Life after NAFTA?

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- The odds that NAFTA will be torn up, not simply amended, appear to be increasing
- Predicting life after NAFTA is all the harder because we don't know what tariff regime would replace it
- A 4% across-the-board increase in tariffs between Canada and the U.S.—roughly equivalent a reversion from NAFTA to WTO tariff rates—could reduce Canadian GDP growth by about 1% over 5 to 10 years
- A minority of the half-million Canadians working in highly trade-sensitive sectors would be most affected
- Industries that trade a lot, like the auto sector, are sensitive to even small tariff increases and would bear a greater share of the negative impact
- Tariff hikes would likely hit corporate profits and consumer prices sooner than workers
- The loss of NAFTA's dispute settlement mechanism would make Canada more vulnerable to non-tariff barriers
- When it comes to services, the biggest risk appears to be restrictions on the cross-border movement of professionals
- A more extreme scenario, in which the U.S. ignored WTO commitments and implemented larger tariff hikes, would be much worse for the Canadian economy

A "bad" NAFTA result—either a renegotiated agreement that delivers less trade or a tear-up of the deal—appears increasingly likely. Our view: the end of NAFTA would be a negative outcome for the Canadian economy, but a manageable one, provided the U.S. continues to respect its WTO commitments. We estimate that an effective hike in tariffs up to WTO levels could lower Canadian GDP by a total of about 1% over 5 to 10 years. And while job losses are difficult to tally, it's likely that a minority of the half-million Canadians working in highly trade-sensitive sectors would be affected.

Complicating predictions of a post-NAFTA environment: we don't know what tariff regime would replace it. There has been speculation that bilateral trade could revert to something like the earlier Canada-U.S. Free Trade Agreement. But given the Trump administration's protectionist bent, a bilateral arrangement may not safeguard Canada from ongoing punitive trade actions—consider recent U.S. moves to levy tariffs against Canadian softwood lumber and Bombardier-manufactured jets.

The U.S.'s most-favoured-nation tariffs aren't that high. U.S. tariffs under the WTO aren't much higher than NAFTA's preferential rates—its average most-favoured-nation tariff in 2016 was 3.5%, below Canada's 4.1%. And it's important to note that, even with NAFTA's advantages, when it comes to expanding trade with the U.S., Canada has lagged behind some others. China and the EU have expanded their trade with the U.S. by a relatively greater amount than Canada since 2001, despite not having bilateral deals in place.

Small tariff hikes can have a big impact on trade-sensitive industries. Tariffs are a tax on trade flows, not net production, so even incremental increases could have a disproportionate impact on industries that trade a lot across the border. Decades of free trade have resulted in tightly knit production chains: intermediate goods often cross the border multiple times at different stages of production. That means the same product can show up in both export and import flows—and potentially more than once.

One way to understand the impact that those flows have is to look at output and export data for Canada's auto sector. Canadian exports of finished motor vehicles to the U.S. totaled $63 billion last year, though the sector's direct contribution to GDP was about $8 billion. The export total is bigger in large part because of the multiple trips that intermediate goods took across the border.

Though the auto sector gets cited most often, tariff hikes would hit numerous other sectors. Due to the growth in the services sector, highly trade-intensive goods-producing industries make up a smaller share of output than they used to. Still, **sectors with trade with the U.S. of at least double their Canadian production footprint make up roughly 6% of Canadian GDP and about 5% of Canadian employment.** Those industries (see Chart 2)—everything from appliances and cleaning products to computer equipment—could see tariffs on trade flows amounting to at least double their production bases.

Even under the WTO, tariffs in some sectors would be higher. U.S. tariffs on clothing products averaged 12% under the WTO last year but were generally tariff-free under NAFTA. The average rate for agricultural products was 5.2%—although about 30% would enter tariff-free under the WTO. Some of the petroleum products the U.S. currently imports freely from NAFTA partners would face some tariffs under WTO rules. The average U.S. tariff on petroleum products was 6.5% in 2016.

Losing NAFTA: Some Scenarios

- **Higher tariffs could weigh on GDP growth**

It is notoriously difficult to estimate the impact of trade disruptions on GDP growth. Nonetheless, our estimates suggest that a roughly 4% across-the-board increase in tariffs between Canada and the U.S. would reduce Canadian GDP growth by about 1% over 5 to 10 years. The implied annual impact of 0.1% to 0.2% might not appear all that large, but it adds up to a substantial amount of foregone production potential—about $20 billion (in today's dollars) of annual output over time.

