

Why NAFTA Negotiations Are Stuck: A Look at Key Issues

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KEY TAKEAWAYS

- **Trilateral trade between the US, Mexico and Canada under the North American Free Trade Agreement (NAFTA) amounted to over \$1.1 trillion in 2016. NAFTA is currently facing an existential threat. It may not survive.**
- **The US and its global trading partners could be entering uncharted territories, which could lead to increased uncertainty and volatility in markets around the world.**
- **There can be little doubt that global investors should be keenly aware of the potential ramifications of the US exiting NAFTA.**
- **Securing a NAFTA deal by the end of March would be very favorable as it would avoid complications from Mexico's presidential election in July and US midterm elections in November.**

“We are in the NAFTA (worst trade deal ever made) renegotiation process with Mexico & Canada. Both being very difficult, may have to terminate?”

– President Donald Trump, Tweet. August 27, 2017.

“While we have made progress on some of our efforts to modernize NAFTA, I remain concerned about the lack of headway. 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.”

– US Trade Representative (USTR) Robert Lighthizer’s statement at the end of the fifth round of NAFTA renegotiations in Mexico City, November 2017.

Trilateral trade between the US, Mexico and Canada under the North American Free Trade Agreement (NAFTA) amounted to over \$1.1 trillion in 2016. A withdrawal from NAFTA by the US—a distinct possibility—could disrupt major supply chains in a variety of industries in all three countries, particularly in diversified manufacturing. In addition, exiting NAFTA could impact both equity and fixed income markets, and thus, global markets are closely following current efforts to renegotiate by the March 31 deadline.



Securing a NAFTA deal by the end of March would be favorable as it would avoid complications from Mexico's presidential election in July and US midterm elections in November, as well as a potential lapse in the US' "fast track" trade authority. Only two rounds of talks remain, with the next being held currently in Montreal and the final sometime before the end of March.

However, after five rounds of exhausting and often frustrating trade talks this past year involving the three countries, there can be little doubt that the trilateral negotiations to redraft NAFTA are stuck and may "not reach a satisfactory result," as USTR Robert Lighthizer put it. Many observers note that the US government's demands call into question whether it intends to renegotiate, or in fact end the trade agreement. Our team has put over 50% odds that President Trump could announce that negotiations have failed and trigger the six-month notice to withdraw from NAFTA.

What if President Trump Says, "Adios, NAFTA"?

What could happen if the president triggers a withdrawal remains up for debate and doesn't necessarily mean the end of NAFTA. This would be uncharted territory; there is no precedent or mechanism for withdrawal from NAFTA. In fact, according to the Congressional Research Office, NAFTA is the only free trade agreement the US has in place that does not contain exit provisions. In this respect, it is similar to the exit dilemmas now confronting the UK and Europe as the UK seeks to withdraw from the European Union.

What we do know is that the US' withdrawal from NAFTA would create a serious congressional challenge that could likely end up in the courts, ultimately requiring a ruling from the Supreme Court.

So What Are the Main Sticking Points?

- **Trade Dispute Mechanism – Chapter 19:** North American investors rely on the Chapter 19 investor-state dispute resolution mechanism. It allows companies that face state intervention in their investments, to plead their case to a panel of judges appointed by the three NAFTA countries and settle the disputes according to the guidelines provided by NAFTA. It is key to investors that these disputes are not caught up in local courts for years on end.

The Office of the USTR is demanding the removal of Chapter 19, saying that it reduces US sovereignty. They want disputes handled in US courts. At the same time however, the US' demands challenge Canada's and Mexico's own sovereignty. Mexico and Canada have stated that an independent panel must be maintained, but both have agreed that it could be updated. Canada would prefer to reduce companies' ability to sue a government when it comes to a country's public policy initiatives (cigarette labeling is a global, famous case in point).



