No more NAFTA: How Canada could thrive without the trade pact

By Barrie McKenna
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For months now, the prospect of the United States pulling out of NAFTA has seemed like a bad dream.

President Donald Trump made the menace much more real this week, warning Prime Minister Justin Trudeau at the White House that the deal may be "terminated" if the U.S. doesn't get what it wants.

This is the nightmare scenario long feared by many Canadians after almost three decades of free trade with our southern neighbour.

Or is it?

Obviously, the end of the North American free-trade agreement – the foundation of Canada's relationship with the U.S. and Mexico – is not this country's preferred option. There would be economic pain and dislocation, at least initially. Untold numbers of jobs would be lost and investments delayed or cancelled if the world no longer perceived Canada as a gateway to the vast U.S. market. Complex supply chains, particularly in the auto sector, would be disrupted.

But it wouldn't have to be an economic catastrophe. If Canada plays its cards right, the death of NAFTA could become a catalyst for making the Canadian economy stronger, more outward-looking and less tethered to an increasingly unreliable partner.

"If NAFTA were to cease, I don't think it would be a complete disaster. And in some respects, it actually has a silver lining," argues David Emerson, a former lumber executive and federal minister of both foreign affairs and trade.

The troubled NAFTA talks are a "wake-up call" for Canada, says Mr. Emerson, who insists he's speaking for himself and not the numerous corporate boards and advisory groups he sits on. Among other things, he says, Canada should use this time to forge closer ties with China, Japan and other Asian nations, ease the regulatory burden at home and invest heavily in the kind of infrastructure that will make trade easier – all to hedge against the risk of an increasingly protectionist and inward-looking U.S.

"If it isn't Trump, it will be somebody else," Mr. Emerson warns. "There is a strong protectionist, self-serving sentiment that runs deep through the American legislative and regulatory process. Ultimately, we're going to have to diversify our economic linkages in ways that ensure our whole economy is not dangerously vulnerable to those protectionist, Make America Great Again actions."

In fact, Canada may be looking at a decade or more of "antipathy to globalization" in the U.S. that outlasts the Trump administration, according to Gary Hufbauer, a former top U.S. trade and investment official who is now a senior fellow at the Peterson Institute for International Economics in Washington. To counter that mood, he says, Canada should stay the course, open its borders wider to trade and investment and pursue free-trade deals in Asia.

"Canada could survive and even thrive [in a post-NAFTA world]," he says.

The reality for companies is that tariffs aren't as important as they were when Canada and the U.S. struck their first free-trade agreement in 1989. Costs related to transportation, logistics, data flows and supply chains are far more important now than duty rates.

Canada's economy would take a hit from the demise of NAFTA, but the impact would be "fairly small in the long run," according to Dan Ciuriak, a former deputy chief economist at Foreign Affairs and International Trade. The shock to Mexico would be larger, but relatively muted for the U.S., says Mr. Ciuriak, who is currently modelling the economic impact of what he calls a "NAFTA requiem" for an upcoming C.D. Howe Institute study.

A lot will depend on how NAFTA comes apart and what replaces it – a reversion to the original Canada-U.S. free-trade agreement (CUSFTA), prevailing World Trade Organization rules and tariff rates or some new arrangement. Mr. Trump mused this week about forging a new bilateral Canada-U.S. deal if NAFTA fails.

"I'd be surprised if teams of Canadian officials were not already gaming out these scenarios," says Roland Paris, a former foreign policy adviser to Mr. Trudeau and a professor of public and international affairs at the University of Ottawa.

The CUSFTA remains on the books, and some experts argue it would automatically kick in if the U.S. terminates NAFTA, salvaging at least some preferential access to the U.S. market for Canada.

But Toronto trade lawyer Mark Warner warns that the original free-trade deal could prove to be no better than the deep concessions the Trump administration is seeking in the current NAFTA talks. It could lead to more fractious relations and more trade disputes. "People need to go back and read it," he says.

Then again, Mr. Trump could terminate both agreements, leaving Canada in the same boat as most other countries.

The gap between WTO tariff levels and the generally duty-free NAFTA border has narrowed substantially over the years. Under WTO rules, for example, the U.S. tariff on cars would climb to 2.5 per cent from zero and to 3.5 per cent from zero on many parts.

