Softwood lumber: A shot across the bow?

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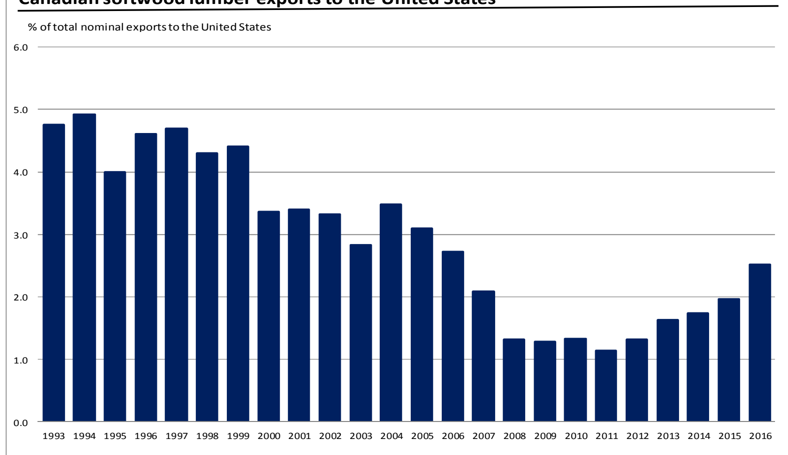
During last year's U.S. election campaign, much of the trade talk focused on Mexico and China. But the administration's first major import duties were against Canada—the latest salvo in the long-running softwood lumber dispute between the two countries. The trade action didn't come as much of a surprise, and is likely to have a limited impact on the broader Canadian economy. But with the U.S. even threatening a full withdrawal from NAFTA, further signs of a breakdown in the bilateral trade relationship are significant.

A sign of things to come?

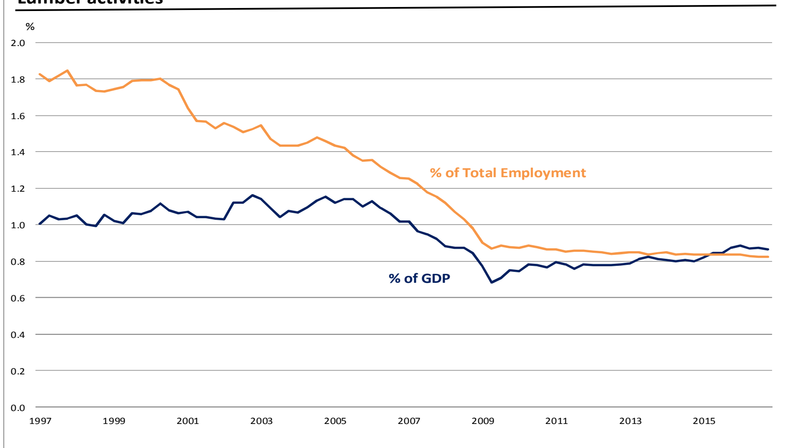
The October 2015 expiration of the 2006 Softwood Lumber Agreement, and the termination of a subsequent 12-month 'standstill' period, enabled the U.S. to again allege unfair practices in the Canadian lumber industry. On April 24, it slapped 20% average duties on softwood lumber imports from Canada, with fees to be collected retroactively for the past 90 days. The U.S. asserts that the 'stumpage fees' charged to Canadian producers for use of provincial Crown lands are artificially low, and allows Canadian producers to sell their product at below 'fair value' into the U.S. market.



Canadian softwood lumber exports to the United States

Source: Statistics Canada, RBC Economics Research

The Canadian government contends that this view has been disproved repeatedly by international tribunals since the 1980s. While softwood lumber accounts for only a small share of Canadian economic activity and overall exports to the U.S., the shift in tone from our largest trading partner could be a sign of how aggressive the new administration will be in any NAFTA renegotiation. A deterioration in the long-standing bilateral trade relationship could have significant implications across industries.



