USMCA: More Name than Game Changer


Aaron Goertzen, CFA
Senior Economist
aaron.goertzen@bmo.com
416-359-8229


Sal Guatieri
Senior Economist
sal.guatieri@bmo.com
416-359-5295


Alex Koustas
Senior Economist
alexandros.koustas@bmo.com
416-359-4624

After the USMCA was signed in late September, we concluded that the deal implied some upside for Canada's economy by removing a big cloud over businesses.[1] In this note, we turn our sights on the U.S. economy—**assuming, of course, the deal is ratified by all three legislatures**. House Democrats want to change labour, environment and drug provisions, while Canada and Mexico are miffed about ongoing metal tariffs. As a result, the deal is unlikely to be passed this year and may not be until after the 2020 presidential election.[2]

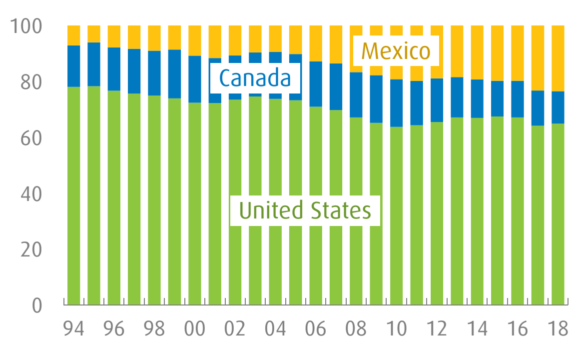
To provide a basis for Congress' ratification vote, the International Trade Commission has been working on a study titled *"Likely Impact on the U.S. Economy and on Specific Industry Sectors"*. The report was scheduled for release in mid-March, but has been delayed, likely due to the immense challenge of adding up the costs and benefits.

Our sense is that the deal will have a **modest positive impact on the U.S. economy**, largely by re-incentivizing some vehicle production and raising agricultural sales, mostly dairy products to Canada. As the new trade agreement is largely a modernized version of the old NAFTA, the full impact should be limited, and the U.S. trade deficit will likely stay large. However, it will remove one avenue of trade-policy uncertainty for businesses.

The USMCA's **provisions for the auto industry** are no doubt aimed at Mexico, whose share of the North American market has grown steadily (*Chart 1*). However, the **effectiveness of the provisions** in raising or even preserving American (and Canadian) production is **questionable**. A side letter outlining production thresholds on Mexican passenger vehicle output (to avoid tariffs under Section 232) is a moot point, as the majority of American automakers have cancelled most of their domestic passenger vehicle line-ups in the interim, while some have shuttered plants. Trucks are excluded from the provision, which is arguably a more important segment insofar as future production allocations are concerned. It should also be noted that the threshold placed on Canadian supply is well above current capacity, **so it is highly unlikely to be binding**. Under the deal, content regulations have been tightened, as have standards and supervision. Domestic content thresholds will rise from 65% under the net cost method to 75% by 2023, which should provide some modest support to U.S. parts producers. Steel and aluminum thresholds have also been set at 70% USMCA content; raising costs but ostensibly supporting local producers.

However, the most targeted auto industry measure is the **labour-value content provision**, which will scale from a minimum of 15% of high-wage material and manufacturing expenditures (set at US$16) in 2020 to 25% by 2023. While this could be an issue, note

Chart 1
Mexico Motoring
North America (% of total)
Motor Vehicle Manufacturing Share



Sources: BMO Economics, Wards Intelligence

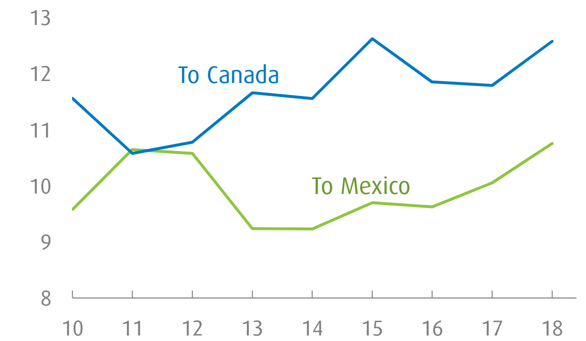
[1] BMO Economics Special Report: *NAFTA 2.0: How Do You Spell Relief? U-S-M-C-A*. October 4, 2018. https://economics.bmocapitalmarkets.com/economics/reports/20181005/sr20181005-usmca.pdf