"People would have to do a lot of number crunching," acknowledges Dennis Darby, president and chief executive of the Canadian Manufacturers and Exporters, which speaks for more than 2,500 companies. "Companies are looking at their competitive advantage on costs all the time."

It's unlikely that manufacturers with substantial investments in Canada would immediately pull up stakes if NAFTA wasn't there. But Mr. Darby says a dark cloud would hang over future investments as companies scramble to figure out if it makes more sense to supply the large U.S. market from plants in Canada or in lower-cost countries such as China or Taiwan.

"Industries will react as they always do: They'll make rational decisions," Mr. Darby explains.

Canada would lose access to NAFTA's dispute-settlement regime – Chapter 19 – as well as the deal's government purchasing rules. But those losses would be mitigated by WTO rules, including access to dispute-settlement panels.

There is also a very real possibility that even if Mr. Trump terminates NAFTA, Congress would balk at passing the necessary legislation to take the U.S. out of the deal. Congress' pivotal role was underscored this week in Washington when Mr. Trudeau met with members of the powerful House Ways and Means Committee, which has responsibility for trade.

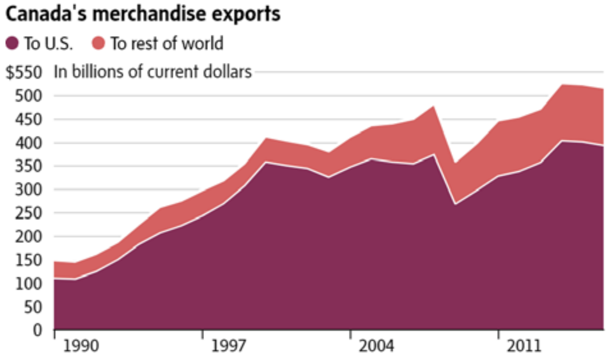
It's also worth remembering that the Trump era is not entirely unprecedented. Canada has been here before, in the 1980s, when there was another populist in the White House (Ronald Reagan), widespread angst about the overvalued U.S. dollar and rising protectionism.

"It's a very similar environment to the 1980s, and we came out of that with the original free-trade agreement," Mr. Ciuriak points out. "It's not as scary as it seems today if you know the history."

Being highly dependent on the U.S. may have made a lot of sense for Canada for 30 years. But it has left Canada underexposed to the fastest-growing regions of the world, including China and India.

NAFTA also entrenched Canada's historic dependency on the U.S. In 2016, roughly 76 per cent of Canada's merchandise exports went to the U.S. – a slightly larger proportion than in 1990. It is a testament to the fact that loading products on a tractor-trailer and hauling them across the Canada-U.S. border has always seemed easier than tapping distant overseas markets.

Canada's merchandise exports



THE GLOBE AND MAIL, SOURCE: STATSCAN AND U.S. CENSUS BUREAU / CUSTOMS BASIS

Two-way trade totalled more than $1-trillion last year, worth roughly 42 per cent of Canada's GDP.

Whatever happens, Canada would be wise to diversify its trade relationships. The trade deal reached with the European Union will help a lot.

But there is much more Ottawa could do. It could salvage what's left of NAFTA with Mexico. It could also aggressively pursue the Trans-Pacific Partnership with Japan, Australia, Mexico, Malaysia, Vietnam and others – the so-called TPP 11 – or pursue bilateral deals modelled on the deal with the European Union.

With NAFTA gone, Canada could also kick into high gear ongoing trade negotiations with China and India.

"We have to think differently," Mr. Emerson says. "A lot of that is unilateral – we can do that ourselves. A lot is not."

There is another way to diversify Canada's trade. Mr. Ciuriak says Canada could unilaterally remove all of its existing tariffs, declaring itself a free-trade zone. The hit to government revenues would be in the range of $5-billion a year, spread broadly across industries. But it would make Canada a much more attractive destination for investment, according to Mr. Ciuriak.

"We would simply return to a more normal pattern of trade – one that's more economically optimal," he says.

Even in a world of higher tariff walls, Canada will do okay if it maintains its capacity to "play in the knowledge-based economy," Mr. Ciuriak says. That means having a skilled and educated work force and creating an environment that encourages innovation.

The demise of NAFTA may prove to be less of a dead end than an unpredictable trip down a road less travelled.