NAFTA NEWS

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We are pleased to present *NAFTA NEWS*, a periodic newsletter offering information and insight as the renegotiation of the North American Free Trade Agreement takes shape in 2017.

Through Manatt's and Monarch's offices in Washington, D.C. and Mexico City, and TACTIX' head office in Ottawa, the firms are collaborating to provide their respective clients with the critical data and experienced judgment global companies and North American industry associations need to help navigate the NAFTA process. Each edition of NAFTA NEWS provides our readers with need-to-know information and political insights from the three NAFTA national capital cities.

Highlights

For this edition of NAFTA NEWS, our partners in Ottawa, Mexico City, and Washington considered the probability of U.S. withdrawal from NAFTA and the implications for each of the three NAFTA nations.

Canada

To say things are not going well would be an understatement. Five rounds of NAFTA negotiations have yielded little in the way of progress on major issues and no deal is realistically in sight. As 2017 winds down and we look ahead to the New Year, it is timely to assess the state of the NAFTA negotiations and consider what may lie ahead.

If anyone tells you they know how the NAFTA renegotiations will end, do not believe them. The only honest answer to the question is, "Who knows?" In an environment fraught with great uncertainty, it is incumbent upon the Government of Canada to be prepared for all possible scenarios. Much rides on how the government reacts to various scenarios: the measure of success of a government is more often than not how it responds to issues beyond its control. It is fair to assert that the NAFTA negotiations fall into this category.

So, what can we reasonably anticipate Ottawa will do in the coming weeks ahead of, and during, round six scheduled for Montreal, from January 23-28, 2018? Strong clues to the government's approach were evident in testimony given by Canada's chief NAFTA negotiator, Steve Verheul, before the House of Commons Standing Committee on International Trade on December 4th.

Of course, Mr. Verheul's audience that day did not consist only of Members of Parliament sitting around the committee table. He was also speaking to the Canadian public at large, to Mexico City and to Washington, D.C. The following is a snapshot of what these audiences should have heard:

- Canada will continue pursuing the progressive and inclusive trade agenda outlined in the August 14, 2017 speech delivered by Foreign Affairs Minister Chrystia Freeland. The core objectives of Canada's international trade agenda include:
  - promoting gender equality;
  - increasing participation of Indigenous peoples in trade;
  - inserting strong labour safeguards;
  - integrating enhanced environmental provisions; and.
  - ensuring governments have the unassailable right to regulate in the public interest.

What is often forgotten in this trade agenda is the objective of inclusiveness. Minister Freeland very clearly asserted that the benefits of trade must be "fairly and broadly shared". Each of these objectives will continue to guide Mr. Verheul and his team of negotiators at the NAFTA tables.

Let there be no mistake: there is a domestic political imperative underpinning this agenda. The Liberal government will be seeking re-election in just under two years. Electoral success in October 2019 rests to a large extent on the Liberals continuing to siphon off voter support for the other so-called "progressive" party, the NDP, as they did in the 2015 election. Moreover, the road to re-election for the Liberals almost certainly runs through the Province of Quebec. A progressive policy agenda generally plays well there.

- Canada has no intention of blinking in the face of what Mr. Verheul repeatedly called the United States' "extreme proposals", namely proposals introduced during rounds three and four relating to the automotive and agricultural sectors, government procurement, dispute settlement, and a five-year sunset clause. In his opening remarks and while responding to MPs' questions, Canada's chief NAFTA negotiator frequently sprinkled words and phrases such as "wholly unworkable", "unacceptable", "Canada will not accept", "entirely unacceptable" and "completely unworkable" when discussing the U.S.' "extreme proposals". Will any of the NAFTA nations blink?

- The Canadian government is currently preparing for all possible scenarios, including the "nuclear" outcome: the triggering of Article 2205 (the six-month withdrawal clause) by the United States followed by that country's actual withdrawal from the NAFTA (i.e., not just deploying 2205 as a negotiating tactic). To that end, respected economist Douglas Porter, Chief Economist of BMO Financial Group, recently released a report entitled The Day After NAFTA laying out the key macroeconomic outcomes for which the federal government needs to prepare. These include increased consumer prices due to modestly higher tariffs, a depreciating Canadian dollar and lower capital spending by business.

