Tough, and completely unnecessary negotiations are underway. What might this mean?

In a recent trip to the USA to visit my son, we enjoyed dinner with an old friend, formerly a Prince George resident. My friend left PG about 15 years ago as a fledgling young banker, and wound up in another Western Canadian city as a very successful real estate developer. He is Canadian through and through, but married to an American, and resettled there now.

In our brief discussion about financial market conditions, this successful businessman with significant cross-border transactions had heard nothing whatsoever about NAFTA renegotiations presently underway. This is a testament to the guns and hosers juxtaposition we find ourselves mixed up in. It's just tough to get respect being the cutesy northern neighbour.

Several months in to NAFTA talks, we are still apparently a long way from a new deal. What might this mean? My article today borrows heavily from a recent insightful report by RBC Economics.

A "bad" NAFTA result—either a renegotiated agreement that delivers less trade or a tear-up of the deal—appears increasingly possible. 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. RBC estimates 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.

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.

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, 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 would likely drag 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

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 top 15 trade sensitive industries in Canada 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.

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