- **Trade Dispute Mechanism – Chapter 11:** This chapter considers company-to-company disputes and provides that they also be resolved by a panel of judges appointed by the three NAFTA countries. The US wants to remove that as well, preferring that the disputes be resolved in US courts, where judges presumably favor US companies over their foreign counterparts. Mexico has come back with a counterproposal that calls for a three-person panel comprised of someone appointed by the US government, someone appointed by the country in question and a third neutral party that both the US and the disputing country agree upon. The counterproposal is now being reviewed by the USTR. Canada is willing to compromise but has not outlined detailed demands.
- **Rules of Origin:** NAFTA specifies that a certain percentage of a product must be produced in the NAFTA member nations in order to receive favorable tax treatment (percentages vary by product). President Trump wants to increase these percentages and add a minimum requirement for US content. Currently, for example, cars have 62.5% NAFTA content; President Trump wants it raised to 85% with 50% US content. Both Canada and Mexico have indicated that they would be willing to increase the content requirement for North America, but have not yet agreed on the new level, and 50% from one country is probably too great of a demand.
- **Sunset Clause:** The US wants to adopt a sunset clause, which would force NAFTA to expire in five years unless all three countries agree to renew it. Both Mexico and Canada are against this. Putting a sunset clause in the agreement would effectively nullify the agreement's core benefit. NAFTA contains provisions that protect North American investors. Those provisions are what companies need to be comfortable investing for the long term, and they may not invest if they know their protections have renewal risk every five years.
- **Labor and Environmental Standards:** The US wants higher labor standards in Mexico, and this is one area where Canada is in agreement. Mexico is willing to raise labor standards, but is opposed to making wages equal to those of the US or Canada, as it would eliminate Mexico's competitive advantage.
- **Agriculture:** The US would like to remove barriers to entry in Canada's agriculture arena. These barriers encompass Canada's protected dairy industry and quotas for poultry, milk and eggs, as well as the high tariffs imposed on imports. Canada has resisted moving on this issue. In contrast to Canada, Mexico is much more open with agricultural trade.
- **Government Procurement:** Chapter 10 of NAFTA requires all three countries to accord non-discriminatory, national treatment to suppliers of goods and services. The US is seeking a cap on the US dollar value of government contracts that NAFTA firms can win from the US government. The US wants to cap the dollar value at no more than the sum of the value of contracts US firms win in Canada and Mexico. Mexico has come back with a counterproposal that would limit the amount of government contracts US companies could win from Mexico to the dollar value of the contracts Mexican companies win in the US. US companies do more business in Mexico than the reverse,



so what the USTR is demanding would ultimately hurt US firms. Canada pushed back but has not yet outlined its position. Canadian firms won \$850 million in US procurement contracts in 2016. In contrast, US firms won \$530 million in Canadian government procurement contracts. The difference, however, is trivial when you consider that US GDP is about \$18.5 trillion.

- **Telecommunications:** The US is looking to gain access to the Canadian and Mexican telecom market. The US proposal is to codify the Mexican telecom reform into the NAFTA agreement. Billionaire Carlos Slim's entrenched telecom interests are holding up this issue. Slim has controlling interest in America Movil, the largest wireless telecom and pay-TV provider in Latin America.

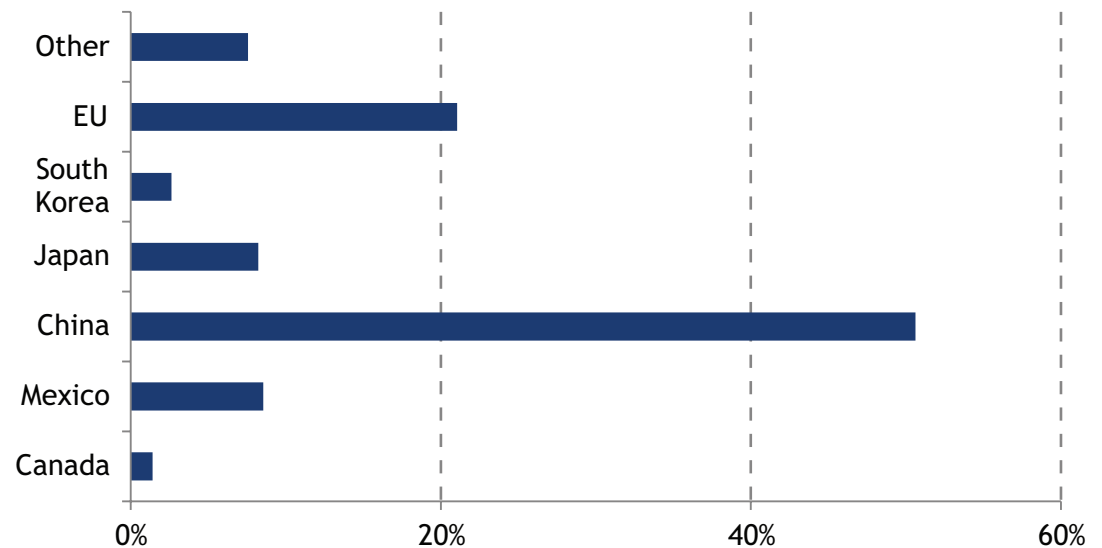
Why Exiting NAFTA Will Cost All Three Nations Dearly

