RTA Exchange

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Introduction

The first round of talks on modernizing NAFTA – the NAFTA (re) negotiation - took place in Washington, DC, on the third week of August, with Canada, Mexico and United States negotiators making detailed conceptual presentations of their positions. Negotiators from the three countries will meet again several times during the next few months with the aim to conclude the whole negotiating process in seven rounds of talks through December this year and perhaps early 2018. They would try to wrap up a whole new agreement before elections in both the United States (mid-term legislatives) and Mexico (July presidential elections) lead to further complications.

This is a rather ambitious goal. The original NAFTA negotiations took three years to be completed, and the three participating countries were on the same page and had a shared goal: to complete a landmark agreement that would set the North America region on a path of economic integration and sustainable development. This time the negotiations would be further complicated by the position taken by the United States vis-à-vis Mexico since the beginning of President Trump administration, and even before, during the US presidential elections last year.

On the campaign trial, candidate Trump consistently called NAFTA the "worst trade deal" the United States had ever signed, and after notifying Congress of its intentions to renegotiate the agreement, in mid-July the USTR unveiled its major objectives for the NAFTA renegotiation. Chief among them was to reduce the U.S. trade deficit, which president Trump has blamed for shuttering factories and contributing to significant job losses in the U.S. manufacturing sector.

Source - © Getty - Freight lorries pass through Mexican customs control before entering the US

THE ECONOMICS OF NAFTA

The North American Free Trade Agreement, or NAFTA, which entered into force in January 1994 provided for the elimination of most tariffs on products traded among Canada, Mexico and the United States. Liberalization of trade in agriculture, textiles, and automobile manufacturing was a major focus. The deal also sought to protect intellectual property, establish dispute-resolution mechanisms, and, through side agreements, implement labour and environmental safeguards.

NAFTA fundamentally reshaped North American economic relations driving an unprecedented integration between Canada and the United States' developed economies and Mexico, a developing country. It encouraged a more than tripling of regional trade and cross-border investment between the three countries also grew significantly.

NAFTA came into effect during President Bill Clinton's first term, but was the brainchild of Clinton's Republican predecessors, George H.W. Bush prime among them. Mexican tariffs were far more protectionist than American ones at the time, and business leaders had lobbied successive governments for a free-trade agreement with Mexico to match one already in place with Canada. With Japanese productivity booming and the European Union forming around the same time, keeping the United States competitive was a major concern. Despite pushback from Democrats and union leaders concerned about labour and environmental protections, Clinton championed the broadened agreement alongside Rep. Newt Gingrich (R-Ga.), then the House minority whip.

One of the terms most closely associated with NAFTA is outsourcing: the process through which companies take advantage of trade agreements to put their operations in the country that's most cost-effective. Untangling these retooled supply chains is part of what would make NAFTA so costly to withdraw from. The agreement became a conduit for that new economic "ideology", which was already emerging as technology improved global transport: by letting corporations operate across borders with minimal regulation, they will provide cheaper goods and more jobs.

When negotiations for NAFTA began in 1991, a key goal for all was the integration of Mexico with the highly developed, high-wage economies of the United States and Canada. The hope was that freer trade would bring stronger and steadier economic growth to Mexico, providing new jobs and opportunities for its growing workforce and discouraging illegal migration from Mexico. For the United States and Canada, Mexico was seen both as a promising new market for exports and as a lower cost investment location that could enhance the competitiveness of U.S. and Canadian companies.

NAFTA also ushered in a new era of regional and bilateral free trade agreements (FTAs), which have proliferated as the World Trade Organization's (WTO) global trade talks have stagnated. The United States now has FTAs with twenty countries, and is planning for major new regional deals with Asia and Europe. NAFTA also pioneered the incorporation of labour and environmental provisions in U.S. trade agreements, provisions which have become progressively more comprehensive in subsequent FTAs.

Economists largely agree that NAFTA has provided benefits to the North American economies. Regional trade increased sharply over the treaty's first two decades, from roughly $290 billion in 1993 to more than $1.1 trillion in 2016. Cross-border investment has also surged, with U.S. foreign direct investment (FDI) stock in Mexico increasing in that period from $15 billion to more than $100 billion.

