NAFTA: Uncertainty to Persist Throughout 2018

- We believe that a consensus on ‘renegotiating and modernizing’ the North American Free Trade Agreement (NAFTA) will eventually be achieved, but that it is unlikely by the current deadline of end-March 2018. A number of contentious US demands have complicated the talks: tighter rules of origin for vehicles, a possible ‘sunset clause’ tied to periodic renegotiation of the agreement, abolition of Canada’s supply-management systems, significant weakening of NAFTA’s dispute-settlement mechanisms, and hard constraints on Canadian and Mexican involvement in US government procurement.

- The year ahead will likely see attempts by both Canada and Mexico to help the United States reframe and revise these demands in ways that would make them less onerous and lopsided in their emphasis on US interests.

- As NAFTA negotiations extend beyond the end of Q1 2018, uncertainty about the future of NAFTA is likely to persist as the White House and the US Trade Representative (USTR) take possible steps to intensify pressure on Canada and Mexico ahead of the November 2018 US midterm elections. This may impose a chill on investment in both countries, even as the statutory terms of our trading relationships with the United States remain unchanged.

- We expect that NAFTA will survive what could be an extended ‘zombie’ period where it is not clear if the pact will be renegotiated and modernized, but the United States has not withdrawn from it.

NAFTA’S FUTURE IS UNLIKELY TO BE CLARIFIED SOON

The teams involved in the effort to renegotiate and modernize NAFTA remain far from reaching a consensus, and uncertainty regarding the agreement is likely to remain throughout 2018. A set of contentious proposals from the United States has stymied discussions among the three NAFTA countries and may even have delayed the closure of talks on specific issues, including small- and medium-sized enterprises, telecommunications, competition policy, digital trade, good regulatory practices, and customs and facilitation—topics on which agreements were previously said to be close. The odds of the NAFTA countries reaching a consensus on a new agreement by the end of March 2018—which we believe has always been an ambitious goal—have become longer.

THE END IS NOT NIGH… BUT NEITHER IS A CONCLUSION

Nevertheless, we do not believe this is the end of NAFTA. It remains very unlikely that any material changes in the trading relationships between Canada, Mexico, and the United States are in the offing. We do not expect NAFTA to be radically restructured to favour the United States, nor do we anticipate that the world’s most successful regional trade agreement is about to meet its end. Instead, beyond the extended end-March 2018 deadline for the negotiations, we believe that we are likely to see NAFTA enter a so-called ‘zombie’ phase where the pact isn’t dead and the terms of tariff and non-tariff
barriers to trade with the United States are more or less unchanged, but where continued uncertainty hangs over the agreement’s future. We expect this uncertainty to be resolved eventually with a consensus on the modernization of NAFTA, but this could take additional months or even years.

**US ‘POISON PILLS’ ARE ‘REDLINES’ FOR CANADA AND MEXICO**

Negotiations have stumbled on at least five major US demands that are untenable to Canada and Mexico.

1. A stated desire to tighten NAFTA’s rules of origin with a particular focus on increasing US content in automobiles by introducing a new requirement that vehicles must have 50% US value-added content and 85% NAFTA value-added content to qualify for NAFTA preferences.

2. The introduction of a possible ‘sunset clause’ that could see NAFTA up for review on a regular basis (likely every five years) and subject to cancellation if it is not affirmatively renewed.

3. The end of Canada’s dairy, poultry, and egg supply-management systems.

4. The gutting of NAFTA’s dispute-settlement mechanisms on investor protection, trade, and the operations of NAFTA itself.

5. Government procurement, where the United States wants to limit access to Canadian and Mexican firms in the US market to the total size of their own national public procurement sectors—while maintaining unbound access for US firms to Canadian and Mexican public procurement.

By institutionalizing these demands in a revised set of the USTR’s NAFTA negotiation objectives, the United States has made it harder to walk back or compromise on these redlines. Furthermore, because trade negotiations are all-or-nothing series of interlocking concessions, there is little chance that the three countries could conclude agreements on less-contentious issues and leave these more difficult points for further discussion at some later date.

**THE GOAL: ENGINEERING A US ‘WIN’ WITHOUT A ‘LOSS’ FOR CANADA AND MEXICO**

Canada and Mexico have adopted two approaches to counter these poison pills in the hope that the United States will make less onerous proposals that allow for a US win without also demanding that Canada and Mexico lose.

1. **On autos**, Canada used the fifth round of talks held during November 15–21, 2017, in Mexico City to show that the US proposal on rules of origin is unworkable and disadvantageous for the United States.
   - It is likely that the US proposal would drive vehicle and parts production overseas rather than back to the United States.
   - It would be difficult or impossible for most automakers to meet the content requirements the United States seeks given the increasing share of electronic components in most vehicles, which tend to be sourced from non-NAFTA nations.
   - The US proposal is a problem looking for a solution: NAFTA content in Canadian- and Mexican-assembled automobiles exported to the United States has risen since 2011, according to automaker data collected by the National Highway Traffic Safety Administration (NHTSA).

   At the same time, efforts are underway to find new methods to calculate content shares in Canadian and Mexican automobiles that would give the appearance of higher US shares, such as by placing a greater emphasis on US research and development contributions in value-added measurements.