The economic and political costs of withdrawing from NAFTA would be high, not just for Mexico and Canada, but also for the US. For Mexico, exports to the US represent 80% of the country's total exports and 30% of GDP. For Canada, it is 76% and 32%, respectively. For the US, trade with NAFTA represents a smaller portion of the economy (17% of total exports go to Mexico and 18% go to Canada; and exports represent 13% of US GDP), but there are significant links at a sector and industry level.

While the US has been running a \$60 billion plus trade deficit with Mexico, which the Trump administration has railed against, this pales in comparison to the US trade deficit with China. As shown below, the real issue for the US is its trade deficit with China, not Mexico.

PERCENT OF US GOODS TRADE DEFICIT BY PARTNER COUNTRIES

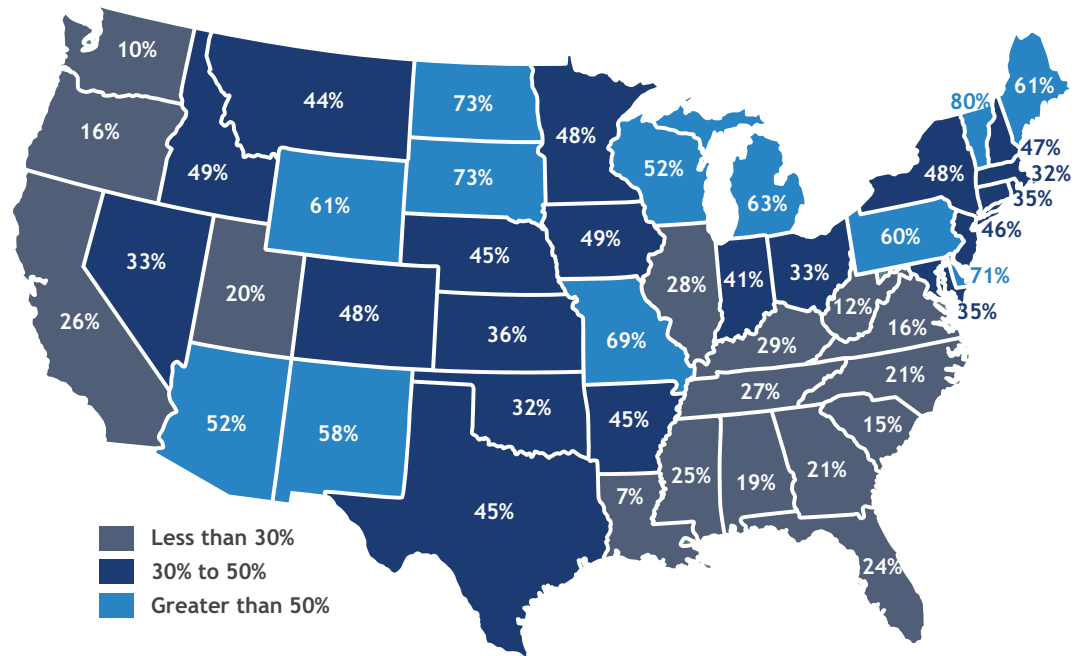
Source: Thomson Reuters Datastream, data as of January 2, 2018.





