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Economics Group

Special Commentary

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The Ties that Bind: Canada-United States Trade

Officials from the United States, Canada and Mexico recently abandoned plans to wrap-up NAFTA renegotiation talks by year-end and extended the deadline to March 2018. Media reports describe a contentiousness to the negotiations particularly around U.S. demands for major concessions as well as a so-called "sunset-clause," which stipulates that NAFTA would expire after five years unless the parties agreed to extend it.

Recent decisions by the United States to impose tariffs on Canadian softwood lumber and Bombardier jets have signaled that the current administration is willing to put words into action when it comes to erecting trade barriers, at least to some extent. While the most vitriolic criticism of trade during the campaign trail centered on Mexico, tariffs imposed so far this year also demonstrate a concern for re-forming trade with America's northern neighbor. Canadian stakeholders have understandably been expressing more uncertainty over the future of trade relations with the United States.

Tariffs imposed so far this year demonstrate a U.S. concern for re-forming trade with Canada.

A comprehensive analysis of the NAFTA negotiations is outside of the scope of this report. What we offer is a fact-based analysis of the trade dynamics between the United States and Canada so decision makers on both sides of the border can better frame their thinking on the issue. We evaluate claims that NAFTA has cost American manufacturing jobs and examine the nature of the trading relationship between the United States and Canada.

Figure 1

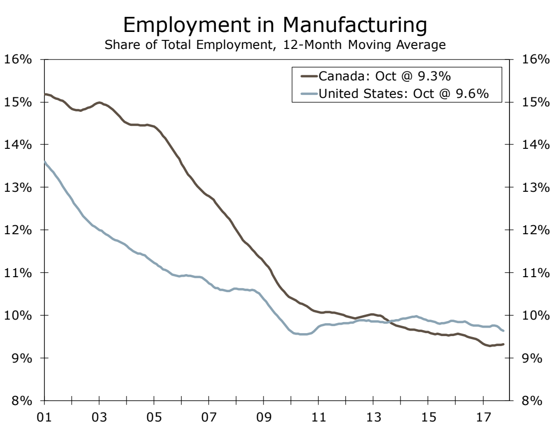
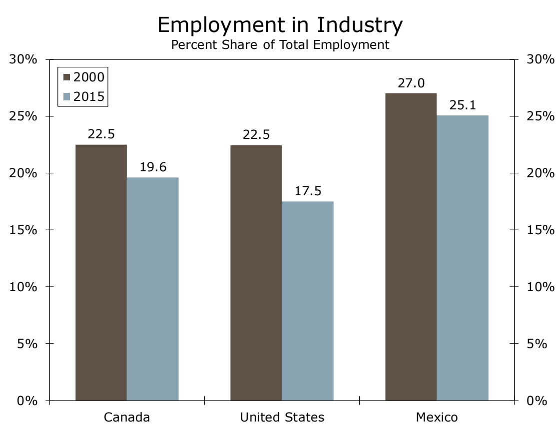


Figure 2



Source: U.S. Dept. of Labor, Statistics Canada, ILO and Wells Fargo Securities

Testing the Argument: "They're Taking Our Jobs!"

The current administration in the United States criticized trade agreements including NAFTA on the campaign trail and made a protectionist "America-First" platform the centerpiece of the inauguration speech. The rationale for the opposition to trade centers on the loss of U.S. manufacturing jobs ostensibly because labor costs are lower in other places.

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

The industry share of employment has declined in Canada, the United States and Mexico.

Since NAFTA was signed, the United States has indeed seen manufacturing employment shrink as a share of total employment (and in absolute terms). Importantly though, the United States is not alone in this regard. Over the past decade and a half, the manufacturing share of employment has fallen even faster in Canada (Figure 1). Data on Mexican manufacturing employment were not readily available, but a comparison of "industry" employment data from the International Labor Organization (ILO) shows that employment in this sector as a share of overall employment has declined for all three NAFTA countries from 2000-2015 (Figure 2). Industry is a broad category that includes all non-agriculture and non-services employment. Manufacturing currently makes up slightly less than half of industry employment in both the United States and Canada, so it is not a perfect measure of changes in manufacturing jobs. However, declining manufacturing and industry employment shares in Canada, the United States and Mexico suggest that something other than trade is also a factor in manufacturing job losses, such as mechanization and technology.

