

Mexico and NAFTA 2.0: The Good, The Bad, and The Unexpected

Executive Summary:

- There are a number of areas where we see NAFTA 2.0 as a potential positive for the Mexican economy, such as: 1) boosting efficiency and investment in the energy sector, 2) helping combat corruption & impunity—among the main obstacles to business in the country, 3) helping increase productivity in the Mexican economy by incorporating SMEs into regional supply chains and reducing informality, 4) improving access to financing for smaller firms. In addition, enhancing investor protection mechanisms, and including newly opened sectors (such as energy) into these protections should be positive for FDI flows into the country.
- An area that would be positive for Mexico, but where we don't see progress being made, is in using NAFTA to drive an overhaul of the country's social security system to combat informality, and reduce Mexico's "dual economy problem". However, due to wide-apart views on social security between the three nations, and the fact that the topic is not even on the table, we don't expect progress here. This, despite the fact that improving institutional frameworks and labour standards are stated priorities for all three countries.
- There are a number of potential proposals that would cause Mexico to walk away from the table in our opinion, including: voluntary export restraints (VERs), proposals that set minimum US content requirements (as opposed to regional ones), as well as proposals that permit unilateral (rather than arbitrated) dispute resolution on trade issues.
- If NAFTA finds its demise, one potential "surprise" could be a decision by Mexico to unilaterally cut WTO Most Favoured Nation (MFN) tariffs to increase the competitiveness of its exports (about 70%–80% of the country's imports are intermediate goods).

A base case for the results of NAFTA's negotiations:

As [our team in Toronto discussed a couple of weeks ago](#), our base case is that the NAFTA negotiations may generate noise, but the result will ultimately be better than some of the rhetoric that has come out of the US administration. Some of the key issues raised by our team to support this view are:

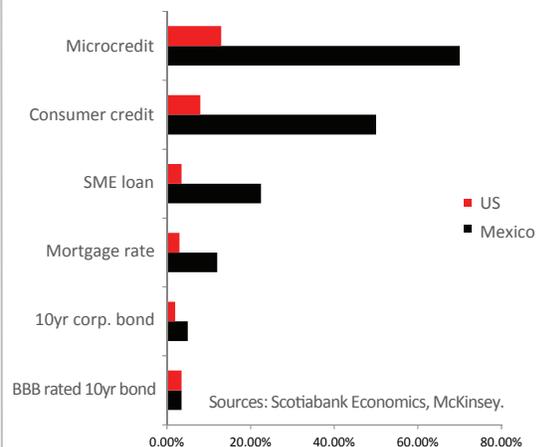
- There seem to be a lot of areas of common ground between the three member countries in the priorities for the treaty's overhaul, including: 1) improving regulatory standards and anti-corruption enforcement, 2) regulatory harmonization, 3) streamlining customs procedures, 4) enhancing labour and environmental standards, 5) updating the agreement to cope with technological change, such as e-commerce, and 6) establishing protocols for dealing with anti-competitive practices by SMEs. In addition, energy is another sector where the three countries will look for common ground in our view.

CONTACTS

Eduardo Suárez, VP, Latin America Economics
 52.55.9179.5174
 Scotiabank Economics
eduardo.suarez@scotiabank.com

Chart 1: The cost gap between financing costs for larger, and globally integrated firms in the US and Mexico is narrow. But as we move down the ladder the cost widens substantially—integrating Mexico's SMEs into regional supply chains could help them get better financing conditions. Reducing corruption, and improving rule of law through NAFTA could also help.

Financing Costs in Mexico vs the US (%)



- Important parts of the “US establishment”, not only among corporates with NAFTA-wide interests, but also in the political establishment have come out in defense of the agreement, and of free trade across North America. Examples include: Several Governors of States with strong trade ties to Canada and Mexico, [18 Republican Senators](#), as well as [all 32 first-term Republican Representatives](#). In addition, several [CEOs from important US companies](#) have also spoken out defending the treaty.
- In short, our take is that despite the potential for the negotiations being volatile and noisy, the final outcome will be benign.

Which benefits for Mexico look likely?

One of the most beneficial aspects of NAFTA 1.0 for Mexico has been the boost to the open part of the economy from integration to global supply chains. Through integration to global supply chains, Mexico’s manufacturing sector has become increasingly sophisticated (it has gone from a toy & textile assembly, to compact cars, and now luxury vehicles and even airplanes), more technologically advanced, and has managed to keep costs in check thanks to competition (a problem that is haunting Brazil’s closed manufacturing sector—[look at the rise in costs that being isolated from global competition allowed](#)). As [McKinsey argued](#), Mexico’s modern firms (larger companies exposed to global trade & investment) saw productivity growth of +5.8% per year in the 1999–2009 period (sadly, we don’t have newer productivity data per firm size, but we expect the story hasn’t changed much). On the flip side, traditional firms have seen a productivity drop of -6.5% per year in the same time span. In short, the part of the economy that integrated to the modern and open economy thrived, the rest backtracked.