2. **On the sunset clause**, Mexico has indicated a willingness to consider formalizing a regular meeting of the three countries—say, every five years—to review and renew NAFTA, but without the US-requested feature that NAFTA would lapse if a consensus were not reached on proposed changes to the agreement.
Nevertheless, US leverage in the negotiations should not be overstated. Although around 75% and 80%, respectively, of Canadian and Mexican exports go to the United States, only about half of non-petroleum exports take advantage of NAFTA preferences (see chart 1). For the rest, average World Trade Organization (WTO) most-favoured nation (MFN) tariffs have fallen so much over the last 23 years that the due diligence required to qualify for NAFTA duty-free access may no longer be worth the tariff savings generated. Specific sectors, such as the highly integrated North American auto industry, are, however, much more dependent on NAFTA because production goes back and forth several times across borders and would compound even low MFN tariffs (see chart 2). Light truck manufacturers that would face a 25% US import tariff would be more severely impacted than autos producers that would need to pay only a 2.5% duty.

Despite these and other creative efforts by both Canada and Mexico, we do not see a win-win-win solution emerging by the end of March 2018—but, this is not cause for despair. Trade deals are not typically made in just a few months: NAFTA took four years to negotiate, it took six years to negotiate the Trans-Pacific Partnership (TPP) Agreement, and it took seven years to negotiate the Canada-European Union Comprehensive Economic and Trade Agreement (CETA). Fundamentally renegotiating NAFTA in just a few months has never been a credible proposition, in our opinion.

**KEEP CALM AND TRADE ON AS THE ZOMBIE NAFTA ERA DAWNS**

The chances of NAFTA being ripped up are slim, but it is likely that the agreement will face an extended period of uncertainty during 2018, resulting in a zombie NAFTA era, during which time the status of the pact will remain unclear. It is very difficult for President Trump to change fundamentally the United States’ trading relationships with Canada and Mexico.

- President Trump may invoke—or simply hint at invoking—NAFTA Article 2205, which would initiate a six-month withdrawal notice period if a consensus is not reached by April 2018. This would allow him to increase pressure on Canada and Mexico ahead of the November 2018 US midterm elections. However, the passage of a US tax reform package could mitigate the perceived need for the White House to take bold action on trade.

- President Trump is unlikely to take the next step and actually withdraw the United States from NAFTA.
  - In his first year as President, Mr Trump has shown a consistent pattern—whether on debt limits, the Paris climate accord, health care, or immigration reform—to speak loudly and carry a small stick. On each issue, follow-through after initial bombast has been limited.
  - Senators, representatives, state governors, and local officials, as well as more than 300 US chambers of commerce, many from areas that helped to elect the President, have come out in support of NAFTA.
  - Although settled legal opinion has generally implied that the President might have the power to cancel a trade deal without congressional consent, the White House would likely be reluctant to face multiple constitutional court challenges to any attempt to pull the United States out of NAFTA. These cases would likely take between 18 months and two years to resolve.

Substantive aspects Canada’s trade relationship with the United States are unlikely to change in the near term, even if the United States takes a break from NAFTA. NAFTA would continue in its current state as court challenges to any attempt to withdraw from the trade pact proceed. Even if the White House were to succeed in these cases and the United States were to withdraw from NAFTA, the main result would likely be an end to US participation in NAFTA’s dispute-settlement panels on trade and investment: broad and durable changes in tariffs and non-tariff barriers would require legislation.

No matter the outcome of the 2018 midterms, Congress would still be unlikely to pass a bill to raise tariff and non-tariff barriers. The President does not have the power to effect a generalized increase in duties without Congressional approval.
Regardless of what the United States does, NAFTA would continue to govern trade and investment interactions between Canada and Mexico unless either country decides to withdraw. For instance, investor protections for Canadian assets in Mexico would remain in place even after a US withdrawal from NAFTA.

CANADA AND MEXICO CAN SURVIVE—EVEN THRIVE—UNDER ZOMBIE NAFTA

Macro-level data imply that NAFTA uncertainty has not yet dented investment growth in Canada or Mexico and is unlikely to have a major impact on growth in the future. Looking forward, if an extended period of zombie NAFTA were to cut investment growth rates in Canada and Mexico by a full percentage point, Scotiabank Economics’ Global Macroeconomic Model implies that overall annual real GDP growth rates would be shaved by only about 10 basis points (bps) in Canada and up to 20 bps in Mexico over the next couple years. Further out, we expect growth in both countries to return to trend.

If the White House were to make moves to withdraw the United States from NAFTA, the Canadian dollar and Mexican peso would likely immediately adjust to increase the competitiveness of Canadian and Mexican exports, while the central banks in both countries would be inclined to cut interest rates to cushion the impact of US withdrawal on their domestic economies. If the White House were to succeed in shifting to MFN tariff rates a year or two following withdrawal, the effects would vary widely at the sectoral level, and would have:

- little impact on extractive industries, where MFN tariffs are generally zero or very low;
- varied, but moderate effects on metal goods, unrefined agricultural goods, and retail sectors; and
- a much more significant effect on trade in food products, textiles, autos, and manufactured goods businesses, amongst others.

Yet, at the economy-wide level, we believe both Canada and Mexico would adjust. Annual real GDP growth would be cut only by up to 30 bps in Canada and up to 50 bps in Mexico for the first couple of years after the switch to MFN tariffs. In later years, the economy-wide effects of a move to MFN tariffs would likely be muted owing to generally low tariff rates and a natural adjustment of the economy to a changing trade landscape.

NAFTA IS LIKELY TO SURVIVE THE ZOMBIE APOCALYPSE

Our core expectation is that NAFTA will survive any zombie phase: renegotiation and modernization will eventually happen on terms that deliver a tripartite win. However, this is likely to take more time than the current end-March 2018 deadline permits and there will be significant uncertainty through much of 2018 for industries dependent on the agreement.
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