If NAFTA fails, according to a lengthy August 2017 study by the economic consulting firm ImpactECON—“Reversing NAFTA,” withdrawal could have the most severe impact on low-wage employment, with Mexico losing approximately 951,000 jobs, the US losing 256,000 and Canada losing 125,000 over a three- to five-year period. It could also potentially slow GDP growth in all three countries. In the US, auto production and agriculture would be particularly hard-hit areas. As can be seen in the chart below, US agricultural exports to Mexico and Canada, or NAFTA trade, account for a huge portion of total US agricultural exports.

SHARE OF TOTAL AGRICULTURAL EXPORTS TO NAFTA
Source: USDA FAS, AFBF calculations, data as of December 31, 2016.



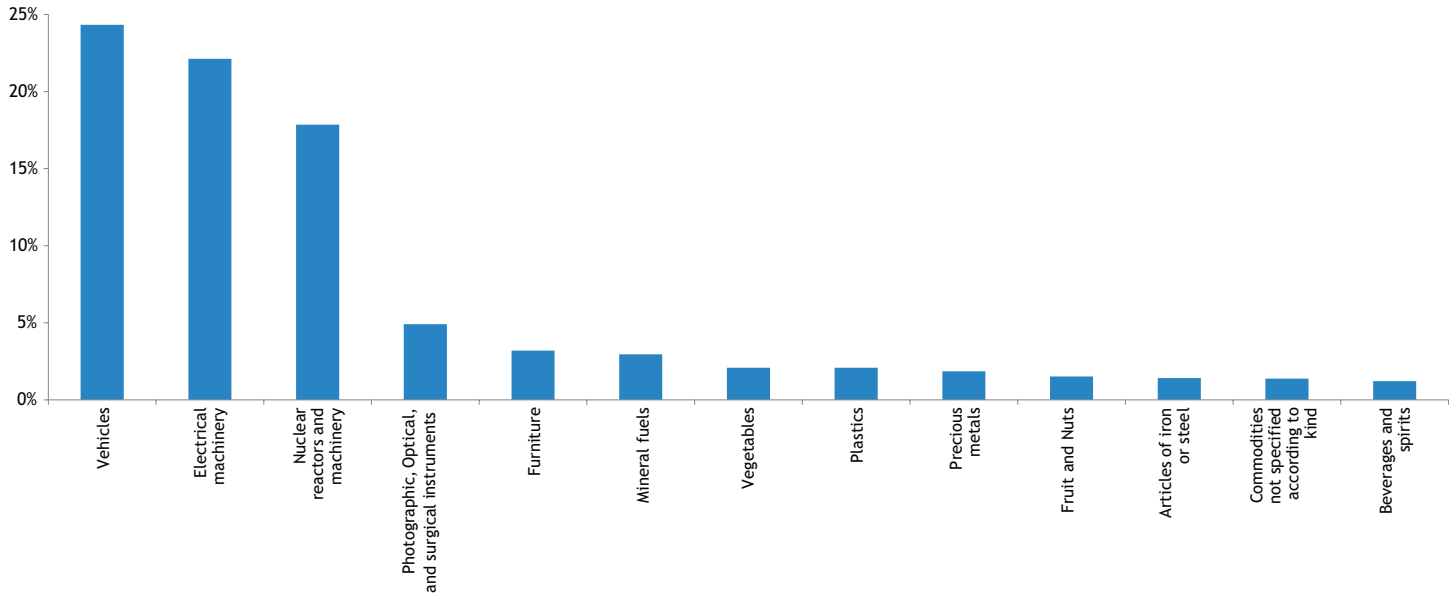
Under prior World Trade Organization (WTO) rules, which could go into effect if NAFTA is eliminated, Mexico would be able to put a 194% tariff on US corn, 79% on wheat, and 38% on rice, according to information provided by the Mexican Commerce Department. For the US and Canada, it is unclear whether they would revert to their past free trade agreements or WTO rules. It's just the sort of scenario that could ricochet in unforeseen ways.

NAFTA is facing an existential threat. It may not survive. As a result, the US and its global trading partners could be entering uncharted territories, which could lead to increased uncertainty and volatility in markets around the world. Breaking down trade relationships increases hostilities and can create a multipolar globe. There can be little doubt that global investors should be keenly aware of the potential ramifications of the US exiting NAFTA.