[2] President Trump has threatened to tear up the old NAFTA if the new deal isn't ratified, so the status quo may not be an option, either.

that Mexican goods (which are exempt from Section 232 tariffs under the side-letter agreement) could still be imported at a very low WTO tariff if they do not meet the threshold. Recent investment activity indicates that Mexico remains an attractive place for truck manufacturing even with the prospect of tightened standards.

The USMCA should be **positive for U.S. agriculture**. Most importantly, it removes the risk of farmers losing preferential access to Canada and Mexico, which together account for nearly one-quarter of U.S. agriculture exports (*Chart 2*). Over time, the deal also opens up 3.6% of the Canadian dairy market and about 1%-to-1.5% of the poultry and egg markets to tariff-free U.S. exports. Canada has further agreed to align its pricing for non-fat milk solids with U.S. benchmarks and curtail exports of such products, which will create opportunities for U.S. dairy producers. In the grain space, Canada has agreed to modify its grading rules in a way that will put U.S. wheat on an equal footing with Canadian product.

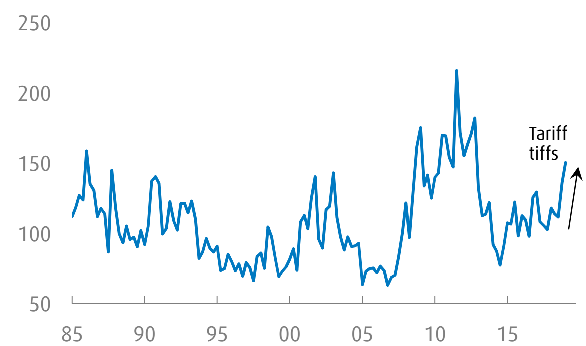
Chart 2
Hey, Big Spenders
United States (% of total agricultural exports)
Agricultural Exports



Sources: BMO Economics, Office of Trade and Economic Analysis

U.S. retailers, especially online sellers, could benefit somewhat from higher duty-free limits on Canadian and Mexican purchases of American goods. Retailers would see both higher sales and lower administrative costs for customs clearance. The deal raised the threshold value of Canadian imported goods purchased online or via mail order that qualify for duty-free access from C$20 to C$150, with goods valued at less than C$40 also exempt from sales taxes.[3] However, given the low-valued Canadian dollar (below so-called purchasing power parity), it's unlikely that Canadians will be in any hurry to crank up purchases.

Chart 3
Tariff-ic Uncertainty
United States (1985-2009 = 101)
Economic Policy Uncertainty Index



Sources: BMO Economics, Haver Analytics

No doubt, the **best thing about the deal is that—if and when it's ratified—some uncertainty over trade policies will ease** (*Chart 3*). Surveys of U.S. business leaders suggest the broad trade war has delayed investments and led to supply delays and disruptions. However, it's not possible to isolate the impact of uncertainty arising from NAFTA last year (and delayed ratification since then) and other trade battles, in particular tariffs imposed on China and threatened actions against the European Union. Moreover, the impact of uncertainty has been allayed by the strong push from tax reform and deregulation. In fact, real private non-residential investment rose 7.2% in 2018 (Q4/Q4), faster than in the prior three years. With the lift from tax reform fading, USMCA ratification would bolster confidence and help temper an expected slowing in investment this year.

Bottom Line: The USMCA would provide a modest lift to the U.S. economy via firmer exports of dairy products and grains, improved business confidence, and support for the domestic auto industry as it adjusts production amid late-cycle conditions. While it's not a game changer by any means, ratification would clearly mark a step in the right direction given the many other risks on the trade-policy front.

---

3 Mexico agreed to a US$117 tariff-free threshold (up from $50) and a $50 tax-free threshold.