Lumber activities

Source: Statistics Canada, RBC Economics Research
* Forestry & logging, wood product manufacturing

First, sizing softwood

Countervailing and anti-dumping duties raise the price of Canadian lumber in the U.S. market, dampening demand and adding to the headwinds Canada's forestry sector has faced over the past two decades. Softwood lumber accounted for nearly 5% of total Canadian exports to the U.S. in the early 1990s when NAFTA came into force, but dropped to 1% when the bottom fell out of the U.S. housing market during the 2008/09 recession. Exports gradually recovered, and Canada shipped C$9 billion of softwood lumber products to the U.S. in 2016. This represented 2% of total exports to the U.S. and about 0.4% of Canadian GDP.

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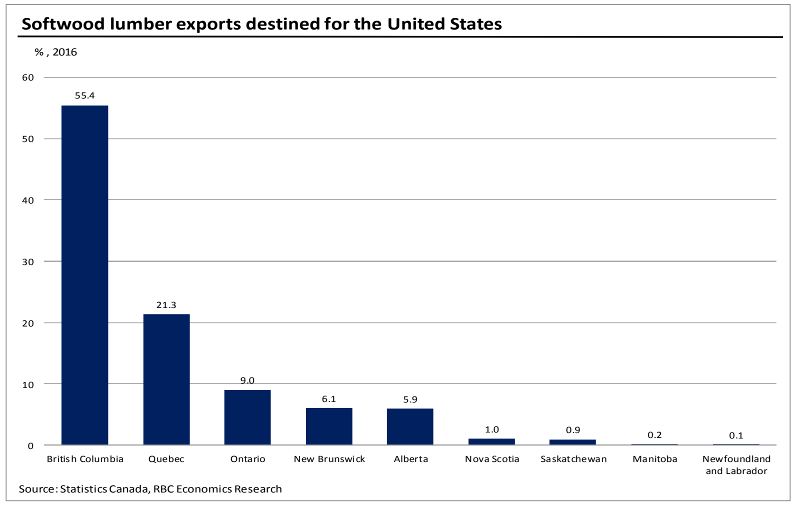
The impact on the broader Canadian economy is likely to be minor, given that forestry, logging and wood manufacturing production represents 1% of Canadian GDP. The share is larger in British Columbia—where more than half of Canadian softwood exports to the U.S. originate—although softwood exports to the U.S. account for just 2% of B.C.'s economy. The shares are even smaller in New Brunswick, Quebec and Ontario.

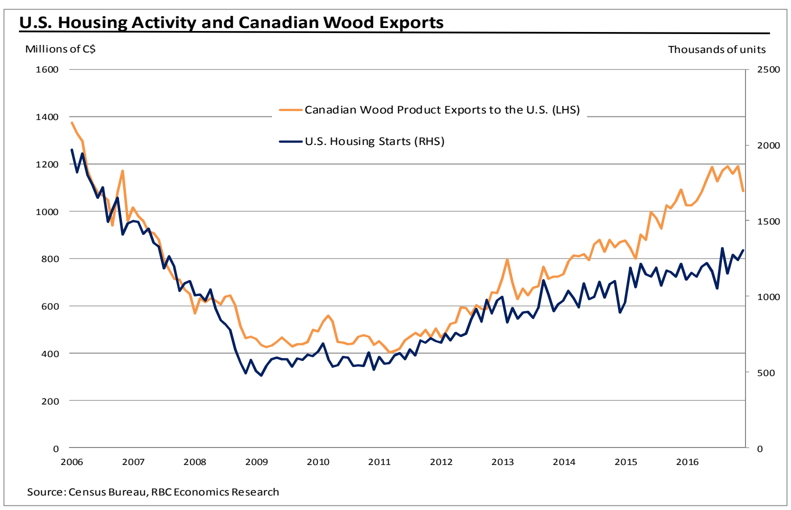


U.S. homebuilders rely heavily on our lumber

One-third of the lumber used in the U.S. in 2016 was imported, 95% of it from Canada. As a result, the imposition of 20% tariffs on wood products from Canada will drive prices higher for U.S. homebuyers, consumers and businesses. The National Association of Home Builders estimates that the increase in the price of lumber will add close to US$3,600 to the price of a home in the U.S.

More worrisome: broader trade implications

The April 24 announcement of tariffs on softwood lumber has raised some concern that the new administration will take a more aggressive stance in NAFTA renegotiations. Those concerns were exacerbated by reports that the Trump administration was preparing an executive order to withdraw the U.S. entirely from NAFTA, although the White House moved to play down that possibility.



