INTRODUCTION

On February 16, 2017, the Senate adopted a motion that authorized the Standing Senate Committee on Banking, Trade and Commerce to study and report on current and emerging issues regarding U.S. banking regulation, U.S. monetary policy, and economic relations between Canada and the United States. Some of the committee's senators (the delegation) travelled to New York City, New York on May 8 and 9, 2017, and to Washington, D.C. on May 10 and 11, 2017, for a fact-finding trip regarding these issues.

The delegation met with representatives from the U.S. financial sector, including banks and private-sector investors, as well as from U.S. federal agencies and financial sector regulators, think tanks, trade associations and an international organization (representatives).

This report summarizes the information that the delegation gained during its meetings, with particular focus on the following topics:

- the priorities of, and challenges faced by, the Trump administration as of May 2017;
- the expected deregulation of the U.S. financial sector;
- the possible renegotiation of the *North American Free Trade Agreement* (NAFTA);
- emerging issues in U.S. monetary policy;
- the prospects for reform of the U.S. tax system; and
- some factors affecting the U.S. and Canadian economies as of May 2017.

THE PRIORITIES OF, AND CHALLENGES FACED BY, THE TRUMP ADMINISTRATION

The delegation heard that the Trump administration's priorities are taxes, the U.S. banking sector, health care, the U.S. energy sector, international trade and deregulation. In mentioning that hundreds of appointed positions remain vacant in federal departments and agencies, and that – consequently – the Trump administration is "grossly understaffed," some of the representatives suggested that Canadian parliamentarians should continue discussing relevant issues with members of the U.S. Congress.

THE EXPECTED DEREGULATION OF THE U.S. FINANCIAL SECTOR

The delegation was told that a likely consequence of President Trump's February 3, 2017 Executive Order in relation to the U.S. financial system is the deregulation of certain financial-sector activities that were affected by implementation of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act) after the 2008 financial crisis. On June 13, 2017, the U.S. Department of the Treasury released a report that it had prepared for President Trump. The report contains the department's recommendations for regulatory reform of banks and credit unions.

One representative said that a lack of unanimous agreement about the causes of the 2008 financial crisis led to a variety of solutions being proposed, and that regulators are still drafting rules to implement some aspects of the Dodd-Frank Act. While a number of representatives agreed that the Dodd-Frank Act has made the U.S. financial system more stable, including through the establishment of the Financial Stability Oversight Council, some indicated that the Act could be simplified. In particular, they suggested the following:

- exempting community banks from certain requirements of the Dodd-Frank Act;
- increasing the asset threshold required for designation of a domestic bank as systemically important from $50 billion to $250 billion;
- changing the governance structure of the Consumer Financial Protection Bureau to reduce its power and make it subject to greater oversight;
- repealing the authority of the Federal Deposit Insurance Corporation to be the resolution authority for banks, which would allow banks to go bankrupt; and
- repealing the Volker Rule that prohibits banks from engaging in proprietary trading.

Representatives pointed out that total repeal of the Dodd-Frank Act is unlikely, and some suggested that the Financial CHOICE Act – a bill that was introduced in the U.S. House of Representatives in 2016 – could be a framework for possible changes to the Dodd-Frank Act. The delegation was informed that the bill would repeal many aspects of the Dodd-Frank Act, including the Volker Rule, and would provide banks that have a leverage ratio exceeding 10% with an exemption from the higher capital requirements set out in the Dodd-Frank Act. In the view of most representatives, the bill would probably not be passed by the U.S. Senate.

The delegation was told that, from the U.S. financial sector's perspective, deregulation of the sector– or, at a minimum, having no new financial regulations introduced – would be welcome because financial institutions could then plan for growth in their operations. One representative mentioned that it is difficult and costly for a bank to prove that it is not involved in proprietary trading, and stated that Deutsche Bank AG was fined about US$20 million by the U.S. Federal Reserve for violating the Volker Rule. Other representatives commented that the capital requirements set out in the Dodd-Frank Act are too complex for smaller financial institutions, and that there are too many U.S. regulators.

