NAFTA: USMCA Preserves Open Trade in North America

- **The US and Canada reached a late Sunday night agreement on outstanding bilateral issues in the renegotiation of NAFTA and, together with Mexico, have announced a refresh of the 1994 trade agreement under the name of the US-Mexico-Canada Agreement (USMCA).**
- **A draft of the USMCA has been submitted to the US Congress for review, a necessary step to ensure President Trump and Mexican President Enrique Peña Nieto can sign the deal prior to the end of the Mexican President's term on November 30, 2018. With the ratification of the agreement likely to follow by the legislatures in all three countries, the future of trade policy on the continent is now clear after nearly a year and a half of uncertainty.**
- **While the USMCA preserves the main features of free trade under NAFTA, the USMCA also provides for greater local content in North American automobiles and increased access for US producers to Canada's managed dairy, egg, and poultry markets.**
- **Most importantly, the USMCA's side letters provide Canada and Mexico with clear protection from any future move by the US to impose Section 232 'national-security' tariffs on imports of their vehicles and parts.**

The US and Canada announced late Sunday night an agreement on outstanding bilateral issues in the revision of the North American Free Trade Agreement (NAFTA) that allows Canada to join the set of preliminary understandings reached between the US and Mexico in late-August on revamping the rules of North American trade. The announcement authorised the US Trade Representative's (USTR) office to send to the US Congress the draft text of this trilateral overhauling of NAFTA—now rebranded the United States -Mexico-Canada Agreement (USMCA)—by the October 1 deadline for review ahead of a potential signature by US President Trump and Mexican President Enrique Peña Nieto on EPN's last day in office on November 30, 2018.

The agreement is positive news in that it preserves tariff-free trade between all three countries on close to all of the goods and services exchanged between them. Overall, USMCA updates and improves on some elements of NAFTA, injects minimal new frictions into North American trade regulations in response to domestic political concerns, and represents a strong outcome when set against some of the member countries' initial negotiating positions.

This note reviews and analyses the main features of the draft USMCA text across 34 Chapters and 12 side letters, and it looks forward to next steps on the deal's road to institutionalization. We expect the agreement to be signed and ratified by all three member countries on the most expeditious timetable possible—which even then will likely stretch well into the first half of 2019 for the US process. The agreement should more or less immediately alleviate any uncertainty regarding the future of North American trading arrangements and lift any drag this uncertainty may have imposed on economic activity in the near to

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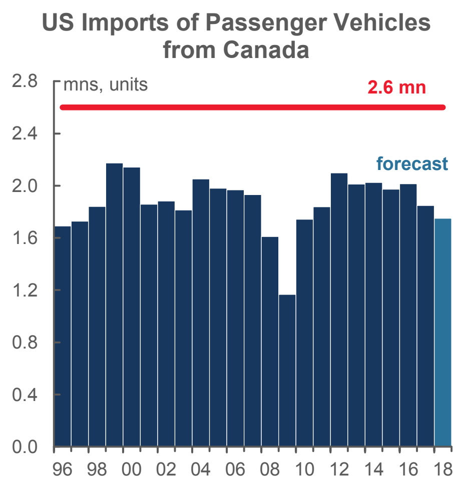
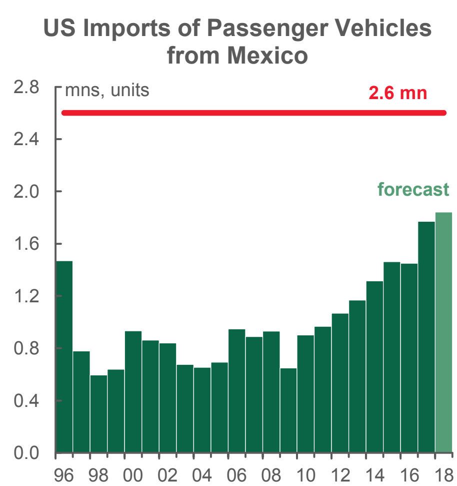
Chart 1



Sources: Scotiabank Economics, US ITC.