Broader spillovers into non-trading industries, the impact of uncertainty on business investment, and the potential cost of non-tariff barriers are more difficult to quantify. The partial or complete dismantling of NAFTA would likely spark near-term financial-market volatility, further weighing on near-term business and consumer confidence and therefore growth. Against this backdrop, we would expect the Canadian dollar to weaken, making Canadian goods more competitive abroad. Investors in Canadian equities, however, would likely pull back until there was clarity on the impact on exports and investment. And interest rates could come under downward pressure as investors pile into safer assets. The Bank of Canada would likely shift to an even more gradual rate-hiking path than is currently priced into markets.

- **The impact would be heavily concentrated in a small number of highly trade-sensitive sectors**

Table 1 lists the largest industries that would be most sensitive to even small tariff increases. The auto sector is well known, but other examples include the petroleum industry, primary and fabricated metal products, and plastics. **Industries that trade very little could be hit by 'second-round' effects.** The income earned by auto workers, for example, helps to support other industries like retail and construction that do not have a major trade footprint.

Any impact on labour markets is also likely to be concentrated among trade-sensitive industries. The ones listed in Table 1 directly employ more than 500,000 people. For many industries—even highly integrated ones—**the negative impact on employment might not be fully felt immediately.** Production chains in these sectors are simply too entrenched to change quickly, so tariff hikes would likely hit corporate profits and consumer prices sooner than workers. The end result might be a slow decline in these sectors, rather than an immediate disruption.

Table 1: Top 15 industries (by GDP size) with trade/GDP ratios of 200% or more

Industry	Share of GDP (%)	Trade/GDP ratio (%)	Employment thousands (% of total)
Petroleum and Coal Product Manufacturing	0.60	217	19 (0.12)
Primary Metal Manufacturing	0.55	332	54 (0.34)
Motor Vehicle Parts Manufacturing	0.48	511	72 (0.45)
Plastic Product Manufacturing	0.46	205	82 (0.51)
Aerospace Product and Parts Manufacturing	0.43	217	46 (0.29)
Motor Vehicle Manufacturing	0.41	1250	43 (0.27)
Basic Chemical Manufacturing	0.31	231	12 (0.07)
Pharmaceutical and Medicine Manufacturing	0.28	279	28 (0.18)
Miscellaneous Manufacturing	0.25	267	56 (0.35)
Pulp, Paper and Paperboard Mills	0.24	256	23 (0.15)
Other General-Purpose Machinery Manufacturing	0.19	345	29 (0.18)
Resin, Synth Rubber/Artificial/Synth Fibre/Filament M	0.18	422	6 (0.04)
Agricultural, Construction & Mining Machinery Mfg	0.15	367	28 (0.17)
Grain and Oilseed Milling	0.14	295	7 (0.04)
Other Electronic Product Manufacturing	0.14	390	20 (0.13)

Source: Industry Canada, Statistics Canada, RBC Economics Research

- **Canada could be more vulnerable to non-tariff barriers**

The loss of a dispute settlement mechanism also means more vulnerability to non-tariff barriers. Changes to regulatory requirements can impose additional trading costs comparable to those of tariffs at the border. Canada has had some success in the past using the WTO arbitration process, but arbitration can last for years.

The impact of non-tariff barriers is hard to quantify. A Statistics Canada study looked at the impact of a new security regime post-9/11 on truck-borne trade and found a relatively small equivalent tariff increase of about 0.3%. Those measures weren't even designed to disrupt trade. It would be possible for policymakers with a protectionist bent to come up with new rules that could significantly impact trade flows.

- **Services could be constrained**

NAFTA is most often looked at through the lens of goods, but its collapse would leave big questions around market access and non-discriminatory treatment of services. Services are, on average, significantly less trade-intensive than goods production—and so less vulnerable to trade disruptions. Moreover, the U.S. generates a trade surplus in services with Canada in most services categories. So for Canada, the biggest risk would appear to be restrictions to the temporary cross-border movement of professionals.

A growing facet of the services economy is the provision of digital services. On this score, the U.S. has signalled a push for more stringent intellectual property standards (such as copyright and patent protections) that some observers believe would favour incumbent U.S.-based IP owners. A NAFTA collapse would see the issue recede for Canada.