Rather than introducing legislative changes, some representatives speculated that less stringent regulation of the U.S. financial sector could be achieved through the following:

- new regulations being issued by banking regulators;
- the forthcoming appointment of new heads for U.S. financial regulators; and
- the Trump administration's appointment of possibly six of the seven seats on the Board of Governors of the U.S. Federal Reserve in the next few years.

Regarding Canadian banks operating in the United States, the delegation heard that the Dodd-Frank Act has been beneficial for Canadian banks because the increased regulation resulting from the Act has led a number of European banks to leave the U.S. financial market.

THE POSSIBLE RENEGOTIATION OF THE *NORTH AMERICAN FREE TRADE AGREEMENT*

Many representatives discussed NAFTA and Canada–U.S. trade, with a particular focus on whether the Trump administration would pursue renegotiation of or a withdrawal from NAFTA. Representatives had varying opinions on the possible renegotiation of NAFTA; some felt that any changes would be minor, which could mean that renegotiation would occur on a timely basis and with limited amendments, while others thought the renegotiation could be extensive . The delegation heard that areas that might be renegotiated include rules of origin, government procurement, market access, intellectual property, digital trade, and other topics that were addressed during the negotiation of the Trans-Pacific Partnership agreement.

Regarding the method by which NAFTA could be renegotiated or cancelled, representatives explained that NAFTA is not a treaty; it was negotiated by U.S. President George H.W. Bush as a congressional executive agreement, and Congress' role was to pass the bill to implement NAFTA. The delegation was informed that, as a result, the United States' participation in NAFTA could be cancelled by President Trump without congressional approval. According to representatives, in order to renegotiate an agreement like NAFTA, the U.S. president would have to give notice to Congress of his/her intention to do so; on May 18, 2017, President Trump provided notice in relation to NAFTA.

Representatives suggested that Canada should not react to the negative U.S. rhetoric regarding trade with Canada, and should focus on areas where there is agreement between Canada and the United States, such as energy, or on areas in which Canada could perhaps agree to concessions. One representative characterized the recent dispute between Canada and the United States about dairy as a minor issue because the dispute is focused on a small subset of dairy products – diafiltered milk products – and because the United States has a trade surplus with Canada in dairy products.

The delegation was told that, during discussions with the United States, Canada should emphasize the high degree of integration in North America's auto sector, state governors' support for NAFTA, and the importance of renegotiating a trilateral agreement, rather than two bilateral agreements. As well, one representative suggested that Canada should continue with its "friendly approach" when discussing trade with the United States, but should provide "hints" about possible retaliatory trade measures that Canada could take against the United States. Regarding Mexico, representatives believed that the country is likely to seek many changes to NAFTA.

Some representatives speculated about the possible consequences for Canada of NAFTA being renegotiated or cancelled, including delayed investments by businesses due to uncertainty about the status of NAFTA. They also mentioned that Canadian banks with operations in the United States may be affected by a reduction in both capital and the flow of workers into the United States from Canada.

EMERGING ISSUES IN U.S. MONETARY POLICY

Representatives indicated that the U.S. Federal Reserve intends to sell some of its holdings of U.S. Treasury securities, which it accumulated during several rounds of quantitative easing over the 2008–2014 period that were designed to lower interest rates and increase economic growth. The delegation was told that these holdings will be sold in a gradual and predictable manner. As well, representatives shared their expectation that the U.S. Federal Reserve will further increase its target range for the federal funds rate later in 2017.

THE PROSPECTS FOR REFORM OF THE U.S. TAX SYSTEM

Regarding possible reforms that could occur in response to the April 21, 2017 Executive Order by President Trump in relation to tax regulatory burdens, most representatives felt that a corporate tax rate reduction would be more likely than comprehensive reform of the U.S. tax system. Some representatives suggested that a priority of the Trump administration is a reduction in the U.S. federal corporate tax rate, which could make combined federal-state corporate tax rates in the United States more competitive with Canada's combined federal-provincial rates. As well, the delegation was told that a decrease in the U.S. federal corporate tax rate could result in a shifting of business operations – and perhaps profits – from Canada to the United States by U.S. corporations that have Canadian subsidiaries, as well as an increase in U.S. economic growth; higher economic growth in the United States could affect Canadian economic growth and exports to that country.

