NAFTA NEWS

(click the flag for the country of interest)

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 2018.

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 provided a snapshot of the political pressures facing an agreement in each of the three NAFTA nations.

Canada

Everything changed on June 1, 2018. That was the day Canadian steel and aluminum – ironically, including Canadian steel and aluminum used in the manufacture of U.S. military equipment – became national security risks to the United States. The relationship between Canada and the U.S. shifted fundamentally when President Trump exercised executive authority under Section 232 of the *Trade Expansion Act of 1962*, imposing tariffs of 25% on imports of Canadian steel and 10% on aluminum.

As a NAFTA negotiation ploy, this move fell flat. Prime Minister Trudeau immediately denounced the categorization of Canada as a national security risk to the U.S. as "insulting". His attempts to work collegially with President Trump over the past 18 months clearly had not worked. A new approach had to be deployed. It may be that the PM is now being guided by the wisdom of Winston Churchill, who once said, "An appeaser is one who feeds a crocodile, hoping it will eat him last."

The Canadian government responded with corresponding tariffs to be applied to a carefully selected list of goods exported by the U.S. into Canada, effective July 1, Canada Day. The Canadian government targeted key regional American lawmakers who can have influence over the President, either directly or indirectly through Congress. For example:

- Licorice candy and chocolate products from Hershey, Pennsylvania would be subject to Canadian tariffs. Pennsylvania is a key Trump battleground and home to Senator Pat Toomey, a key Republican lawmaker on the Senate Finance Committee. The senior Senator from Pennsylvania is Democrat Bob Casey, ranking member of the Subcommittee for International Trade.

- Canadian tariffs would apply to Kentucky whiskey, targeting Senate Majority Leader Mitch McConnell.
- Makeup from Utah is also a target of Canadian tariffs. Utah is home to Republican Senator Orrin Hatch, Chair of the Senate Finance Committee.

A looming and mutually damaging trade war between the two long-standing allies and trading partners has thrown the success of the NAFTA negotiations into serious doubt.

It has now dawned in Canada that the President of the United States views the international economic and security order, established in the post-WWII era, as a giant Jenga tower, to be dismantled piece by piece. Each Jenga block, beginning with the 1944 Bretton Woods Conference, establishing the International Monetary Fund and the International Bank for Reconstruction and Development, and continuing with the United Nations, the GATT/WTO, and the G7, among others, builds on all of the other blocks. The result has been the creation of a delicately balanced order aimed at global economic stability and security, led by the U.S., with support from its allies in the West, Asia, and Austral-Asia.

Since taking office 18 months ago, the U.S. President has deliberately and unilaterally been removing Jenga blocks – taking the U.S. out of the Trans-Pacific Partnership Agreement; withdrawing from the Paris Agreement on climate change mitigation; withdrawing the U.S. from the Iran nuclear agreement. Declaring Canada, Mexico and the European Union as national security threats, and imposing tariffs on their steel and aluminum, removes another foundational block from the Jenga tower.

Moreover, the *ad hominem* attacks on Prime Minister Trudeau following the G7 conference in Charlevoix, Quebec, as well as the continued denigration of the U.S.' G7 partners, portends yet another Jenga block being removed from the tower. At this state of affairs, Putin and Xi can only smile.

As more and more blocks are removed, the Jenga tower is at risk of collapsing. If that were to happen, what would take its place? Based on recent accounts, it appears that President Trump's preference is to play checkers, *mano-a-mano*, in a winner-take all zero-sum game. Oh, and by the way, according to the U.S. Administration's rules, the President would begin with more checkers on the board than his opponent.

It is in this poisonous spirit that the NAFTA negotiations have come to a near standstill. The Government of Canada will not, indeed politically cannot, give in to U.S. poison pill demands and cannot stand idly by as Canada's steel and aluminum industries are made uncompetitive by U.S. tariffs. In fact, the Canadian government is preparing a fresh round of tariffs to be strategically applied should the situation escalate further. At least for now, President Trump has handed PM Trudeau multi-partisan political support to remain steadfast in his government's resolve to not bend to U.S. NAFTA demands and to retaliate in kind to U.S. tariffs.

As a damaging trade war looms on the horizon, it can only be hoped that the description of international trade by another Republican President, Ronald Reagan – he who presided over the first Canada-U.S. Free Trade Agreement – will come to the fore once again: "The freer the flow of world trade, the stronger the tides of human progress and peace among nations."

Mexico

Mexicans are currently divided by the July 1 presidential election and united in support of "El Tri's" participation in the World Cup. This confluence of events means little attention is being paid to the NAFTA negotiations, apart from those officials participating in the ongoing negotiations and those in the automotive, steel and aluminum sectors.

