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The End of NAFTA: What It Means for Canada's Retail Sector

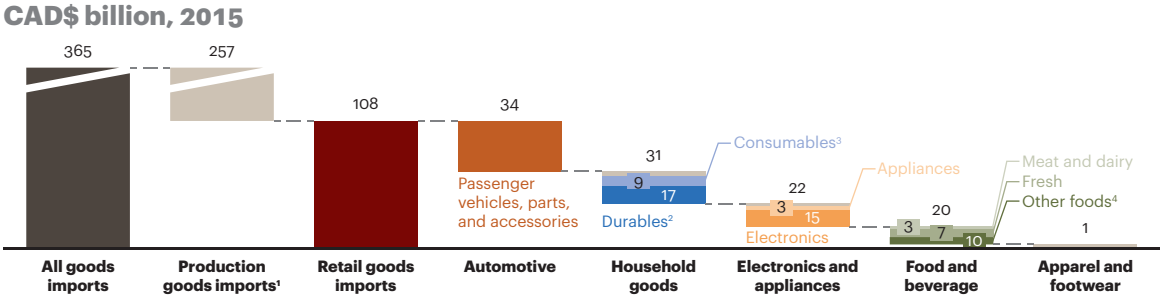
The North American Free Trade Agreement (NAFTA), which has been in force since 1994, may now be in jeopardy. Repeated threats by US President Donald Trump to unilaterally withdraw from the pact were followed by efforts to renegotiate the treaty on terms that are more favorable to the United States. We have thus seen five rounds of talks with no significant breakthroughs. The description of the parties' positions by Canadian Minister of Foreign Affairs Chrystia Freeland as "large conceptual differences" does not bode well for the successful conclusion of talks.

NAFTA, the second-largest free trade agreement in the world, eliminates tariffs on most goods flowing between the United States, Canada, and Mexico. The consensus is that the treaty has been good for all three parties, leading to increased sales, a lower cost of goods, and more jobs. Canadian consumers have benefited from tariff-free access to 94 percent of goods imported from the United States and, according to the Office of the US Trade Representative, there has been a 38 percent real increase in trade value since 1994.

As negotiations continue to flounder, the risks of a NAFTA termination have increased. The retail sector is likely to be particularly hard hit, and retailers need to begin thinking about how to prepare for a future where US-originating merchandise does not seamlessly move across the border.

An end to NAFTA will have a drastic impact on the Canadian economy. A.T. Kearney, in partnership with the Retail Council of Canada (RCC), took a deep dive into how big that impact would be for the Canadian retail sector (see sidebar: Calculating the Impact: Our Approach on page 2). The retail sector, which makes up 5 percent of the country's economy and employs 12 percent of its workforce, had 2016 sales of $452 billion. It is one of the five biggest drivers of the Canadian economy, along with real estate, manufacturing, finance, and healthcare. What we found was alarming: the end of NAFTA could cost Canadian retailers billions. Goods originating in the United States—worth approximately $108 billion in 2015—have been an important source of supply for retailers in Canada. And, for every 1 percent increase in tariffs, retailers would see their costs increase by at least $1 billion in direct impact alone (see figure 1).[1,2] Indirect effects will boost that number even more. Short of a return to the 1988 Canada–US Free Trade Agreement, an end to NAFTA would lead to increases in tariffs between the two countries significantly higher than 1 percent.

Figure 1
Retail imports from the US total about $108 billion



[1] For example, machinery and equipment, commodities, and chemicals
[2] Household items with high purchase frequency (for example, soap, paper towels, toilet paper, toothpaste, and garbage bags)
[3] Household items with low purchase frequency (for example, furniture, mattresses, drapes, and linen)
[4] Other foods includes, for example, baked goods, fish and shellfish, food oils, cereal, and alcohol.
Sources: US exports data 2015; A.T. Kearney analysis

[1] All monetary amounts are expressed in Canadian dollars.

[2] Direct impact was calculated for eight subcategories: automotive, household consumables, household durables, electronics, appliances, fresh foods, meat and dairy, and other foods.

