The Comprehensive Economic and Trade Agreement: A 2016 Update
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In February 2016 the legal review of CETA concluded, making room for the agreement to be ratified between Canada and the European Parliament. With the approval of the deal currently at risk, we revisit the trade agreement with an update to our original report released in October 2013.

Overview

The Comprehensive Economic and Trade Agreement (CETA) announced by Canada and the European Union is an agreement in principle to promote bilateral trade by eliminating tariffs and reducing non-technical barriers to support the flow of goods, services, investment and labour. The ratification of the deal is currently in balance and some details underlying the negotiated terms still remain vague. As a result, the full implications of the deal are difficult to fully assess. That being said, a broad outline of the proposed deal indicates the benefit for the Canadian economy is potentially significant and thus, a failure to ratify would be a notable loss for Canada. A number of sectors will be offered greater trade opportunities though some offset will occur in areas that need to adjust to greater foreign competition. This brief note aims to provide an overview of the trade agreement as it currently stands to gauge the potential impact on the Canadian economy and the extent to which the deal will alter the comparative landscape of various key sectors in Canada.

Given the export-oriented nature of Canada’s economy, widening the channels for trade with the European Union—which accounted for 16.9% of world GDP in 2015—will likely provide a net benefit to Canada over the longer term. Potential economic benefits cited by a joint Canada-EU study that supported the launch of trade negotiations in 2008/09 included a projected 20% boost to bilateral trade and a $12 billion annual increase in economic activity—roughly a 0.7% lift to Canadian GDP each year. Given the lack of details for the deal however, it is difficult to verify these claims.

The European Union is Canada’s second largest export destination although accounts for a considerably smaller share than its largest partner, the U.S. Of the $525.3 billion in goods Canada shipped abroad in 2015, merchandise exports to the EU comprised $39.5 billion (including $16.6 billion in goods to the UK). Imports from the EU to Canada totalled $53.0 billion resulting in a $13.5 billion trade deficit ($8.6 billion in imports from the UK).

In 2015, Canada ranked 11th in major trading partners with the EU which was led by the United States, China and Russia. Canada absorbs 2.0% of EU exports and supplies 1.6% of the region’s imports – both equivalent to ~0.2% of GDP for the EU. The degree to which Canada is integrated into the market has shifted slightly over the past five years – EU exports to Canada have grown slightly above the growth in exports to the rest of the world (7.8% vs. 5.8%), however, import growth was below the average
growth from the rest of the world (2.7% vs. 3.0%), a disappointing development for Canada’s export sectors.

The service sector accounts for more than 70% of economic activity in Canada and international trade in services equated to 5.2% of the country’s GDP in 2015. CETA aims to promote the flow of services including management services, engineering and technical services and computer and information services through provisions such as the mutual recognition of professional qualifications. In 2014, service receipts from the EU totalled $19.9 billion and relied heavily upon commercial services followed by transportation and government services and travel receipts. In exchange, payment to the EU for services rendered in Canada totalled $24.9 billion resulting in Canada running a modest services trade deficit.

**Sectoral Analysis**

Despite an overall net positive for the Canadian economy, the impact will vary within and across industries depending on how firms adapt to the changing trade environment. Canadian goods entering the EU are subject to approximately 9000 tariff lines which over a period of seven years following implementation will largely be phased out (99.6% of non-agricultural tariffs eliminated immediately, rising to 100% over 7 years and transition periods of 3, 5 and 7 years will eliminate 94% of agricultural tariffs over the same period). The negative hit from the trade agreement will be evident in industries that benefit from protective tariff barriers – as imports will now be coming into Canada at lower prices. While details on industry specific measures are limited, preliminary provisions in the agreement provide insight into potential opportunities and challenges facing key industries.