Chart 2



Sources: Scotiabank Economics, US ITC.

medium term. **We also expect the Canadian and Mexican teams to earn an exemption from tariffs on steel and aluminum imports in the coming months.**

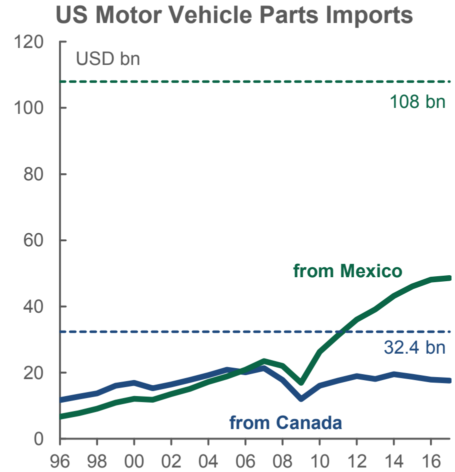
NAFTA IS SET TO BE CANCELLED AND REPLACED

At the outset, the USMCA draft anticipates that it will replace NAFTA. In contrast, NAFTA superseded its precursor, the Canada US Free Trade Agreement (CUSFTA). This has left lingering uncertainty whether CUSFTA remains a fall-back option for Canada and the US if the one of the NAFTA member countries were to withdraw from NAFTA. Under USMCA, NAFTA would be cancelled, not superseded.

BETTER THAN EXPECTED ON THE US'S STRONG OPENING DEMANDS

In the autumn of 2017, the US made five extreme demands as the NAFTA talks moved beyond preliminary issues and into substantive discussion. On each of the issues, the USMCA draft provides a better outcome than some initially thought would be possible. Looking at each negotiating point in turn shows a draft agreement that, while not perfect, keeps the essence of NAFTA in place.

Chart 3



Sources: Scotiabank Economics, US ITC.

I. Automobile rules of origin (ROO)

The USMCA raises local content requirements in automobiles and parts, but less so than initially demanded by the US. The US opened talks on automobiles by insisting on an increase in the regional value content (RVC) required for vehicles to move duty-free in North America from the current 62.5% to 85%. Within this 85% RVC, the US sought to require that 50 percentage points would be generated in the United States. This 50% US sub-requirement was dropped some time ago and the 85% North American RVC rule was lowered to 75%. For parts, where RVC shares of between 50% and 60% have been required under NAFTA, the thresholds are raised to between 60% and 75%. Instead of a US-specific RVC, 40% of an auto's content must come from plants where the hourly wage is at least USD 16/hour—which has been dubbed a new 'labour value content' share or LVC. The LVC has different sub-requirements for light trucks. The USMCA ROOs also require vehicle makers to certify that 70% of their purchases of steel and aluminum are from North America.

Both the labour and regional content requirements have four-year phase-in periods that provide automakers with a relatively long runway to adjust their production. Regarding passenger vehicles and light trucks, the RVC must be 66% or higher on January 1, 2020; this share is scheduled to increase by three percentage points each year until it reaches 75% in 2023. The LVC requirement is slated to kick-in at 30% in 2020, with a three percentage-point increase in each of 2021 and 2022 and a final four percentage-point increment in 2023 to 40%.

Canadian and Mexican auto production should find it relatively easy to comply with USMCA's new RVC requirements: the North American RVC in Canadian auto production is already around 71% and the RVC for the Detroit Three is over 80%. The new LVC rule may, however, shift a marginal amount of production from Mexico to the US and Canada, where wages and productivity levels are already consistent with this new standard.

Side letters to the agreement also ensure that Canada and Mexico are provided with practical assurances that they will not be subjected to so-called 'national security' tariffs on autos and parts under the US's Section 232. For both Canada and Mexico, respectively, the side letters exempt up to 2.6 mn cars annually from Section 232 auto tariffs, even if the White House elects to move ahead with these duties against imports from other countries. As chart 1 shows, US auto imports from Canada sit well below the 2.6 mn threshold and it is highly unlikely that they will reach this limit in the foreseeable future and thus be subject to US tariffs. In Mexico's case, it could hit the side letter's ceiling at some point in the latter half of the coming decade if production in the country continues to increase as it has in recent years (chart 2). By that point, however, it may be possible to renegotiate the letter's terms. The side letters also spell out upper bounds for parts imports from both countries in US-dollar terms. On current trends, chart 3 shows that this ceiling is unlikely to be hit by either Canadian or Mexican auto parts imports to the US. Under the side letters, light trucks are exempted from Section 232 tariffs.