Presidential Campaign

Mexico's presidential campaign had largely focused on domestic issues (principally corruption and security) with little attention paid to foreign policy or trade. A promise to address Mexico's long-standing corruption problem (and an image as a clean politician) have propelled the campaign of left-leaning Andres Manuel Lopez Obrador (AMLO) to a commanding lead in the polls over the "establishment" candidates from the governing PRI coalition and the PAN-PRD right-left coalition. Both of these candidates are viewed by most voters as having participated in schemes to enrich themselves and their allies while in power and having done little to strengthen the economy for average Mexicans while the security situation deteriorated. Further, because Mexico has reached a consensus in favor of trade there is little room for the candidates to exploit differences in the electorate. Indeed, the main candidates largely share a common view that NAFTA has been good for Mexico overall (though not for all Mexicans) while firmly rejecting President Trump's rhetoric about Mexican immigrants and claims that their country would pay for the border wall.

The lack of attention to trade issues during the campaign changed with the May 31 announcement, without prior warning, that the United States would no longer exempt Mexican steel and aluminum from the Section 232 tariffs. Mexico condemned the decision and immediately announced that it would retaliate against $3 billion in U.S. exports. On June 5, Mexico published a target list that focused largely on products produced in Congressional districts represented by Republicans including steel, aluminum, toys, and agricultural products. Mexico also initiated World Trade Organization (WTO) dispute settlement case.

Reactions from Mexican political leaders were swift and uniformly negative (though without as deep a sense of insult as that experienced by Canadians). PRI candidate Jose Antonio Meade supported the current Administration's actions and stressed that Mexico needed to demonstrate that it was not playing games. PAN candidate Ricardo Anaya suggested that the measure demonstrated the need for Mexico to further diversify its trading relationships while relying on multilateral institutions to resolve disputes. Perhaps surprisingly, AMLO called for cooler heads to prevail. He called on the government to act firmly but to avoid responses that could cause the situation to deteriorate into a trade war which Mexico could ill-afford. Instead, he suggested that President Peña Nieto meet personally with Trump to deescalate the situation and promised, if elected, to request a meeting in the first days of the transition to help sustain a friendly bilateral relationship based on partnership and mutual respect.

On the economic side, the Mexican peso, one of the world's most undervalued currencies, has been hit by rising US interest rates as well as uncertainties associated with the NAFTA negotiations and the July 1 presidential election which AMLO is poised to win. And yet, there are concerns that the markets have not fully priced in the impact of an AMLO victory, suggesting that the peso could shoot up to 24-25 pesos per U.S. dollar in the weeks following the election before settling back to 20-21 range this fall.

NAFTA Negotiations

Mexico remains committed to achieving a "win-win-win" update of the existing trilateral agreement. Mexico will not consider splitting NAFTA into two bilateral agreements, as proposed on a number of occasions by President Trump, an undesirable alternative since North American competitiveness is enhanced by the trilateral relationship. Speaking at a public event in Washington, D.C. on June 13, Mexican embassy Deputy Chief of Mission, Amb. Jose Antonio Zabalgoitia, said that the steel and aluminum tariffs have not helped the atmosphere for the NAFTA talks, but nor have the talks been interrupted. Steel and aluminum are on a different track, he noted, and reiterated Mexico's commitment to reaching a mutually acceptable outcome. Referring specifically to the contentious issue of autos, Ambassador Zabalgoitia observed that since the industry is present in all three countries, any agreement must represent a feasible solution for both government and industry in all three counties.

Yet, the Mexican position has not waivered – no deal is preferable to a bad deal on NAFTA. Lopez Obrador made the same point recently and noted that Mexico can live without NAFTA (though it would prefer not to). We tend to agree. Existing supply chains are firmly entrenched such that trade would continue, at least in the short to medium term, albeit with additional hurdles and disruptions.

Going forward, Mexico will remain at the negotiating table as long as the United States does. Following the election, the presidential transition team will join the delegation (perhaps in an unofficial role). AMLO's designated Secretaries of Economy and Finance (Hacienda) have recognized the benefits of NAFTA for Mexico and have expressed support for the negotiations to update the agreement. They have also expressed interest in participating in the negotiations so they can be in a position to support the eventual ratification of the new agreement by the Mexican Senate (assuming the outcome of the negotiations is favorable). An AMLO victory could incentivize the Peña Nieto Administration to accept some of the more controversial U.S. demands in order to lock in reforms and constrain AMLO's maneuverability. A congressional majority for AMLO's Morena party, however, would make Congressional ratification of such an agreement more challenging.

While the NAFTA negotiations proceed, Mexico continues to explore alternative markets. In addition to becoming the first country to ratify the Comprehensive and Progressive Trans Pacific Partnership (CPTPP) Agreement, Economy Minister Ildefonso Guajardo recently traveled to Japan to meet with Japanese firms with operations in Mexico as well as his counterparts in the Japanese government. This trip followed a late 2017 trip to Argentina and a March 2018 trip to Brazil that form part of an effort to reach out to traditional and non-traditional trading partners which will continue in the months ahead. Nevertheless, the United States will remain the overwhelming focus of Mexico's international commerce with, or without, an updated NAFTA.