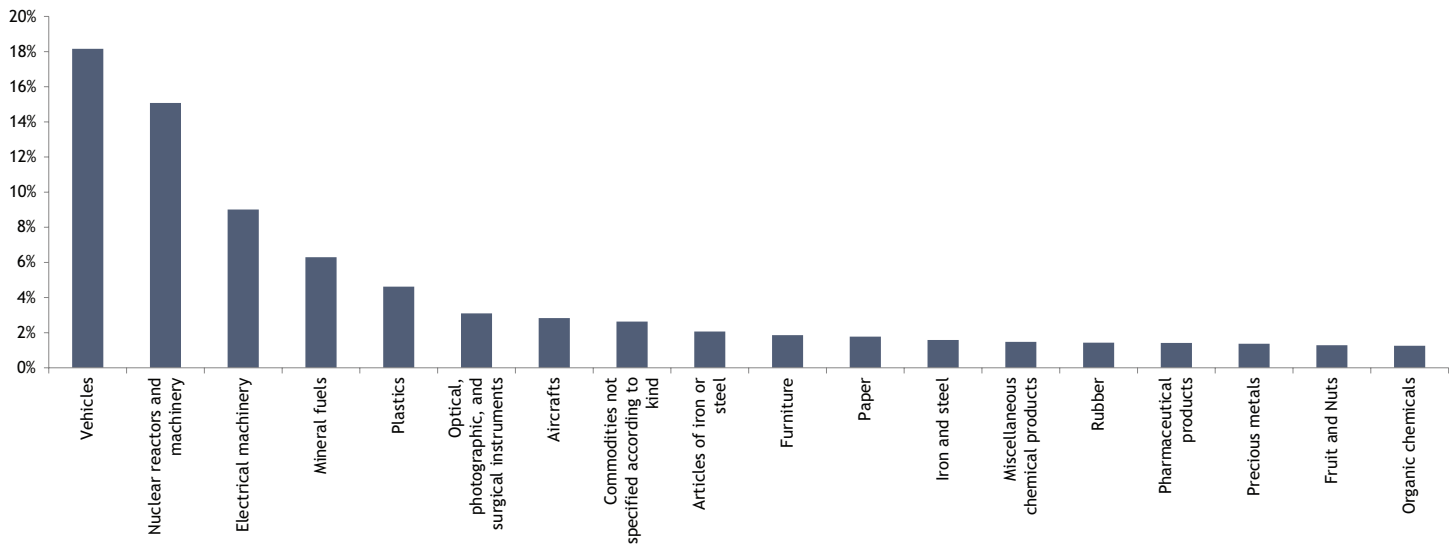
NAFTA Today: Three Intertwined Economies Trading \$1.1 Trillion in Goods and Services

2016 MEXICAN EXPORTS TO THE UNITED STATES



Source: UN Comtrade Database, data as of January 2, 2018.

