SPECIAL REPORT

TD Economics

February 9, 2015

NAFTA: THE PARTNERSHIP THAT KEEPS GIVING

Highlights

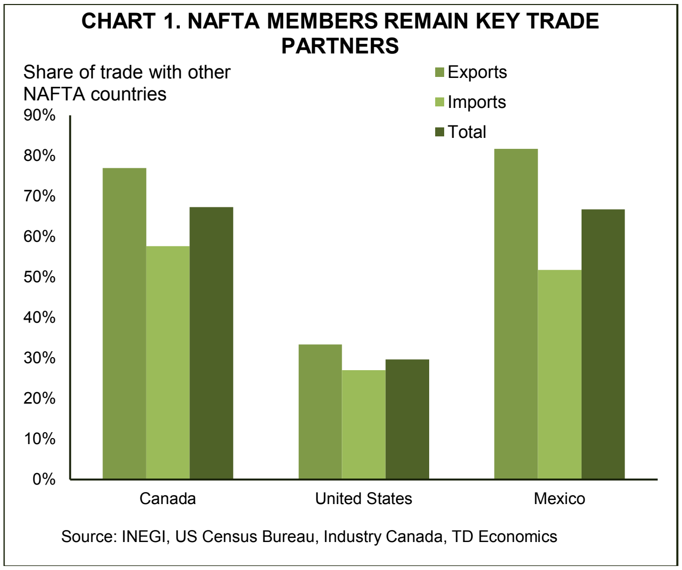
- Trade with NAFTA partners remains important for Canadian exporters, representing nearly 80% of the export market.
- Much of the growth in trade has been with the United States. Mexico remains a relatively untapped market for Canadian exporters.
- The trans-NAFTA supply chain is growing, as U.S. exports increasingly rely on imports.
- The immediate economic outlook for our NAFTA partners is positive. Growth in these countries is expected to outpace other trading partners, such as the euro-zone, helping Canada weather the recent downturn in commodity prices.
- Scope remains for improving the NAFTA relationship. In particular, border processing and pre-inspection remain key areas where efficiencies can be realized.
- Current projects, such as the Beyond the Border initiative, aim to further enhance the NAFTA partnership. Accelerating these projects via the trilateral NAFTA summit later this year will help boost trade in the coming years.

Trans-oceanic trade agreements, such as the Comprehensive Economic and Trade Agreement (CETA), have captured a lot of public and media attention. However, the North American Free Trade Agreement (NAFTA), and the free trade agreement between Canada and the US will reach their respective 21st and 27th anniversaries this year, and remain the most important agreements for Canada in terms of size: exports and imports within North America still represents the lion's share of Canadian international trade. As this report shows, North America south of the 49th parallel is expected to be a bastion of stability and accelerating growth amid of sea of tepid economic performances, which will benefit Canada in the coming years. Although NAFTA has provided Canada with numerous benefits, there are still some bottlenecks that could be eliminated. This special report provides a summary of the benefits NAFTA has provided to date, a review of the economic outlook for the NAFTA area, and examines area in which the goals of NAFTA could be expanded.

The benefits and importance of NAFTA

Trade with other NAFTA nations is of paramount importance for Canada and Mexico, both of which send more than 70% of their exports to other NAFTA countries (primarily the United States). For Canada, this amounts to more than $470 billion dollars a year in exports: that represents about $1.3 billion dollars in exports leaving Canada each day headed for the U.S. and Mexico. Similarly, a significant share of imports also comes from NAFTA partners. The U.S. is the exception, where trade with NAFTA partners represents around 30% of the total (Chart 1).

Brian DePratto, Economist, 416-944-5069



The significance of NAFTA for Canadian trade underscores the importance of strengthening the relationship. While other trade agreements will help expand and broaden export markets (for instance, CETA gives Canada access to the $1.5 trillion eurozone import market), the already large size of our NAFTA trading relationships means that even a modest improvement in export volumes can result in significant gains in income.