Calculating the Impact: Our Approach

Drawing on data from a broad range of credible sources—including the World Bank, Euromonitor, Statistics Canada, Scotiabank, the U.S. Department of Agriculture, trade statistics from the U.S. Census Bureau, and the Canada Border Services Agency—we calculated both the direct and indirect impact of a NAFTA termination under three different scenarios. In doing so, we:

- **Created a baseline for imports and tariffs by examining current NAFTA and WTO tariffs and US-originating imports across more than 5,000 line items**
- **Created three scenarios based on different tariff structures for a post-NAFTA trade relationship between the United States and Canada**
- **Estimated direct impact of increased tariffs on US-originating cost of goods sold (COGS)**
- **Quantified indirect impact on retail sales due to lower consumer spending based on:**
  - **Slowdown in Canadian gross domestic product (GDP) growth due to reduced access to the US market**
  - **Reduction in household retail spend**
  - **Shift in category share of wallet due to income elasticity of different retail subsectors**
- **Summarized gross margin impact for different retail subsectors**

For details of these calculations, see About the Study on page 8.

Storm Clouds on the Horizon

The question is, what will take the place of NAFTA? We believe there are three distinctly different scenarios:

- **Scenario 1: Reversion to Canada–US Free Trade Agreement (CUSFTA).** Canada and the United States fall back to their own bilateral free trade agreement from 1989, similar to the current NAFTA agreement.
- **Scenario 2: End of North American free trade.** Tariffs on US imports change to rates applied on other nations' exports to Canada under World Trade Organization (WTO) rules.
- **Scenario 3: Return of protectionism.** Rising nationalism and calls for protectionism might see the United States breaking with the WTO treaty and raising tariffs above agreed-upon levels to protect domestic industry, prompting Canadian retaliation in kind.

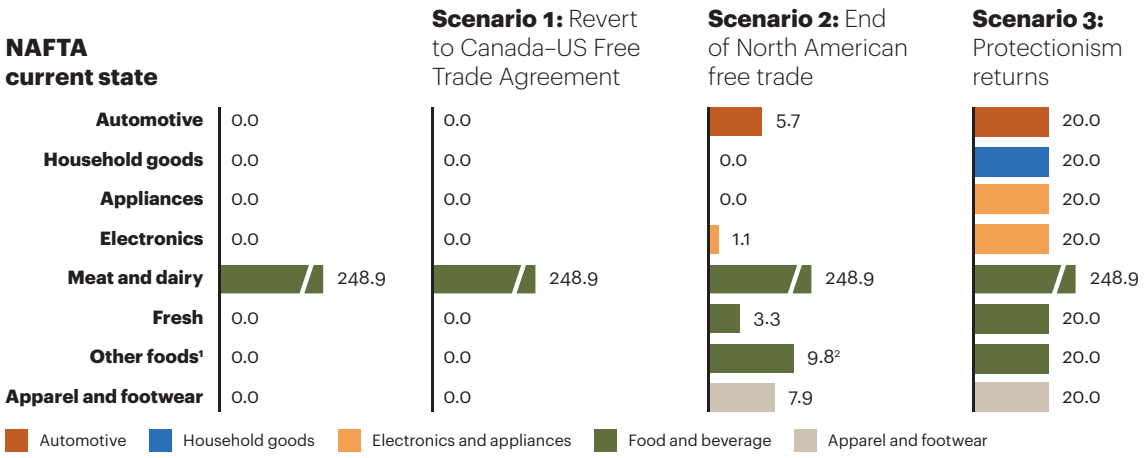
Retailers will feel both a direct and an indirect impact should NAFTA be terminated. The extent of that impact will depend on which of the three scenarios transpires, as well as the category of goods from which they derive their income. Our analysis examines both direct and indirect impact across the major retail categories.

Direct impact

An end to NAFTA may result in tariff increases on US-originating goods, which will in turn raise retailers' cost of goods sold (COGS). Based on analysis of the current tariff schedules outlined by the Canada Border Services Agency (CBSA) and the WTO, we have estimated the average tariffs that may apply to different categories under the three scenarios outlined (see figure 2 on page 3).

