NAFTA Disruptions: Possible Impact on the Canadian Energy Sector

- **A US-led disruption in NAFTA would be expected to have limited impact on the Canadian energy sector.**
- **Even if bilateral Canada-US trade were to move away from NAFTA terms and to relatively low fuel-sector Most Favoured Nation (MFN) tariff rates, an anticipated initial depreciation in the Canadian dollar could generate net benefits for the Canadian energy sector.**

See Scotiabank Economics' NAFTA homepage for more NAFTA-related research.

US withdrawal from NAFTA would likely be a long process that could see NAFTA tariff preferences (i.e., tariff and non-tariff barriers) unchanged for years.

- The US President does not have clearly unfettered authority to withdraw the US from an international trade agreement such as NAFTA. A move by the White House to invoke NAFTA's withdrawal clause, Article 2205, would require an initial notice period of six months. Following this notice period, the US may withdraw from NAFTA, but in contrast with the European Union's Article 50, the US would not be compelled to do so. If the White House did move to withdraw, this action would likely be stayed under an injunction while challenges to its constitutionality proceed through the legal system. This could take up to two years and NAFTA's tariff preferences would remain in place during this time.
- Uncertainty regarding NAFTA's future could exert a chilling effect on investment in Canada's economy, but this should be limited for the energy sector since a disruption in NAFTA would be expected to have only minimal impact on the sector.
- If these legal challenges prove unsuccessful and the White House goes forward with withdrawal, the initial effect would be to end US participation in NAFTA's Chapter 11 Investor-State Dispute Settlement (ISDS) framework and Chapter 19's tribunals for trade disputes. A wholesale, across-the-board change in US tariffs, however, would require Congressional action, which may not be forthcoming. NAFTA tariff preferences would still remain in place until Congress acts to change them.

Revival of the Canada-US Free Trade Agreement—while possible—is unlikely. Bilateral trade between Canada and the US is more likely to move to MFN tariffs in the event of a US withdrawal from NAFTA.

- Revival of the Canada-US Free Trade Agreement (CUSFTA) would require Congressional action: it would not be automatically revived on US withdrawal from NAFTA. It is unlikely that the current White House would find a return to CUSFTA terms palatable since tariff schedules under NAFTA have largely converged with those that would be prescribed under CUSFTA.
- In the absence of a trade agreement between Canada and the US, both countries' commitments under their membership in the World Trade Organization (WTO) imply that they would move to the imposition of their respective Most Favoured Nation (MFN) tariffs on their bilateral trade (see table 1 at top of next page).

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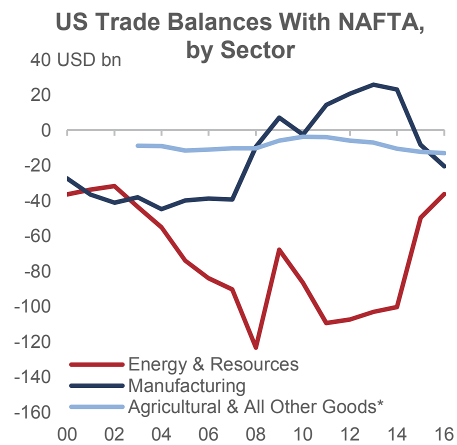
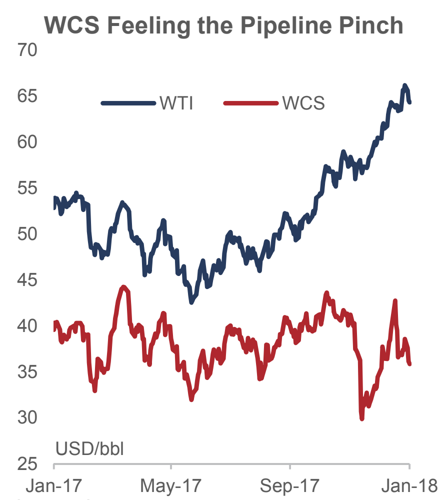
Chart 1



Sources: Scotiabank Economics, US Census Bureau.
* data on printing products not available pre-2003.

