



January 30, 2017

CANADA'S PROSPECTS AMIDST CHANGING U.S. TRADE POLICY

Summary

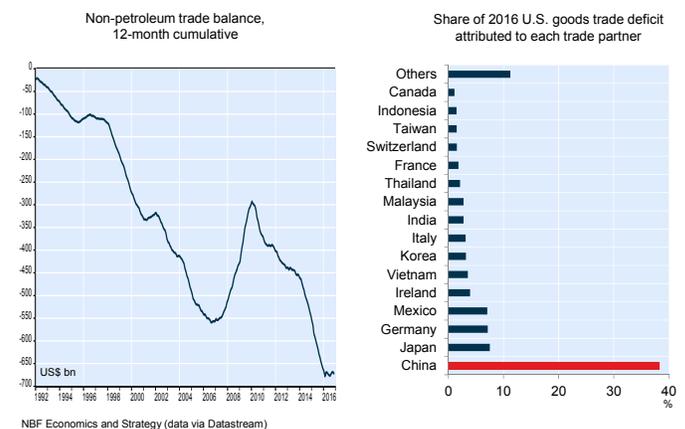
- *The arrival of new leadership in Washington brings both opportunities and threats to Canada. While the energy sector is set to benefit from U.S. President Trump's executive order on Keystone XL, the outlook for non-energy Canadian exporters is less clear amidst calls by the new administration to re-negotiate the North American Free Trade Agreement or even scrap the latter in favour of a separate bilateral agreement.*
- *Should policymakers fail to reach an agreement to exempt Canada from upcoming U.S. trade barriers, Canada's exports and hence economic growth would take a significant hit. For instance, if the U.S. imposes a 10% border adjustment tax on imports and nothing else changes, Canada's total goods exports to the U.S. would drop roughly 9% based on U.S. import price elasticities, enough to chop about 1.5% from Canada's GDP growth. Under that scenario, Ontario and New Brunswick would be the worst hit among provinces given their relatively high exposures to the U.S.*
- *U.S. protectionism could do more than just derail Canada's plan for export resurgence. It would keep the country's economic growth model skewed to housing/consumer spending to an unhealthy extent.*
- *Whether or not Canada-U.S. trade relations suffer, expect Ottawa to keep working hard in establishing new trade relationships and reinforce existing ones. An enhancement in interprovincial trade is a laudable objective. Policymakers will also have to find ways to make Canada more competitive not just via a weakening Canadian dollar but through more sustainable methods including measures to enhance investment and boost productivity.*

Anti-NAFTA sentiment: Politically popular, but economically unwarranted

Having just taken oath of office, U.S. President Trump is wasting little time in addressing one of his administration's key priorities, namely renegotiating or even withdrawing from trade agreements. At the stroke of a pen, America's participation in the Trans-Pacific Partnership was withdrawn. Next in the crosshairs is the North American Free Trade Agreement (NAFTA) which the new President has vowed to address within his first month in office.

The tirade against NAFTA can be puzzling to those who actually analyze data before recommending policy changes. In fact, Canada and Mexico account for only a small portion of the U.S. goods trade deficit, contrasting sharply with China which accounts for roughly 40% of the deficit. Hitting Canada and Mexico with trade barriers such as tariffs or a border adjustment tax will arguably do little to shrink the U.S. trade deficit while potentially dealing a crippling blow to all NAFTA partners, including the U.S. where several key industries have integrated supply chains across North America.

U.S.: Trade deficit in the crosshairs



Regardless, multilateralism appears dead in this new Washington, with the focus now shifting to bilateralism. Thankfully, when it comes to dance-partners for the U.S., Canada might be the least ugly one at the ball. There's been some acknowledgement of that from the new administration.

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Trump's executive order in support of the Keystone XL pipeline is a positive for both the U.S. and Canada. In addition to the thousands of construction jobs generated by the project on both sides of the border, Keystone XL, when completed, would increase export capacity by about 830,000 barrels a day. This pipeline alongside conditional approval of two other pipeline projects by Canada's Prime Minister (Trans Mountain and Line 3), would be an important relief valve for Western Canadian oil producers, where crude production will be stepping higher. Pipeline development would lessen dependence on oil by rail, where safety concerns linger. So, Ottawa may decide to swallow "Made in America" provisions for the greater good.

Non-energy exporters also got some encouragement from Stephen Schwarzman, an adviser to President Trump, during a recent visit to Canada: "I think trade between the U.S. and Canada is very much in balance and is a model for the way trade relations should be. There will be other countries with large trade imbalances and other types of markets, which aren't as open as Canada, which would be more of an area of focus for the new administration".