Within Canada, all provinces have seen an expansion in exports since NAFTA went into effect (Chart 2).[1] The gains have been led by a dramatic expansion of exports to the United States in most provinces. In contrast, exports to Mexico grew only modestly, and with the exception of New Brunswick, were significantly outpaced by exports to non-NAFTA countries.

What industries have gained most from NAFTA? Perhaps unsurprisingly, the largest gains have been among primary industries (Chart 3). Oil and gas, petroleum, utilities, crops, and manufactured food have been among the best performing industries in the post-NAFTA period. One area that clearly stands out is the export of commercial services – which includes sectors such as banking, consulting, engineering, and other professional services – the third fastest growing export sector.

Although exports from many of these industries would surely have grown absent NAFTA, the strong expansion of utilities exports – that is, electricity – was in large part due to easing of barriers to the export of electricity built into the NAFTA agreement. Similarly, NAFTA significantly eased restrictions on the provision of services across borders.

NAFTA also led to a more closely integrated North American supply chain. This can be seen most clearly in the United States (Chart 4). The import content of exports, which measures how much of a given unit of exports contains materials or components not produced in the exporting nation, provides a rough measure of the degree of international linkages in the supply chain.

Both the Canadian and Mexican supply chains are highly externally integrated; with an import content of exports as high as 45% . In contrast, the import content of U.S. exports has risen approximately 4 percentage points, but at 17%, remains well below its NAFTA peers.

The upward trend in the import content of U.S. exports creates additional opportunities for Canadian exporters to provide key inputs to U.S. manufacturing products. Such inputs need not be limited to raw materials or basic components. Categories such as software, precision components, structural materials, and others are high value exports that nonetheless become integrated into a larger end-product. Indeed, by removing barriers to trade, NAFTA members can take advantage of their comparative strengths to improve efficiency throughout the supply chain.

While trade has grown rapidly since the introduction of NAFTA, a somewhat surprising fact is that trade growth post-NAFTA was actually somewhat slower than in the years preceding the agreement. Regardless of how trade is measured, the growth rate of both exports and total trade slowed in the post-NAFTA period, with growth between 50% and 66% of the pre-agreement pace. This counterintuitive result is likely due to the presence of several large recessions in

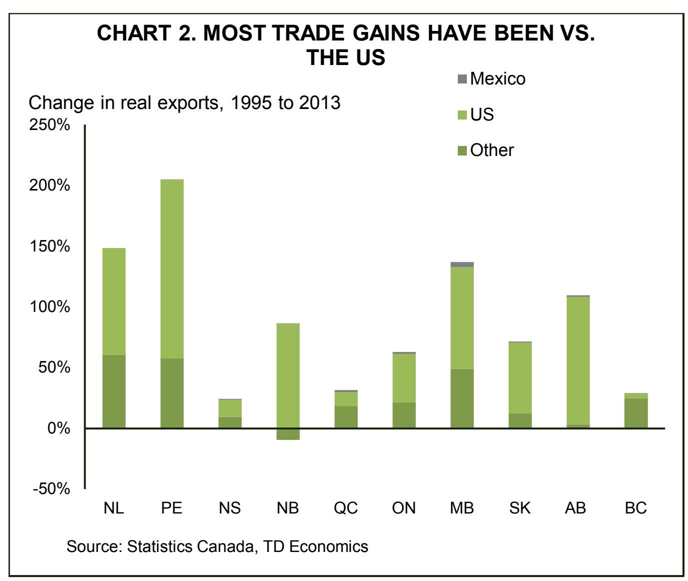
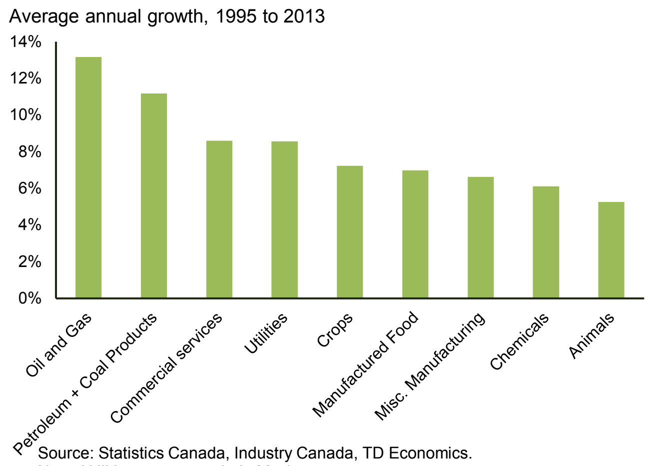
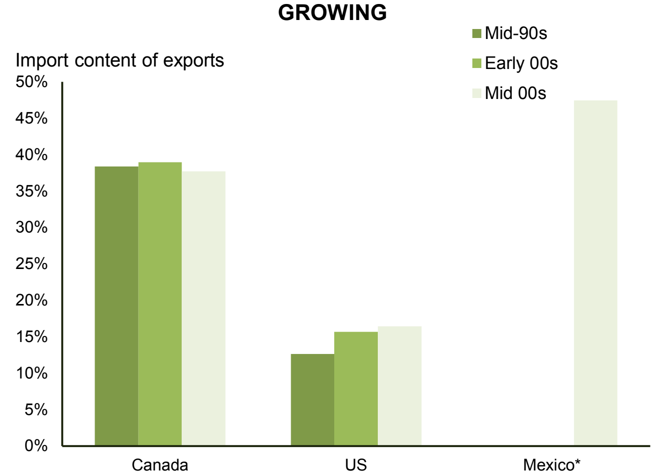