**Raw minerals**

Mining, oil and gas products accounted for 41% of Canadian exports to the EU in 2015. This largely consisted of gold and silver ore (27% of total exports) as well as other non-metallic minerals, iron ore, copper, nickel, lead, zinc and coal (11%). Under current trade conditions, most raw materials entering the EU are not subject to any tariffs. The products that do not enter the region duty-free are metals and minerals that are processed and are included in manufactured exports – these include non-ferrous metals and make up 7.1% of EU imports from Canada. As a result, a preliminary review of the deal suggests a minimal impact to most commodity exports with a positive boost likely for processed goods as 99.3% of industrial good tariffs will be eliminated upon implementation, rising to 100% over 7 years (For example, EU tariffs on forestry products will be eliminated upon implementation of the deal).

Despite the release of a technical summary, it is not clear the extent to which oil and gas exports from Canada will face discrimination under the EU’s proposed Fuel Quality Directive – a set of proposed rules to penalize greenhouse gas intensive fuels upon entry into the region. The concern lies with the potential for precedent to be set with other trading partners and not with the direct impact on Canadian oil and gas exports to the EU as they are limited. With that said the capital intensive industry is expected to benefit from a relaxation of rules for foreign investment in Canada (see below).

**Update:** The European Commission agreed in 2014 to label crude oil...
from the Canadian oil sands with the same emission value as other conventional oil products. This removed a key barrier to Canada shipping crude oil to Europe under CETA.

**Agricultural Industries**

Canadian exports from agricultural, fishing and hunting industries accounted for 6.8% of exports to the EU in 2015. Wheat exports accounted for a sizeable share of these exports (2.3% of total) followed by soybean farming (1.4%) and seafood products (1.3%). With average tariffs on agricultural goods entering the EU of 13.9%, the elimination of these levies would support increased access to the EU market. The European Union will eliminate 93.6% of tariffs for Canadian goods including on maple syrup and fresh, frozen or processed fruits and vegetables – although additional product details are limited. Tariff elimination for wheat exports is of greater consequence for Canada, however. Over the 7 year implementation period, current duties for grain products will be phased out including the $190/tonne and $122/tonne for durum and high quality wheat, respectively. In the meantime, a transitional duty-free quota of 100K tonnes will be implemented for low-to-medium quality wheat. Finally, where tariffs remain across agricultural sectors following the implementation of the deal, subsidies will be allowed – providing protection for these yet to be identified industries.

Canada’s supply management system that includes controls on production, imports and prices for eggs and poultry will remain unchanged. According to the federal government, the vast majority of supply managed products will be exempt from increases in market access. This is not to say that certain agricultural sectors will not be affected. For the dairy industry, the milk protein substances tariff will be phased out; however, Canada will gain duty-free, quota-free access to the EU market. Cheese products from the EU will have greater access to the Canadian market with the current import quota expected to be raised by 17k tonnes annually though the timeframe remains unclear. In exchange for the protection of supply managed goods, the European Union will maintain an ‘entry price system’ restricting the import of various fruits and vegetables.

*Update: Canada was concerned with preserving Canadian trademarks, notably for cheeses and cured meat products; but agreed to open the door to geographic indications in agricultural products. For example, producers in the future will have to add “style”, “manner” or “imitation” when referring to some cheeses: feta, gorgonzola, asiago.*

For meat products, CETA is expected to establish “tariff rate quotas” allowing Canadian farmers duty-free access to the EU market including 81K, 50K and 3K tonnes of pork, beef and bison, respectively that is expected to be a net positive for the industry. Finally, the European Union is the largest importer of seafood in the world (40% of trade activity in the industry) with Canada’s share of seafood exports to the EU above 10%. With current tariffs averaging 11% in the industry, reducing the impediments to the free flow of seafood products and creating greater market access (with 95.5% of tariffs to be eliminated) would be of particular benefit for exporters of shrimp, lobster and other seafood.

**Wine**

Under CETA, some areas of activity in Canada are expected to receive ‘special recognition’ where the origin of the product confers a particular
quality or character including wine and spirits. Wine imports make up ~2% of Canadian imports from the EU and lower prices would make these foreign goods more competitive in the Canadian market. A specific provision is included in CETA, however, that will allow Canadian wineries to continue to sell only their own products on site and at small off-site stores.