Under the new USMCA draft, the US agrees to a negotiating period of 60 days during which any new US Section 232 actions shall not apply to Canada and Mexico, pending "an appropriate outcome based on industry dynamics and

historical trading patterns." Notwithstanding NAFTA, USMCA, and WTO obligations, the US's USMCA partners are empowered to respond in kind with measures of equivalent commercial effect, and they retain their WTO rights to challenge Section 232 measures.

Over a longer-term horizon, USMCA's extra administrative requirements and higher wage costs will likely increase the price of North American cars and reduce the international competitiveness of the industry—with the possible result that some production is eventually shifted overseas rather than re-shored to the US.

II. Dispute settlement mechanisms

The US negotiating objectives initially sought the elimination of both the investor-state dispute settlement (ISDS) process under NAFTA's Chapter 11 and the review process for the application of anti-dumping and counter-vailing duties under Chapter 19. Chapter 20, which lays out a process for treating disagreements over the implementation of NAFTA, had not been raised as an issue by the US. **In the USMCA draft, Chapters 19 and 20 survive renumbered, but apparently unchanged.** This is a substantial win for the Canadian government, which considered Chapter 19 a non-negotiable must-have in any renovated North American free trade agreement.

For at least the three years subsequent to the replacement of NAFTA by USMCA, existing investments across NAFTA's borders have their protections under Chapter 11 grandfathered in. Beyond that point, Chapter 11 is eliminated for Canada-US cross-border investments, its protections are curtailed to a specific set of sectors for US-Mexico foreign direct investment (FDI), and Canada-Mexico investment disputes would be treated under provisions spelled out in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) that provide similar protections to NAFTA's Chapter 11.

III. Supply management

Under USMCA, the US actually managed to improve on the access it would have been provided under the Trans-Pacific Partnership (TPP) across dairy, poultry, and eggs (table 1). Under the terms announced, Canada will open a similar percentage of each market as would have been the case under TPP, but rather than sharing this access with 10 other countries, US producers alone could move into these markets. The US's opening demands on Canadian supply management ranged from a rhetorical demand for the end of the system to a more limited call for the elimination of the class 7 milk-pricing category that rendered some US unfinished dairy exports uncompetitive in Canada.

The USMCA draft adds a future requirement of 30-days' advance notice and consultation on changes to Canadian tariffs on dairy, poultry, and eggs, and similar expectations on alterations to US tariffs on sugar, sugar products, and dairy goods.

Table 1

Tariff Rate Quotas Under FTAs

	CPTPP	USMCA	CETA
Cheese (MT)			
year 1	2,416	2,084	3,774
year 6	14,500	12,500	17,700
year 13	15,545	13,402	17,700
year 16	16,016	13,808	17,700
year 19	*16,502*	*14,226*	*17,700*
highest access: CETA			
Milk (MT)			
year 1	8,333	8,333	-
year 6	50,000	50,000	-
year 13	53,607	53,607	-
year 16	55,231	55,231	-
year 19	*56,905*	*56,905*	-
CPTPP = USMCA			
Cream (MT)			
year 1	500	1,750	-
year 6	580	10,500	-
year 13	713	11,257	-
year 16	*734*	11,599	-
year 19	734	*11,950*	-
highest access: USMCA			
Eggs (mn dozens)			
year 1	2.8	10.0	-
year 6	16.7	16.1	-
year 13	17.9	*31.4*	-
year 16	18.4	31.4	-
year 19	*19.0*	31.4	-
highest access: USMCA			
Chicken (MT)			
year 1	3,917	47,000	-
year 6	23,500	57,000	-
year 13	25,195	61,112	-
year 16	25,959	*62,963*	-
year 19	*26,745*	62,963	-
highest access: USMCA			

MT = metric tons; italics represent ceiling
Sources: Global Affairs Canada, USTR.

IV. Sunset clause

Under USMCA, the agreement's operations would be subjected to a concerted review every six years. This stands in contrast to a US proposal to move from NAFTA's current indefinite status to a five-year sunset-clause at which point a country's involvement in the free-trade area would end unless the country instead affirms its desire to remain in the deal.

