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How will NAFTA negotiations play out?

Introduction

Donald Trump's promise to take a much tougher line on trade was a key part of his election platform. After withdrawing from the Trans-Pacific Partnership, he is now focused on renegotiating NAFTA.

This report analyzes:

- The main sectors up for negotiation
- Changes that could be made to NAFTA
- Why Trump will not attempt to withdraw from NAFTA
- Why the disagreements between NAFTA members will ultimately pale in comparison to the growing trade tensions between the United States and China

Despite President Trump's repeated threats to walk away from NAFTA if he is unable to negotiate a better deal, his main goal is to extract enough concessions from Mexico and Canada to declare victory without overly disrupting the U.S. economy and alienating his electoral base.

The main sectors up for negotiation

Rules of origin

The United States wants to increase how much of a product must be produced within the NAFTA trade zone to qualify for tariff-free status. It is also pushing for the right to add a new U.S. content requirement. For example, under NAFTA, at least 62.5% of an automobile must be made in the trade bloc to avoid the imposition of tariffs. Raising this threshold to 75%, for instance, would force manufacturers to reduce the amount of materials they source from outside the NAFTA zone, or pay more tariffs.

The rules of origin could also be modernized to include sophisticated electronics and software, which were virtually non-existent in cars when NAFTA came into effect in 1994. Canada's Automotive Parts Manufacturers Association estimates that advanced electronics/software accounts for 25%-30% of the value of a typical car today, up from less than 1% in 1994.[1] Much of these electronic components are currently imported from Asia.

Canada and Mexico have indicated that they are open to increasing the content requirements but that any changes must apply equally to all three countries. We feel that the push for a U.S. content requirement is merely a ploy for extracting concessions in other areas. What this means is that the chances of arriving at an agreement in this area are fairly high.

Trade dispute mechanism

The United States wants to eliminate the trade dispute panel (Chapter 19), which is used when one country challenges the legality of another country's trade barriers. It has been employed mostly by Mexican and Canadian companies against the United States. The Trump administration maintains that the panel infringes on the country's sovereignty and wants to revert to U.S. courts instead. Both Canada and Mexico have stated that maintaining this panel is crucial but have left the door open for it to be "modernized."

As for the investor-state dispute settlement mechanism (Chapter 11), which allows corporations to sue national governments over alleged unfair treatment or legislative practices, the U.S. position is less clear. Despite the fact that Trump has railed against the system for undermining U.S. sovereignty during the election campaign, the United States has yet to settle on a clear position for this issue. This could be because American corporations have come out strongly against weakening this dispute settlement mechanism. Canada, on the other hand, clearly wants to weaken the ability of corporations to sue governments over public policy decisions. Mexico has not yet come out with a clear position on the matter.

[1] "Auto groups side with Canada, Mexico on NAFTA origin rules," Reuters, August 17, 2017

A compromise could be to reduce the ability of countries to challenge the trade policies of other countries (U.S. position) in exchange for weakening the capability of corporations to challenge government policies (Canadian position).

Government procurement

The United States' opening position is that Canada and Mexico must open their government contracts to U.S. companies while the United States maintains its existing "Buy American" provisions. Canada and Mexico are proposing that all countries be barred from giving preferential treatment to their respective companies.

Agriculture

The United States is seeking to eliminate Canadian barriers to its agricultural exports. Canada sets production quotas for milk, eggs and poultry and adds tariffs of up to 300% on imports. **Like it did when it accepted increased tariff-free imports of European cheese in order to reach a trade deal with the EU, Canada could dangle increased access to its agriculture markets in return for gains in other sectors. As for Mexico, it is already relatively open to U.S. agricultural products.**

Labour and environmental standards

While Canada and the United States are at odds in many areas, they appear to be in tacit agreement that low labour standards in Mexico constitute an unfair competitive advantage. The two countries feel that tighter labour standards would help increase Mexican wages. For example, despite billions in FDI over the last decade, Mexico's auto industry still pays wages that are 12% to 18% of those in the United States.[2]

Mexico, for its part, is understandably wary of adopting regulations that would render it less competitive. While it is officially open to ensuring a stricter enforcement of its labour laws, Mexico does not support specific measures that would force it to raise wages.