United States

It will surprise no informed observers that U.S.-Canada-Mexico relations are more fractured than ever. All sides are frustrated by the lack of progress on numerous key provisions in the NAFTA negotiations, and the Trump administration's recent decision to impose tariffs on imports of steel and aluminum from our NAFTA allies has brought relations to a new low. The imposition of tariffs on steel and aluminum imports stems from the administration's determination under Section 232 of the Trade Expansion Act of 1962 that such imports worldwide threaten domestic industry and thus pose a national security threat. Though the imposition of tariffs on our NAFTA and EU allies is widely viewed as a negotiating ploy - one a U.S. Senator recently described privately as "high stakes poker" - the hot public exchanges, not surprisingly from President Trump, have not been helpful. All are playing to their base constituents and are viewed to be moving away from compromise. Even so, talks are expected to continue – although not likely until after the Mexican election on July 1.

So, with limited "real" news on the NAFTA front, just what is the current U.S. perspective on the state of the negotiations? It depends on whom you ask.

To understand the chaos, if that is possible, one must look back to the 2016 presidential campaign. Candidate Trump was vocal in his view that NAFTA has been a "bad deal" for the United States and he campaigned continuously in 2016 against it, promising to renegotiate the agreement or end it entirely. That view also extended to other agreements, including TPP, the Paris Climate Accord, and the Iran Nuclear Agreement. From the beginning of his administration, the president has set out to fulfill campaign promises and has pulled the U.S. out of TPP and the Paris Climate and Iran agreements, actions that have been popular with his base. Similarly, there have been strong signs that his preferred method of dealing with NAFTA is withdrawal – an option that congressional leaders say continues to be a possibility. Fortunately, congressional leaders and administration economic advisers have been thus far successful in securing continued negotiations for now. President Trump has also stated his interest in pursuing bilateral deals not only with Canada and Mexico, but also with the European Union. Both President Trump and his top economic advisor, Larry Kudlow, have suggested to the media that the President is seriously considering separate trade negotiations with Canada and

Mexico, as the dynamics and issues with each country are somewhat different. Many speculate this to be another negotiating tactic, though recently one U.S. Congressman privately stated that withdrawal of NAFTA remains a real concern.

While the fact that the Trump administration has not yet resorted to the "nuclear option" does point to the notion that the negotiations still have some possibility of success, the biggest disagreements between the U.S. and its NAFTA partners remain unsettled. The administration still insists on restrictive rules of origin for the automotive sector, resists investor-state dispute settlement, and demands a five-year sunset clause requiring all three parties to take active measures to renew it. Though there is bipartisan opposition in Congress to a sunset provision and support for ISDS, there has been no indication that either USTR Lighthizer or the White House itself have softened their positions.

On Capitol Hill, Republican Members have become more vocal in opposing the tariffs on Canada, Mexico and the EU. Senator Bob Corker of Tennessee, a staunch pro-free trade Republican and usual ally of Senate leadership, harshly criticized his own leadership for blocking an amendment challenging the administration's tariffs on steel and aluminum. Also, Republican Senators Orrin Hatch, Chairman of the Senate Finance Committee, and Pat Toomey recently took Commerce Secretary Wilbur Ross to task on the tariffs during a recent Finance Committee hearing with the Secretary. Both pointed out that the tariffs amount to de facto taxes on American consumers and questioned the administration's use of a Section 232 determination based on national security concerns. Open criticism of the strategy and effect of also targeting allies when China is the real culprit could undermine the support and cohesiveness needed for approval if a NAFTA agreement is reached. Even with the fast-track authority under TPA (which the administration has requested be extended), Congress still has the power to approve or disapprove the pact with an up or down vote, the timing of which poses yet another challenge.

According to most experts, the deadline for the U.S. Congress to consider NAFTA this year is long past. Politically, this poses an immense problem for the Trump administration as there is a possibility that Democrats could gain control of one or both chambers following the midterm elections. Traditionally skeptical of trade agreements due primarily to labor and environmental concerns, any agreement negotiated by the Trump administration will be viewed with extreme caution. Given that concern, a senior Republican House Chairman just last week said that if a NAFTA agreement can be reached, and the ITC can complete its review more rapidly than it ever has before, the House of Representatives is willing to take it up for passage in the lame duck session.

So, while hope springs eternal that the NAFTA negotiations will continue and an agreement will be reached, expectations are low without even mentioning the added wrinkle of a López Obrador victory in the Mexican elections. But unless tensions cool, and major progress is made whenever negotiations resume, it is becoming more difficult to see a path to any agreement this year. It is indeed "high stakes poker"!

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