This view is consistent with the [Levy & Rodrik’s “Mexican Paradox” argument](#) that the Mexican economy failed to reverse this dualism through NAFTA, and may have even gone in reverse to some degree. As they argue:

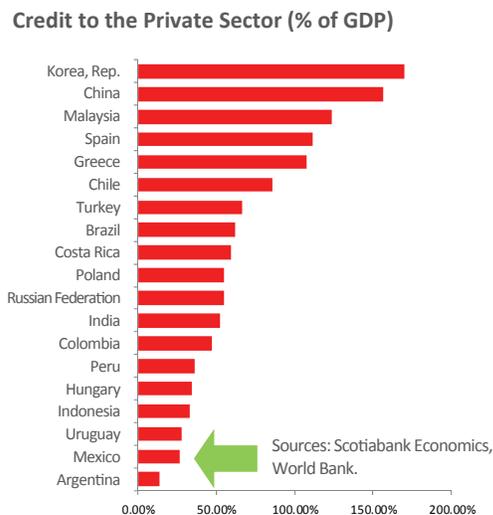
“A large part of the answer—to the poor aggregate performance of the Mexican economy, despite all its reforms—has to do with the Mexican economy’s extreme dualism—a problem that has been called the “two Mexicos.” The bulk of Mexican workers remain employed in “informal” firms—especially firms in which employees are not on salaried contracts—where productivity is a fraction of the level in large, modern firms that are integrated into the world economy.”

“What is striking is that this dualism has worsened during the period of Mexico’s liberalizing reforms. Research by one of us (Levy) shows that informal firms have absorbed a growing share of the economy’s resources. The cumulative growth of employment between 1998 and 2013 in the informal sector was a whopping 115%, compared to 6% in the formal economy. For capital, cumulative growth was 134% for the informal sector and 9% for the formal sector.”

This duality is one of the reasons why Mexican manufacturing productivity is only around 1/4 of the US’ on average, even though Mexico’s top firms’ productivity exceeds that of the US average. Where could progress be made?

- ⇒ Among the areas where there seems to be consensus between NAFTA members is streamlining customs processes, in order to make it easier for smaller firms to integrate to global supply chains and export. This could, if properly implemented, help Mexico’s smaller and more inward-looking firms integrate to regional supply chains (we see it as a useful, but insufficient step on its own).
- ⇒ Another key issue that explains the poor productivity of the laggard half of Mexican firms is their restricted access to financing. Not only is access to credit by Mexico’s private sector very low (see chart 2), but it’s also expensive (see chart 1). There are many reasons for this, but they include: 1) a weak court system, which makes lending riskier (this will be addressed with institution building—on which NAFTA 2.0 plans to help—as fighting corruption and increasing rule of law are priorities for all three countries), and 2) widespread informality in the Mexican economy makes access to formal lending limited (the gap between funding costs for Mexican vs US companies is much wider the more we move away from larger more sophisticated

Chart 2: Mexico has very low credit penetration, among other reasons, due to high informality. NAFTA 2.0 could help reduce informality through several channels.



companies, as chart 1 shows). How can NAFTA 2.0 help on reducing informality? We see two of the priorities held by the three member countries as potential positives in reducing informality: 1) by making it easier for smaller firms to integrate themselves to regional supply chains, and 2) fighting corruption and institution building.

One of the main hurdles of doing business in Mexico according to various CEO / investor surveys is corruption, and it's also one of the areas of common ground that the three NAFTA nations see as priorities. According to the [WEO's Global Competitiveness Report](#), the main obstacle for doing business in Mexico, based on its executive survey, was corruption, followed by crime and theft (related issues). As we argued a few weeks ago, there is some progress being made, due to a combination of civil society pressure and regulatory overhauls, but there is still a large amount of ground to cover, and NAFTA could be a way of anchoring the path on the right direction, and speeding it up. An interesting piece that outlines how an agreement like NAFTA can be used as a driver of change in issues such as rule of law, and strengthening institutions is [this article from the Mexico Institute](#).

