Special Report

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A timely analysis of economic issues

October 5, 2018

NAFTA 2.0
How Do You Spell Relief? U-S-M-C-A

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Overview

After 13 months of sometimes fractious negotiations and waves of uncertainty for Canada's economy, policymakers and financial markets, we have an agreement to replace NAFTA. The **U.S. and Canada have agreed in principle on a new deal,** which both leaders have endorsed, but which must be ratified by all three legislatures including a new U.S. Congress. Clearly, this is a major relief for Canada, lifting a heavy cloud of uncertainty from the outlook and opening the door for increased investment. **The one change we are making to our forecast as a result of the deal is an additional Bank of Canada rate hike in 2019 (in January).** Bond yields jumped following the announcement, while the Canadian dollar initially strengthened to just over 78 cents, though we remain sceptical about its long-term prospects.

From Canada's perspective, the biggest concession appears to be giving the U.S. access to just under 3.6% of the dairy market, in exchange for the preservation of the dispute resolution mechanism and some assurances, however technical, that Canada would not be hit by a 25% tariff on autos under Section 232. In a nutshell, **Canada was forced to make concessions, but is coming out quite clean considering the array of potentially negative options and threats that were on the table**. Below are the major elements and key takeaways from Canada's perspective.

What's in the Deal and Why It Matters

- **Name and lifespan:** The deal will be called the **United States-Mexico-Canada Agreement**, or **USMCA**. **Canada is largely agreeing to the major elements of the U.S.-Mexico deal**, unless stated otherwise. More specifically, the **new trilateral deal will last for 16 years**, with a review to be made at the six-year mark. At that point, the three countries can extend the agreement or begin formal negotiations to fix any irritants. However, as before, any party can still decide at any time to exit the agreement after six months' notice.

- **Chapter 19: The dispute settlement mechanism** for countervailing and anti-dumping duties, a.k.a. **Chapter 19** in the original NAFTA and not part of the U.S.-Mexico deal, is retained. (It will apparently now be known as **Chapter 10**.) This was a Canadian red-line issue and was the sticking point on bilateral negotiations as far back as the original FTA in the late 1980s. In other words, this was a big deal for Canada.

- The **state-to-state dispute resolution mechanism** (NAFTA's **Chapter 20**) was already retained in the U.S.-Mexico deal. The investor-state dispute settlement mechanism (NAFTA's **Chapter 11**) will be eliminated between Canada and the U.S. (A scaled back version was retained with Mexico covering oil and gas, infrastructure and telecommunications.)

- **Supply management: U.S. dairy farmers** will get access to just under 3.6% of Canada's protected market, slightly above the 3.25% that the Asia/Pacific nations received under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Canada has agreed to eliminate its Class 6 and Class 7 milk categories within six months. Given that Canada's dairy market is growing by roughly 1% per year, and that the import quotas will be phased in over six years, Ottawa believes that the industry can adjust to the changes. Even so, the federal government intends to compensate dairy farmers. It's important to note that poultry and egg producers are also relinquishing market share in Canada, with poultry opening up by almost 5% over a six-year period and egg producers ceding 1.3% with no phase-in period.
- **Autos:** Automotive production will be subject to higher North American content provisions for duty-free shipments across the three countries, with a minimum 40% coming from USMCA jurisdictions that pay workers at least US$16 per hour. This clearly helps Canada (and the U.S.) versus Mexico. There's a "side letter" guarantee that potential U.S. Section 232 tariffs on **automotive products** will not be applied to Canada or Mexico up to a certain limit. Canada agreed to a 2.6 million passenger vehicle duty-free limit per annum and US$32.4 billion in parts (light trucks are exempt). These are not binding constraints as Canada currently produces just under 2 million light vehicles for its domestic and export markets, and currently exports just over C$20 bln (or roughly US$16 bln) in parts. Effectively, this portion of the agreement is more of a safeguard that Canada will not become a high-volume producer in the future; given that Canada's vehicle production has been trending lower for more than 15 years, this was a low-probability likelihood. We would judge the overall effect of the agreement on autos with the U.S. and Mexico as a net positive for Canada.
- **U.S. steel and aluminum tariffs:** These remain in place for the time being, as do Canada's retaliatory tariffs. It looks like a quota here might also be the way out, but this issue may not be settled until the agreement is officially approved by all three nations. A broader concern is that the deal does not limit the U.S. Administration from imposing Section 232 tariffs on other Canadian industries, apart from autos.
- **De minimis threshold value on imported online goods:** The deal raised the threshold value of Canadian imported goods purchased online (or via mail order) that qualify for duty-free access from C$20 to C$150. Imported goods valued at less than C$40 will also be exempt from sales taxes. The higher threshold value comes with both benefits (to consumers and businesses) and costs (to retailers). Canadian consumers will enjoy lower prices and faster delivery times due to less customs processing. Canadian businesses buying U.S. supplies online will save on administration costs and face fewer delivery delays, reducing uncertainty. However, Canadian retailers will lose out due to the relative loss of competitiveness. Notably, the minimum threshold value for Americans shopping on Canadian online sites was slashed from US$800 to US$100.
- **Prescription drugs:** Canada will extend the patent protection for certain **prescription drugs** (biologic drugs) from 8 to 10 years, matching what Mexico

had already agreed to. This is the one portion of the deal that is a clear negative for Canada, since it will add to drug costs with little upside in return.