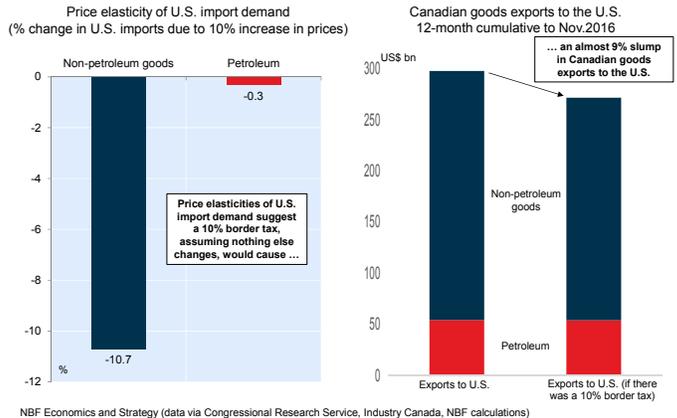
In other words, Canada may be able to avoid being swept aside by changing U.S. trade policy if our policymakers and negotiators play their cards right. Complacency during negotiations would be fatal because the price of failure is likely to be steep.

Border tax would sink exporters ...

Despite Schwarzman's assurances, the U.S. government has Canadian softwood lumber in its sights — recall that the U.S. International Trade Commission made a preliminary finding of "injury" on what it feels are subsidized stumpage rates in Canada. That could be a precursor to painful tariffs and prompt tit-for-tat retaliation from a Canadian government that prevailed in past softwood lumber disputes. The softwood lumber dispute may be like a litmus test for Canada-U.S. trade relations under Trump. How harsh the U.S. moves may give some idea about how hard-line America aims to be when renegotiating NAFTA.

Trade barriers such as a tariff or border tax adjustment — which would raise the price American consumers pay for imported goods and hence would curtail demand for Canadian products — would be detrimental to Canada where dependence on exports has grown in light of slowing domestic demand. While our petroleum exports to the U.S. would not be significantly impacted, non-petroleum goods exports could sink almost 11% based on U.S. import price elasticities, enough to cause Canada's total goods exports to the U.S. to drop roughly 9%. That's enough to chop about 1.5% from Canada's GDP growth, assuming nothing else changes.

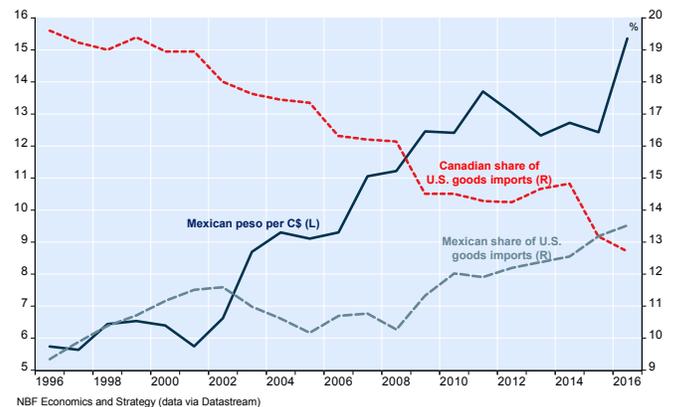
Canada: Border tax adjustment could cause export slump



Canada's non-energy exporters would welcome not having to deal with further headwinds. They already have competitiveness challenges ahead thanks in part to the Canadian dollar's strength. Recall that the loonie ended 2016 as one of the few major currencies registering gains against the USD, in contrast to the Mexican peso which continued its slide against the greenback. This loss of relative competitiveness for Canada suggests its share of U.S. goods imports, which is already below that of Mexico, could continue to shrink this year.

Canada: Loss of currency competitiveness and market share in the U.S.

Mexican peso per C\$ versus Mexican and Canadian share of U.S. goods imports



... and hammer the Canadian dollar

To the extent Canada's trade balance with the U.S. deteriorates (owing to a less open border, a prospective border tax, etc...) then the already-sizable current account deficit could widen. That could leave Canada even more reliant on capital inflows and may necessitate a much cheaper C\$. So trade decisions made in Washington could ultimately end up influencing how actively Canada needs to court foreign capital.