When it comes to the environment, it is highly doubtful that Washington will agree to Canada's demands for adding protections in NAFTA. After all, the Trump administration is pulling out of the Paris Agreement and recently eliminated numerous environmental regulations.

Would (or could) Trump actually withdraw from NAFTA?

President Trump's recently revived threat to pull the United States out of NAFTA has again renewed the debate over whether the President actually has the authority to unilaterally withdraw from trade deals.

Some experts maintain the President can unilaterally walk away from NAFTA with only six months' notice, while others feel only Congress has the constitutional authority to kill trade deals.[3]

Regardless of who is right, we believe it is highly unlikely that President Trump would actually take steps to withdraw from NAFTA. The economic and political costs would be too high. It would spark a rebellion in Congress, create market turmoil, risk disrupting the activities of companies with supply chains spread across the NAFTA trade zone, and trigger a wave of lawsuits challenging the legality of the move. It could also anger several trade-reliant, pro-Trump border states. All of this would further consume a Presidency already struggling with the collusion investigation, leaks, internal infighting, high disapproval ratings, and an increasingly stalled legislative agenda.

Even more importantly, President Trump does not have to resort to the nuclear option of ripping up trade agreements in order to implement protectionist measures. He has the legal authority to impose tariffs or quotas on virtually any sector of the economy without the approval of Congress. This is because, over the past century, Congress has relinquished much of its power to regulate trade to the executive branch.

One extreme scenario would be for Trump to trigger the six-month notice to withdraw from NAFTA in order to force his negotiating partners to make concessions. However, there is a risk that public anger from their citizens could force Canada and Mexico to harden their positions. Indeed, Mexico has already threatened to withdraw from negotiations if Trump triggers the six-month notice period.

[2] "Labor Wants to Make Nafta Its Friend. Here's the Problem," New York Times, August 22, 2017
[3] "Trump can't withdraw from NAFTA without a 'yes' from Congress," The Hill, August 16, 2017

Negotiations must also contend with a busy electoral calendar

The longer it takes to conclude negotiations, the greater the risk they become a major campaign issue. Mexico has an election scheduled for July 2018, while U.S. mid-term congressional elections are slated for November 2018. Congressional Republicans do not want to go into these elections with trade uncertainty looming as a major issue.

As for Mexico, there is the risk of the next president changing Mexico's stance on NAFTA immediately upon taking office (the current president cannot run for re-election). This risk been heightened by the fact that Trump's sometimes incendiary rhetoric against Mexico has bolstered support for far-left presidential candidate Manuel Lopez Obrador of the Morena Party. This left-wing populist has positioned himself as a major critic of Trump and NAFTA. He has promised to cancel any agreement that hurts Mexico. A July 23 poll by the newspaper Reforma put Obrador's party in first place with 28% of the vote, followed by 23% for the centre-right PAN Party and only 17% for the currently governing PRI Party. Regardless of who wins, an angry Mexican government could also scale back cooperation on crime, drugs and illegal immigration. **All of these factors will ultimately force Trump to moderate his stance vis-à-vis Mexico in trade negotiations.**

Finally, efforts to conclude NAFTA negotiations by early 2018 at the very latest so they do not become a major election issue leaves very little time for major changes to be negotiated. It took nearly three years for the United States, Mexico and Canada to negotiate the terms of the original NAFTA deal in the early 1990s.

The real sources of trade tensions will be between China and the United States

Despite the headlines generated by the NAFTA negotiations, the main source of trade tensions over the long term will be between the United States and China for the following reasons:

