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Valitas Insights: The League of the Overshadowed

In the realm of economics, there are three very large countries which, while not exactly overlooked, nevertheless tend to be overshadowed by their even larger neighbours, the United States and China. These three overshadowed countries are Japan, Canada, and Mexico.

Japan is the third largest economy in the world. Canada is the tenth largest economy in the world and the second largest landmass. And Mexico is the only country, apart from the U.S. or the BRIC states, to be among the top fifteen in the world in economic size, population, *and* landmass.

Currently, trade between Canada, Mexico, and Japan is quite small. Neither Canada nor Mexico are included among Japan's top fifteen trade partners. And while Mexico and Canada do considerable trade with one another — Mexico recently overtook Britain to become Canada's third biggest trade partner — Mexico accounts for less than three percent of Canada's total trade. Their trade with one another is greatly eclipsed by their trade with the U.S.. Indeed, California alone trades more with Canada, Mexico, and Japan than they do with one another.

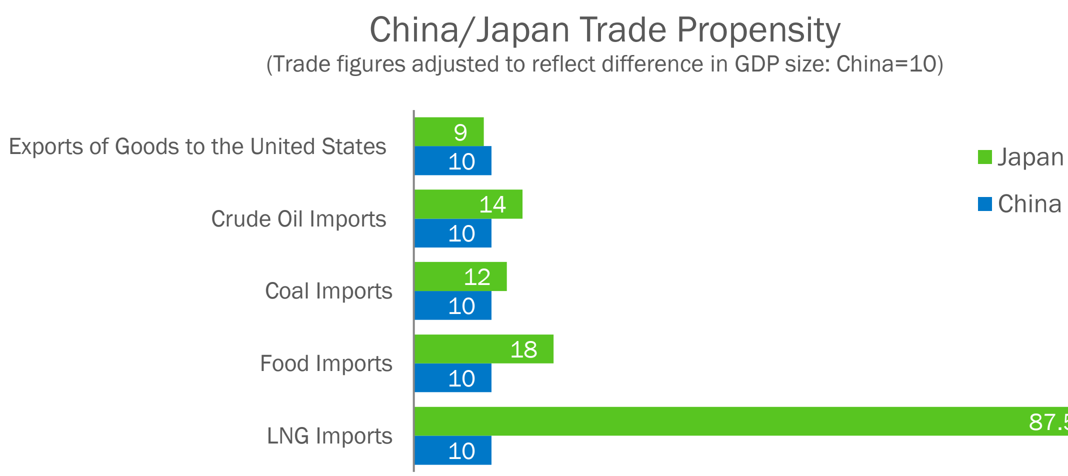
The current U.S. administration, however, is creating uncertainty for its trade relationships with Canada, Mexico, and Japan. President Trump's first executive order was to withdraw from the Trans-Pacific Trade Partnership (TPP), in which Japan would have accounted for over 60 percent of the twelve member-states' GDP, apart from the U.S. itself. Trump has also signaled his intention to tighten the U.S.-Mexico border and reduce legal and illegal immigration into the U.S.. Additionally, he has triggered a renegotiation of NAFTA to remedy what he has called the "worst trade deal the U.S. has ever signed".

These actions could have the effect of driving U.S. trade partners closer together. Canada and Mexico have an interest in showing that they can trade with one another regardless of what the U.S. government intends to say or do about NAFTA. Canadian cities would also become the obvious destination for Latin American emigrants, in the event that the U.S. government follows through on its recently announced plan to reduce legal immigration while prioritizing immigrants with English-language proficiency.