The economic impact of NAFTA for the US economy cannot be hidden. In the years since NAFTA, U.S. trade with its North American neighbours has more than tripled, growing more rapidly than U.S. trade with the rest of the world. Canada and Mexico are the two largest destinations for U.S. exports, accounting for more than a third of the total. Most estimates conclude that the deal had a modest but positive impact on U.S. GDP of less than 0.5 percent, or a total addition of up to $80 billion dollars to the U.S. economy upon full implementation.

Such upsides of trade often escape notice, because while the costs are highly concentrated in specific industries like auto manufacturing, the benefits of a deal like NAFTA are distributed widely across society. Supporters of NAFTA estimate that some fourteen million jobs rely on trade with Canada and Mexico, while the nearly two hundred thousand export-related jobs created annually by the pact pay 15 to 20 percent more on average than the jobs that were lost.

Source - Draco 77/Getty

Critics of the deal, however, argue that it is to blame for job losses and wage stagnation in the United States, driven by low-wage competition, companies moving production to Mexico to lower costs, and a widening trade deficit. The U.S.-Mexico trade balance swung from a $1.7 billion U.S. surplus in 1993 to a $54 billion deficit by 2014.

With regards to the Mexican economy, NAFTA gave a major boost to Mexican farm exports to the United States, which have tripled since NAFTA's implementation. Hundreds of thousands of auto manufacturing jobs have also been created in the country, and most studies have found that the pact had a positive impact on Mexican productivity and consumer prices.

The pact was the continuation of a decade of economic liberalization that saw the country transition from one of the world's most protectionist economies to one of the most open to trade. Mexico had reduced many of its trade barriers upon joining the General Agreement on Tariffs and Trade (GATT), the precursor to the WTO, in 1986, but still had a pre-NAFTA average tariff level of 10 percent.

But Mexico's NAFTA experience has suffered from a disconnect between the promises of some of its supporters—that the pact would deliver rapid growth, raise wages, and reduce emigration—and the deal's more mixed outcomes. Between 1993 and 2013, Mexico's economy grew at an average rate of just 1.3 percent a year during a period when Latin America was undergoing a major expansion. Poverty remains at the same levels as in 1994. And the expected "wage convergence" between U.S. and Mexican wages didn't happen, with Mexico's per capita income rising at an annual average of just 1.2 percent in that period—far slower than Latin American countries such as Brazil, Chile, and Peru.

Canada has also seen strong gains in cross-border investment in the NAFTA era: Since 1993, U.S. and Mexican investments in Canada have tripled. U.S. investment, which accounts for more than half of Canada's FDI stock, grew from $70 billion in 1993 to over $368 billion in 2013. However, the most consequential aspect for Canada—opening its economy to the U.S. market, by far Canada's largest trading partner—predated NAFTA, with the 1989 entry into force of the Canada-U.S. Free Trade Agreement (CUSFTA). Overall Canada-U.S. trade increased rapidly in the wake of Canada's trade liberalization. Post-NAFTA, Canadian exports to the United States grew from $110 billion to $346 billion, while imports from the United States grew by almost the same amount.

Agriculture saw a boost. Canada is the leading importer of U.S. agricultural products, and one of NAFTA's biggest economic effects for Canada has been to increase bilateral U.S.-Canada agricultural flows. Canadian agricultural trade with the United States more than tripled since 1994, as did Canada's total agriculture exports to NAFTA partners.

Neither the worst fears of Canada's trade opponents—that opening to trade would gut the country's manufacturing sector—nor its highest hopes—that it would spark a rapid increase in productivity—came to pass. Canadian manufacturing employment held steady, but the "productivity gap" between the Canadian and U.S. economies wasn't closed: Canada's labour productivity remains at 72 percent of U.S. levels.

RE-NEGOTIATING NAFTA

Robert E. Lighthizer, the Trump administration's chief trade negotiator, listed substantially reducing the trade deficit as one of the main United States goals for NAFTA renegotiations, pointing out that since NAFTA went into force, the U.S. trade deficit with Mexico has increased considerably, standing today at about $60 billion, and the U.S. has lost about 5 million jobs in the manufacturing sector.