Representatives indicated that, while a border adjustment tax could generate a significant amount of revenue, it is unlikely to be implemented. The delegation heard that such a tax would result in higher prices for goods imported into the United States, including basic goods; a large number of U.S. consumers would find it difficult to afford such an increase.

SOME FACTORS AFFECTING THE U.S. AND CANADIAN ECONOMIES

The delegation was told that the U.S. economy has recovered well from the 2008 financial crisis, and that business and consumer confidence levels regarding expected economic conditions are currently very high; that said, the U.S. economy faces a number of challenges, such as increasing poverty rates, rising income inequality, a shrinking middle class, declining productivity, and a low rate of labour force participation. As well, representatives indicated that U.S. infrastructure is in poor condition. They added that public-private partnerships are rare in the United States, and that a number of U.S. states are considering new ways in which to develop infrastructure.

Regarding Canada, the delegation heard that the country's economy had performed well in the first quarter of 2017, primarily as a result of the residential housing sector, but that economic growth is likely to be lower in 2018 because of the expected decline in public spending. One representative thought that the proposed Canada infrastructure bank could affect long–term economic growth if it invests in strategic projects that support growth, such as trade-enabling infrastructure.

Some representatives expressed concern about the stability of Canada's housing markets, with one calling them a "major risk." They highlighted three areas of concern: Canada's high and rising house prices; mortgage costs that are unaffordable for some households; and high household debt. The delegation was told that Canada's high household debt levels make it difficult for the Bank of Canada to increase its target for the overnight interest rate because such a change would lead households to pay more in order to service their debt, which would have implications for consumption. It is expected that the target range for the federal funds rate will rise in the United States, and a limit on the Bank of Canada's ability to increase its target for the overnight interest rate might lead to a wider gap between Canadian and American interest rates than would otherwise have been the case; in turn, the relative value of the Canadian dollar could fall. One representative suggested that the federal government should consider a cap on the amount of debt that a household can assume in order to purchase housing.

CONCLUSION

After considering the views expressed by the various groups and individuals with whom the delegation met during its fact-finding trip to New York City, New York and Washington, D.C., it is clear that certain representatives are of the opinion that the Canadian economy is facing a number of risks in the short and medium terms, some of which are related to potential developments in the United States.

Approximately 76% of the total value of Canada's merchandise exports was destined for the United States in 2016, and that country is likely to remain our main trading partner for the foreseeable future. Thus, the Trump administration's seemingly protectionist tendencies – not only in the context of renegotiation of NAFTA but also in terms of speculation about such measures as a border adjustment tax – underlines the risks for Canada of an overreliance on the U.S. market and of the need for increased market diversification. Regarding the renegotiation of NAFTA, the federal government should highlight the potential negative implications of disrupting highly integrated sectors, and should focus on areas where Canada and the United States agree.

The possibility of federal corporate tax reform in the United States also poses a risk to the Canadian economy. A significant decrease in the U.S. federal corporate tax rate could affect Canada's attractiveness as an investment destination, and could result in business operations being shifted from Canada to the United States. As well, the United States' implementation of a border adjustment tax would likely be detrimental for the Canadian economy.

From the U.S. perspective, another cause of concern is the high level of Canadian household indebtedness – due in part to rising housing prices in certain housing markets – that make Canadian households more vulnerable to economic shocks. High levels of household debt constrain the Bank of Canada's ability to increase its target for the overnight interest rate, which could be problematic if – for example – the Bank experiences difficulties in ensuring that inflation remains within its target range.

Lastly, recognizing that a number of Canadian banks have operations in the United States, Canada's federal government should carefully monitor possible changes to U.S. financial sector regulation, and should assess their potential impacts on those banks and the Canadian financial sector as a whole.