Chart 2



Source: Scotiabank Economics, Bloomberg.

Table 1

Weighted Average Most Favoured Nation (MFN) Tariff Rate for All Products, 2016

Imports from:	Canada	Mexico	US	World	Avg NAFTA
Canada	-	2.92	3.33	3.20	3.13
Mexico*	5.76	-	4.94	4.45	5.35
US	2.24	3.83	-	2.80	3.04
Avg NAFTA	4.00	3.38	4.14	3.48	**3.84**

Sources: Scotiabank Economics, WorldBank World Integrated Trade Solutions.
*2015 tariff rates.

If Canada-US trade were to move to MFN tariff rates, the US would put itself at a broad disadvantage.

- The overall weighted average of US MFN tariffs on all imports from Canada, at 2.24%, is lower than Canada's 3.33% weighted average MFN rate on all imports from the US (see table 1 above).
- Note that energy & resources have accounted for the lion's share of the US goods trade deficit with NAFTA countries over the past decade; the US energy boom and the associated collapse in energy prices has recently narrowed this gap (chart 1).

Currently, the effective tariff on Canadian oil exports to the United States is 0%, as one would expect for a country that has traditionally imported oil.

If the US were to withdraw from NAFTA, one of two likely scenarios would be expected to unfold for the Canadian energy sector.

- **Scenario 1 (90% probability).** Owing to US refineries' continued demand for Canadian crude, a special exemption would likely be created for Canadian petroleum products in whatever trade arrangement follows NAFTA to ensure the US effective tariff rate would remain at or near 0% for these goods. This would represent a continuation of current market conditions. On a side note, US withdrawal from NAFTA would likely be accompanied by an initial depreciation of the CAD that would see it initially overshoot below fair value, which we estimate to be around CADUSD 0.81. This would increase the value of energy sector revenues in CAD terms, but increase the cost of equipment imports for the sector; the net result would likely be positive at least until CAD corrected over time back to fair value.
- **Scenario 2 (10% probability).** Bilateral US-Canada energy-sector trade could instead be moved to MFN tariff rates. The broad "Fuels" category has a weighted average US duty of 3.12% (2016), but crude oil exports (not products) have a listed US MFN tariff rate of between US$0.0525–0.21 per barrel. This tariff would be paid by the US entity importing oil, but the economic burden of the tariff would depend on the extent to which there are easy substitutes for this Canadian crude:
    - ◊ If US refiners could easily find other sources of similar crude, the price charged by Canadian suppliers on exports to the US would have to fall by the full amount of the tariff. For example, WCS is currently trading around US$36/bbl while WTI is trading near US$64/bbl (i.e., a US$28/bbl discount, see chart 2); the application of a US$0.0525–0.21 per barrel US MFN tariff would force the discount wider by the amount of the tariff on exports to the US. The economic incidence of the tariff would fall wholly on Canadian oil producers; or
    - ◊ It's more likely, however, that at least part of the economic burden of the tariff would have to be borne by US refiners. Mexican and Venezuelan production—the other two sources of US heavy crude imports—are in decline, which limits the extent to which substitutes for Canadian crude could be easily found. Canadian producers would not have to absorb the full cost of the MFN tariff to remain competitive and the WCS discount into the US market would not widen by the full amount of the tariff.
    - ◊ As in Scenario 1, US withdrawal from NAFTA would be expected to have an immediate and negative impact on the CAD, which would increase the value of oil revenues in CAD terms, but also raise the cost of equipment imports. Again, the net effect could be positive, at least until CAD corrects over time to fair value, which we estimate to be around CADUSD 0.81.

Canada and Mexico could decide to maintain NAFTA to govern their bilateral trade and investment relations. While bilateral Canada–Mexico trade and investment flows are relatively small, keeping NAFTA alive would ensure, amongst other things, that Canadian direct investments in Mexico would still be covered by the NAFTA Chapter 11 ISDS framework. It would also keep alive an opportunity for the US to return to NAFTA at some future point.