CHART 3. NON-MANUFACTURED EXPORTS HAVE GROWN THE MOST



Source: Statistics Canada, Industry Canada, TD Economics.
Note: Utilities exports exclude Mexico

CHART 4. IMPORT CONTENT OF US EXPORTS GROWING



Source: OECD, TD Economics. *Note that Mexican data has gaps.

the post-NAFTA period, including the 2001 downturn, and the 2009 recession. Over the past two years, however, there has been a marked acceleration in Canadian exports, corresponding broadly with the decline in the exchange rate. Export growth over this period has been well above historic norms, and with the Canadian dollar expected to remain low, export growth is likely to continue.

Beyond the impact of the exchange rate, the size of the NAFTA trading relationship, alongside geographic convenience and rising labour costs in competitor markets such as China, means that trade with NAFTA partners will remain a significant source of Canadian export growth for some time. This will be reinforced by the improving North American economic outlook, as Canadian exports help satisfy growing demand on North American soil.

The economic outlook for North America

The medium-term outlook for Canada has weakened recently, as the impact of lower commodity prices has begun to feed into the broader economy. As a result, domestic sources of growth, such as business investment and consumption are likely to remain soft. While the volume of commodity exports will fall, the price effect will be significant, reducing national income.

Given the weak outlook for domestic growth and commodity prices, exports of manufactured goods will be a key supporter of Canadian growth in the coming years. Fortunately, the outlook for Canada's NAFTA partners remains strong. The latest TD Economic Forecast indicates that North America (excluding Canada) will experience accelerating growth in 2015 and 2016 (Table 1). Mexico in particular is expected to experience robust growth of nearly 4% by 2016, while the U.S. is forecast to experience above trend growth of close to 3%. The NAFTA performance stands in contrast to other major trading partners. Chinese growth is slowing (albeit still at a fast pace), while growth in the euro-zone is expected to remain tepid.

The expected composition of U.S. growth will also create additional export opportunities for Canadian businesses. Consumer expenditures, business investment, and residential construction are all forecast to see strong growth in 2015 and 2016 (Table 2). These sectors, particularly residential construction, are areas in which Canadian exporters have years of experience. With U.S. imports expected to grow by around 6% per year, supported by the strong US dollar/weak Canadian dollar, all the ingredients for an acceleration of Canadian exports to the U.S. are in place.