A common argument for why trade agreements including NAFTA are "bad" for the United States is that cheaper wages elsewhere have driven American producers to re-locate factories outside of the United States and then export products back, costing jobs and inflating trade deficits. An examination of manufacturing wages in Canada and Mexico lends only partial support to this line of reasoning, at least when it comes to NAFTA.

Figure 3

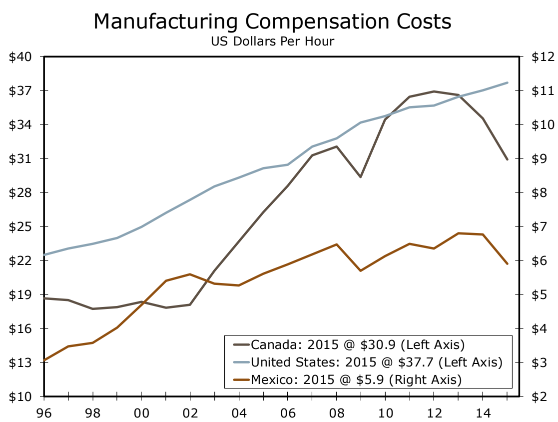
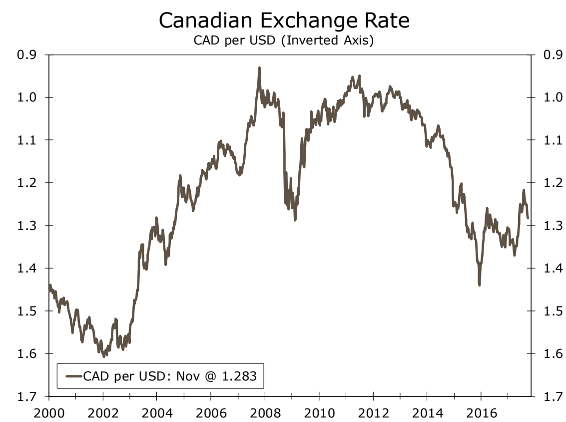


Figure 4



Source: Conference Board, Bloomberg LP and Wells Fargo Securities

NAFTA is only one factor behind shrinking manufacturing employment in the United States.

With significantly lower wage costs in manufacturing, Mexico offers a relative bargain for employers seeking to lower costs. The same cannot be said about Canada, where manufacturing wages are much closer to those in the United States. (Figure 3). For three years (2011-2013), compensation was actually higher in Canada. Since these costs are expressed in dollar terms, the depreciation in the Canadian dollar in the last four years has been a factor bringing down the relative cost of wages in Canada (Figure 4). However, Canada's manufacturing labor cost at $30.90 per hour remains in the ballpark of the $37.70 per hour paid in the United States.

The takeaway is that NAFTA is only one factor behind shrinking manufacturing employment in the United States. At play here is also that technological change is reducing the labor intensity of manufacturing in the United States and in many other countries, including Canada and Mexico. Arguments about lower labor costs driving American manufacturing jobs overseas may apply to Mexico, but not to Canada.

At Stake for Canada: Are You a Man or a Mouse?

Former Canadian Prime Minister Pierre Trudeau famously compared the Canada-U.S. relationship to a mouse living beside a sleeping elephant: "no matter how friendly and even-tempered is the beast... one is affected by every twitch and grunt" (1969). Earlier this year, current Canadian Prime Minister Justin Trudeau returned to his father's analogy, suggesting that a moose would be a more appropriate stand-in for Canada, "strong and peaceable, but still massively outweighed." Regardless of whether Canada is mouse or moose in this scenario, the fact remains that the United

States is Canada's most important international trade partner and is hugely influential for the Canadian economy. As follows, we set aside the merits of arguments for or against NAFTA and examine what is at stake for Canada in a renegotiation of the agreement.

Figure 5

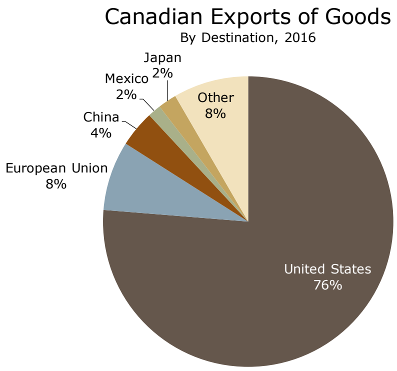
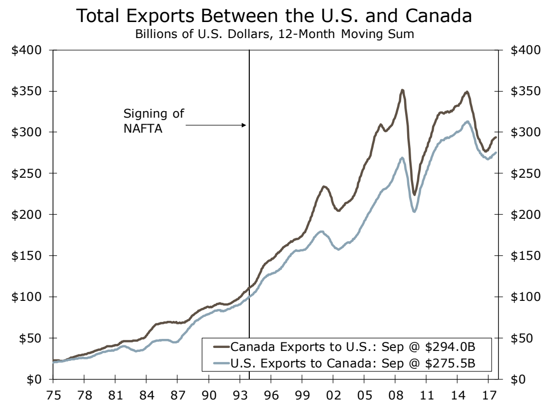