Figure 2

The end of NAFTA could result in several different tariff scenarios



[1] Other foods includes, for example, baked goods, fish and shellfish, food oils, cereal, and alcohol.

[2] Calculated as a weighted average of the average MFN applied duties for the following retail categories: alcohol (3.8%), baked goods (0%), cereals (20.5%), fish and shellfish (0.9%), food oils (3.8%), and other foods (3.5% to 10.4%)

Notes: Other NAFTA categories (non-retail) with MFN applied tariffs include petroleum (0.9%), chemicals (0.8%), transport equipment (5.7%), manufactures (2.5%), and wood and paper (0.9%). MFN is most favored nation.

Source: A.T. Kearney analysis

Under Scenario 1, tariffs would largely be unchanged from the current tariff structure prevalent in NAFTA. Under Scenario 2, tariffs would shift to levels that Canada typically applies to other trading partners globally. Under Scenario 3, if the United States adopts a protectionist stance, WTO rules would no longer apply, and tariffs would probably be significantly higher. There is no way to predict the level of tariffs the Canadian government would impose in response to US protectionism. But for the purpose of our calculation we assumed a 20 percent tariff for all categories that are currently tariff-free.

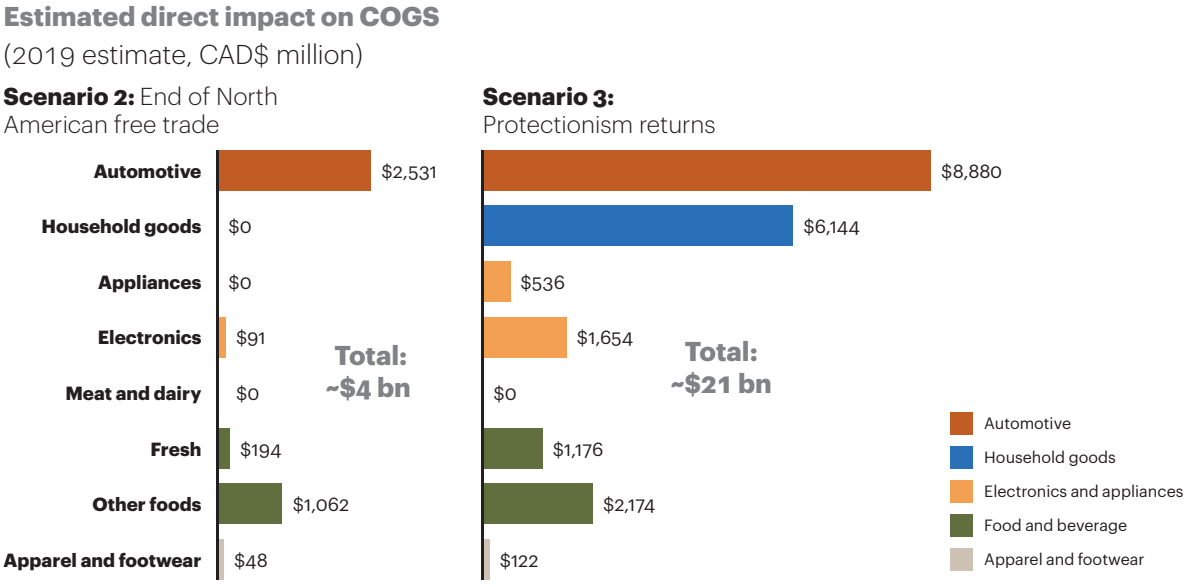
> For every 1 percent increase in tariffs, Canadian retailers would see their costs increase by at least $1 billion in direct impact alone.