**Government Procurement**

According to the federal government, the European Union government procurement market is estimated at $2.7 trillion – 18% of which are contracts for business services. Under the CETA provisions, Canadian firms will have access to bid on contracts from the European Commission, EU Parliament and European Council, 28 member states, regional and local government entities and entities in the utilities sector. Similarly, the deal will allow European firms to bid on contracts in Canada, with some exceptions – notably defence contracts, research and development, Aboriginal business, education, social and health care services. In the EU, Canadian firms will be excluded from bidding on contracts for broadcasting, shipbuilding, postal services and ports and airports. As well, the government can give preference to Canadian companies through grants, loans and fiscal incentives and continue to determine selection criteria. Thus, it is possible for the EU to impose similar restrictions and limit access to the procurement market in the EU. As it currently stands, Canada is likely to be a net beneficiary of this segment of the agreement as its exclusions are much broader in scope than those imposed by the EU.

**Foreign Direct Investment**

In 2015, the European Union represented the second largest source of FDI in Canada at approximately $242 billion – or 31% of total FDI into Canada. Similarly, the European Union served as the second largest destination for Canada’s direct investment abroad at $210 billion - or 21% of Canadian direct investment. Under CETA and in conjunction with the Investment Canada Act, the investment thresholds requiring formal review will be raised from $344 million to $1.5 billion for EU investments. Moreover, as a result of the EU/Canada trade agreement, the investment thresholds will increase correspondingly for the US, Mexico and other countries for which Canada has a trade agreement in place. The motivation behind this change is to promote the ease for which smaller investments can be made in Canada. That being said, the government will continue to enforce the ICA by conducting reviews of ‘high value investments’ to ensure that they are of net benefit to Canada. Decisions on whether to permit such an investment or not will not be subject to CETA provisions.

**Auto Industry/Rules of Origin**

Despite its place as the second largest Canadian export, automobile exports have limited penetration in the European marketplace – engines, turbines and power transmissions make up 2.6% of exports to the EU, the largest export component related to the auto industry. While the elimination of a 10% tariff on passenger vehicles into the EU could stimulate a slight pick up in demand for Canadian autos in the EU, the impact is likely to be mostly felt on this side of the Atlantic. The phasing out of the 6.1% tariff over 7 years will likely be passed down to consumers through lower prices, which may benefit EU imports of vehicles. That being said, European auto imports to Canada (representing 9.2% of Canadian imports from the EU – the 2nd largest good) are highly concentrated in luxury products and make up a relatively small market share. Moreover, as the tariffs are expected to be phased in over a period of 3 to 7 years, Canadian auto manufacturers will be able to adapt over time to potential changes in their industry as a result of the agreement.

An issue that has been raised however is that of CETA’s ‘rules of origin’ that specify how much production must occur in a region for the product to be considered as ‘originating in’ Canada or the EU. As outlined in the agreement, preferential tariffs will be provided to vehicles with higher Canadian content (50% or more will be duty-free falling to 45% over 7 years; if 20% Canadian made, will be limited to 100K units). The impact will depend on how content classification is determined – if restricted to ‘in-vehicle’ content, the benefit will be minimal as there is less than 10% Canadian labour in a vehicle. If an EU-US trade agreement arises, however, auto parts made in US that are used as inputs in Canadian motor vehicle production will be considered as originating in Canada and will receive preferential treatment. Overall, firm details on the agreement will provide greater insight as the deal is currently vague - with provisions that aim to “strike a balance to respect real-world sourcing patterns” while also encouraging Canadian production.