In our view, one of the most beneficial aspects of NAFTA 1.0 for Mexico was establishing investor protection mechanisms. Under Chapter 11 of NAFTA, foreign investors are offered a wide range of protections—including against government expropriations ([Article 1110](#)), which may not look like a big issue today, but was likely a bigger concern in the early NAFTA years. Dispute settlement mechanisms are another important protection NAFTA granted foreign investors and look likely to be revised in NAFTA 2.0, given at least the US and Mexico have spoken about the need to update the chapter ([Section B of Chapter 11 in NAFTA 1.0](#)). In the US' "[Summary of Objectives for the NAFTA renegotiation](#)" (July 17, 2017), one of the priorities for the Trump administration is to "[Secure for U.S. investors in the NAFTA countries important rights consistent with U.S. legal principles and practice, while ensuring that NAFTA country investors in the United States are not accorded greater substantive rights than domestic investors](#)". If further safeguards are put in place to give additional protection for foreign investors in Mexico, where the court system is not yet among the most robust in the world, we would expect investment in the country to increase.

On the energy front, there are many aspects of the NAFTA negotiations that could be positive:

- Refining & pipelines: by making the flow of refining inputs easier across North America, the region could optimize its refining capacity, and improve the competitiveness not only of the sector, but of all industries heavily reliant on energy and refined products. Similar to refining, a region-wide policy for energy pipelines would help improve the region's energy efficiency.
- Investor protections: When NAFTA 1.0 was negotiated, Mexico's energy sector was controlled solely by the State. Hence, for Mexico, Chapter 6 basically limits itself to saying "*The Mexican State reserves itself the following strategic activities, including investment in such activities as well as the provision of services*". These restricted activities basically include all of the oil & gas, petrochemicals, and supply of electricity as a public service. There is some debate on whether because NAFTA seems to refer to the Mexican Constitution on energy, by updating the Constitution, the NAFTA protections under Chapter 11 also apply to the sector. However, it is at best an uncertain protection. Thus, by formally adding energy to NAFTA—and its investors' safeguards, investment in the country should become more attractive (and pledged investments since the 2013 reform have already exceeded US\$55bn in oil & gas, and close to US\$10bn in renewables and pipelines, making this arguably the largest privatization in the country).

On which key area will NAFTA not deliver?

As [McKinsey](#), the [World Bank](#), and [Levy & Rodrik](#) all argue, and with which we concur, the biggest obstacle to Mexico taking its next step in both economic and social development is breaking the wall between the country's modern and open parts, and those that have remained in informality and shut off from the rest of the world.

One area which offers some interesting potential to help address the "two Mexicos problem", but which is currently not on the table—and we don't expect it to get there—is social security reform. Even though all three countries have argued that labour standards are one of the areas that need to be addressed in NAFTA 2.0, we strongly doubt the negotiations will be far-reaching enough to get to the point where countries' social security systems and their funding will be put on the table. However, as Santiago Levy argues—quite convincingly in our view ([Chapter 6 of this book by the World Bank](#)), one of the reasons why Mexico's informal sector is so large, which in turn affects the country's productivity, is the structure of its social security system and the incentives it provides for firms and workers to remain in informality due to the way the costs of social security benefits are distributed in Mexico.

As [Mark Aspinwall of the Mexico Institute](#) argued, NAFTA 1.0 had an under-appreciated and, to some degree, misunderstood impact on labour standards and the development of civil society in Mexico. He notes that the “*North American Agreement on Labor Cooperation (NAALC) established that any Mexican civil society group could take a complaint about Mexican non-compliance to the Department of Labor in Canada or the Department of Labor in the United States*”. However, because only a small number of labour rights were actually enabled as potentially leading to trade sanctions (he noted that “*While 11 labor principles are mentioned in the agreement, only three of them give rise to potential trade-suspension sanctions (protection for children and young persons; minimum employment standards; and prevention of occupational injuries and illnesses)*”), the broad impact on labour markets was limited, although the impact on boosting civil society was more relevant. There is a strong case to be made that on the labour front, it has not only been the channels opened for civil society that have led to improved practices in Mexico, but also the interaction of Mexican labour with its US and Canadian counterparts which has driven change. Can a similar experience lead to reform of Mexico's social security? So far, the US administration has suggested it wants to broaden the scope of the Labour agreements that were established under NAFTA 1.0 to cover the ILO's broader set of principles. These principles are: “*freedom of association and the effective recognition of the right to collective bargaining, the elimination of forced or compulsory labour, the abolition of child labour and the elimination of discrimination in respect of employment and occupation*”. Although these are a broader set than what was covered under NAALC, they fall well short of discussing social security networks and, given the wide differences that exist not only between Mexico and its partners but also between Canada and the US, we are highly skeptical this topic will be part of NAFTA 2.0.