Our analysis shows that the impact on individual retailers will be highly dependent on their exposure to a particular category (see figure 3 on page 4). We have assumed no change in COGS for retailers in the meat and dairy industry, since this is currently a NAFTA-exempt category. But for other categories, changes are in the offing. For example, under WTO rules, automotive is subject to a 5.7 percent average tariff, while apparel and footwear are taxed on average at 7.9 percent.[3]

[3] These are blended tariffs across tariff line items (for example, in automotive, 5.7 percent reflects the average across auto parts, light passenger vehicles, and light trucks).

Figure 3

The direct impact of rising tariffs will be an increase of about CAD$4–$21 billion in costs for retailers in Canada



Source: A.T. Kearney analysis

Likely to be especially hard hit are low-margin categories such as fresh foods and packaged consumer foods. Meat and dairy are unlikely to increase (and could come down) given the already high tariff rates in effect. Overall, while increases would likely be minimal under Scenario 1, under Scenarios 2 and 3 COGS could swell by anywhere from $4 to $21 billion for the sector as a whole.

Indirect impact

An increase in COGS is only part of the story, however. There is also likely to be a significant "flywheel effect" characterized by slower growth and a reduction in consumer spending. The downward trajectory might go something like this: Following the institution of higher tariffs and reduced access to the US market, Canadian GDP growth begins to slow due to its dependence on trade with the United States. With less disposable income and higher prices, consumers cut back, buying fewer goods. Discretionary categories such as electronics are especially hard hit, while more price-inelastic categories such as food necessities are less affected, and as a result there is a change in category share of wallet. The economy shrinks further and retailers are faced with some stark choices, none of them good.

The moderate increase in tariffs outlined in Scenario 2 would lead to a lowering of GDP growth by 30 basis points according to an econometric analysis from Scotiabank. Based on our further analysis, that translates into a reduction in household retail spending of about $170 annually. The more dramatic rise in tariffs under Scenario 3 would lead to a far grimmer economic picture, with GDP growth 180 basis points lower and a drop of more than $1,000 in household retail spending. Discretionary categories such as electronics would be especially hard hit, while more price-inelastic categories such as food necessities would be less affected, resulting in a change in category share of wallet (see figure 4 on page 5).

All told, the indirect impact of tariff increases would be a reduction in retail sales of between $2.6 and $17 billion (see figure 5).[4]

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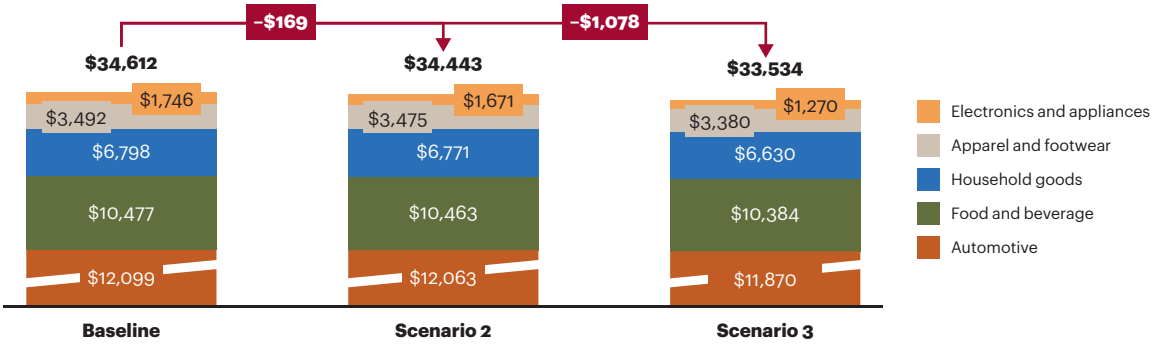
Taken together, the direct impact (rise in COGS) and indirect impact (decline in sales) will pack a one-two punch, hitting retailer gross margins in the gut. But because these two forces will be operating simultaneously, we adjusted the reduction in COGS to account for lower sales,

Figure 4

Household retail spending may drop by more than CAD$1,000 annually, with discretionary categories hardest hit

Estimated average household retail spend (CAD$, 2019)