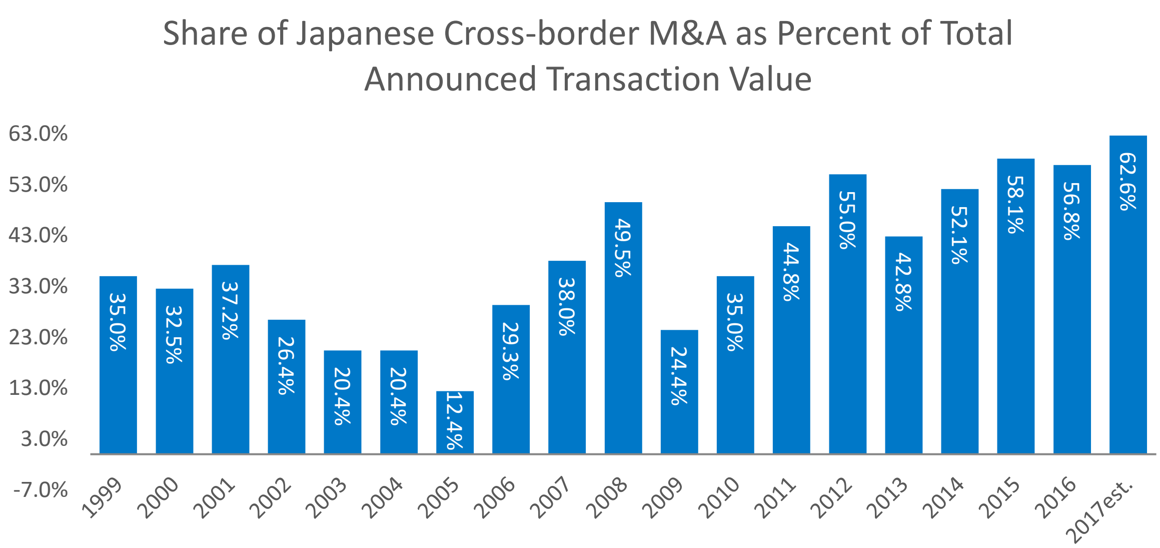
Additionally, Canada has an interest in trading more with Asian countries, where energy prices remain expensive relative to the shale-rich U.S. Indeed, on June 1, Canadian senator Paul Massicotte wrote an op-ed calling for Canada and Japan to sign a free trade agreement with one another as quickly as possible, given TPP's failure and the NAFTA renegotiation. Similarly, a summit in Toronto was held earlier this spring, in which representatives of the eleven TPP countries apart from the U.S. discussed the possibility of going ahead with the TPP without American participation.

The TPP countries are also being impacted by the current economic transition in China. China's demand for imports of natural resources is declining in conjunction with a slowdown in its GDP growth and industrial growth. China's M&A spending on Canadian companies, for example, which historically focused on mineral and energy sectors, peaked in 2012. Most of the energy China does consume will probably continue to come from within its own borders — China only imports 15 percent of the energy it consumes — or else be imported from its "One Belt, One Road" partners in Asia.

For Japan, in contrast, trans-Pacific trade may be crucial. Japan has few resources of its own, and, being an island nation, has no Silk Roads to access. Japan imports more than 90 percent of the energy it consumes, mainly from Arab states. Its access to the Middle East, however, is in jeopardy, both from competition with other energy consumers such as China, as well as from Middle Eastern conflicts. Japan accounts for 30-40 percent of all LNG imports globally, for example, yet its primary supplier, Qatar, is now in an open feud with Saudi Arabia.



Between competition and conflict, Japan may have to rely more on trans-Pacific trade to acquire resources. It would not be the first time it has had to do this; in the 1930s, prior to the Second World War, over eighty percent of the oil that Japan consumed was imported from North America.



Source: JP Morgan; Dealogic and Thompson One

Complementary Economies – Potential Driver of Trade

The world today is being defined both by globalization (the result of the Internet and cheap oil) and by political movements, like Trump's, to protect against some of globalization's effects. As we've discussed, U.S. decisions on NAFTA, TPP, and Hispanic immigration could bring Canada, Mexico, and Japan closer together. Beyond this, however, there may be a more significant trend: the growing importance of *complementarity*, as opposed to physical proximity, in determining the size of bilateral trade relationships between countries.

Today, trade between Canada, Mexico, and Japan is limited because the countries do not border one another, and because of their physical proximity to the U.S., or in Japan's case, China. But as — or, at least, *if* — globalization continues, this may matter less than the complementary nature of their economies. Canada is rich in land but poor in labour, Mexico is rich in labour but poor in capital, and Japan is rich in capital but poor in land. Each country has something to offer the others. While their most important bilateral relationships are, of course, likely to remain with the U.S. and China, nevertheless these three large, overshadowed nations might become a formidable economic grouping in their own right.