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Economic Flash!

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It's Not NAFTA, But It's Good Enough

Don't call it NAFTA, at least not while Donald Trump is listening. But the good news is like a rose by any other name, a deal reached last night between the US, Canada and Mexico will smell pretty sweet relative to the alternative of an all-out trade war. That said, relative to the status quo before the trade front fell into dispute, the deal won't be a huge game changer for Canadian growth, given the country's poor track record in advancing either export volumes or non-energy industrial capacity since 2000.

Win Some…

In what will now be called the United States Mexico Canada Agreement (USMCA), the biggest wins for Canada are avoiding punitive auto tariffs and the preservation of the chapter 19 dispute resolution mechanism. Other key wins for the Canadian side were in the US agreeing to drop a troublesome demand for a sharp reduction in access to American government procurement contracts, and the US agreement to at least a 16-year term with highly likely extensions ahead.

Although President Trump could move forward with the imposition of auto tariffs on global vehicle imports under section 232 national security grounds, Canada will be shielded. Indeed, Canada has negotiated a quota for tariff-free exports of autos stateside amounting to a level that is roughly 40% higher than current exports. That should provide a buffer for as far as the eye can see, as long as the product meets North American content requirements which have been inflated from 62.5% to 75%.

The preservation of the Chapter 19 dispute resolution mechanism that has historically been instrumental in maintaining fair trade practices, in lumber in particular, was another significant win. It limits the ability of the US or Mexico to impose arbitrary anti-dumping and anti-subsidy duties at their discretion. Chapter 20, the government dispute resolution mechanism also remains in place. NAFTA's Chapter 11, under which companies from one country could sue for damages arising from policy changes that will affect its investments in the other, will no longer apply to Canada, but will be retained in some sectors for companies operating in Mexico, which is likely the best possible outcome from the Canadian standpoint.

Give Some…

One notable concession was to dairy supply management which will be loosened to enable US exporters to have better access to Canadian consumers. Canada agreed to eliminate a new tariff class that had been a point of contention for US dairy, and also opened up a larger slice of the dairy market to the US than was on offer had the US signed the Trans Pacific trade deal. That's a "give" from the viewpoint of Canadian producers, but potentially a benefit to consumers.

Health care costs in Canada could also be impacted since US drug makers will have their patent protection period extended by two years. Retailers in Canada will face more competition from online sales, as the ceiling on goods that can be shipped across the border while avoiding tariffs increased from C$20 to C$150. But sales taxes will still apply on items over C$40.

Saved for Later

No deal was reached to remove the recent US-imposed aluminum and steel tariffs, or the retaliatory tariffs imposed by Canada. It does appear, however, that talks on that issue will ensue, so there's hope that with a warming of trade relations in the wake of this deal, progress might be made on base metals. The US also agreed that in the future it would give Canada and Mexico advance notice, and a window in which to negotiate, should it find new industries that it wants to subject to these "national security" tariffs. Uranium has been mentioned in that regard.

Market Implications

Markets have responded with a rally in the Canadian dollar, reflecting greater certainty that the Bank of Canada will hike rates in the coming months. Canadian equities in sectors under the trade cloud should also garner some support. But the trade deal is not a cure all for Canada's export sector.

Note that we had already assumed a resolution to NAFTA disputes would be reached by October so our base case forecast doesn't change. The deal paves the way for a rate hike by the Bank of Canada this month, and a follow-up move that we now see coming in January. The Bank of Canada had imposed a 0.2%-point per year drag on growth from trade uncertainties, but it won't lift all of that in its next forecast, given that the steel/aluminum issue remains unresolved.

We don't share the optimism that the Bank of Canada sometimes, but not always, expresses on the ability of trade and related business investment to supplant housing as a source of growth as interest rates climb. The Bank's own research department has cast a more negative light on export competitiveness. Real exports from the US are up 75% from 2000 levels, but Canadian real exports have seen little growth over the same period.

Keeping the Canadian dollar range-bound or even weaker will be a necessary condition over the medium term to turn that around. That should still see the Bank of Canada trail the Fed, hiking only 50 bps in total in the next few quarters. Look for the Canadian dollar to return to the low 1.30 range in 2019 as the BoC is outgunned by the Fed.