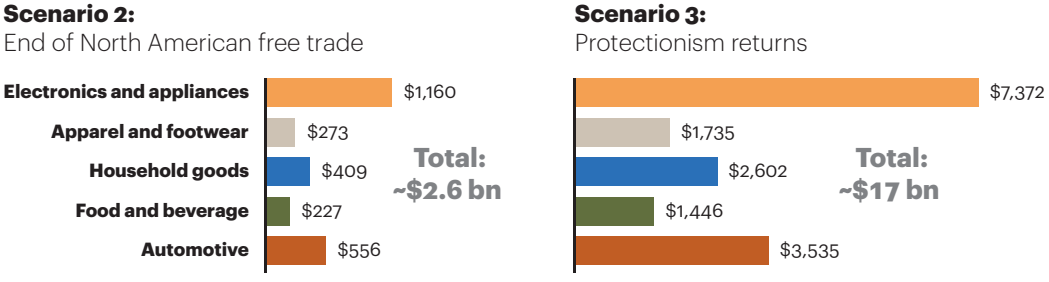


Source: A.T. Kearney analysis

Figure 5

The indirect impact of rising tariffs will be a reduction of about CAD$2.6–$17 billion in retail sales

Estimated indirect impact on retail sales (2019 estimate, CAD$ million)



Source: A.T. Kearney analysis

[4] For more information on how these numbers were calculated, see About the Study on page 8.

yielding a more accurate estimate. Our analysis indicates that the cumulative direct and indirect impact under Scenarios 2 and 3 would potentially reduce gross margins for the retail sector by between $5 and $25 billion.

Gross margin impact for an individual retailer will depend on a range of factors, including their exposure to US-originating goods and the scenario under consideration. It will also depend on the categories of goods they sell, since income elasticity of demand differs across categories, and an economic downturn is likely to shift share of wallet away from discretionary goods. If retailers have this information in hand, armed with real numbers, they can have a better understanding of what changes to their business will best position them for the future.

The cumulative direct and indirect impact under Scenarios 2 and 3 would potentially reduce gross margins for the retail sector by between $5 and $25 billion.

Getting a Head Start on the New World Order

What happens next is anyone's guess, and it may not make sense to place bets on a particular outcome. But complacency is not an option: we cannot assume negotiations will be successful. It is clear that an end to NAFTA will have significant consequences for the Canadian economy as

Organizing for Uncertainty

Preparing for a post-NAFTA world will take time, and we recommend getting a jump-start through the following activities:

- **Understand risk exposure. Quantify potential impact to internal and competitor COGS under different scenarios. The primary factors to consider are category COGS, proportion of imports from the United States, and current versus future tariff structure.**
- **Outline potential response. Frame options for responding to different scenarios (for instance, passing through of costs to the consumer, improving internal cost structure to offset COGS increases, and exploring alternative sources of supply outside the United States). Each of these strategies should factor in potential competitor responses.**
- **Join with the RCC to make an impact. Be an active voice with government and the media to advocate for retail in Canada. Participate in upcoming discussions to show how changes are likely to affect your company and your customers. Be prepared to share confidential data with government to demonstrate impact.**

a whole and the retail sector in particular. Companies would do well to consider the broader implications of a NAFTA termination on their business and to actively prepare for the worst.

Retailers, especially smaller retailers, with high exposure to US-originating goods are likely to feel a disproportionate impact should NAFTA end. In order to avoid a hit to profitability, they will either need to trim costs or pass price hikes on to their customers. Furthermore, the imposition of tariffs on US-originating goods may force retailers to source their goods from non-NAFTA suppliers. This may mean they will have to reconfigure their complex supply chains and redesign their distribution networks. This is not trivial. For many retailers, there is very little institutional capability to make these changes given how long NAFTA has been in effect and the "default" nature of working with US suppliers. Finally, if new trade agreements must be negotiated, retailers will need to upgrade their in-house capabilities in the areas of trade compliance, sourcing, and supply chain management. They may also need enhanced capabilities to analyze bill of materials and product classifications in order to assess origins and tariff impacts.