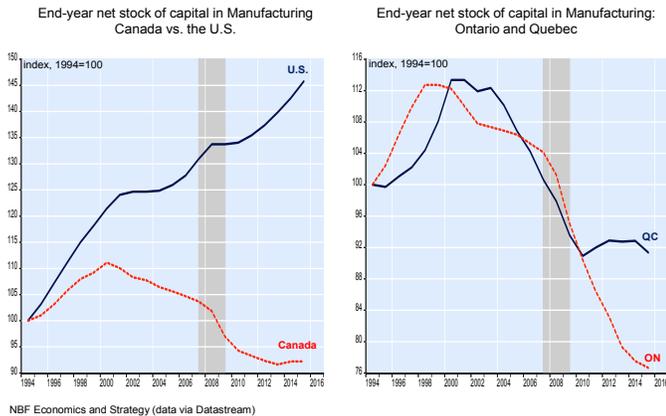
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Great rotation on hold?

All told, U.S. protectionism could do more than just derail Canada's plan for export resurgence, which itself was meant to provide vital offset to the inevitable pullback in overheated housing markets and related consumer spending. It would keep the country's economic growth model skewed to housing/consumer spending to an unhealthy extent. In other words, the Bank of Canada's desire to see a "great rotation" from domestic demand to exports would remain unfulfilled.

Stumbling exports would not help rekindle investment spending, more so considering upcoming corporate tax cuts and deregulation in the U.S. would make Canada even less competitive in the relative sense. Why build a factory in Ontario when that could be done at lower cost in Michigan? So notwithstanding the more positive tone in the last couple Business Outlook Surveys, we risk seeing Canada's capital stock hollowed out. This is already a noted concern in Ontario.

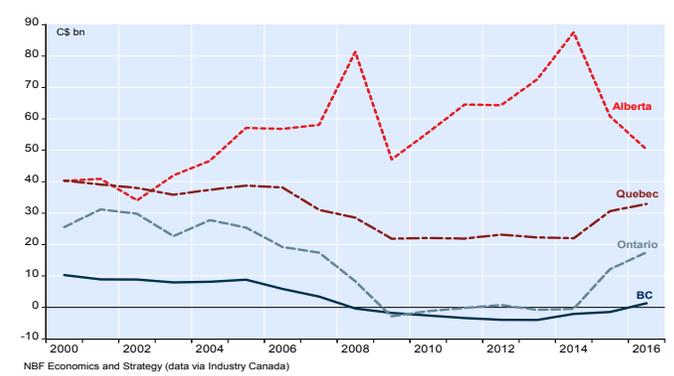
Canada: Ongoing destruction of capital stock in manufacturing sector



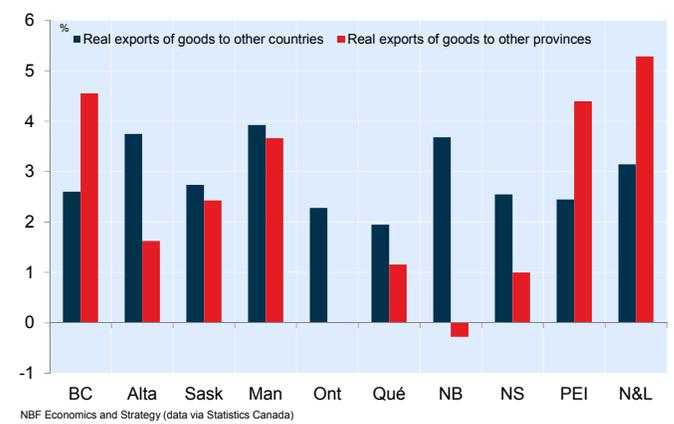
Which provinces are most at risk?

Among provinces, Alberta and Quebec have the largest trade surpluses with the U.S. That's not to say they are the most exposed to U.S. trade protectionism. A closer look into provincial trade data reveals Ontario and New Brunswick may be more at risk. In the last 20 years there has been no growth in real exports of goods for those two provinces to other provinces. In other words, Ontario and New Brunswick have been most focused on shipping their goods outside the country, rather than cultivating internal trade ties (within the federation). Compare that to BC or Manitoba for instance, which have both registered above average growth in goods exports to other provinces.

Big four provinces all have goods trade surplus with the U.S.

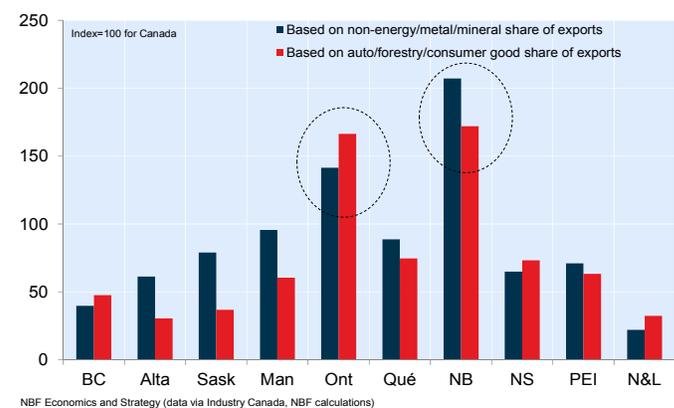


Weak growth in interprovincial trade for Ontario and New Brunswick



We constructed measures of export vulnerability to reflect (a) the share of exports comprised of politically sensitive or highly price elastic goods (e.g., softwood lumber, autos, consumer goods), (b) the U.S. share of total international exports and (c) the relative importance of merchandise exports to a given province's economy. Our analysis confirms what we had suspected, i.e. Ontario and New Brunswick are the most at risk from rising protectionist sentiment south of the border.