Figure 6



Source: Statistics Canada, U.S. Department of Commerce and Wells Fargo Securities

Canada sends more than three quarters of its merchandise exports to the United States, totaling $284 billion worth of goods in 2016 (Figure 5). This represents 13 percent of all goods imported by the United States last year. Since the implementation of NAFTA, trade between the United States and Canada has more than doubled in dollar terms (Figure 6). However, the share of goods destined for the United States is not as big as it used to be. As recently as the 1990s, more than 80 percent of all Canadian goods exports were headed for the United States. Today, Canada is increasingly sending exports to destinations such as China, the European Union and Mexico (Figure 7). This means that the United States market as a share of merchandise export volume is actually less important to Canada than it was at the time NAFTA came into force in 1994.

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Figure 7

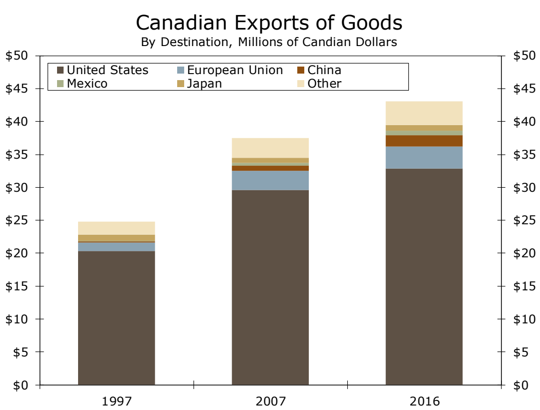
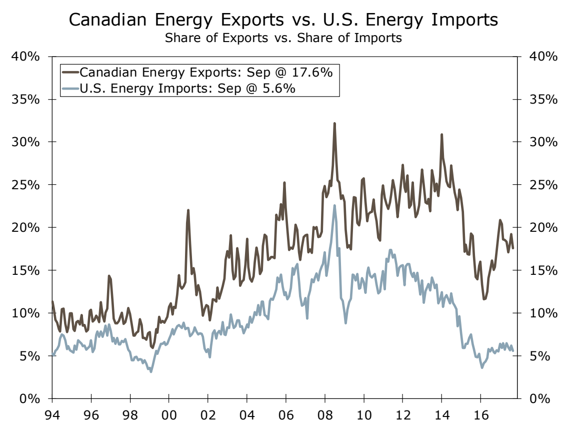


Figure 8



Source: Statistics Canada, U.S. Department of Commerce and Wells Fargo Securities

The decline in Canada's export share sent to the United States is in part a story about the energy sector. As shown in Figure 8, Canadian energy exports closely track U.S. energy imports (with both series expressed as a share of total exports/imports). However, the correlation between these two series has broken down somewhat since 2010, in the same period that the widespread adoption of fracking in the United States contributed to an increase in American energy production (Figure 9).[1] U.S. imports of crude oil declined 13 percent from 2010-2017, measured in barrels. So far, much of this decrease in volume has come at the expense of imports from OPEC countries rather than Canada, but demand for Canadian crude oil has expanded more slowly in recent years.

While Canada still exports the vast majority of its energy to the United States (94 percent in 2015), the country is looking to find new trading partners as the U.S. produces more of its own energy. Prime Minister Trudeau approved Kinder Morgan's Trans Mountain pipeline in 2016 as part of an effort to increase energy exports to Asia. The Trans Mountain pipeline would run from Alberta to the Pacific coast of British Columbia and, if built, would triple the capacity of the existing pipeline along this route.

Canada has already made inroads in diversifying its trading partners.

Merchandise exports and imports are equivalent to about 53 percent of Canadian GDP, according to World Bank figures (slightly above the world average of 50 percent). Given the importance of the United States trading relationship to Canada, anything that threatens that relationship needs to be taken seriously. However, it is also important to recognize that Canada has already made inroads in diversifying its trading partners and that Canada is less, rather than more, dependent on trade with the United States since NAFTA was originally signed (as a share of export demand).