Which sectors could be at risk?

Many Canadian industries are highly exposed to U.S. demand for intermediate inputs. They tend to be concentrated in goods-producing sectors, although natural resources sectors also export products that serve as inputs in U.S. finished goods. Services from Canada to the U.S. could also be at risk, since services trade between the two countries has more than doubled since the implementation of NAFTA, exceeding C$123 billion in 2015.

The U.S. administration's anti-free-trade rhetoric has centered on industries that run large trade surpluses with the U.S. Canadian industries that run an annual trade surplus of C$1 billion or more—and thus highly exposed to trade renegotiation—are predominantly manufacturing-related and include some components of mining activity as well.

The motor vehicle sector is one target, given its significant trade surplus with the U.S. The U.S. administration is likely to push for at least some changes, particularly around 'rules of origin'. But deeply integrated supply chains that run across the border limit the chances that a significant trade disruption will emerge, given the attendant harm on U.S. industrial counterparts.

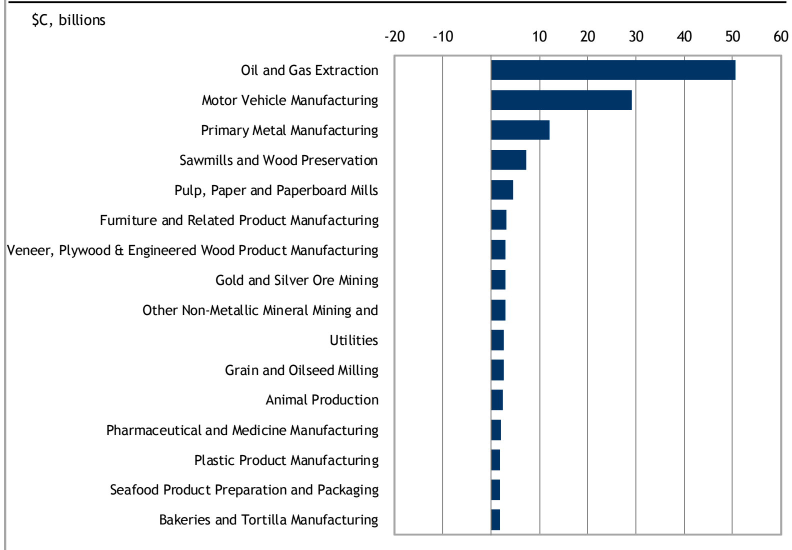
Dairy trade is a longstanding point of contention in Canadian international trade negotiations. But the Canadian dairy sector produces primarily for the domestic market and does not significantly export or import (dairy products account for ~0.1% and ~0.2% of Canadian merchandise exports and imports with the U.S. market, respectively). That limits the extent to which the U.S. can target the Canadian dairy industry directly. More likely: U.S. retaliatory action against other industries.

In recent comments, President Trump lumped energy in with dairy and lumber as sectors where Canada is unfairly competing.

The likely source for the comments is the large energy trade surplus that Canada has with the U.S. (C$50 billion in net oil & gas trade in 2016) as the vast majority of Canada's oil production is exported south of the border. That said, targeted import tariffs on Canadian oil output would generate sharply higher gasoline prices for U.S. consumers in the Midwest, where oil supply is more dependent on Canadian production.

Other sectors that are both relatively trade-sensitive and ran a significant trade surplus with the U.S. in 2016 include primary metals, plastic products, chemicals, pharmaceuticals and seafood products.

Canada/U.S. Trade Balance by Industry (Canada Perspective...)



Source: Statistics Canada, RBC Economics Research

Canada: on guard

Canadian goods and services exports to the U.S. have more than doubled in size since NAFTA's inception in 1994. The U.S. and Mexico were also beneficiaries with trilateral trade increasing more than three-fold over the period, clocking in above US$1 trillion in 2015. Over this time, businesses have benefitted from lower tariffs, greater clarity on trade rules and lower technical barriers to trade, making the outright dissolution of NAFTA a scary proposition. The consequences would be significant across all three countries. The softwood lumber development may have been a shot across the bow. But President Trump has shown a willingness to reverse an earlier position. He may have a change of heart once again.