If the member countries do not raise any problems, the agreement would renew for another 16 years with the next review six years off. If, instead, issues are raised, the member countries would move to annual reviews for up to a decade: once any outstanding issues are solved they would revert to reviews every six years. If a country finds its concerns aren't resolved within this decade, it would be understood that it could exercise an option to withdraw or renegotiate the pact. This rolling

16-year horizon provides greater assurance to business that it can undertake investment under a stable set of rules that are more aligned with typical capital-expenditure cycles than a five-year sunset clause would have provided.

V. Government procurement

The USMCA draft leaves access to all three countries' procurement processes unchanged from the status quo. The USTR initially sought to limit Canadian and Mexican access to all US public procurement processes to the equivalent size of their respective domestic government procurement markets. The US dropped its earlier insistence on intensified 'Buy America' provisions.

OTHER ISSUES: A MIXED, BUT MAINLY POSITIVE, BAG

A surprise warning on free-trade with China. Chapter 32 of the USMCA draft provides the accord's biggest surprise: it commits the member countries to a three-month notice period ahead of any negotiations with a 'non-market' country on a free-trade agreement (FTA). The chapter appears to hint at possible trade negotiations by Canada or Mexico with China, which has been the main target of the US administration's protectionist policies. In the event that an understanding on an agreement is reached, it further commits the member countries to a one-month consultation on the draft agreement with their USMCA partners. Finally, it empowers any of the three countries to terminate the USMCA if one of them concludes an FTA with a non-market country. The definition of what constitutes 'non-market' rests with the discretion of each USMCA member.

Intensified intellectual property provisions. As expected, the USMCA provides for intensified protections on intellectual property through longer patent periods and tighter copyright provisions. The move to extend patent protections on drugs from eight to 10 years in Canada will delay the introduction of future generics, and likely increase costs for consumers, insurers, and government drug plans.

Increased *de minimis* thresholds (DMT) for Canada and Mexico. The lower bound for the application of tariffs on inbound shipments to Canada is set to increase from CAD 20 to CAD 150, with the lower threshold for sales taxes set to be raised from CAD 20 to CAD 40; the Mexican DMT for tariffs would rise form USD 50 to USD 100. The proposed increases in the DMT for duties should increase choice and affordability on small purchases from abroad for Canadian and Mexican consumers and small businesses. It could also, paradoxically, increase effective protection for Canadian retailers: at present, tariffs are only intermittently collected on small deliveries since the cost of imposing them may be more than they're worth. With a higher DMT, we could see Customs Canada collect duties more consistently, raise more government revenue, and put Canadian retailers in a more competitive position. The proposed terms also keep the DMT on sales taxes relatively low at CAD 40, which should keep the playing field relatively level for both e-commerce providers and bricks-and-mortar stores in Canada.

No change in NAFTA visas. There had been a hope that a revised NAFTA would see an updating and expansion of professional (TN) visa provisions. In the current circumstances, this is probably the best that could be expected.

Greater autonomy on natural resources. The USMCA removes the expectation under NAFTA, which was never tested, that Canada would provide consistent year-on-year supplies of oil to the US. A side letter to the USMCA spells out that Canadian freshwater resources are excluded from the agreement. Finally, Chapter 8 of the USMCA institutionalizes Mexico's recent constitutional changes around hydrocarbons in the trade pact.

Withdrawal clause marginally more automatic. A small adjustment in the wording of the withdrawal clause from NAFTA to the USMCA draft implies that, following a six-month notice period, withdrawal could be presumed to be automatic rather than optional.

Currency manipulation line in the sand. An entire chapter is introduced in the USMCA that warns against currency manipulation by any of the member countries. The chapter is more or less moot given that all of the three parties have flexible exchange rate regimes, but the text clearly serves as a model for future US demands in other bilateral and regional trade agreements.