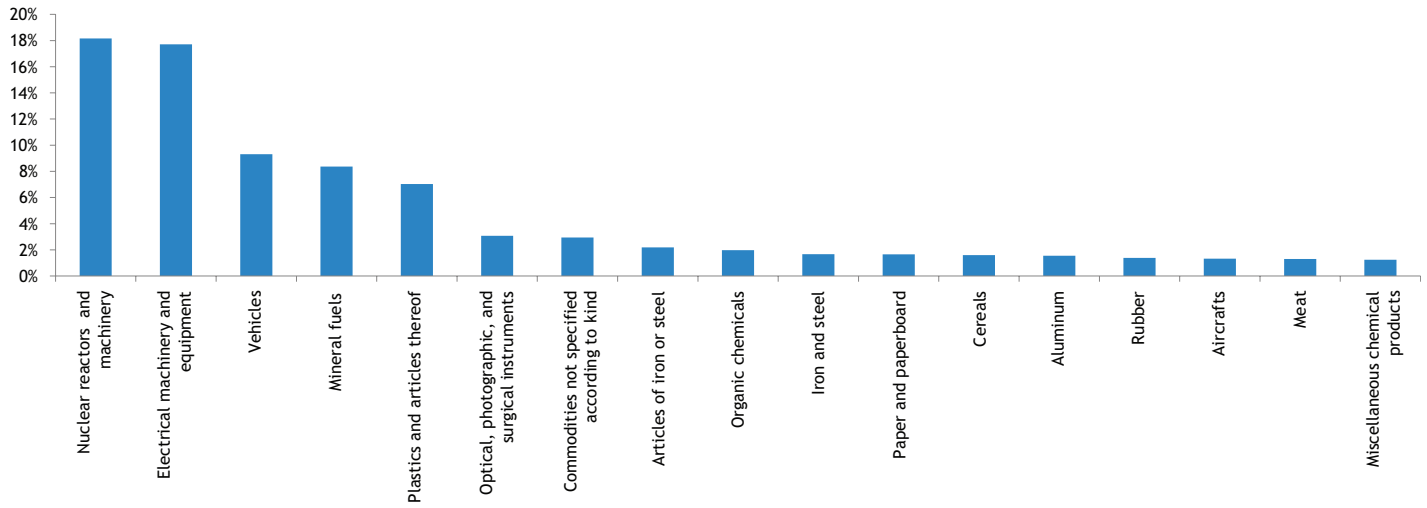
2016 CANADIAN EXPORTS TO THE UNITED STATES



Source: UN Comtrade Database, data as of January 2, 2018.

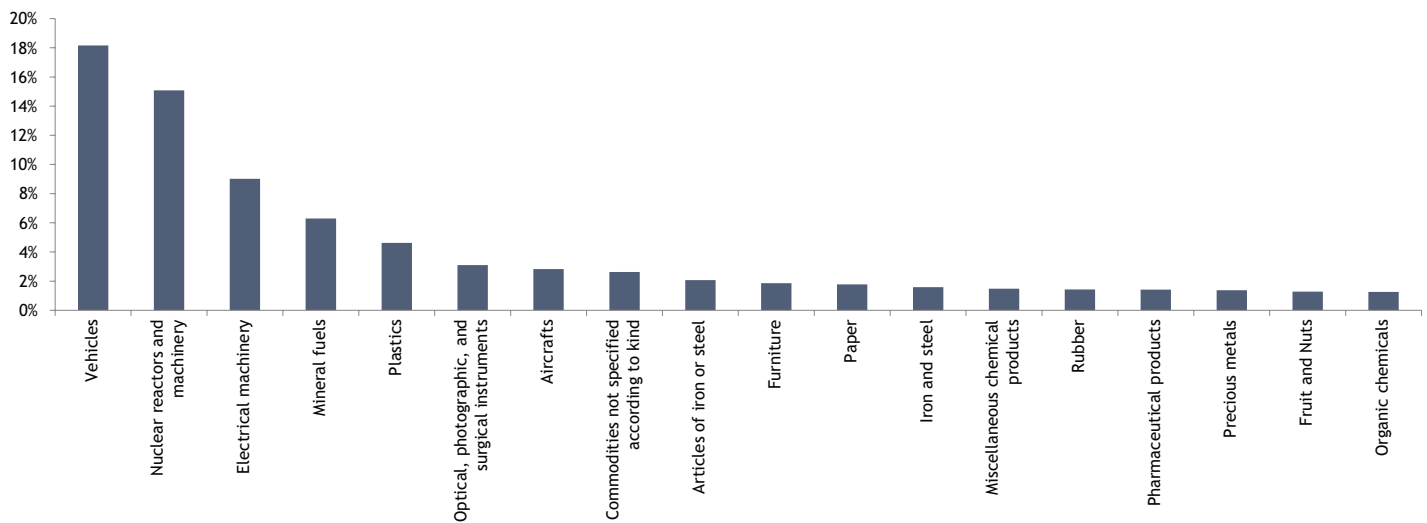


2016 UNITED STATES EXPORTS TO MEXICO



Source: UN Comtrade Database, data as of January 2, 2018.

2016 UNITED STATES EXPORTS TO CANADA



Source: UN Comtrade Database, data as of January 2, 2018.

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