- **Cultural:** Previous protections for Canadian **cultural industries** are retained. However, Canada made concessions on copyrights (out to 70 years after death, from 50 years currently), which were beyond TPP proposals.
- **Restrictions on Canada's ability to forge free-trade deals with "non-market" countries**: The deal gives the U.S. and Mexico the right to review any trade deals that Canada forges with non-market countries (read China), and to abrogate the USMCA with six months' notice if unsatisfied. This clause could discourage Canada (and/or Mexico) from signing a free-trade deal with China, curbing its ability to diversify shipments away from the U.S.
- **Establishing a Tri-nation Macroeconomic Committee**: The Committee will consult to prevent each USMCA member from embarking on a perceived "competitive devaluation". Since Canada has long abandoned the practice of using foreign exchange intervention to "manage" its currency, this might not be a big deal. Still, it could see the Bank of Canada second-guess policy decisions given the potential impact on the loonie. While the Committee seems innocuous, could it have challenged the BoC's rate cut in early 2015 (during the oil shock)?
- **Eliminates "Proportionality" clause in energy production**: The elimination of this clause is favourable for Canada's energy industry, as it had the potential to limit its ability to reduce shipments to the U.S. and hence diversify sales to other faster-growing regions, such as Asia. The rapid rise in U.S. oil production in the past decade made this clause from the original FTA all but redundant from a U.S. perspective. Canada will also have more flexibility to alter the mix of its energy production, perhaps in favour of natural gas over oil.
- **Timing:** The plan is for Prime Minister Trudeau, President Trump and President Pena Nieto to **sign the USMCA at the end of November**. Unless the new deal can then be rushed through in the lame duck session in December (highly unlikely), it will need to be ratified by the new U.S. Congress in 2019.

Implications for Markets and the Economy

- **The economy:** This deal was mostly about minimizing the negative impact on Canada's economy that could have resulted from the harshest U.S. demands. While Canada made some concessions, the biggest positive from this deal is that it will remove a massive cloud of uncertainty for policymakers and businesses. **We had been assuming that an agreement would *eventually* be reached, but the deal heavily reduces lingering uncertainty surrounding our 2019 outlook.** There is now upside **risk to our call of 2.1% GDP growth next year**, which we further bumped up this week on news of the LNG deal.
- **The Bank of Canada:** NAFTA and broader trade uncertainties have been a key issue for the BoC over the past year. Indeed, the September policy statement said *"the Bank is also monitoring closely the course of NAFTA negotiations and other trade policy developments, and their impact on the inflation outlook."* Suffice it to say that this deal, along with recent solid data, all but cements a rate hike on October 24, barring a shock over the next three weeks.

Looking further out, a major downside risk appears to have been cleared. Governor Poloz has stressed the *"gradual"* rise in rates, but that narrative may well change with a deal in hand. **We are now calling for three rate hikes in 2019 (January, April, and July)**. Effectively, the BoC will now be just matching the Fed's rate hikes through next year, leaving overnight spreads in place.

- **The loonie:** Accompanying the broad move higher in Canadian bond yields, the currency initially appreciated moderately on news of the deal. This was more or less the market scrubbing out risk of a negative outcome. There could be modest further near-term currency strength as some of the negative sentiment around Canada unwinds, but the longer-term picture is still challenging. Canada continues to struggle from a competitiveness perspective and the USMCA doesn't change that. Broader policy changes are needed to address this issue, meaning any further strength will be relatively limited. **Prior to the deal, we were looking for 78.5 cents ($1.275) for the end of this year and 80 cents (or $1.25) for the end of 2019. We remain generally comfortable with that call,** although similar to the growth outlook, there is now some upside bias to that forecast—especially if Canadian oil prices can better reflect the recent gains in world prices.

- **Stocks:** A limited TSX reaction to the deal likely reflects the fact that much of the index was never all that exposed to a negative NAFTA outcome to begin with (we often argue that the index is not an ideal reflection of the underlying Canadian economy). And, the deal does little to address other weights, such as the record oil-price differential and slowing credit growth. As such, this will be more of a case-by-case basis for equities in areas such as auto parts (which rose on relief after the announcement), some industrial products and dairy. The bigger picture is that Canadian equities are relatively cheap versus their U.S. peers, with the forward earnings yield gap recently trending around the widest level of the cycle—if the trade deal improves sentiment toward Canada more broadly, it could help narrow that gap.

- **Government finances:** Ottawa made it immediately clear that it will offer some support to dairy, poultry and egg producers as an offset to the concessions made in this trade deal. Look for an announcement in the Fall Economic Statement or Budget 2019, if not earlier. It remains to be seen what the dollar figure for any such support would be. In the wake of past CETA and TPP deals (which each opened up slightly less market share than the USMCA will), the prior government served up roughly $4 billion of support over 10-15 years, through income guarantee and quota-value guarantee programs. The good news is that Ottawa's finances are tracking somewhat better than expected in the current fiscal year (a surplus of $4.4 billion in the first four months of FY18/19, versus a deficit of $109 million in the same period a year ago), leaving some flexibility on this front without seriously denting federal finances.