- ## Rules of origin thresholds seem likely even if NAFTA isn't torn up

What might have to be in a new agreement to secure presidential approval? One of the most contentious proposals is the U.S. demand to dramatically increase the "rules of origin" thresholds in the auto sector and add a U.S.-specific content requirement. The aim: bringing back production that may have moved offshore, and forcing production within NAFTA to shift to the U.S. If set too high, the new thresholds could effectively put an end to free trade in the auto sector. That means lower profits for companies and probably higher prices for consumers, not to mention diminished competitiveness relative to off-shore producers. Indeed, **in the medium to longer run, limiting the tariff advantage for locating auto manufacturing activities within North America could, perversely, simply accelerate the movement of motor vehicle production offshore.**

- ## A more remote possibility is a Trump tariff tantrum

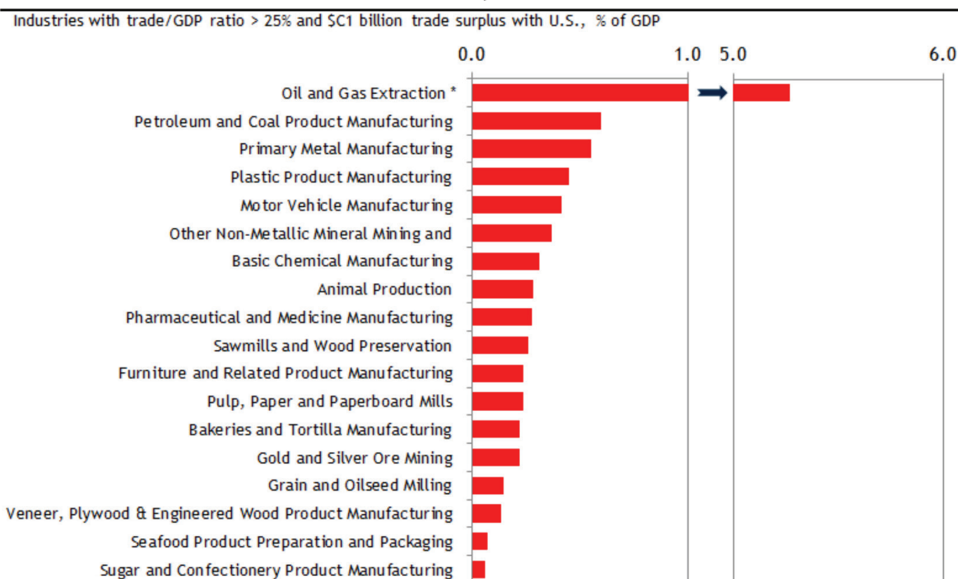
The above discussion generally treats the WTO as a backstop to any changes to NAFTA. A lower-probability scenario is one in which the U.S. abandons both NAFTA and refuses to honour WTO commitments. The Trump administration's 2017 Trade Policy Agenda itself cited the importance of "America First" ahead of WTO obligations.

The outcome of this potential scenario is uncertain, but could result in significantly more distortionary tariffs along the lines of the 20% import duties on softwood lumber and 300% tariffs on Bombardier CSeries jets already announced by the U.S. Commerce Department.

Given the preoccupation of the president with trade deficits, tariffs under this type of scenario could be focused on areas in which Canada has a trade surplus with the U.S. Of course, it would also expose the U.S. to possible retaliation. Chart 1 shows the top 15 industries in Canada, ranked by GDP size, that ran surpluses with the U.S. of $1 billion or more last year. The direct employment share from these industries is not particularly large – even the oil and gas sector makes up a significantly smaller share of employment than GDP. Together, those industries still account for more than 500,000 jobs. **The potential for larger disruptions absent a WTO tariff rate backstop also means a greater potential for larger secondary spill-over into other industries.**

The energy sector is by far the largest shown in Chart 1 and the original U.S. negotiation objectives did suggest the energy sector would be a subject of discussion. With that said, one of President Trump's first actions as president was to approve the Keystone XL pipeline. That support suggests energy trade isn't high on the list of current grievances. But in the current environment, it is difficult to rule out any potential outcome entirely.

Chart 1: 'Vulnerable' industries by share of GDP



Source: Statistics Canada, Industry Canada, RBC Economics Research

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Chart 2: Canada trade-to-GDP ratios by industry

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