It is with these potential impacts in mind that Ottawa is:
  - undertaking a sector-by-sector analysis of where the greatest impacts would be felt;

o preparing contingency plans to make sure the impact is as modest as it can possibly be, including preparing for what would be significant bilateral discussions with the U.S. regarding the automotive sector;
o considering the basis of tariffs that could be put back in place by Canada;

o continuing to work very closely with the United States' business and agricultural communities as well as U.S. Senators and Representatives to try and prevent the end of a trilateral NAFTA; and,

o assuring the Mexican government as well as Canada's and Mexico's business and agricultural communities that Canada would maintain the NAFTA between Canada and Mexico.

We live in interesting times.

Mexico

Mexican officials have long made clear their support for the NAFTA agreement while also expressing their interest in modernizing the agreement to take into account changes in the past 25 years. They also have stressed the opportunity to use a modernization to enhance North American competitiveness especially in light of the U.S. decision to withdraw from the Trans-Pacific Partnership (TPP). Though Mexico did not request a renegotiation, the government expressed an openness to doing so and completed a public comment process to identify the country's priorities for the negotiations well before the United States completed its own review.

During the recently-concluded 5th round of negotiations (November 15-21), Mexico put forward counter-proposals in response to U.S. proposed language that were seemingly designed to demonstrate a commitment to negotiating in good faith. In response to the U.S. five-year sunset proposal that would terminate the agreement absent affirmative action by all three parties, Mexico proposed a mandatory and comprehensive five-year review albeit without an automatic termination component. Economy Secretary Ildefonso Guajardo also suggested that Mexico could accept an opt-in mechanism with respect to investor-state dispute settlement (ISDS) as long as each country could define its own opt-in terms. Mexico also responded to the U.S. proposal on government procurement with a counter-proposal designed to emphasize that the U.S. proposal would have a far greater impact on U.S. business firms than on their Mexican counterparts. Indeed, a U.S. withdrawal would have a chilling impact on the Mexican economy, especially in the short term. The uncertainty caused by the threat of withdrawal has already led to a slow-down in foreign direct investment. With his administration at historically low levels of popularity, President Enrique Peña Nieto does not want to be remembered as having "lost" NAFTA.

At the same time, Secretary Guajardo has been very clear that if Trump announces an intent to withdraw, Mexico will not "negotiate with a gun to its head." While it is certainly possible that this too is a negotiating ploy, the dynamics in Mexico only a few months before the presidential election (with the ruling PRI party's candidate in third place), make it very unlikely that Mexico could remain at the table following a withdrawal announcement. Further, growing nationalist/anti-Trump sentiment among the Mexican electorate creates an even more challenging dynamic for the current administration hoping to improve the fortunes of its chosen successor.

Mexico has already been exploring alternatives to respond to the worst-case scenario of a U.S. withdrawal. The main focus of Mexico's efforts has been to seek to diversify trading patterns and thus reduce dependence (to the extent possible) on bilateral trade with the United States. These steps have included: active participation in the TPP-11 talks on the sidelines of the APEC conference in Vietnam early last month to advance the Trans-Pacific Partnership among the eleven countries remaining in the talks after the U.S. withdrawal; continued talks to update the Mexico-European Union free trade agreement which could be completed before the end of 2017; and free trade discussions with Brazil and Uruguay. In addition, Mexico recently contracted to purchase wheat from Argentina and Brazil – a tangible manifestation of Mexico's options to reduce consumption of U.S. products, at least in some sectors.

If the U.S. withdraws, Mexico will have a number of potential policy tools from which to choose if it wishes to retaliate for the damage to its economy. Tariff rates for U.S.-produced imports would revert to WTO Most Favored Nation rates. For some agricultural products for which Mexico is a significant consumer, such as poultry and high-fructose corn syrup, these MFN rates could reach 75%. Mexico will likely take a very strategic approach when increasing tariffs to impact specific U.S. Congressional districts or states that Trump won in 2016 while limiting the damage to its internal consumers of various inputs and finished products. How Mexico responds to the elimination of its government procurement obligations with respect to U.S. firms will also be telling. One can assume that Mexico will continue to craft tenders that would allow for purchase of U.S.-made products without suitable substitutes (such as patented medicines or specialized medical devices) but might offer advantages for products produced in FTA-partner countries where alternatives are present (such as lower tech medical devices or generic medicines) thus increasing competition or undermining what had been a U.S. comparative advantage.