These figures may justify President Trump's argument that trade deficits destroy jobs and therefore the main purpose of NAFTA's renegotiation is to reduce the U.S. bilateral trade deficit with Mexico. But as referred in a recent Brookings Institution report, the story is not so simple. Trump's view of international trade is, to say the least, not very sophisticated. Focusing on bilateral trade deficits is meaningless as they do not reflect the bigger picture.

Often, the trade deficit with a particular set of countries is offset by a trade surplus with other countries. Overall, the U.S. has a trade deficit of about $450 billion a year. Bilateral trade surpluses with Hong Kong, Australia, Chile, and Brazil, for example, offset part of the deficit with countries such as China, Mexico, Germany, and Japan, among others. Thus, even if the renegotiation of NAFTA for some reason results in a reduced U.S.-Mexico bilateral trade deficit, it likely won't change the overall deficit of the U.S. with the rest of the world.

Source - BLOOMBERG NEWS - Canadian, American and Mexican flags are seen ahead of the first round of Nafta renegotiations in Washington, D.C., U.S., Aug. 16, 2017

Thus, the trade deficit may make the headlines of the US newspapers and guide the evaluation of the negotiations outcome, but they would not be part of the negotiating agenda. Other issues, such as rules of origin, dispute settlement and government procurement would draw the attention of the NAFTA negotiators.

The issue of rules of origin would be particularly contentious. To be traded duty-free within the three countries, goods must contain a certain percentage of North American content, which differs for various products. As referred by The Economist, rules of origin relating to the car industry will be particularly contentious. Without that trade, America would have no deficit in goods with Mexico. At issue are the rules that set the amount of regional content a product must have for it to count within the deal. At present, cars must contain at least 62.5 percent of North American content, and the United States wants to increase its content threshold for NAFTA goods in a bid to return manufacturing jobs to the United States.

Mr Lighthizer says that the rules of origin should require higher NAFTA content and “substantial” American content. The Mexicans will balk at any asymmetry in favour of America, arguing that it violates the spirit of a regional deal. Companies will resist too, and where non-NAFTA tariffs are low, they have the option of simply operating outside the parameters of the agreement. Tariffs on cars entering America are a mere 2.5%. For products where non-NAFTA tariffs are even lower, more than a quarter flowing into America from Mexico bypass the deal entirely.

In the words of the Financial Times, one of the US’s obsessions serves as an example of why, in a modern open economy, attempts to manage trade do more harm than good. As indicated, Washington wants to tighten up the so-called “rules of origin”, but tightening rules of origin will merely encourage foreign producers to pay the US external tariff (just 2.5 per cent for vehicles and vehicle parts) and export directly to the American market. The highly integrated NAFTA auto supply chains will be disrupted and Mexico will be encouraged to focus its increasingly efficient car industry elsewhere. The number of jobs created in the US is likely to be negligible, if not negative.

Another issue that would figure prominently in the NAFTA re-negotiations is dispute settlement. The United States may seek to ditch the so-called Chapter 19 tool, under which binational panels hear complaints about illegal subsidies and dumping and then issue binding decisions. It would also like to introduce minor tweaking of the NAFTA Chapter 11 provisions, which are designed to ensure firms that invest abroad receive “fair and equitable” treatment by foreign governments. As with Chapter 19, opponents of the provisions argue they infringe on sovereignty which benefits multinational corporations. Canada may want to update the mechanism to allow governments to regulate in the interest of the environment or labour.

On government procurement, the United States is pushing for national, state and local governments in Canada and Mexico to open up their tender processes to U.S.-made products, while at the same time is defending existing “Buy American” procurement laws. The Buy American provisions have blocked the use of Canadian steel to build U.S. bridges, and Canada is pushing for a freer market for government procurement. Mexico says it expects government procurement, already included in NAFTA, to be part of the renegotiation.

PERSPECTIVES

All interested parties, labour and business organizations, civil society groups, non-government organizations are getting organized to exercise their influence in the NAFTA renegotiations. They include, notably, workers from the auto industry which have already expressed their view that the US negotiating objectives are rather vague and could fall short of what American and Canadian workers hope the NAFTA renegotiation would achieve. According to the Canadian union UNIFOR and United Automobile Workers union from the United States, trade rules shape where and how their industry develops, and NAFTA has made things worse across the continent.