An unexpected path if NAFTA talks do break down, and the agreement finds its demise:

What if things don't work out? Under WTO's Most Favoured Nation (MFN) rules, US goods would face higher tariffs than Canadian or Mexican goods would. However, we would argue that if NAFTA were to find its demise, it could be in Mexico's best interests to voluntarily cut tariffs. Why? If you look at Mexico's trade balance, roughly 70%–80% of imports are “intermediate goods”. If Mexico were to suddenly face higher export costs due to the disappearance of NAFTA, reducing the cost of imported components by unilaterally eliminating WTO MFN dictated tariffs on intermediate goods could actually make Mexico's exports more competitive, and partly offset the blow to Mexico's exports from a NAFTA elimination.

When would we expect Mexico to walk away?

An initial fear when the NAFTA renegotiation was initially discussed was the potential for the US to demand voluntary export restraints (VERs) in areas such as autos and auto parts. These concerns were amplified when President Trump appointed Lighthizer to the USTR, given [he had been a backer of VERs in previous US trade disputes, even as recently as 2010](#); however, at the moment, they do not seem to be part of the US list of NAFTA 2.0 plans. Proposals to introduce VERs would be a deal-breaker in our opinion.

In addition, [we will quote the reasons outlined by our team earlier](#), which we believe are deal-breakers for Mexico (the next five paragraphs are excerpts from the article submitted by our Chief Economist and Deputy Chief Economist a few weeks back):

“The most toxic proposal in the USTR's Objectives concerns the suggestion to do away with NAFTA's Chapter 19, which spells out the mechanisms by which disputes with respect to goods and services trade are resolved. Despite repeated calls throughout the Objectives for a means to increase market access for US exports, this proposal goes in the opposite direction. Chapter 19's expert tribunals provide neutral reviews and prescribe remedies in cases of alleged dumping, unfair subsidies, or other nontariff barriers that go against the letter and spirit of the level playing field NAFTA seeks to create. This dispute-settlement mechanism was the key reason that Canada entered into discussions on the CUSFTA and it is the most essential element of NAFTA for both Canada and Mexico. Chapter 19's processes could be improved through standing rosters of experts to participate on its tribunals, but Chapter 19 cannot be wholesale trashed. Without some version of Chapter 19, there is no NAFTA for either Canada or Mexico”.

“Canada and Mexico are also adamant that they need to maintain their existing exclusion under NAFTA from temporary ‘safeguard’ tariffs that the US imposes on surges of imports of specific goods from other countries. The USTR Objectives propose an end to this exclusion, which would hurt exporters from both countries in the event of a US trade dispute with non-NAFTA countries. Ending this exclusion is antithetical to the rules-based certainties under NAFTA that concessions in other areas are meant to provide”.

“From a foundational perspective, neither Canada nor Mexico can agree with the USTR’s overriding goal of reducing US trade deficits. As chart 1 shows, trade with China accounts for about 60% of the total global US trade deficit, trade with Europe covers about 21% of the deficit, and only about 7% of the deficit comes from trade with Canada and Mexico. Abstracting from energy and energy-related resource flows, the US runs a trade surplus in both goods and services with Canada. Substantial reductions in the US trade deficit can’t be achieved through changes in the trade policy framework with Canada and Mexico. Moreover, so long as the US dollar remains the global reserve currency, the US Treasury market maintains its role as a major haven from global risk, and the US as a whole spends more than it earns, the US will continue to run a surplus on its international capital account that has to be matched by a trade deficit in its international current account.”

“The USTR’s Objectives raise the possibility of revising NAFTA’s rules on the minimum amount of North American content goods must have in order to move throughout North America on a duty-free basis. NAFTA’s current rules of origin put this minimum local threshold at 62.5% of total content for autos and 60% for all other goods. On average, North American auto production easily exceeds this minimum and there could be room to raise it further without disrupting existing supply chains, though such a move would likely reduce the global competitiveness of North American vehicle production. It would be nearly impossible, though, for Canada and Mexico to agree to a further modification of NAFTA’s rules of origin that specifies a minimum contribution of US content: rather than advancing free trade, such a move would put NAFTA on an increasingly mercantilist footing.”

“Finally, the US government’s negotiating Objectives include several references to a desire to make public procurement process at all levels of government in the US more exclusively the domain of US suppliers under ‘Buy American’ rules—even as Canadian and Mexican government purchasing programs are increasingly open to firms of any nationality. Naturally, this movement toward less rather than more reciprocity under NAFTA would be politically and practically difficult for Canadian and Mexican negotiators to accept when the USTR Objectives themselves call for “Fair, transparent, predictable, and non-discriminatory rules to govern government procurement in the NAFTA countries.”

Recommended Readings:

[“America is now a dangerous nation”](#) G. Rachman—FT (August 14, 2017)

[“The Mexican paradox”](#) S. Levy, D. Rodrik—Project Syndicate (August 10, 2017)

[“Canada and Mexico rebuke Trump at tense start of Nafta talks”](#) S. Donnan, J. Webber—FT (August 16, 2017)

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