Figure 9

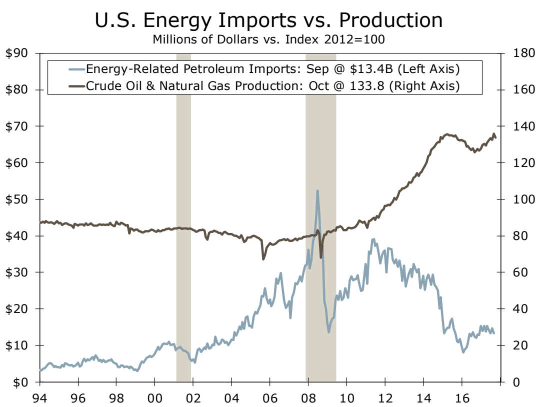
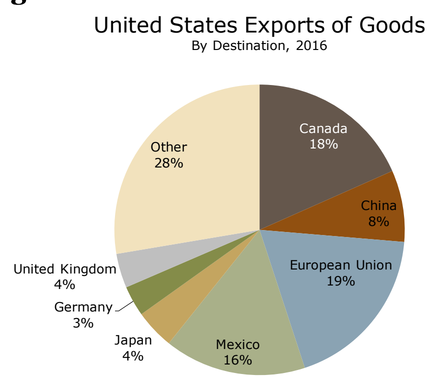


Figure 10



Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities

Canada is the top export market for the United States.

From the United States perspective, the Canadian market is less important as a destination for exports (about 18 percent of U.S. goods exports are sent to Canada). Nevertheless, Canada is the top export market for the United States nationally and for 32 of the individual U.S states. According to the U.S. Department of Commerce, goods exported to Canada supported 1.2 million American jobs in 2015.[2] In addition, while the United States has a moderate goods trade deficit with Canada ($11 billion in 2016), on the services side the United States enjoys a $24 billion trade surplus. The point here is that if trade barriers were erected, Canada would not bear the higher costs alone. On both sides of the 49th parallel, there are tremendous incentives for free trade negotiations to succeed.

The US-Canada Relationship: Beyond Just NAFTA

Canada and the United States have deep cultural and economic ties that exist for reasons beyond any single trade agreement. As United States President John F. Kennedy said in 1961, "geography has made us neighbors. History has made us friends. Economics has made us partners. And necessity has made us allies." More than 50 years later, these words remain true.

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[1] Currency fluctuations also play a role in the decline in U.S. energy import share over the last few years. Since crude oil is priced in US dollars, a period of dollar strength (e.g. late 2016) reduces the value of energy imports, and thus their share of total imports.

[2] Rasmussen, C. & Xu, S. (2016). *Jobs Supported by Export Destination 2015*. U.S. Department of Commerce, International Trade Administration, Washington, D.C.

The Canada-U.S. border is the longest undefended border in the world, and is crossed daily by 554,000 trains, buses, trucks and cars. About 780,000 Americans were born in Canada and 12,700 Canadians immigrate permanently to the United States every year. Travelling the opposite direction, around 2,500 American immigrants settle permanently in Canada each year, joining more than 316,000 American-born Canadians. While Canada and the United States welcome far more immigrants from other countries than from each other, the exchange of ideas across the Canada-U.S. border has an important effect. Immigration between the two countries tends to be among educated professionals, with more than 50 percent of Canadian immigrants to the United States holding a bachelor's degree or higher (compared to a third of Americans and 25 percent of Canadians). "Brain churn" between the United States and Canada has closely connected the countries' people and economies through networks of family and knowledge, beyond the exchange of goods.

Co-operation between the United States and Canadian governments also extends far beyond trade. North American Aerospace Defense Command (NORAD), a collaboration between the U.S. and Canadian militaries, protects the airspace of both countries. Meanwhile, both countries are signatories in the North Atlantic Treaty Organization (NATO) and partners in many other international organizations and causes.

It is important not to lose sight of the depth and longevity of the Canada-U.S. relationship.

Concerns about the future of NAFTA are well-founded given the importance of trade between Canada and the United States, especially for Canadian exporters. However, it is also important not to lose sight of the depth and longevity of the Canada-U.S. relationship. The re-negotiation of one trade agreement will not upend centuries of co-operation between the two countries and the strong mutual economic and cultural ties that currently exist.

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