Following their analyses, in 1993, the United States had an automotive trade deficit with Mexico of $3.5 billion. By 2016 that deficit had grown to $45.1 billion. For auto parts, the United States’ deficit with Mexico was $100 million in 1993; by 2016, it was 200 times larger, at $23.8 billion. In terms of Canadian trade with Mexico, the overall automotive deficit has increased fourfold under NAFTA, to $8.7 billion from $1.6 billion.

Source - LUKE SHARRETT / BLOOMBERG A worker at the Ford plant in Louisville, Ky.

Despite this, the North American auto industry remains a powerhouse of advanced manufacturing, innovation and economic activity. Directly responsible for two million jobs across the continent, the industry serves as the anchor for supply chains including auto parts producers, suppliers of raw materials and service providers. For every auto assembly job, there are at least nine to 10 other jobs created — these are often good jobs with above average wages. Thus, the NAFTA re-negotiation offers an opportunity to fix the agreement and make to benefit workers in the three countries.

As in all modern trade negotiations, however, it is not the economic rationale nor the logic of the arguments that would determine the final outcome. The trade deficit that the US negotiators have argued is a key component of their negotiating strategy that may not be on the negotiating table, but could be omnipresent when the Administration present the outcome of the negotiations for approval by the congress and, notably, the public. As argued by Edward Alden in a recent Council on Foreign Relations´ blog, President Trump needs to show that he has changed the agreement not just in ways that may benefit all three countries, but in ways that will help the United States relative to Canada and Mexico. That is a much harder task.

Of course, as pointed out in the same blog, President Trump could try out a more traditional "pro-America" argument for trade—that strengthening NAFTA rules for digital commerce, for intellectual property, for labour and environmental standards, would all help U.S. companies and the workers they employ. But since the U.S. negotiating proposals on these issues are borrowed almost entirely from the Trans-Pacific Partnership (TPP) agreement that Trump tore up on his first day in the White House, this seems unlikely.

NAFTA was the beginning of a new set of regional trade agreements, the first great experiment in freeing trade between developed and developing countries. It set the basic template for many deals that followed, including the CAFTA with Central America and the Dominican Republic, and China's entry into the World Trade Organization. None of those deals has become more popular with age. A successful renegotiation of NAFTA would be another milestone, demonstrating such deals can be updated, improved, and continue to work in the interests of all participating countries. A failure, however, would continue to erode the already fading public confidence in trade agreements.

What is certain at this stage, is that the outcome of the negotiations would be determined as much on the negotiating table as outside of it. As negotiators prepared to initiate the second round of talks to renegotiate NAFTA – in Mexico City, on September 1st - President Donald Trump renewed calls to pull out of the agreement—a drastic course U.S. officials said he came close to pursuing in April before backing down and agreeing instead to negotiate.

As reported by The Wall Street Journal, on at least four separate occasions since Aug. 22—in speeches, on Twitter, and a press conference—Mr. Trump has raised the prospect of getting the US to withdraw from NAFTA. "We're working right now on NAFTA, the horrible, terrible NAFTA deal that took so much business out of your state and out of your cities and towns," he told a cheering crowd in Missouri. "Hopefully we can renegotiate it, but if we can't, we'll terminate it and we'll start all over again with a real deal."

Mexican Foreign Minister Luis Videgaray responded by telling reporters that if the Trump administration begins the required six-month process of terminating the accord—a move some Mexican and Canadian government officials say is a negotiating tactic—Mexico would walk away from the talks. “We don’t think it would be the right path or a viable path to terminate the agreement just when we’re in negotiations,” Mr. Videgaray said.

Source - The Economist

Still, Mexico’s business and political classes are increasingly pessimistic over the NAFTA talks. As reported by the Financial Times, Mexican and US business leaders have begun studying legal options in case President Donald Trump follows through on renewed threats to scrap what he terms the “horrible, terrible” North American Free Trade Agreement. In the words of The Economist, President Trump most serious opponents are internal, and his strategy, of getting a better deal by threatening to pull out altogether, is odd. It worsens relations with America’s negotiating partners, at a time when Mr Trump’s plans face just as much opposition at home.