*Update: ‘Rules of origin’ in the final agreement are based on standard EU roles with notables exceptions for vehicles, textiles, fish and some agricultural products. A limited quantity of Canadian exports in these groups will be exempt from the rules of origin; export volumes in excess of these quotas will be subject to EU rules. The agreement also notes that “a future rule of origin cumulation with the US for vehicles” is possible if the Transatlantic Trade and Investment Partnership is finalized.*

**Temporary Foreign Workers/Promotion of services trade**

All services are expected to be covered by the trade pact unless a service is specifically excluded from the deal. For Canada, services that are off limits to foreign suppliers include those encompassed in the health care sector, public education and social
services. It is unclear at this point which sectors will enforce similar restrictions in the EU though preliminary documents suggest unimpeded access to all sectors. CETA will also include temporary entry provisions to make it easier for highly skilled professionals to work in the EU and Canada. According to the agreement, the EU commitments for temporary entry under CETA will be ‘extensive’ and will allow for greater transparency in licensing and will streamline the recognition of professional qualifications – an issue that Canada continues to face with interprovincial trade.

For financial services, the agreement is void of details apart from “Canadian banks with investments in the EU will benefit from enhanced investment protection and further access to the EU market”. This investor protection includes an investor-state dispute settlement to allow for enhanced consultations and new mediation provisions to promote the efficient resolution of such disputes. While provisions in the agreement aim for the fair and equitable treatment of investors, the governments retain the right to take prudential measures to ensure the integrity of the financial system. Finally, the largest import into Canada from the EU is for pharmaceutical and medicine manufactured goods which make up 10.7% of imports from the EU. The terms of CETA will continue to extend protection for the pharmaceutical sector providing 8 years of market exclusivity. Additional protection beyond this timeline will be extended for pharmaceutical products for up to 2 years in Canada and 5 years in the EU. If the terms of this agreement result in negative impacts for provincial/territorial governments, the federal government is prepared to address these incremental cost impacts.

**Update:** The final terms provide a guarantee to financial service providers that the existing framework will not become more restrictive. For Canada, this relates to the provision of cross-border insurance, reinsurance and intermediation, as well as portfolio management services. Exemptions to this relate to “sensitive sectors” where the EU can introduce discriminatory measures in the future; these include public monopolies, public utilities and public services: education, health, water supply.

**Investor-dispute settlement mechanism:** The final negotiations resulted in a bilateral system of dispute settlement with a panel of three arbitrators to be selected from an approved list (NAFTA was a model for the provisions). As a result, CETA marks a step forward in the field of dispute settlement: investors will benefit from increased protection as well as recourse against a State should they suffer a loss resulting from a State’s violation of the agreement.

### Economic Implications of CETA

Given the relatively small share of exports currently going to the EU combined with the long implementation process and a view of sluggish growth in the region, there will be little noticeable economic impact for Canada over the short-term. As it stands, ratification of the deal remains in balance. If successful, the full impact of the trade deal will not occur until all provisions come into effect which is likely to be 7 years after the trade pact is finalized.

From an economic perspective, details on the terms of the agreement are still too vague at this point to precisely quantify the potential impact on the Canadian economy. Further, the impact will vary within and across industries depending on how firms adjust to the changing trade environment. For goods exporting industries, tariff elimination will open up new markets for fish, seafood and agricultural products as well as duty-free access for forestry and wood products, nickel, copper, steel, and zinc. Aside from the benefits to the goods trade, changes associated with the CETA will also impact services exports, paving the way for improved access for professional services.

A greater transition cost from the trade agreement will be evident, however, in those industries that have benefitted from tariff barriers and will have to compete with lower cost imports – potentially cheese, wine and motor vehicles. That being said, a successful transition opens the door for firms even operating within these industries to benefit.

### Notes

1. Additional exclusions include: contracts less than $1M for regional economic development in the Atlantic provinces, MB, and the Territories; agricultural goods; broadcasting, shipbuilding; ports and airports, public private partnerships for services and utilities; sensitive goods for security-mandated entities, goods or services used for promotional purposes by BC, AB, QB and the Atlantic Provinces.

2. Quebec and Ontario are to retain a 25% value for the procurement of public transit vehicles with Quebec able to require that final assembly be in Canada within its 25%.


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