Table 1. NAFTA Countries To See Rising Growth Rates

	Annual GDP Growth (%)		
	2014	2015	2016
Canada	2.4	2.0	2.2
United States	2.5	3.2	2.7
Mexico	2.1	3.3	3.8
Note:			
World	*3.2*	*3.4*	*3.7*
China	*7.4*	*7.0*	*6.7*
Euro-zone (EU-17)	*0.9*	*1.2*	*1.6*
Forecast as at January 2015			

Table 2. U.S. Growth Breakdown Favourable for Canada			
	Annual Growth (%)		
United States	2014	2015	2016
GDP	2.5	3.2	2.7
Consumption	2.5	3.4	2.8
Bus. Investment	6.2	5.3	5.4
Res. Construction	1.8	9.4	14.3
Government	-0.1	1.1	0.8
Exports	3.2	4.1	4.8
Imports	3.6	5.8	6.4
Forecast as at January 2015			

Mexico presents a unique opportunity for Canadian exporters. While the size of the trading relationship is relatively small at present, and thus likely to have limited impact on Canadian growth in the medium-term, physical proximity, NAFTA, and growing continental infrastructure linkages create an opportunity unlike any other trading partner (save the U.S.). A relatively young and increasingly educated population will result in strong GDP growth. Indeed, the size of the Mexican economy is expected to overtake Canada's by around 2030 – just ahead of the 40th anniversary of NAFTA.[2]

Like the U.S., Mexico produces many of the same products as Canada – particularly manufactured goods. Recent years have seen a number of auto makers and other manufacturing firms choose Mexico over Canada as a destination for new facilities. While this has been a distressing trend from a Canadian perspective, there are nonetheless opportunities being created for Canadian export firms. Opportunities exist at both the low and high ends of the value-added chain. Canadian firms supplying intermediate parts may be able to expand production and supply Mexican firms. More importantly, opportunities are being created for high value-added exports. This may include software, manufacturing equipment, engineering and other consulting services, as well as financial services – all goods and services that a country rapidly becoming wealthy requires.

What can be done to build on NAFTA?

NAFTA has resulted in expanded trade and growth across North America. However, there are still areas where we can come closer to reaching the goals of NAFTA. One of the primary areas for potential improvement is through improved security screening at the border. In many integrated supply chains, products may cross the border several times before being completed, which can lead to extra costs and delayed production should border processing take longer than expected. Post September 11th, border security was greatly increased, particularly for goods entering the United States. The additional security measures, while understandable, can delay and discourage cross-border trade and integrated supply chains. Harmonizing security requirements, and adopting pre-screening of shipments in a 'inspected once, accepted thrice' system would help to reduce border processing times. Such a policy could potentially help reduce non-tariff barriers, such as inspection fees for agricultural products. In addition, 'Buy America' laws and provisions continue to close Canadian firms out of many government contracts, and run counter to the spirit of NAFTA (within Canada, very few jurisdictions still have these type of procurement regulations). Eliminating these rules will help expand export markets.

Other, non-trade barriers remain. Although NAFTA has improved the process of cross-border investment, barriers remain. In particular, the Canadian Investment Act requires a "net benefit" test for foreign investment of more than $369 million, while the U.S. Foreign Investment and National Security Act subjects foreign investments to national security review. Moreover, both Canada and Mexico continue to protect certain industries, such as telecommunications (Canada) and oil and gas extraction (Mexico), although restrictions have been eased in recent years. Progressive removal of barriers to cross-border direct investment will help ensure the continued prosperity and flow of ideas throughout the NAFTA countries.[3]

The ability of individuals to work easily in other countries can also be improved. Currently, NAFTA visas (referred to as TN visas in the US), are only available for individuals working in specific roles. The list of roles is somewhat out of date compared with the varied professional roles within the modern economy. Regular updating of this list, in consultation with industry, will help reduce potential labour shortages, and further increase labour market integration across the continent.

