainty sets the stage for Canadian businesses to put more investment dollars to work.



What hasn't been resolved?

- **Steel and aluminum tariffs:** The so-called 'Section 232' tariffs on U.S. imports of Canadian steel and aluminum remain. White House rhetoric suggests an agreement to eliminate those could follow. The fact that those tariffs remain – even with NAFTA and the chapter 19 dispute mechanism that Canada fought so hard to maintain in the new USMCA still in force – shows there are still limits to Canada's protection from aggressive trade actions from the U.S.
- **Ratification:** The agreement will also still have to be passed by each country's central government. We think it will be ratified in Canada and Mexico. It is also much more likely to make its way through the U.S. Congress now that Canada has joined – even potentially a different Congress controlled by Democrats after the November midterm elections.

What does this mean for the Bank of Canada?

- The Bank of Canada has emphasized both upside and downside risks from trade policy and while the successful resolution of trilateral talks certainly counts as the former, **we don't think it will change the bank's thinking on the future pace and extent of rate hikes.**
- In their July Monetary Policy Report, the BoC estimated that trade uncertainty and US trade actions already taken would subtract 2/3 per cent from Canadian GDP by the end of 2020. While Canada appears to have avoided Section 232 tariffs on autos, the USMCA agreement did not provide relief on steel and aluminum tariffs. Canada's retaliatory tariffs will also remain in place for now. So the BoC is likely to maintain some drag on growth from US trade actions.
- Where we could see an upward revision to their GDP forecasts would be from a reduction in trade uncertainty. But the BoC has indicated they will be guided by how businesses react to new trading arrangements—in the past Governor Poloz has suggested he would want to see investment intentions picking up in response to a positive resolution in Nafta talks. The bank's Business Outlook Survey will once again be key, but the survey period for the upcoming October 15 release will have closed prior to the USMCA deal. The BoC could do some quick follow up to gauge the impact of the new deal, but we might have to wait until the December edition to get a better sense of how businesses are responding.
- So there is risk that the BoC marks their growth forecasts slightly higher on the back of this deal. However, with the economy already running at capacity limits, there is limited scope for a bump up in growth. **The bank is still likely to favour a gradual pace of rate hikes.**
- On the extent of rate hikes, several months ago the BoC was saying that they might need to maintain some level of accommodation over the medium term to counteract headwinds from high household debt, competitiveness challenges and trade uncertainty. In recent months, the Bank has shied away from an explicit commitment to keep monetary policy below neutral – and neutral rates themselves are subject to changes in potential growth and productivity – but we do think household debt will remain a factor arguing for a pause in hikes next year as rate increases feed through more fully to effective borrowing costs. While there have been recent, positive debt developments, households' increased sensitivity to rate hikes is here to stay.
- All told, our BoC forecast has not changed following these latest trade developments. We continue to expect a rate increase at the bank's next meeting in October, and two further moves next year that will lift the overnight rate to 2.25%.