Market Commentary
From NAFTA to USMCA

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The United States-Mexico-Canada Agreement (USMCA) has now replaced the North American Free Trade Agreement (NAFTA), and while on the surface not much appears to have changed, there are some longer-term effects for Canadian industries and markets that are worth considering.

It's important to note that while this is not a victory for Canada in the sense that the new agreement offers new opportunities, it's a victory for what it has *not* done – it hasn't destroyed Canada's auto industry and much of Canada's manufacturing sector overnight. President Trump's threat to impose a 25% tariff on Canadian auto exports needed to be taken seriously and was likely instrumental in getting Canada back to the negotiating table.

In other words, for the foreseeable future, things will roll along as they have under NAFTA. Canada has retained Chapter 19, a critical provision regarding independent dispute mechanism which is important for attracting investment and providing some degree of certainty. There is some debate around the true benefit of Chapter 19 because there are alternative routes to address disputes; however, the provision maintains the status quo, which is important in terms of business sentiment.

In the long term, there are sections in the new agreement that will be more challenging for Canada and will push the country to become more productive and ultimately more competitive, or fail. Moreover, any such failure will further diminish Canada's industrial base.

Take Section 232, which states that Canada will be subject to a 25% tariff if auto exports reach 2.6 million units a year. Current exports total 1.8 million units, so it remains a long-term prospect; but it suggests that Canada will need to invest in productivity-enhancing measures and move up the value chain in order to remain viable.

If Canada cannot increase volumes significantly or if our competitive position declines because labour costs rise – pushing up the cost of doing business – then one requires a strategy to reverse the trend. That strategy is raising the value of the underlying product. In the case of Canada, it means discarding the very basic parts that are made in Canada and investing in the components that are higher value. Within the auto sector, transmissions and engines are a higher value-add while bumpers are lower value-add and better made in a country with low labour costs such as Mexico.

One could have made the same argument previously as it is the lack of competitiveness that is driving more and more auto-related investment south of the border. But moving up the value chain is the way other countries like Japan have in the past moved to limit the damage from auto restrictions into the U.S. In fact, one can thank Robert Lighthizer, the U.S. trade representative who negotiated restrictions on Japanese exports in the 1980s, for prompting Toyota and Honda to build better vehicles. Will Canada do the same? Possibly not, but it may not matter in the end.

The reason is that Canada is increasingly a service economy. While auto manufacturing is down, services continue to grow. Even within the auto sector, the incremental value-add is coming from Canada-based engineers troubleshooting on auto manufacturing platforms south of the border. Companies like Deloitte are using Canada-based consultants who travel south during the week for contracts that may have been signed in New York. In the end, it isn't clear how meaningful this impact will be overall. Certainly, regions where auto manufacturing is vital are likely to be negatively affected without a long-term strategy to move up the value chain.

There is another major issue that tends to get overlooked: the more markets are integrated, the less an individual country is capable of maintaining its sovereignty. Take the USMCA's newly created Macroeconomic Committee which is tasked with considering exchange rate policy. This is the brainchild of the U.S., which wants to limit currency devaluation since it immediately boosts a rival's competitiveness. Trump and future administrations will probably not interpret a U.S. dollar devaluation in the same light but will use it as a tool to justify possible tariffs in the event they feel Canada is devaluing its currency.

How might that influence the Bank of Canada or Canadian Government policy? It is the price to pay for maintaining these important trading relationships. The alternative, i.e. Canada going alone, is not viable in this age. But Canada's loss of sovereignty isn't just limited to the above. In the new agreement it states that "Entry by any party into a free trade agreement with a non-market country shall allow the other parties to terminate the agreement".

One can infer that China is the target. Any attempt by Canada to dilute the influence of the U.S. by reaching out to China is not acceptable to the U.S. administration. The "bully" has spoken and there is little we can do about it. The U.S. is building an exclusive North American trading block that it will anchor and control.

In the end, Canada has to accept these limitations and work with what we have. It has to invest to stop the decline of manufacturing but, ultimately, access to the largest market in the world, including services, is the key to maintaining and improving the general standard of living.

Fortunately for Canada, Trump is more focused on manufacturing than services, which suggests that Canada will maintain control over its economic wellbeing. That should be viewed as a positive thing, especially given the alternative.

Dairy concessions were not addressed in the commentary because these aren't material to the overall picture even if dairy regions will be negatively affected. One would expect federal support to assist farmers affected by these changes. Ultimately, the long-term viability of Canada's dairy industry will depend on the ability to invest in order to compete.

Meanwhile, Canada did maintain protection for its broadcasters under the cover cultural protection.