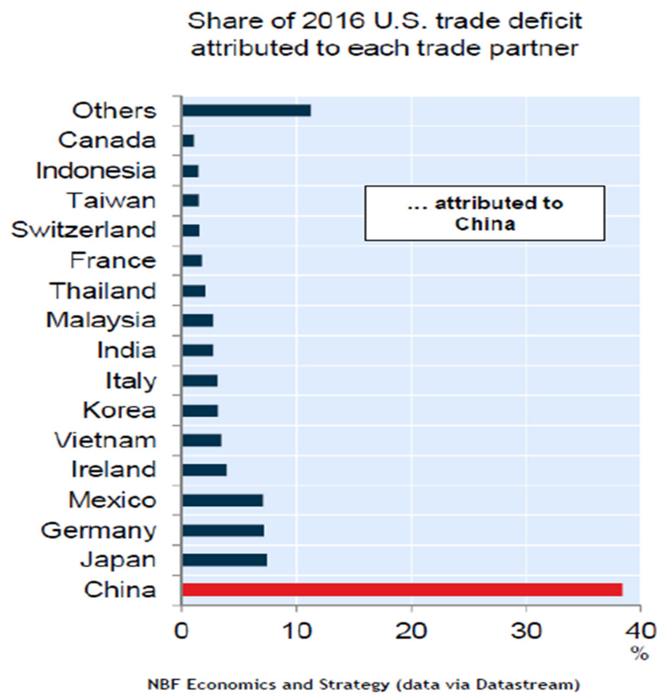
- **Intellectual property theft**: U.S. firms that want access to Chinese markets must often enter into joint ventures with Chinese companies and share their intellectual property. A recent report by the U.S. Commerce Department estimated the annual value of the theft of American intellectual property to be as much as $600 billion. The report named China as the main culprit.
- **Massive trade deficit:** In 2016, the United States registered a trade deficit in goods of $347-billion with China, versus a deficit of only $63 billion with Mexico.
- **Interconnectedness:** On average, only about 4% of the parts found in Chinese imports are sourced from the United States, versus 40% for Mexican imports.[4]

There is also growing agreement among business and political parties that a tougher line must be taken against China.

- **U.S. firms that had long been against imposing tariffs on China are now increasingly in support of reciprocity.** That is, Chinese companies should have access to a sector of the U.S. market only if U.S. firms are afforded the same privilege in China. The following are two examples of the many points of contention that exist: 1) Chinese IT firms such as Alibaba can run data centers in Silicon Valley, whereas their U.S. counterparts, like Amazon, must enter into partnerships with local firms if they wish to do the same in China; 2) China's Geely Holding Group purchased Volvo from Ford in 2010, but U.S. car companies cannot buy Chinese auto manufacturers.
- **The Trump administration's trade team is still led by economic nationalists**. Robert Lighthizer, America's top trade negotiator, agrees with Trump that China's trade surplus with the United States must be reduced. Peter Navarro, another White House trade advisor, is the author of a book called Death by China.
- **The Democrats are also pushing for a harder line on China**. In a recently published report entitled "A Better Deal for Trade and Jobs", Senate Democrats state that they support the creation of: **"a new Independent Trade Prosecutor, which would begin rapidly challenging unfair trade practices by foreign countries, like China, that have been ignored for far too long, without relying on the years-long World Trade Organization process."**
- **U.S. Trade Representative Robert Lighthizer recently launched an investigation** to determine whether China's policies toward intellectual property are in violation of Section 301 of the Trade Act, which allows the President to unilaterally impose trade restrictions. **Senate Democratic leader Chuck Schumer has pressed the President to skip the investigation and implement trade sanctions against China immediately.**

[4] "Preserving Order Amid Change in NAFTA," Stratfor, March 14, 2017

Trade tensions between the two countries will be exacerbated by the fact that China is seeking to become the global leader in several key industries of the future, including artificial intelligence, pharmaceuticals, robotics, computers chips and electric cars. The United States is currently the leader in many of these sectors.



Conclusion

Despite Trump's repeated threats, NAFTA will not be shredded. The economic and political consequences would be much too negative for an administration already struggling with a collusion investigation, leaks, low approval ratings, and numerous foreign policy challenges, including North Korea. What's more, turmoil in the financial markets and in the economy would risk taking away one of Trump's main talking points: the strong performance of the economy and financial markets under his watch.

The most likely scenario is that amendments will be made to several sections of the NAFTA agreement that will be simultaneously minor enough in scope for each country to obtain their legislative approval and significant enough for each side to declare victory.

In the end, the NAFTA negotiations will be perceived as a minor skirmish that sets the stage for the real battle: the trade war brewing between China and the United States.

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