Investments: Is Cancelling NAFTA Bad For Canada?

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The spectre of NAFTA being cancelled is on many people's minds since the election of President Donald Trump. Washington has pulled out of the TPP and wants a better deal for the U.S. in the NAFTA agreement. The recent possible tariffs coming from the Trump administration is also heightening trade concerns. Is cancelling NAFTA a bad thing for Canada? There are 2 ways to examine this question.

The Current State

The first approach is looking at how things currently are and what is likely to happen using this assumption. Canada is the U.S.'s second largest trading partner and the U.S. is Canada's largest trading partner by a large margin. The U.S. is Canada's closest trading partner by physical location. Much of the infrastructure that is already in place caters to shipping goods across the Canada-U.S. border seamlessly – bridges, railways, sea ports, shared production facilities etc. The culture of the U.S. is similar enough to Canada that doing trade is fairly easy. There are no language barriers, religion barriers, or culture barriers relative to other countries. Our currencies are closely aligned, making trade easier in terms of financing, terms of payment and currency exchange. It is fairly easy to obtain U.S. dollars anywhere in Canada. Comparing this to the Japanese Yen shows the contrast. Lastly, the assumption is that the U.S. will protect Canada militarily so Canada can focus on producing other goods.

Using this assumption, if NAFTA is cancelled, Canada may be a big loser in terms of trade. The fears are that Canada's goods will not be exported and economic activity will suffer. We do not have any other trading partners as large or physically close by as the U.S. The infrastructure and financing advantages also do not exist with any countries. Even Mexico who is part of NAFTA has a different currency, language, culture and priorities than the U.S. with respect to trade. Cancelling NAFTA looks like a disaster.

What are the disadvantages of NAFTA or trade deals in general? First, trade deals encourage specialization of industries in the lowest cost / highest benefit production of goods and services. All other production is reduced and or ceased. If you want to develop a new industry, you will have a small chance of success since your trading partners may dominate the industry or limit you from competing. If this is not the case, you may develop the industry on someone else's terms. Starting a business without free reign to experiment usually does not succeed because experimentation is necessary to optimize the market demand, efficiency and need for a given product. These limitations create a volatile economy based on a handful of sectors. In Canada, this means energy, commodities, banking and real estate. The second issue is negotiating power. Trade deals limit what you can negotiate after the deal is made, unless the entire deal is re-negotiated, which is what is happening today with NAFTA. This limits diversification of trading partners and new opportunities which may be present. Sometimes even within an established industry, different market conditions that would normally be taken advantage of would not be available because of the terms of the trade in a deal. As an example, the price of oil is fixed at $50 per barrel between two countries. The price of oil rises to $100 per barrel on world markets, but the seller will not benefit from this since they are selling the oil at $50. Should the price drop to $20, the seller would benefit, but then the question of “how often does this happen and is it worthwhile?” is going to come up. The last disadvantage is the negotiation itself. If you are negotiating with a much bigger, stronger trading partner, you will likely need them more than they need you. This means that they can argue for better terms of trade and if you want to make the deal, you will have to sacrifice more than you may realize. In the case of Canada and the U.S., the U.S. has a more developed economy than Canada, and much more influence on the world stage. If the U.S. wants to dump Canada and trade with someone else, they can do it more easily than Canada can for the U.S. This gives the U.S. more negotiating options than Canada – at least at the present time. The U.S. can offer more products for sale, more options for trade and more customized terms. Let’s say that Canada went to a trade negotiation and said “I will offer technology expertise.” Would that be possible? Not likely, but Canada can offer mining expertise. The U.S. can offer both.

The Opportunity

The second approach is assuming that cancelling NAFTA can be an opportunity, and changes can be made to benefit Canada more so than the current agreement. Why? Trade can be opened up to every country in the world and with open terms. Since the competition is much greater if all countries are available for trade, the opportunities may be greater. The flip side is that more competition may make it harder to trade for an advantage due to cheaper labour or better quality that may be available in other countries.

Cancelling NAFTA would make Canada more independent because we cannot rely on a specific trading partner to buy our goods. This will create more resourcefulness and entrepreneurialism among Canadians. When people have to find a way to survive, there is more effort expended. This effort will create more diversification among industries since we no longer can afford to specialize in certain sectors.

This scenario has started to play out with Canada negotiating more deals with Europe and Asia. Canadian firms have global expertise in certain sectors which gives them an advantage when creating terms of trade.