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The great trade debate

Threat of protectionism grows

August 21, 2009 – The widely broadcast displays of back-slapping cheeriness at the NAFTA summit in Guadalajara, Mexico a couple of weeks ago conveyed a message of warm *bonhomie* and poolside-chat informality. The conference has been dubbed the summit of "The Three Amigos," comprising as it did Canada's Prime Minister Stephen Harper, US President Barack Obama, and Mexico's President Felipe Calderón. But as is always the case with political summiteering of this kind, the real story remained largely submerged. And that could have a serious impact on Canadian equity markets.

In fact, the smiley-face, flesh-pressing photo ops against Guadalajara's richly historic backdrop masked deeper – and darker – undercurrents in bilateral trade relations among NAFTA's big three amigos that haven't been seen in some time. And those undercurrents are only one tributary of a larger global trend: trade protectionism. It's become a stubbornly persistent issue, and one we've frequently warned of in these comments.

Of key concern to NAFTA's two junior partners, Canada and Mexico, is the Obama Administration's "Buy American" policy. On the surface, it sounds fairly innocuous. Who could possibly object to calls to support domestic industry, especially during times of economic crisis? However, the US policy requires that recipients of funding from the US$787 billion stimulus bill use only US-made materials in economic stimulus projects. This rules out obtaining materials such as iron and steel, as well as manufactured goods, from, say, Canada.

So far, the "Buy American" policy has been passed into law only for stimulus funding. But it affects state and municipal governments, which have all been climbing aboard the growing bandwagon as it gains momentum. State and local governments, of course, are not bound by international trade agreements like NAFTA, but they are well and truly tethered to the federal government as a source of funding. It's a powerful lever that Washington is never afraid to use.

Mr. Harper and Mr. Calderón argue, correctly, that this is simply trade-protectionism through the back door. Mr. Obama feebly sought to defend against the accusation by blaming unnamed forces at work. "It was not something I thought was necessary," he said, adding, "but it was introduced at a time when we had a very severe economic situation, and it was important for us to act quickly and not get bogged down in debates around this particular provision." However, the "Buy American" provision is, in fact, a cornerstone of the stimulus package, and continues to spread like clover in a green lawn.

Already, Canadian municipalities have resolved to implement a "Buy Canadian" policy if the US restrictions are not lifted by Canadian suppliers by October. Provincial and territorial governments also promised not to retaliate if Washington grants an exemption. Similarly, Mexico issued its own "Buy Mexican" edict, after a simmering dispute brought about by US restrictions on Mexican trucks crossing the border, but this is seen as largely for show.

President Obama avoided promising that the issue would be addressed anytime soon, saying only that he and Mr. Harper had discussed "mechanisms" for cross-border procurement practices. We suspect the discussion was one sided, as Mr. Harper promised to raise the issue again during a visit to the White House in September.

But the range of trade concerns raised at the NAFTA summit is really just the tip of the iceberg. The "Buy American" policy affects all suppliers all over the world, not just in Canada. Taken alone, it would be enough to spur trade retaliation everywhere. But the Americans have cooked up a far larger pot of toxic trade stew that threatens to set off a trade war of the kind last triggered by the infamous Smoot-Hawley Tariff Act of 1930, which succeeded only in transforming what was a steep recession into the Great Depression.

The toxic stew involves a range of trade protectionist measures masquerading as the Obama Administration's green agenda. New fuel-efficiency standards, for example, bar new entrants to the US auto market by virtue of the extreme technology required to meet those standards, something only existing US car companies and government owned zombies like GM can afford. Carbon emission legislation will impose "carbon tariffs" on trading partners who refuse to reduce emissions – and this includes just about everyone.

Naturally, these policies are seen by America's trading partners for what they are: thinly disguised attempts to dictate American policy to other nations. Both India and China flipped the proverbial bird to Secretary of State Hilary Clinton, during her recent tour through Asia and Africa. India's environment minister was particularly incensed, saying, "There is simply no case for the pressure that we, who are among the lowest emission per capita, face to actually reduce emissions." He went on to add, bluntly, that legally binding emissions targets won't be acceptable.

The Chinese, of course, are past masters at playing the trade protectionist game, and also roundly rejected US carbon policy. We've recently witnessed just how intensely China plays the trade game, with the fuss surrounding its abortive bid to buy Australian iron ore company Rio Tinto. Apart from rumors and unfounded allegations of misdeeds, compounded by the arrest of several Rio Tinto executives in China, the imbroglio highlights just how eager the Chinese are to influence the price of various key commodities. The strategy is to attempt takeovers of over large Western resource companies and to create huge stockpiles of key commodities, all in an effort to protect largely inefficient domestic industries such as steel manufacturing or protect supply, as in the case of energy. It’s an old, old, story – let’s not forget that the US is doing the same thing with its moribund domestic auto manufacturers.

In the long run, such moves to trade protectionism are counterproductive, reducing overall trade and prosperity. Trade wars are like cutting off your own hand so your trading partner can’t shake it. Worst case, they lead to prolonged periods of slow or no growth, which, of course, affect the world’s developing countries the most.

Canada happens to be a large exporter of many of the raw materials and finished products that are at the heart of the developing global trade war. Every sector, from energy (especially the oil sands) to metals (iron ore, coal, copper, zinc, etc.) to forestry and lumber would be a casualty of global trade restrictions. A small example of just how devastating such an environment is can be seen in the devastation caused by the softwood lumber dispute between Canada and the US over the past 25 years.

To be fair, Prime Minister Stephen Harper has been busy opening up new bi-lateral free-trade channels in Central and South America, the Caribbean, Asia, and Europe. Most recently, he signed a free-trade agreement with Panama immediately following the NAFTA summit. Mr. Harper’s persistent focus on trade emphasizes the importance the government places on this, and by implication highlights Canada’s vulnerability to rising forces of trade protectionism emanating from Washington.

It’s pretty clear that unless that growing threat of trade protectionism is defused, and fast, Canadian markets are likely to be right at the front line of suffering, albeit mitigated by Mr. Harper’s efforts at increasing non-US trade channels. We don’t recommend any portfolio prescriptions at this time, other than our usual admonition to diversify and invest within your risk zone. However, we’re watching developments closely for any indications that growing trade disputes are beginning to affect earnings growth expectations.■