The economic relationships established and deepened over the past twenty-three years will not disappear immediately following a U.S. withdrawal though they will become more complicated. Mexico-based firms exporting to the U.S., regardless of ownership, will need to decide whether to adjust the locus of production or to determine what share of the additional costs stemming from MFN tariffs will be passed on to their customers. Since the U.S. has very low MFN rates (averaging 2.5%) and many products already enter the U.S. duty free regardless of country of production, the impact on northbound sales may be limited. In cases where supply chains are disrupted, it will take firms some time to identify alternative sources for their inputs. Where Mexico can effectively compete to attract new investment interested in taking advantage of its extensive network of free trade agreements, it will surely do so.

Finally, the outcome of the July 2018 presidential election campaign will have an impact on the ramifications of a U.S. NAFTA withdrawal. All major and presumed candidates have expressed at least some degree of support for NAFTA and none has expressed an interest in undermining the strong commercial and cultural ties that link our countries. Nevertheless, if faced with the withdrawal scenario, their responses will likely differ and could be more or less "punitive" toward the United States.

United States

As negotiators from the three North American Free Trade Agreement (NAFTA) signatories prepare for the December 11 – 15 mini-round of negotiations in Washington, D.C. between the 5th and 6th formal rounds, confidence that a new agreement can be reached is waning. USTR Robert Lighthizer's statement at the conclusion of the 5th round succinctly sums up the current mood, saying "thus far, we have seen no evidence that Canada or Mexico are willing to seriously engage on provisions that will lead to a rebalanced agreement. Absent rebalancing, we will not reach a satisfactory result." This and other dire pronouncements have alarmed many pro-NAFTA Members of Congress, including six Republican senators who met with President Trump on December 5th to urge him to remain in NAFTA. With the recent news out of the Commerce Department that the U.S. trade deficit is at a nine-month high due to increased imports from China and higher oil prices, the risk that Trump unilaterally withdraws has never been higher. Trump has long believed that the trade deficit, which currently totals $47.5 billion, is the same thing as "losses" and no one in Congress or his own administration has been able to correct this view.

So, with these factors in mind, it might be instructive to take a closer look at the chances of the United States withdrawing from NAFTA and the challenges the administration would face with regards to that decision.

The 5th round of talks concluded in Mexico City on November 21st with the parties still far apart on key issues. Despite some progress on technical issues, trade dispute mechanisms, rules of origin, and government contracting issues have yet to be resolved and little progress since the outset of the negotiations. U.S. proposals to increase regional content requirements to 85 percent from 62.5 percent and to introduce a local content requirement of 50% in the auto sector continue to be deemed too extreme by Mexico and Canada. The automotive proposal has also brought increased Congressional interest as a bipartisan group of 70 lawmakers sent a letter to the administration urging it to discontinue the pursuit of a boost to the current local production requirements.

Before the 5th round, the United States, Canada and Mexico said that they would extend NAFTA negotiations into next year. Previously, the timetable called for negotiations to wrap up by the end of 2017. While extending this window allows negotiators more time to come up with some sort of agreement on the major issues, it also raises the specter of NAFTA talks getting caught up in treacherous political events in the new year. Perhaps most pressing is the beginning of the Mexican presidential election campaign, but if things linger on there is a legislative challenge facing the U.S. Congress as well. In July, Trade Promotion Authority (TPA), which grants the administration more extensive authority to negotiate trade deals and then submit them to Congress for a simple up or down vote, will expire.

The original NAFTA text allows a country to withdraw from the trade pact if it provides written notice of its intent to begin a six-month waiting period. After this, the president can reinstate tariffs (up to the WTO bound rates). However, nothing in the agreement or in U.S. law or regulations specifies how that should be decided. Does the president have final say, or does Congress need to concur? The view within the Trump administration is that the President has final authority, but there would be significant blowback from pro-trade Republicans and some Democrats on the Hill if such an action were undertaken. The Constitution grants Congress explicit authority over tariffs and trade. Additionally, many U.S. business groups have already begun to prepare for a legal battle against the administration which could exacerbate the conflict between Trump's anti-trade constituency and the more pro-business wing of the Republican Party.

Moving past the question of if President Trump has the authority to exit NAFTA without Congressional approval, the immediate aftermath of such an exit would require Congressional action to ensure that the U.S. is not caught in what some refer to as "zombie" NAFTA. The laws implementing NAFTA would remain in place regardless of the administration's decision, meaning that the country would be stuck in a situation where many of the provisions of NAFTA, including the Chapter 19 dispute settlement mechanism, would remain in place while U.S. businesses lacked tariff-free access to the Mexican and Canadian markets. As with TPA and approval for withdrawal, the administration could find itself in another fight with the Republican-controlled Congress in which many members would likely oppose a quick legislative fix.

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