In the growing climate of uncertainty, retailers need to look for ways to limit their risk exposure and avert potentially serious economic losses (see sidebar: Organizing for Uncertainty on page 6). The time to act is now.

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About the Study

We quantified both the direct and indirect impact of a NAFTA termination on the overall Canadian economy and the Canadian retail sector using a five-step process that aggregated multiple data sources. A broad overview of the approach is outlined below. For details, please contact the authors.

Step 1: Quantifying retail-relevant imports from the United States to Canada

Data on US exports to Canada from the US Census Bureau forms the baseline for the analysis. US data was leveraged because (1) the data was available using end-use classifications that make it easier to determine the retail relevancy of the import and (2) the data indicated the portion of US-originating versus re-exported goods. Once identified, these codes were classified as retail, non-retail, or mixed where the categorizations were defined as follows:

1. **Retail:** Imported goods that would directly flow onto retail shelves (for example, packaged food or home appliances)
2. **Non-retail:** Imported goods that are unrelated to direct retail products (for example, commodities, animal feed, or heavy industrial machinery)
3. **Mixed:** Imported goods that can potentially be sold as retail products or be inputs into other products (for example, tomatoes that can be sold on a retail shelf or used as an ingredient for pizza sauce). This categorization was used primarily for food-related imports.

We then mapped the exports to the higher-level categories and subcategories referenced throughout the final study. For food-related imports, the proportion of retail-only imports was derived at an aggregate level by estimating the total food-related output and domestic production of inputs in Canada and estimating the gap that is likely fulfilled by imports. This was re-confirmed through a series of interviews with agricultural economists and industry experts.

Step 2: Estimating tariffs under different scenarios

Leveraging data from the Canada Border Services Agency (CBSA), we reviewed thousands of custom tariff schedules, chapter by chapter, at a tariff line-item level to better understand tariffs currently imposed under NAFTA. Documenting duty-free versus high-tariff items, we created a baseline of average NAFTA tariff rates by category for comparison against the proposed scenarios. Similarly, for Scenario 2, which would result in most favored nation (MFN) tariffs, we used data from the WTO on 2017 Trade Tariff Profiles to identify applied MFN tariffs by category. With the WTO data providing average final bounded duties and MFN trade tariffs, we assigned each tariff product group a retail categorization (retail, non-retail, or mixed)—a category and subcategory classification aligned to baseline import classification. After categorizations were complete, we defined MFN rates by category and subcategory using weighted averages, where weights attributed to each category were determined by taking the percentage share of total imports for a tariff product group.

Step 3: Estimating the direct impact of increased tariffs

We calculated the direct impact by applying the tariff structure developed in Step 2 to estimated US-originating imports in 2019 to quantify the impact on COGS. Using 2015 retail-relevant US imports as a share of 2015 retail sales, and using Statistics Canada data on the growth of the Canadian retail sector, we estimated the potential 2019 share of US imports at current growth rates. As a final step, we recalculated the value of US imports to account for US-originating imports by removing foreign re-exports (namely, goods that transship to Canada through the United States but do not qualify for NAFTA tariffs).

Step 4: Quantifying the indirect impacts

A withdrawal from NAFTA under Scenarios 2 and 3 will not only increase COGS for importers of US goods, but will also affect the overall Canadian economy, which is heavily reliant on exports to the United States. Using a Scotiabank analysis on the impact of NAFTA termination on overall GDP growth and integrating World Bank and Statistics Canada data on current and projected average household income and household retail spend, we estimated the reduction in aggregate average household retail spend. Finally, leveraging US Department of Agriculture data on the income elasticity of demand on retail spend categories for Canada, we derived the shift in household category share of wallet. This was extrapolated to a nationwide indirect impact.

Step 5: Quantifying gross margin impact on retail in Canada

To arrive at the total gross margin impact, we reduced current gross margins in proportion to the sales reduction estimated in the indirect impact and then increased the value of imported cost of goods for the tariff scenario (after adjusting the cost of goods for the sales decrease). Current gross margins by sector data was provided by Statistics Canada.

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