Canada: Ontario and New Brunswick more at risk of U.S. protectionism



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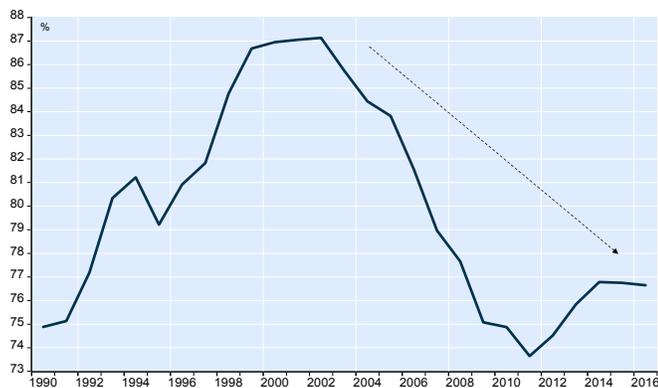
It's clear from those measures that no province should be cheering the emergence of a more inwardly focused/protectionist U.S. administration. But for some, the successful diversification away from the U.S.—British Columbia has done the best job here—or a much greater reliance on low-elasticity sectors like energy/metals/minerals—the three oil producing provinces come to mind—could significantly blunt the fallout. Let's hope this comes to nothing, but as is the case with any number of economic, fiscal, financial metrics, not all provinces are created equal. Alberta's economy has had a tough go of late, but here's one area where it's relatively better positioned because the province's crude will likely continue to flow south-bound with or without a border tax.

How could Canada respond?

Whether or not Canada-U.S. trade relations suffer, expect Ottawa to keep working hard in establishing new trade relationships and reinforce existing ones. While the large majority of Canada's goods still go to the U.S., there has been some success in recent years to diversify our exports. The share of goods exports to the U.S. has fallen from a peak of 87% in 2002 to less than 77% last year. That percentage should drop further with the Comprehensive Economic and Trade Agreement due to kick in later this year after approval by the European parliament. The Trans-Pacific Partnership, assuming it survives after the U.S. withdrawal, should also help Canadian exporters gain market share in Asia and Oceania.

Canada: Diversifying away from the U.S.

Share of goods exports to the U.S. in total goods exports



NBF Economics and Strategy (data via Industry Canada)

If our southern neighbour proves less welcoming to Canadian goods, Canada will need to trade with other countries, but also with itself. We've long lamented the relatively underdeveloped East-West trade ties within Canada. To be fair, some provinces have tapped internal demand, and in some cases, regional trading blocks or bi-provincial agreements have been struck. You'll find examples of inter-provincial cooperation, no doubt aided by the high degree of political cohesiveness that characterizes the provincial landscape. Constructively, federal-provincial governments appear on the cusp of announcing an interprovincial trade deal. And while we're waiting on the fine details, an enhancement in internal trade is a laudable objective — for patriots and economists alike. There will always be irritants and/or sensitive sectors to complicate internal trade, and logistics in some cases are a complicating factor, but whether it's over railways, highways, waterways, high-tension power lines or pipelines, shipping more goods to and from individual provinces could be one way to blunt the fallout from a thicker Canada-U.S. border.

Policymakers will also have to find ways to make Canada more competitive. The Bank of Canada will do its part by keeping the Canadian dollar under wraps via loose monetary policy — the slow-moving economy means inflation is unlikely to be a problem over the forecast horizon. The federal and provincial governments will also have to do their part by not only bringing forward some of the fiscal stimulus that were scheduled for later years but also by considering reforms and incentives to increase private investment and productivity. But the uncertain outlook makes a case for fiscal contingencies, to protect federal-provincial budget balances from broadsides emanating from the White House or other corners of the globe.

All told, downside risks to Canada's economy should not be underestimated in light of changing U.S. trade policy. But until concrete policy measures are approved by the new U.S. administration, we continue to assume in our forecasts that common sense will prevail among policymakers as to not materially hurt businesses on both sides of the border.

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