Beyond pre-screening of goods, improvements in the physical design and layout of land crossings can also improve trade flows, again by making the process simpler, faster, and more convenient both for shippers and travelers.

Energy is another area where simplification and harmonization of rules and procedures can result in increased trade flows. Currently, cross-border energy projects, both for oil and gas and electricity, are regulated by many different government agencies. The result is that gaining approval for an export project can be a complicated, costly, and long process. While legitimate concerns need to be raised and addressed before projects can be approved, simplifying the procedures for these types of projects would result in less uncertainty, and greater investment.[4] Along a related vein, environmental commitments on a continental basis would be a useful step, and could lead to a unified negotiating position at future global summits.

Non-harmonization of external tariffs is another issue that makes the flow of goods across NAFTA members somewhat problematic. For instance, a non-NAFTA component to a Canadian product may face one tariff upon entering Canada, and another tariff once the Canadian product is shipped to the United States or Mexico. Simplifying and harmonizing tariffs and country of origin requirements across member countries will help expand trade by reducing processing times for goods already within the bloc. Moreover, external tariff harmonization can lead to an improved negotiating position in future trade agreements, such as the Trans-Pacific Partnership (TPP); NAFTA countries would be able to negotiate as a bloc, increasing their bargaining power.

Fortunately, many of these issues are already being addressed. The Beyond the Border initiative, a joint Canadian-US effort, aims to tackle many of these problems.[5] Beyond the Border seeks to ensure security in trans-shipments, and reduce processing times at border crossings. A number of projects have been initiated under the initiative, such as the NEXUS trusted traveler program, and the ‘shiprider’ joint maritime security teams.

A number of other projects are currently underway. ‘Trusted trader’ programs allow the submission of import/export information once for acceptance in both Canada and the US. Other programs, such as those related to the physical inspection, transport, and processing of goods are currently in the demonstration or test phase. For instance, a joint effort to identify security risks in cargo shipments has undergone pilot projects at the ports of Prince Rupert and Montreal, but has not yet been expanded to other ports such as Vancouver (the largest Canadian port), or Halifax.

Later this year, Canada will play host to the North American Leaders summit, an opportunity to establish and work towards shared goals within the NAFTA framework. The summit will provide opportunities both to reflect on the progress that has been made to date, as well as moving forward with a refreshed agenda for NAFTA. Working towards the goals outlined in this section, and accelerating and expanding existing efforts will help ensure continued prosperity for all NAFTA members.

Bottom line

Although other, more recent trade agreements often receive more headlines, NAFTA has been a great boost to the North American economy and to Canada in particular. As NAFTA enters its 21st year, the outlook for Canada’s partner countries remains bright, providing a potential cushion against the effect of falling commodity prices on Canadian growth. Excluding Canada, GDP growth is expected to accelerate in 2015 and 2016 – in contrast to some other regions. Despite the many benefits that NAFTA has delivered, there remains room to improve the functioning of the agreement. Beyond the Border has begun to address many of these issues; accelerating these initiatives will lead to smoother, safer trade and the concomitant benefits for all NAFTA members.

Brian DePratto, Economist
416-944-5069

ENDNOTES

1 It cannot be said for certain that trade grew as a result of NAFTA – trade with other members may have expanded by the same amount without NAFTA.

2 Many commentators expect that by mid-century, the Mexican economy will be double the size of Canada's. See for instance http://www.theglobeandmail.com/globe-debate/cetas-nice-but-nafta-is-essential/article15086957/

3 It is important to note that all NAFTA countries have agreed to 'most-favoured nation' clauses as members of the World Trade Organization (WTO), meaning that any changes to these regulations would by applied to investment from all other WTO members.

4 A bill to simplify the approval process in the US, H.R. 3301, has passed the House, and appears likely to pass the Senate, but has been opposed at the Executive level.

5 The US and Mexico are currently engaged in a "High Level Economic Dialog" which shares many goals with Beyond the Border.