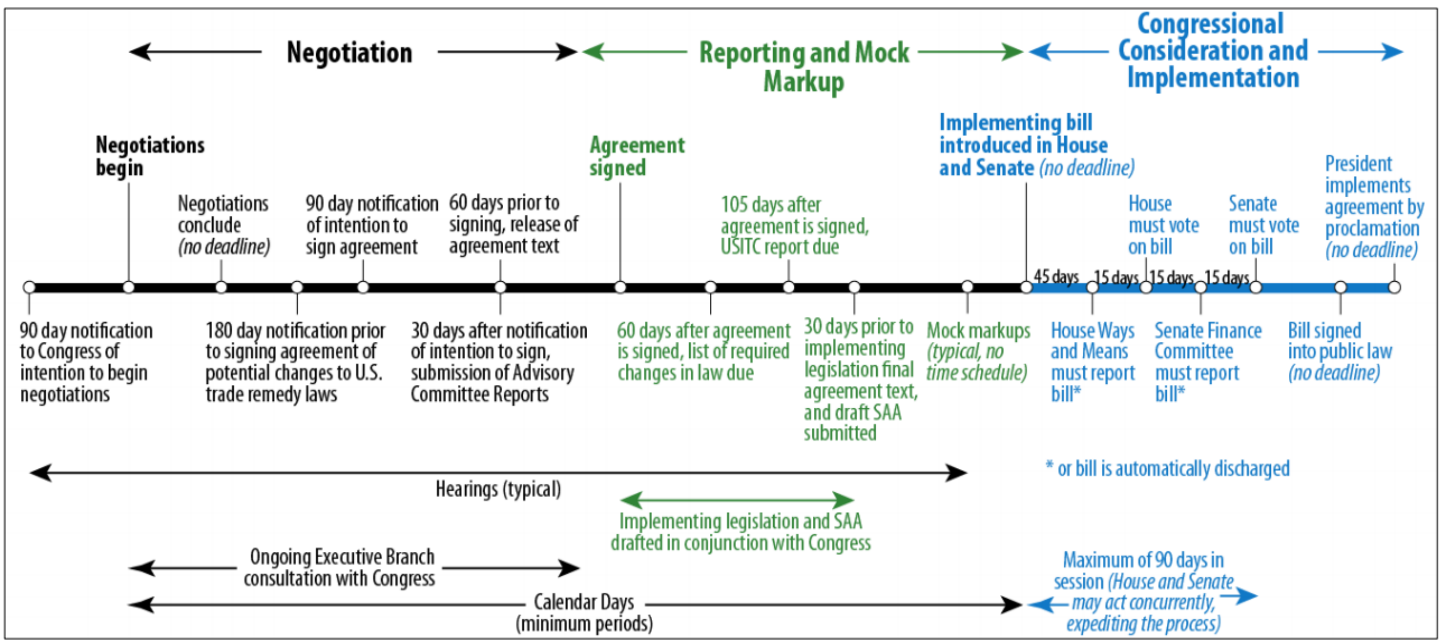
Settling a wine dispute. A side letter commits the Canadian federal government to work with BC to end what the US views as discriminatory rules around the sale of domestic and foreign wine in BC grocery stores. Other provincial alcohol monopolies, grandfathered marketing systems, bottling rules, and other Prohibition-era practices are allowed to continue under the USMCA.

NEXT STEPS: FULL STEAM AHEAD

US Trade Representative Robert Lighthizer indicated that US tariffs on steel and aluminum imports would be discussed following the renegotiation of NAFTA. Now that NAFTA, or USMCA, has been agreed upon, Canadian and Mexican negotiators should push forward with talks aimed at gaining an exemption from the metals tariffs on the basis of 'so-called' national security concerns under Section 232. Furthermore, the new 70% steel and aluminum requirement for autos necessitates an elimination of trade barriers for these materials.

We expect the USMCA text to be scrubbed for typos, inconsistencies, and omissions over the next 60 days and sent into the legislative ratification process in all three countries. This should be straightforward in both Mexico and Canada where the governing parties control majorities in their legislatures. The US ratification is longer and involves more structured review, as laid out in the timeline from the US Congressional Research Service in chart 4—and it will straddle the November midterm elections and the arrival of a new US Congress in January. Nevertheless, we expect the USMCA to be ratified as it more than meets the minimum demands of both sides of the US political divide: it preserves North American free trade as a three-party agreement and it strengthens labour, environmental, and other regulatory measures.

Chart 4



Source: CRS.